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Kingdom of the Netherlands: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Kingdom of the Netherlands on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Kingdom of the Netherlands, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Kingdom of the Netherlands; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS—NETHERLANDS

Staff Report for the 1999 Article IV Consultation

Please note that since the main staff report was issued, additional information on economic and budgetary developments was received and staff projections were updated. This is reflected in a supplementary document, entitled "Staff Report for the 1999 Article IV Consultation—Supplementary Information," which is also included in this publication.

INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS—NETHERLANDS

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the 1999 Consultation
with the Kingdom of the Netherlands—Netherlands

Approved by Jacques R. Artus and Leslie Lipschitz

September 10, 1999

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I. Introduction

1. A staff team comprising Messrs. Ford (Head), Everaert, Martijn, and Oppers, and Ms. Salimi as Administrative Assistant (all EU1), visited The Hague and Amsterdam during June 11–21, 1999 to hold the 1999 Article IV consultation discussions. Meetings were held with the Minister of Finance; the Deputy-Governor of de Nederlandsche Bank; senior officials of these institutions, the Ministries of Economic Affairs, and Social Affairs and Employment, as well as the Netherlands Bureau for Economic Policy Analysis and the Social Economic Council; commercial bankers; academics; and representatives of the employer's federation and the labor unions. Mr. De Beaufort Wijnholds, Executive Director, and Mr. Houtman, Advisor, participated in the discussions.

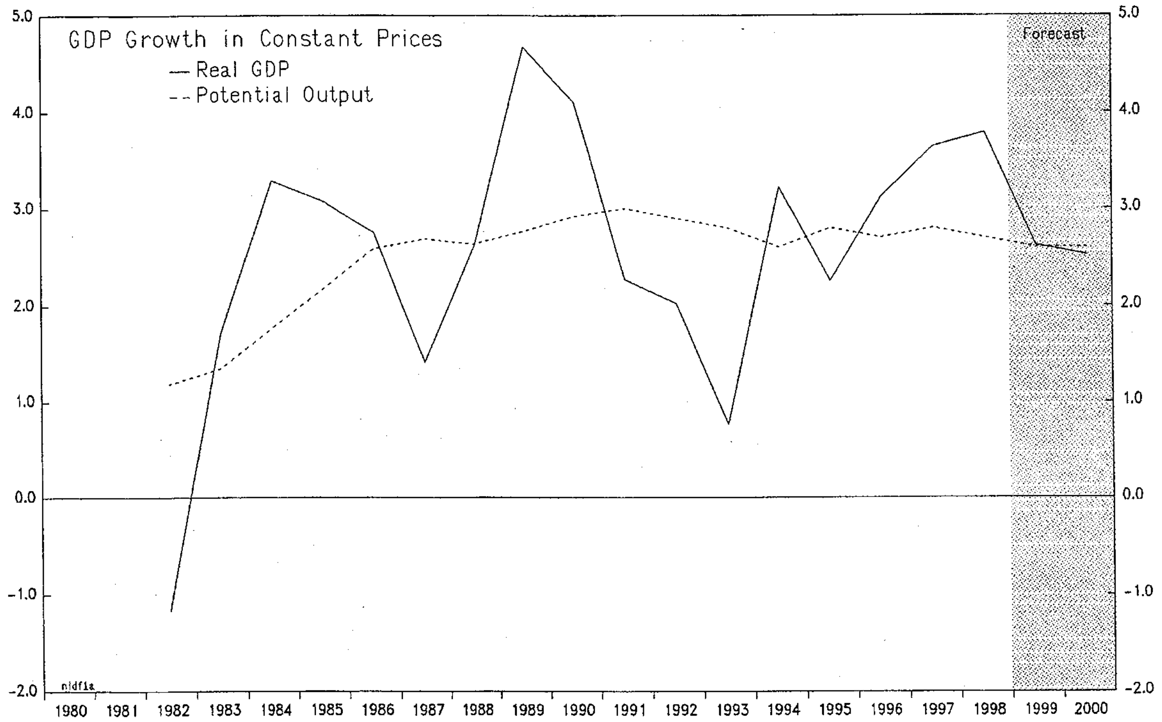
2. The last consultation was concluded on June 12, 1998 (SUR/98/65, 6/18/98). At that time, Executive Directors commended the authorities on the record of strong economic growth and job creation in recent years, which they considered to be the result of the steadfast pursuit of sound macroeconomic and structural policies. They stressed, however, that the structural fiscal deficit, the public debt ratio, and the tax burden were still too high and hidden unemployment was widespread. Many Directors encouraged the authorities to adopt a more restrictive fiscal stance in 1998 than planned, given the advanced cyclical position of the Dutch economy. But others felt that fiscal tightening could wait until signs of overheating materialized. Directors encouraged the authorities to aim for budget balance over the medium term.

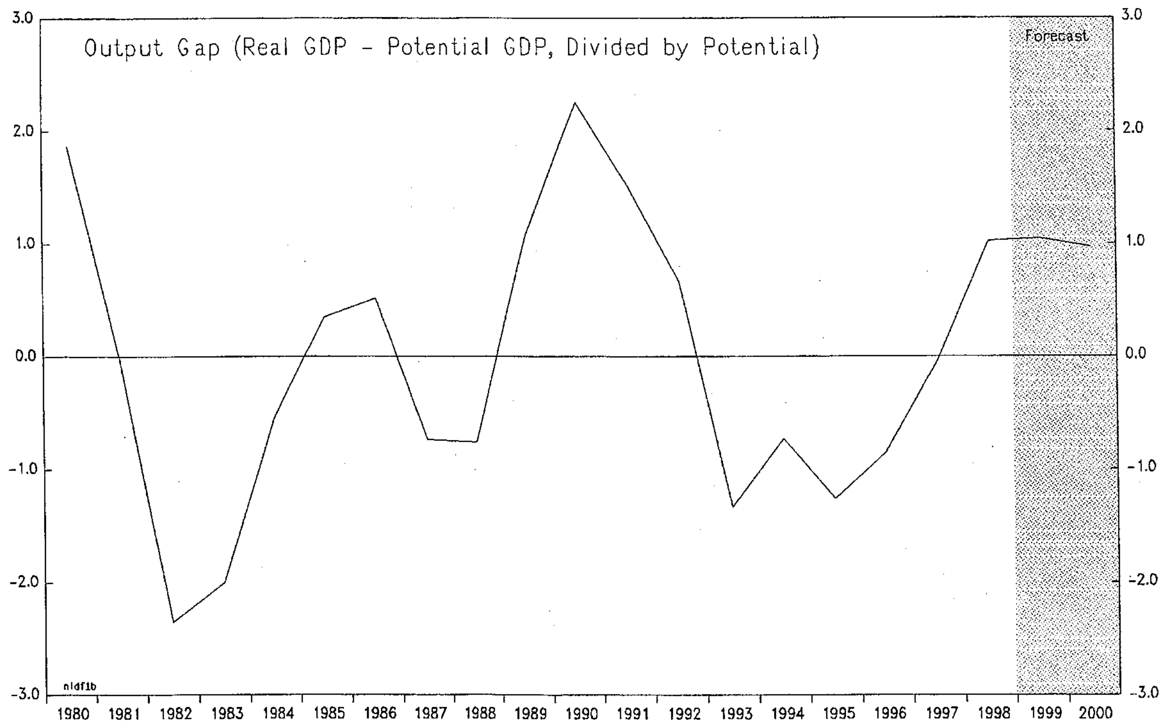
3. The left-right coalition that took office in 1994 began a second term following its reelection in May 1998. There is broad consensus in the Netherlands about the need to continue the economic reform process by further reducing the tax burden and pursuing labor and product market reforms. On January 1, 1999, the Netherlands became a founding member of the euro. It has paid its IMF quota increase and accepted the Fourth Amendment to the Articles of Agreement (Appendix I). The authorities have agreed to participate in the pilot project for the publication of the 1999 Article IV consultation staff report.

II. Background

4. **The Netherlands posted a strong economic performance during the 1990s, based on sound macroeconomic policies and comprehensive structural reform.** Real GDP growth averaged 2.8 percent during 1990–98, about 0.7 percentage points above the euro-area average and 0.5 percentage points above that of Germany (Figures 1 and 2, Table 1). Private consumption was the main source of demand growth, with investment and net exports providing smaller but consistently positive contributions until 1998. Inflation was broadly stable, averaging 2.3 percent a year since 1990, somewhat below the euro-area average of 2.6 percent (Figure 3). Employment growth slowed early in the decade, but picked up from 1995 onward, accommodated in part by rising participation rates and a continuing increase in the working-age population, but also resulting in a fall in the unemployment rate from a peak of 8.7 percent in 1994 to 5.2 percent in 1998 (Figure 4).

FIGURE 1
NETHERLANDS
Real Output

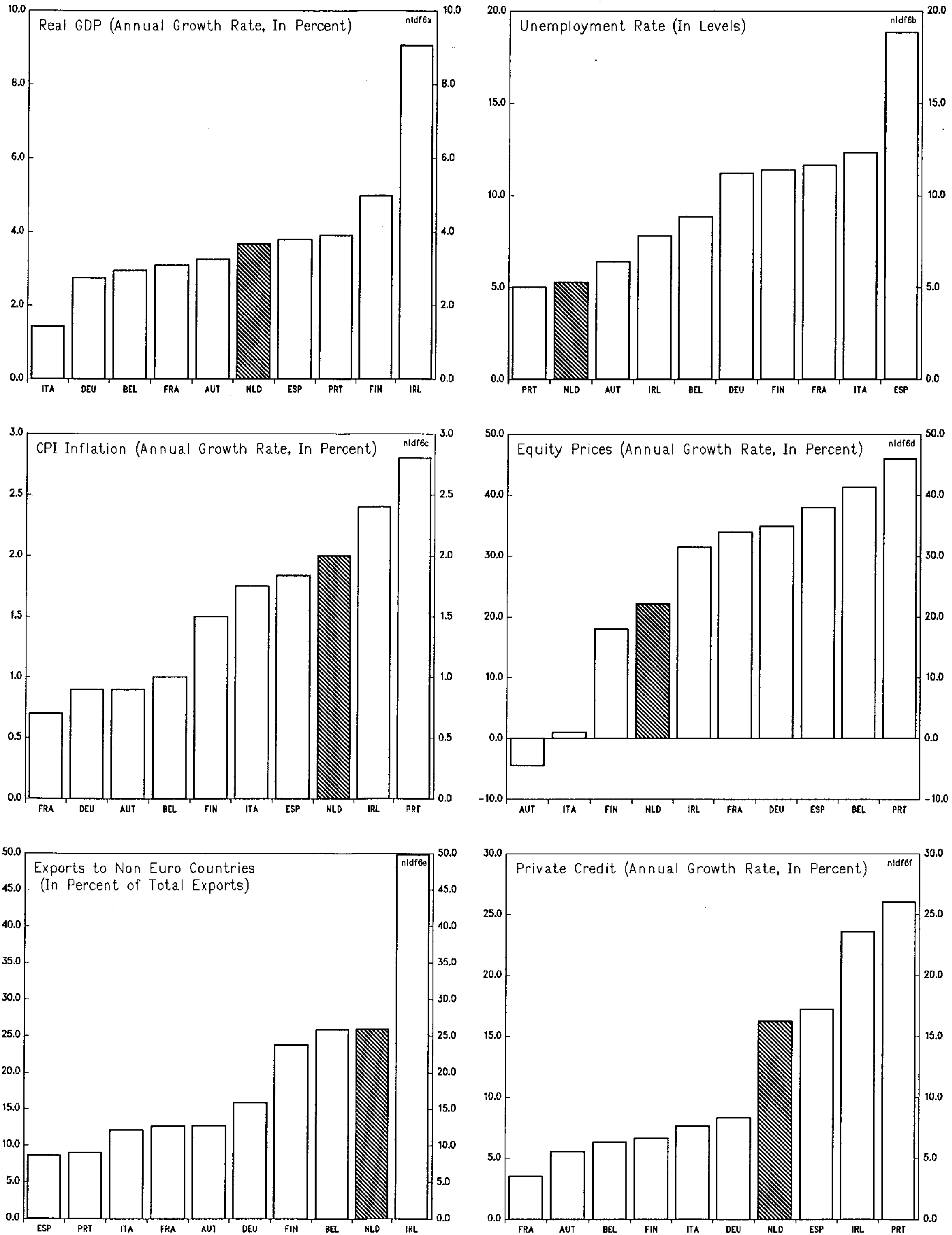




Source: IMF, World Economic Outlook.

FIGURE 2
NETHERLANDS

Key Economic Indicators: Comparison With Euro Area in 1998



Sources: IMF, WEFA database, and staff estimates.

Table 1. Netherlands: Basic Data

Land area (1998)	41.5 thousand sq. km.	
Population (1998)	15.7 million	
Population characteristics and health:		
Life expectancy at birth (1997)	75.2 (male), 80.6 (female)	
Fertility rate (1997)	1.6 children/woman	
Infant mortality rate (1997)	5.0 per 1,000 live births	
Population per sq. km. of land area (1998)	462 persons	
National accounts (1997 at current prices)	(In billions of guilders)	(In percent of GDP)
Private consumption	419.0	59.1
Public consumption	96.9	13.7
Gross fixed investment	141.9	20.0
Stockbuilding	1.5	0.2
Exports of goods and nonfactor services	396.7	56.0
Imports of goods and nonfactor services	347.0	48.9
GDP	709.0	100.0

	1994	1995	1996	1997	1998	1999 Proj.	2000 Proj.
National accounts (constant prices)							
Private consumption	2.2	2.0	2.7	3.0	4.5	3.5	2.7
Public consumption	0.6	0.8	1.2	1.5	2.5	1.6	1.5
Gross fixed investment	2.2	4.8	5.4	6.8	4.0	4.0	3.1
Total domestic demand	3.0	2.3	3.0	3.6	4.2	3.2	2.5
Exports of goods and services	6.7	6.7	5.2	6.7	6.1	3.6	5.8
Imports of goods and services	6.7	7.5	5.3	7.1	7.3	4.8	6.1
Net foreign balance 1/	0.4	0.1	0.3	0.3	-0.2	-0.3	0.2
GDP	3.2	2.3	3.1	3.6	3.8	2.6	2.5
Prices, wages and employment							
Consumer prices (annual average)	2.7	2.0	2.1	2.2	2.0	2.3	2.1
Hourly compensation (manufacturing)	1.7	1.1	1.9	2.5	2.8	2.8	2.8
Unit labor costs	-6.7	-2.5	-0.9	-2.0	1.3	0.0	1.6
Employment	-0.1	2.4	2.0	3.4	2.9	1.8	1.3
Unemployment rate (in percent)	7.6	7.1	6.6	5.5	4.1	3.6	3.7

Table 1. Netherlands: Basic Data (Continued)

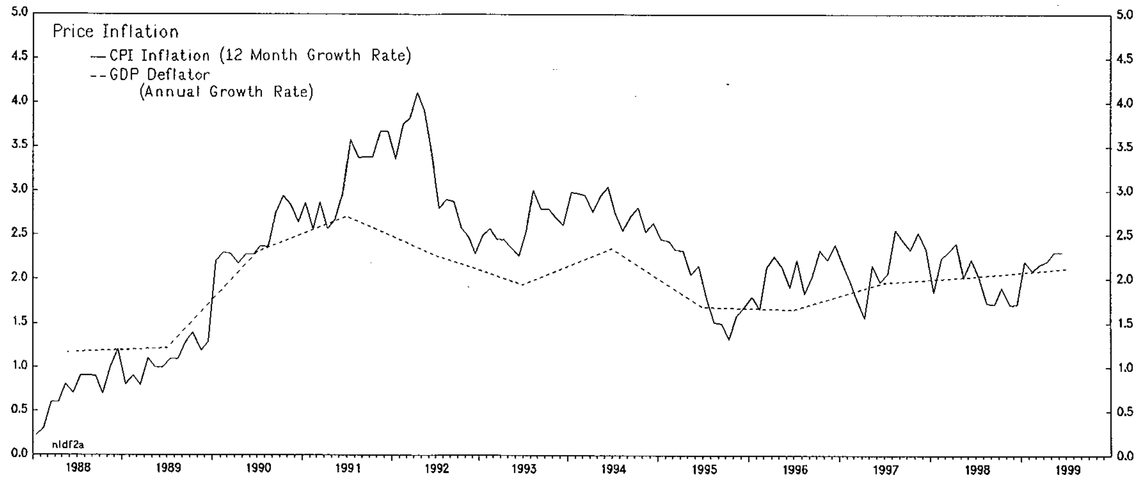
	1995	1996	1997	1998	1999 Proj.	2000 Proj.
Personal sector						
Real disposable income	1.5	2.3	3.1	4.5	3.1	2.4
Household saving ratio (in percent)	11.6	11.7	11.9	11.9	12.0	11.6
External trade						
Exports of goods, volume	7.3	5.0	5.7	6.5	4.0	5.8
Imports of goods, volume	9.5	4.7	7.7	7.7	5.6	6.7
Terms of trade	1.4	-0.6	0.4	0.2	1.6	0.4
Merchandise balance (percent of GDP)	5.5	5.3	4.9	4.4	4.5	4.6
Current account (percent of GDP)	6.0	5.6	5.9	5.3	5.6	6.0
Money and credit (end-period)						
Domestic credit	9.7	10.0	13.1	16.2	...	...
M3H	4.4	5.8	7.4	9.6	...	...
Exchange rates (1995=100)						
Nominal 2/	100.0	98.1	93.5	93.4	92.9	...
Real (relative RULC based) 2/	100.0	96.5	91.0	90.1	89.6	...
Public sector accounts 3/						
Revenue	46.6	47.3	47.0	46.5	46.9	46.2
Expenditure	50.8	48.9	48.2	47.3	47.2	46.2
General government balance	-4.2	-1.6	-1.2	-0.8	-0.4	-0.1
Structural balance	-3.7	-1.0	-1.2	-1.3	-1.2	-1.1
Primary balance	0.5	2.9	3.1	3.0	3.3	3.1
Structural primary balance	1.0	3.5	3.1	2.4	2.4	2.0
General government gross debt	75.7	74.3	68.7	65.0	62.8	60.7

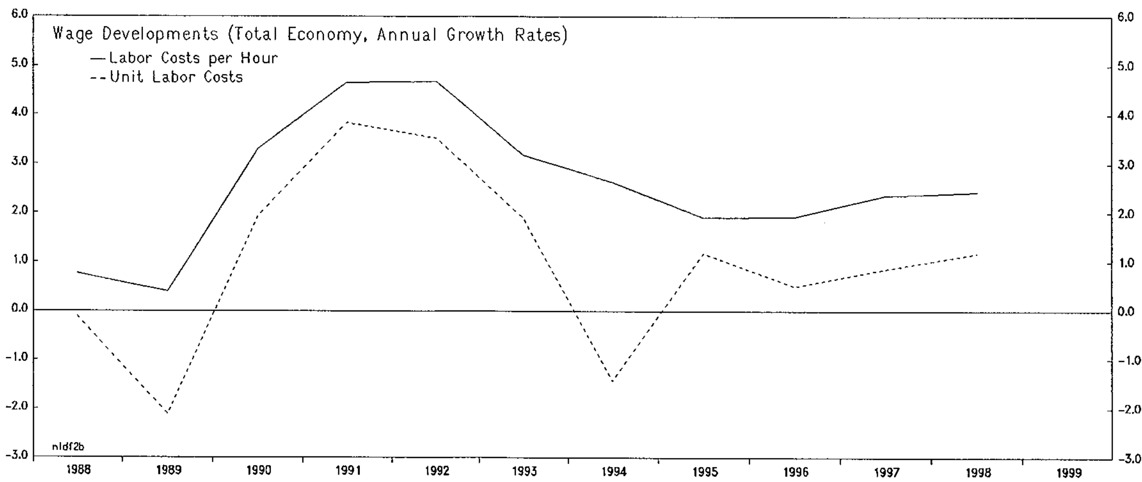
Sources: Ministry of Finance; Netherlands Bank; International Financial Statistics; and Fund staff calculations.

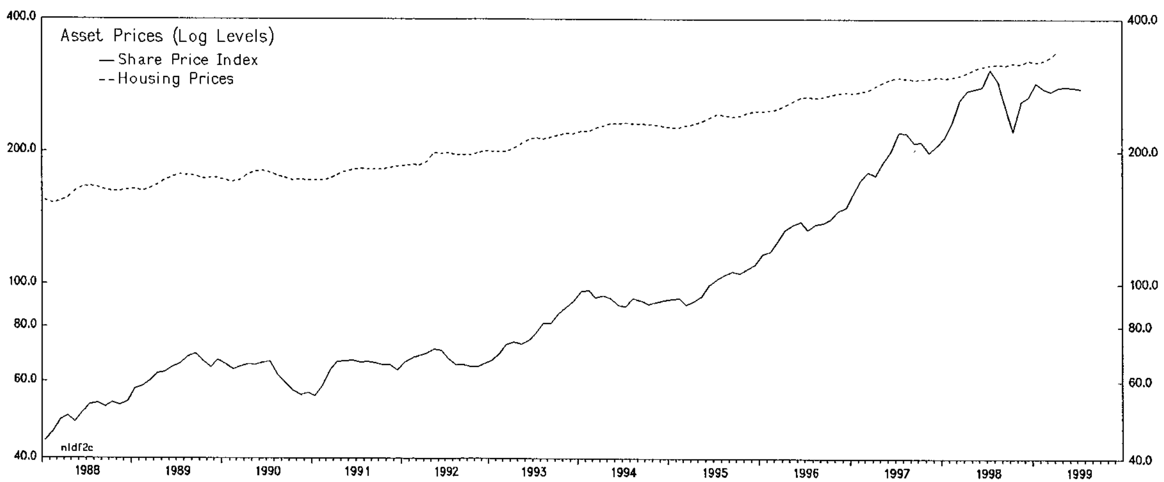
1/ Contribution to GDP growth.
2/ For 1999, average over the first six months.

FIGURE 3
NETHERLANDS

Inflation Indicators

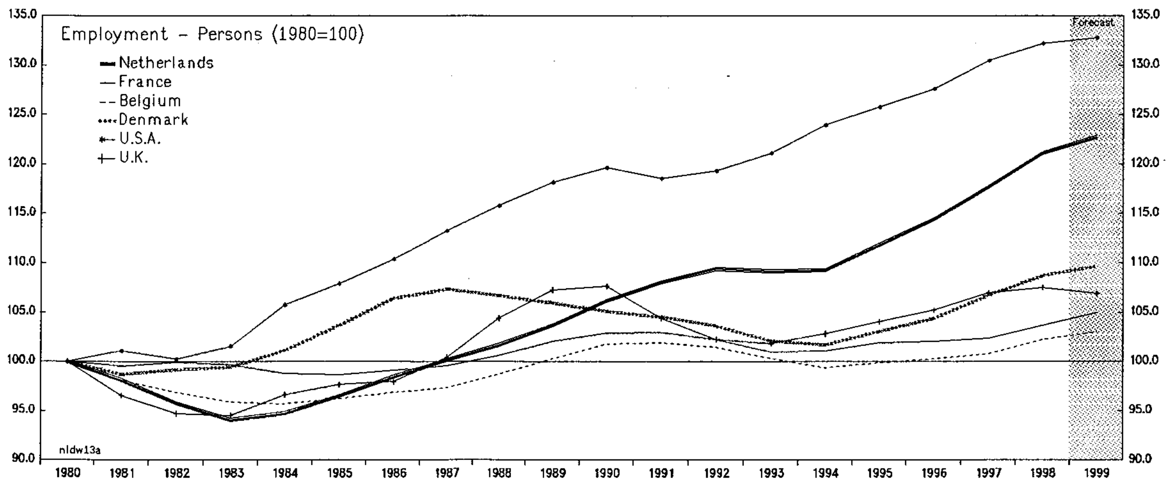


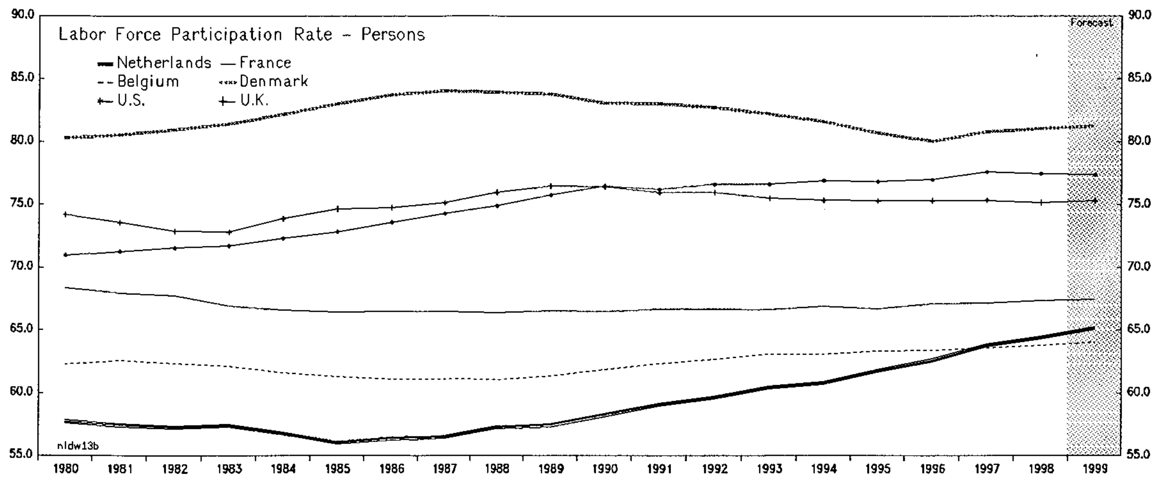


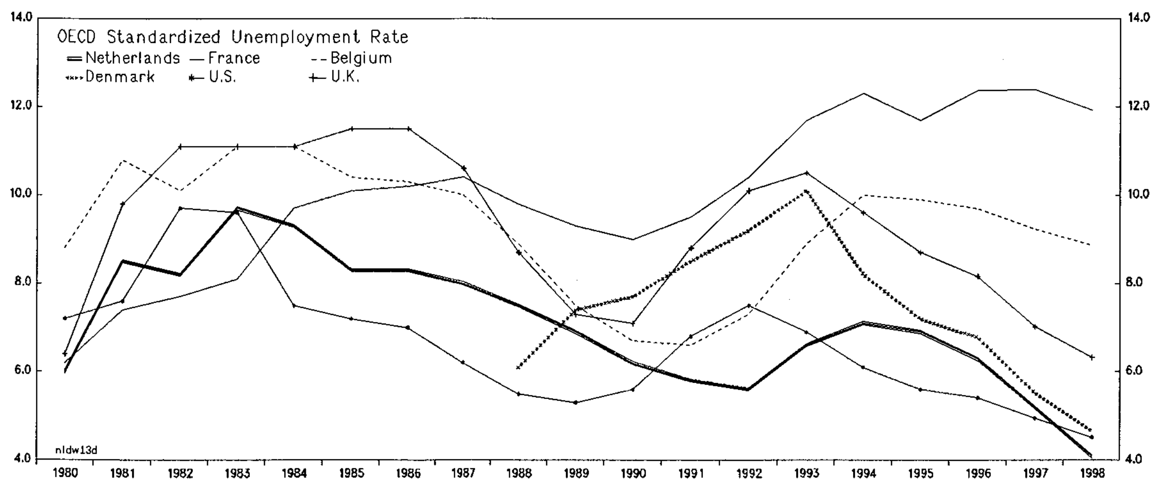


Sources: IMF, International Financial Statistics and World Economic Outlook; and Central Bureau of Statistics.

FIGURE 4
NETHERLANDS
Labor Market Indicators







Source: OECD, Economic Outlook.

5. **Strong economic growth and labor market performance reflected complementary and interlocking reforms to fiscal policy, social security, and labor and product markets.**[1] In addition, wage-setting behavior emphasized labor-cost moderation. Sustained fiscal consolidation based on rules for expenditure control reduced the tax burden while cutting the deficit, partly reversing the runup in the debt-to-GDP ratio that had occurred in the 1980s. These tax cuts complemented earlier reforms that improved labor-market incentives, such as decreases in social security benefits and the minimum wage relative to the average, and fostered wage moderation. Labor-market reforms increased participation rates and reduced structural unemployment; the resulting broadening of the tax base and lowering of social security outlays in turn fostered fiscal consolidation. In addition, high growth sustained the climate that made the reforms acceptable to a broad spectrum of the population.

6. **A simple growth accounting exercise illustrates the importance of the total reform package over the period 1983–98.** Depending on the extent by which the reforms might be credited with reversing an earlier trend of deteriorating labor-market performance, they are estimated to have raised real GDP growth by between 0.1 percent and 1.2 percent per year. Under reasonable assumptions, the magnitude of the effect is most likely to be near the middle of this range. The calculations assume the reforms affected labor-market participation rates and the NAIRU, but not capital accumulation or the rate of technological change (Supplementary Note 1).

7. **Economic activity remained robust in 1998.** Real GDP grew by 3¾ percent, marginally faster than in 1997 and significantly above estimated potential growth of 2½ percent. Private consumption remained buoyant, reflecting high consumer confidence, employment growth, and wealth effects from rising asset prices, though investment growth decelerated.[2] Growth paused in the middle of the year, due to the slowdown in global trade, before picking up again. In the first quarter of 1999 output expanded at an annual rate of 3 percent, while preliminary data for the second quarter show real GDP growing at 3.2 percent.

8. **Despite the advanced cyclical position of the economy, fiscal policy was expansionary in 1998.** The structural deficit increased by ½ of 1 percentage point of GDP, due to tax cuts, although the actual deficit remained at 0.9 percent of GDP, reflecting buoyant

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[1] For a detailed analysis of these developments, see "The Netherlands: Transforming a Market Economy," (IMF Occasional Paper No. 181).

[2] The authorities estimate that the wealth effects of sharp gains in real estate and share prices contributed about 1 percentage point to annual consumption growth.

growth (Table 1, Figure 5).[3] Both expenditures and revenues declined by about 1 percent relative to GDP, and the debt ratio (Maastricht definition) fell by a further 4 percentage points, to 67.3 percent of GDP.

9. **Structural reform continued in labor markets.** To promote the reintegration of the long-term unemployed, schemes for temporary public-sector and subsidized employment were expanded in recent years. In addition, some progress was made in formulating proposals to partially privatize social security administration and create a single gateway—the Centers for Work and Income (CWI)—for those in search of employment or in need of social security benefits (Box 1). A new law allowing employers more flexibility to take on temporary staff and strengthening the position of temporary employees was enacted at the start of 1999 (which could increase employers' costs) and a draft law currently before parliament would grant employees the right to adjust their working hours unless the employer had a strong case that the job had to be full time.

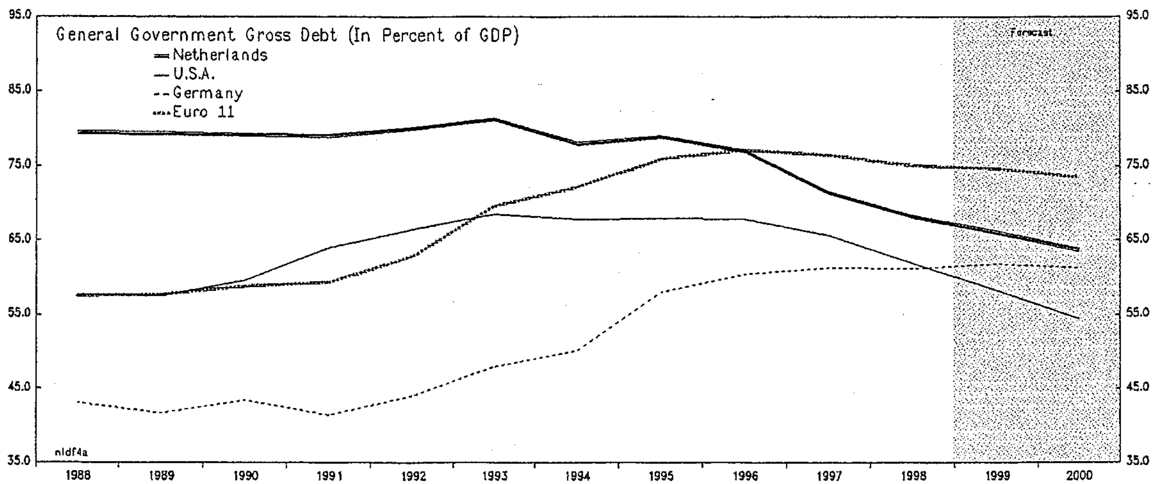
10. **Progress in product market reform has been slower.** Of the 36 projects initiated before 1999 under the umbrella program to promote deregulation and market functioning, only 10 have been completed so far, with the liberalization of shop opening hours in 1996 being the most important. Outside the umbrella program, however, competition policy was strengthened with the enactment of a Competition Law in 1998, and new Telecommunication and Electricity bills were passed to consolidate recent reforms and provide the basis for further liberalization and privatization. The first electric utility was privatized in April 1999 and a new Gas Act is under consideration by parliament to prepare that sector for privatization.

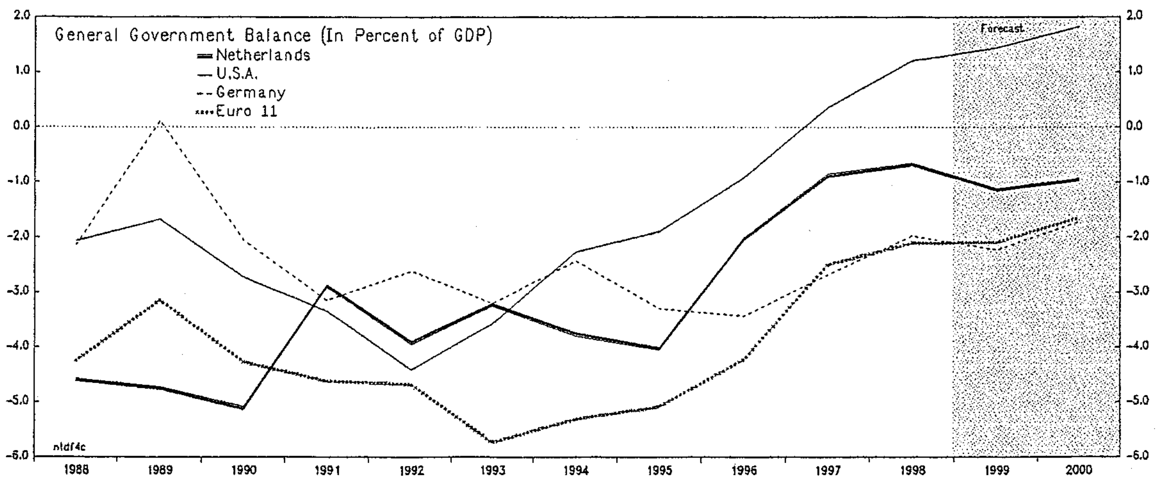
III. Policy Discussions

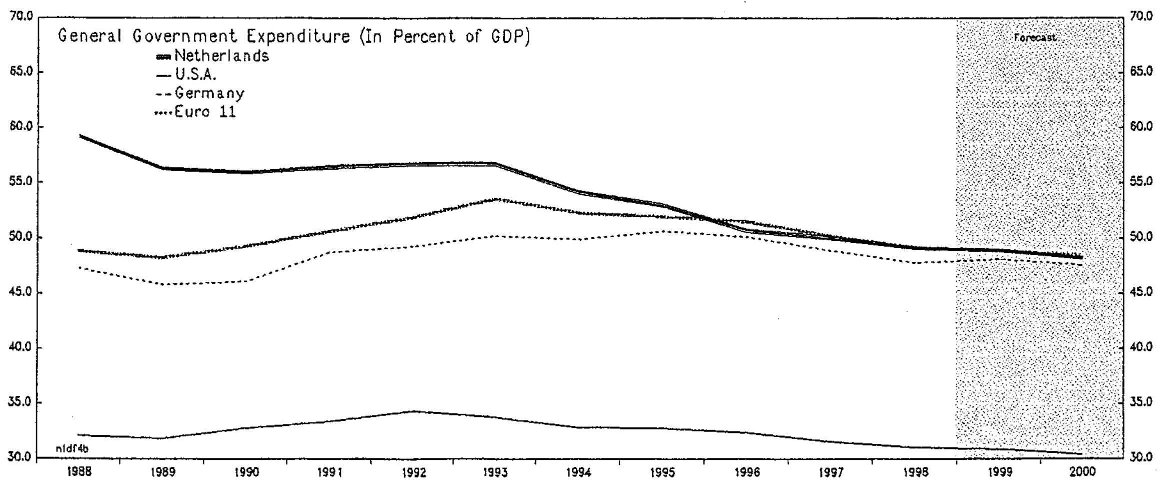
11. **Discussions focused on the short-term cyclical position of the Dutch economy, as well as on how best to sustain and extend the fiscal and structural reforms that will be central to longer term economic performance.** In the current economic environment, three policy issues are of particular importance: first, the cyclical position of the economy and the appropriate policy response in the short term; second, ensuring fiscal sustainability in the longer term; and third, maintaining an environment conducive to noninflationary output and employment growth by sustaining the political and social momentum for structural reform.

[3] The structural primary surplus fell by 1.1 percent, suggesting a rather larger fiscal impulse. The change in the actual deficit between 1997 and 1998 was affected by two once-off transactions. In 1997 the deficit as measured was reduced by 0.3 percent of GDP by the recording of transfers between the government and the social security funds, while in 1998 it was reduced by 0.2 percent of GDP by the sale of broadcast frequencies.

FIGURE 5
NETHERLANDS
Fiscal Indicators







Source: IMF, World Economic Outlook.

Box 1. Social Security Reform

In the 1980s and the early 1990s the social security system was made less generous by reducing benefits, shortening benefits duration, and tightening eligibility. Since 1996, firms have been made financially responsible for sickness and, to some extent, disability payments, in order to reduce inflows into these schemes. A new initiative focuses on strengthening incentives toward reintegration.

At end-1998, there were about 260 thousand unemployment benefit recipients, 760 thousand disability benefit recipients (full time basis), and 450 thousand welfare recipients. The first two of these schemes are included in the social insurance system, administered by branch-wide agencies, and with premiums paid by employers and employees. Unemployment benefits are available for up to five years of unemployment (depending on the claimant's employment history), with the possibility for an extension of two years, after which recipients may be eligible for welfare. Disability benefits start after one year of sickness. The welfare system is run by the municipalities, and financed by transfers from the central government.

The social security system is currently undergoing a large-scale reorganization, with the aim of promoting outflow into regular employment. A single gateway will be created for those in search of employment or in need of unemployment or welfare benefits. Behind this gateway, municipalities will remain responsible for benefits administration and the reintegration of welfare recipients, while the administration of the social insurance system is to be privatized. Benefit and premium levels will continue to be set by the central government.

- Since 1995, the sectoral agencies managing the social insurance system have become independent from unions and employers' organizations, as a first step toward privatization.

- By 2002, the privatized social insurance agencies (together with new entrants into this market) will have to compete for insurance contracts. Large firms and the branch organizations of smaller employers will be required to have a contract with one of these providers, and are likely to select the one that is most effective at improving their disability track record. This would introduce an incentive for the agencies to promote reintegration.

- In order to strengthen the incentive for the social insurance agencies to find jobs for those receiving an unemployment benefit, a bonus system is to be introduced.

- More than 200 public Centers for Work and Income (CWIs) are to be created by 2001, forming the single gateway. The CWIs will transfer benefit seekers to local governments and social insurance agencies, maintain a vacancy data bank, and give advice on individual reintegration plans. They are to determine the "distance" to the labor market of each individual benefit seeker before transferring them to the social insurance agency contracted by their previous employer. This distance will determine the agency's reintegration bonus.

- Both the social security agencies and the local governments can contract out the reintegration activities to specialized firms, including temporary employment agencies and the privatized parts of the current public employment bureaus.

A. The Cyclical Situation and the Stance of Policies

12. **There was agreement that the Dutch economy was operating at close to capacity, with the authorities judging the economy to be broadly in macroeconomic equilibrium but the staff being considerably more concerned about the inflation risk.** It was also agreed that assessing the cyclical position of the economy has been difficult, in large part because the effects of the structural reforms of the last 15 years have been hard to gauge, but also because indicators are mixed. Labor and product markets have tightened significantly, and monetary and asset developments have been consistent with inflationary pressures. On the other hand, there have been few signs of accelerating wage or price inflation.

13. **Labor and product markets have tightened appreciably in recent years.** Continuing gains in employment—concentrated mostly in the service sector—reduced the unemployment rate to below 5 percent by mid-1999 (as estimated by the staff). Although this is below the staff's estimate of the NAIRU, the authorities argued that there was still scope for expansion of the labor force (particularly in view of the low participation rates of some groups) while acknowledging that this would require further structural reforms.[4] Tensions have persisted in certain segments of the labor market, such as information technology and construction, and vacancies (especially for skilled personnel) rose to near historical highs. Capacity utilization also increased during the second half of the 1990s, peaking in early 1998 at close to levels registered in the boom of the late 1980s, although it has since eased.

14. **Credit developments also pointed to inflationary pressures.** Growth in private-sector credit peaked at 17.6 percent in the twelve months to January 1999, and has since eased only marginally (Figure 6). Through most of 1998, mortgage credit growth slowed, but remained above 15 percent. At the same time, credit to the business sector accelerated sharply, a development which may have reflected increased mergers and acquisitions in the euro area, but could not be fully explained by developments in interest rates and economic activity. The staff and the authorities agreed that credit developments needed to be monitored carefully, as they could signal incipient demand pressures.

15. **Equities and, especially, housing prices have also increased strongly.** The rise in share prices has not been out of line with developments in other advanced economies, but

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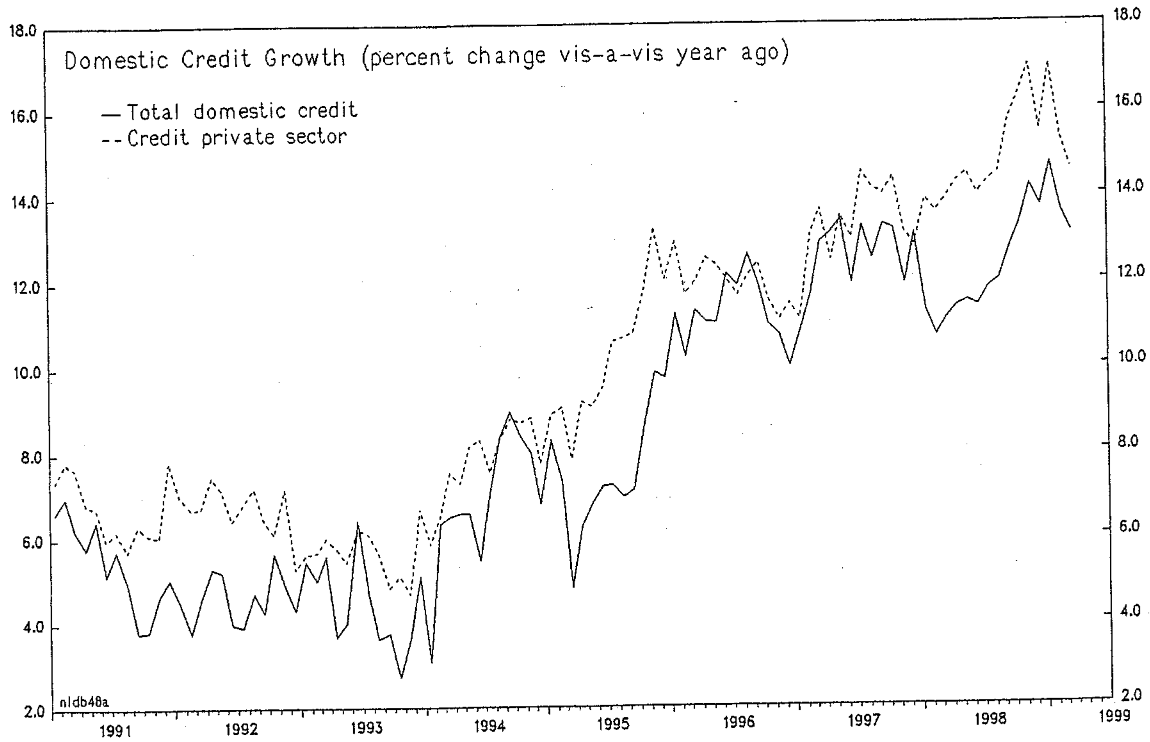
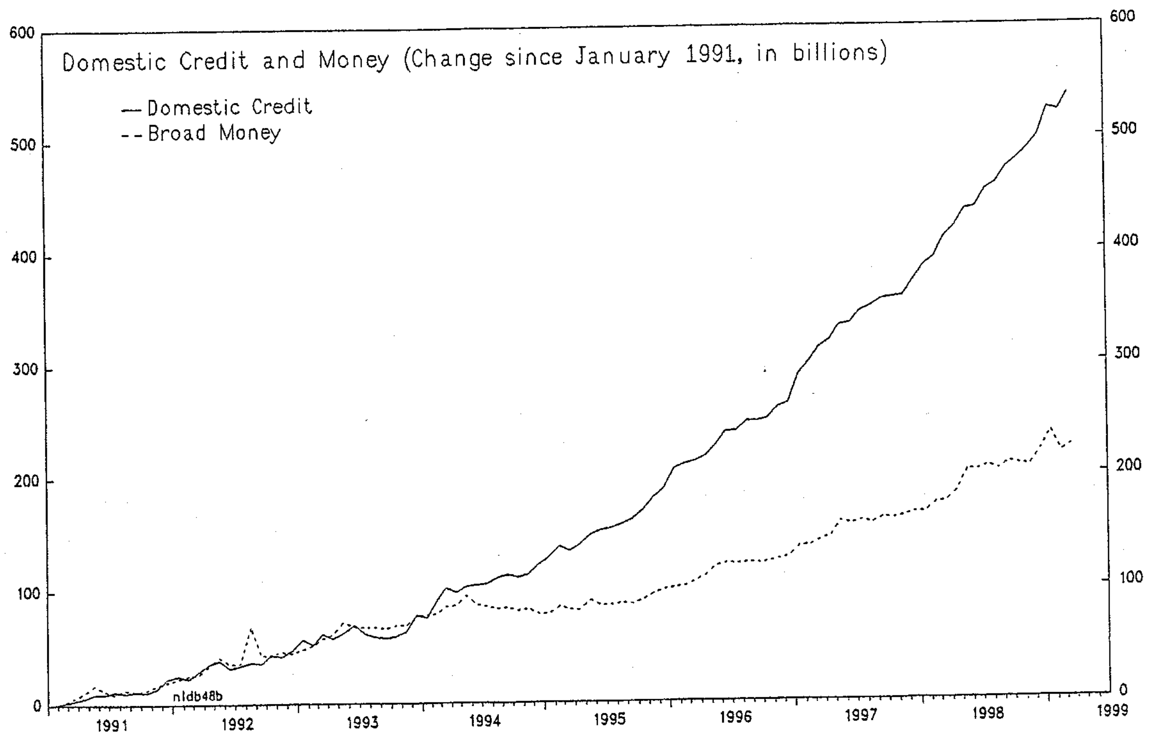
[4] This unemployment rate reflects the national definition used by the Central Planning Bureau (CPB). The staff has lowered its estimate of the NAIRU from 6½ percent to 5¾ percent. It may prove to be lower still, and could fall further if the momentum of reform is sustained. The OECD estimated the unemployment rate to be about 0.8 percent below the NAIRU at end-1998. The CPB, however, has estimated that the unemployment rate is now near equilibrium.

FIGURE 6
NETHERLANDS
Monetary Survey





Sources: IMF, International Financial Statistics; and staff estimates.

residential real estate prices have increased very rapidly, reaching the peak level of 1979 in real terms. But, as the authorities stressed, this did not necessarily indicate inflationary pressure, or that the collapse that followed the 1979 peak might be repeated. While mortgage debt as a percentage of household disposable income had doubled (to nearly 120 percent) since 1993, interest rates had fallen and the ratio of mortgage payments to household income had changed little. In addition, the level of real estate prices remained reasonable compared with those in neighboring countries. The authorities judged that, at least until the first quarter of 1999, housing prices were at most only mildly overvalued, a view shared by the staff (see Supplementary Note 2). Moreover, since in the view of the central bank (De Nederlandsche Bank, DNB) the banking sector was in good health, the authorities were confident that a correction in housing prices, if it occurred, would not result in a credit crunch.

16. **In the face of these indirect indications of possible inflationary pressures, there are few signs of higher price and wage inflation.** On a harmonized (HICP) basis, consumer prices rose by 1.8 percent in the twelve months through July 1999, broadly in line with inflation over the previous three years. The authorities argued, moreover, that inflation was being held up by increases in indirect taxes, as well as the prices of public services, and, in recent months, energy. Collective agreements—which are administratively extended widely through the economy—incorporated wage increases for 1999 that were slightly lower than the year before. In addition, for negotiations of agreements that will take effect in 2000, the major labor union announced a ceiling growth for wages that is ½ of 1 percentage point below that for 1999. The staff pointed to some evidence of emerging wage drift, and expressed concern that wage moderation might not continue, particularly as the settlements for 1999 (negotiated in 1998 and early 1999) had been predicated on unduly low projections of output growth and inflation.

17. **As regards the short-term outlook, the staff projects real GDP to grow at 2½ percent (about potential) in both 1999 and 2000.** With the global economy, and particularly Europe, apparently recovering, export demand is expected to pick up in the course of 1999, setting the stage for an improvement in the net foreign balance next year. Private consumption and investment growth are likely to fall from cyclical highs, particularly if wealth effects moderate. Inflation (on a HICP basis) is projected at 2.3 percent in 1999, with the increase over 1998 mainly due to higher import prices as a result of the weaker euro and higher oil prices. As no further changes in the exchange rate or commodity prices are assumed, inflation is projected to return to about 2 percent in 2000.[5]

18. **There are risks to both sides of this projection, though higher growth than expected would likely pose the greater policy challenge.** The unexpectedly strong second quarter growth underscores the upside risk. With capacity utilization already high and the

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[5] The August 1999 Consensus Forecast average is very close to the staff on growth, though it is slightly lower for 1999 inflation.

world economy recovering, investment demand could prove substantially stronger than projected. Also, continued rapid increases in housing prices would stimulate consumption demand, as it has in the past. But such increases would also increase the risk of a correction which, if it occurred, would cut household wealth and consumption. Growth might also be depressed if business confidence were undermined by wage growth that turns out higher than anticipated. This is largely a concern for 2001 and beyond, as wage bargaining for 2000 is already well advanced. Given the staff's assessment that no slack is left in Dutch economy, higher demand growth than projected would aggravate inflationary pressures.

19. **The authorities projected somewhat lower growth, implying that inflationary pressures, if any, would tend to abate.** The CPB expected real GDP to rise by 2¼ percent in 1999 and by only 2 percent in 2000, below both the staff projection and estimated potential output growth. The main differences with the staff were a sharp fall in the growth of export demand, and a deterioration in business sentiment that would depress investment activity in 2000. The CPB projected consumption growth to slow only slightly in 1999, but lower wage growth and poorer employment prospects were expected to dampen it considerably thereafter. Reflecting weaker growth, inflation was expected to remain at 2 percent in 1999 and to fall to 1½ percent the year after. The DNB projected growth to return to potential in 2000, and inflation to be 2¼ percent in both 1999 and 2000.

20. **The advanced cyclical position raised the issue of how the Dutch economy would adjust within a monetary union.** There has been ample experience with de facto monetary union, given the long-standing peg of the guilder to the deutschemark, but the Dutch and German cycles have moved out of step in recent years, posing an unusual situation. Monetary conditions have eased since 1996, with short-term interest rates being broadly stable but long-term interest rates falling and the exchange rate depreciating (Figure 7). The authorities and the staff shared the view that monetary conditions were appropriate for the euro area, but could present macroeconomic difficulties for the Netherlands, given its advanced cyclical position. The authorities expected that any demand pressure, if it arose, would be resolved mainly through weakening competitiveness. This would cause a deterioration in the trade account and slow the pace of economic growth. Given the strong Dutch current account position—a surplus of about 6 percent of GDP—such a development would not be cause for concern. Indeed, some argued that the Dutch guilder had probably entered the euro slightly undervalued, which was being corrected: while Dutch inflation had remained at around 2 percent, it had declined to about 1 percent in the euro area as a whole; and, based on labor costs, competitiveness against the euro area deteriorated somewhat in 1998 (Figure 8).[6] Staff work on fundamental exchange rates (CGER) shows no significant deviation of the guilder

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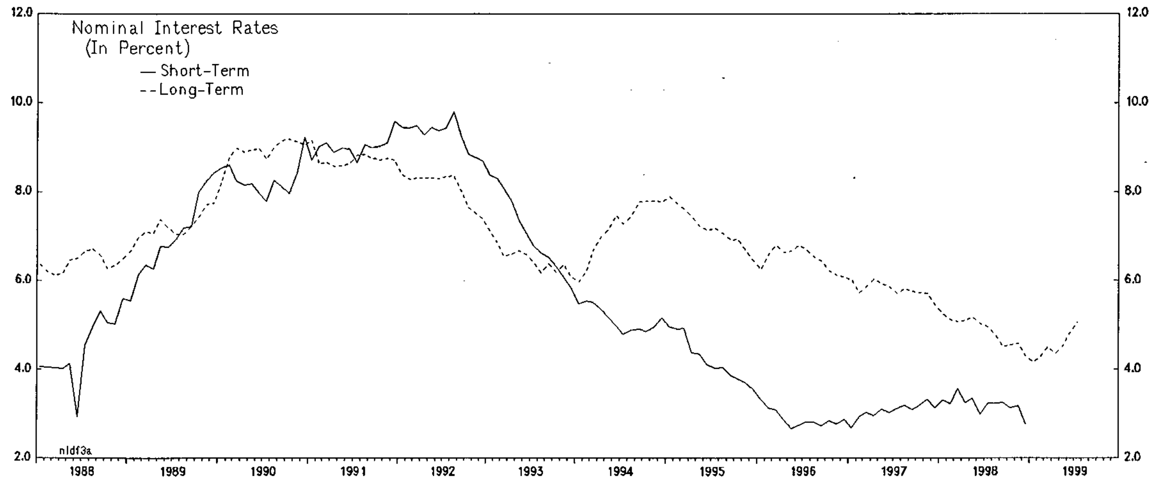
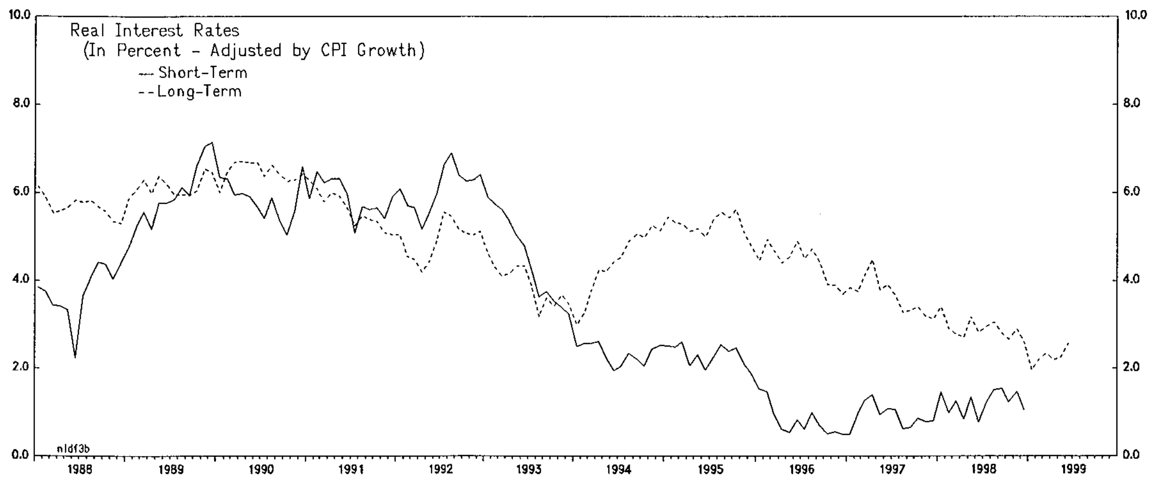
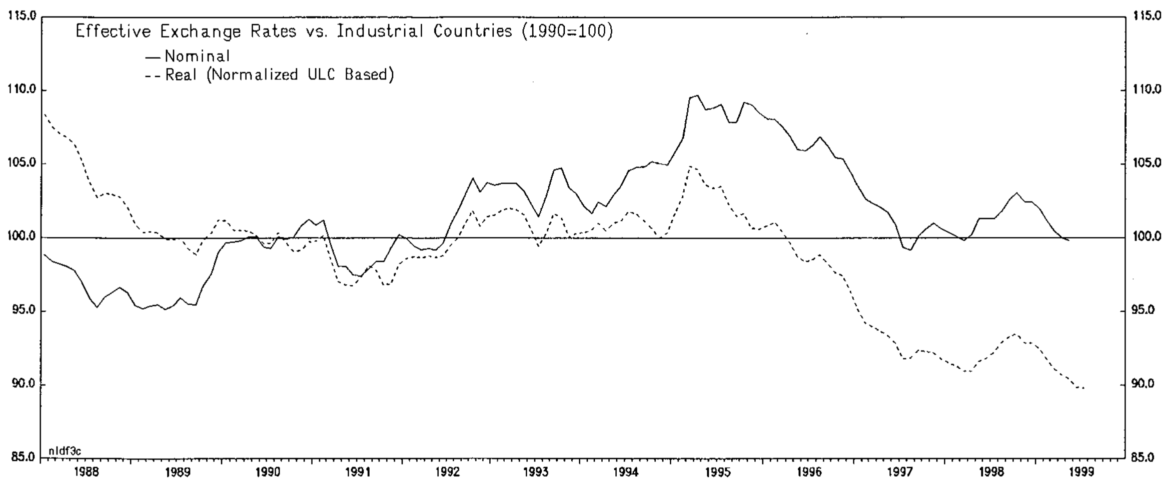
[6] Dutch competitiveness strengthened slightly against all trading partners.

FIGURE 7
NETHERLANDS
Monetary Conditions



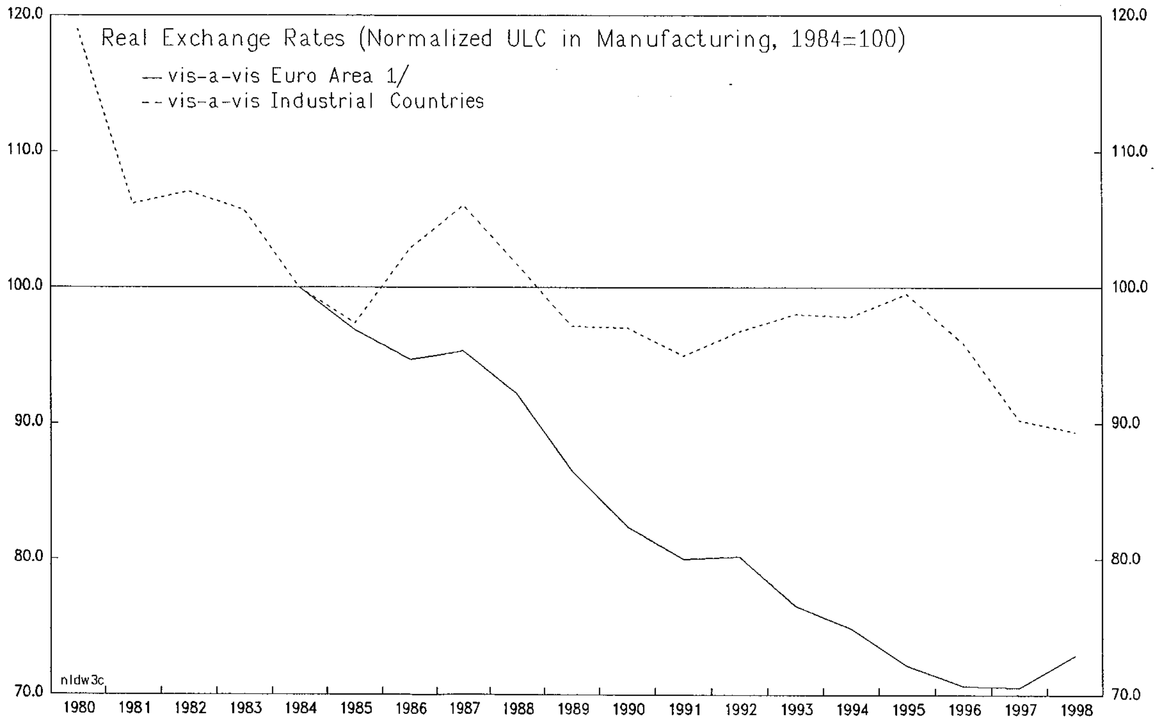


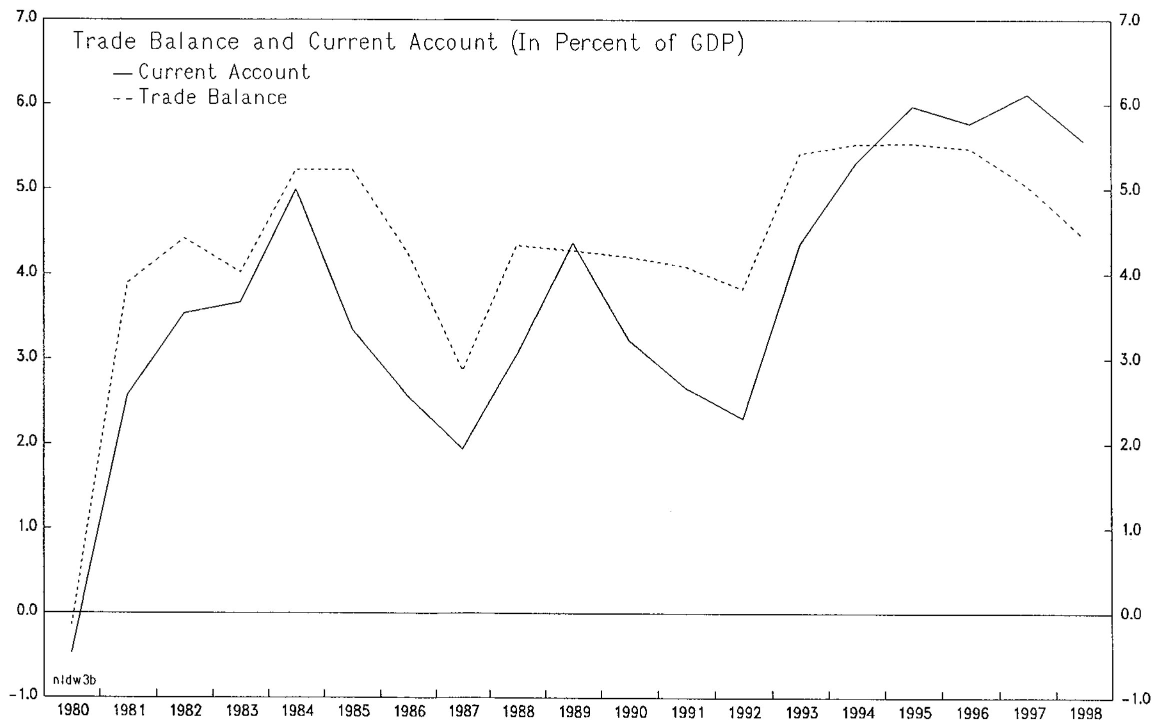


Source: IMF, International Financial Statistics.

FIGURE 8
NETHERLANDS

External Indicators





Sources: IMF, International Financial Statistics and World Economic Outlook; and Fund staff estimates.
1/ Euro area data are not available before 1984.

from its fundamental level. However, in view of the wide margin of uncertainty in this measure, such a finding is not necessarily inconsistent with the authorities' views.

21. **With fiscal policy the sole remaining macroeconomic policy lever, the staff argued that another year of stimulus would need to be avoided.** Projections by the CPB of the 1999 general government deficit were being revised down during the mission, from 1.7 percent to less than 1 percent of GDP. This development was due to more buoyant revenue from indirect taxes and higher-than-projected inflation, which created room under the constant-price expenditure ceiling largely because nominal wages had already been set. Since the mission, however, expenditure-reducing measures that had been planned in the spring to offset emerging overruns were eliminated and additional spending on the Kosovo crisis was approved without offsetting measures. On that basis, the Ministry of Finance has projected the deficit to be 1¼ percent of GDP in 1999 and 1 percent in 2000. Nevertheless, the staff still expects the deficit to stabilize below 1 percent of GDP in 1999 and decline to ½ of 1 percent in 2000, largely reflecting its higher projections of growth and inflation. This would imply little change in fiscal stance, as measured by the change in the structural deficit.

22. **The authorities and the staff agreed that the current situation did not warrant the reopening of the rules-based fiscal framework.** (See Box 2 and the next section for a discussion of the fiscal framework.) The risks of inflation could be reduced through a discretionary fiscal tightening, achieved by lowering the expenditure ceiling in the fiscal framework. But doing so would risk weakening a process that had already delivered substantial benefits by containing expenditure growth and thereby allowing a decline in the tax burden. In any event, the case for significant discretionary tightening was not strong, given the uncertainties regarding demand pressures.[7] Even so, the staff noted that expenditures had already undershot the ceiling, largely due to higher-than-expected inflation, and that maintaining or even enlarging this windfall would be both prudent and consistent with the framework.

B. Medium-Term Fiscal Policy

23. **Fiscal policy will be governed by strict expenditure rules set for the 1999–2002 period.** The key to the rules-based framework is the ceiling on real net covered expenditure (comprising gross expenditures of the central government, social security, and healthcare, less most nontax revenues). This approach contains expenditure growth, while allowing automatic stabilizers to work on the revenue side. Over the 1999–2002 period, this ceiling will be

[7] Eliminating the estimated 1 percent output gap could require significant discretionary fiscal tightening. Based on multipliers supplied by the CPB, expenditure cuts on the order of 1.2 percent of GDP would be needed; tax increases would have to be much larger.

Box 2. Fiscal Rules for 1999–2002

The cornerstone of the authorities' approach to fiscal policy is a medium–term framework for public expenditure. Its rules, set out in the 1998 Coalition Agreement and detailed in the 1999 budget memorandum, are largely similar to those for the previous government period.

- The 1999 Budget law specifies, for each year from 1999 to 2002, separate expenditure ceilings—in constant prices—for the central government, social security, and health care. Overall, expenditure covered by the framework is set to grow at 1.6 percent a year in real terms. The ceilings form the basis for the annual budgets, which are cast in nominal terms. Covered expenditure includes interest expenditure, but excludes some components of general government expenditure that are largely outside the central government's control—in particular local government spending and a fund for infrastructure projects. Also, the ceilings refer to net expenditure, i.e., after subtracting most nontax and nonpremium revenue.

The nominal expenditure ceilings are established as follows:

- In the context of each annual budget, the projected GDP deflator is used to convert real into nominal expenditure ceilings.
- A final adjustment of the projected deflator is made at the time of the regular mid-year supplementary budget. Later changes in the projected GDP deflator are not reflected in nominal spending ceilings and would thus affect the room for expenditure in real terms.
- The expenditure ceilings are not to be adjusted in case economic growth deviates from projections.

In addition, at the time of the budget, a rule allocates deviations of projected revenue from its baseline path between the deficit and tax cuts. This baseline path, in constant prices, was presented in the 1999 budget memorandum for the four years covered by the arrangement. It was based on deliberately cautious assumptions for economic growth. The allocation rule is:

- If expected revenue for the year ahead exceeds the baseline, a quarter of the excess is allocated to additional tax reductions. Symmetrically, if expected revenue falls short of the baseline projection, planned tax cuts are reduced by a quarter of the shortfall.
- However, if revenue overruns are projected to push the deficit below 0.75 percent of GDP, then half of any further excess revenue is allocated to tax reductions. Conversely, once the deficit has risen to 1.75 percent of GDP as a result of revenue shortfalls, tax cuts are lowered by half of the further shortfall.
- Finally, as soon as the 3 percent deficit ceiling under the Stability and Growth Pact is expected to be reached, any further revenue shortfall is fully compensated to ensure the ceiling will not be breached.
- These revenue allocation rules limit the size of the automatic stabilizer on the revenue side. Together with the expenditure rules, which imply no stabilization on that side, the automatic stabilizer is less than 0.4, well below the euro-area average.

allowed to increase by 1.6 percent per year on average in real terms.[8] Total gross government expenditures (which include items not covered by the framework, such as municipal expenditures and some infrastructure outlays) are projected under the framework to grow byonly ¾ of 1 percent on average.[9] Given the government's cautious scenario of 2¼ percent growth a year on average as well as expected changes to taxation, this expenditure path would imply little change in the fiscal deficit, but a decline in the ratios of both expenditure and revenue to GDP (Table 2).

24. **The 1998 coalition program includes a significant package of tax reforms, which is to be implemented by 2001 (Box 3).** An unpublished draft of the legislation was sent to the government's highest advisory council earlier in the year. The reform plan includes several structural changes to the tax structure, including a shift to indirect and "green" taxes; would introduce an earned income tax credit; and would cut net taxes by about ⅔ of 1 percent of GDP.

25. **The authorities were confident that the 1999–2002 framework would provide adequate budgetary discipline.** This judgement was based in part on the experience with the 1995–98 framework, which had been largely satisfactory. To be sure, in that period the ceilings had not really been tested, given high growth and declining interest rates. Success had nevertheless strengthened the framework's credibility and increased its public acceptance. Furthermore, the authorities felt that strains on the ceiling in the period ahead would be mitigated because they incorporated higher spending growth for health care, infrastructure, education, and employment programs.

26. **The staff supported the significant further tax cuts envisaged in the fiscal policy framework for 1999–2002, but felt that the reduction in the deficit was insufficiently ambitious.** The decline in the revenue burden would be welcome, as revenues were still 48 percent of GDP.[10] As to the deficit, the staff projected that on current government plans it would still be about 0.8 percent of GDP in 2002. Moving to budget balance instead would provide more room for the operation of automatic stabilizers within the 3 percent deficit

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[8] The previous 1995–98 framework had a similar structure, but the real expenditure ceiling declined by 0.7 percent a year on average. This ceiling was adhered to, except in 1998, and better-than-projected growth allowed both the deficit and the revenue burden to fall faster than anticipated.

[9] This implies very tight control of gross, non-covered expenditures ("other" in Table 2). The staff projection, by contrast, assumes these remain roughly constant as a share of GDP.

[10] When making cross-country comparisons, it should be kept in mind that, unlike most European countries, the Netherlands records social security benefits on a gross basis, which raises the revenue share by about 5 percentage points of GDP.

Table 2. Netherlands: Three Fiscal Scenarios

(In percent of GDP)

	1996	1997	1998	1999	2000	2001	2002	Real Average Annual Growth Rate 1998-2002
Staff update of the authorities' cautious growth scenario 1/								
Revenue	48.7	49.2	48.1	48.1	48.2	46.3	45.6	0.7
Expenditure	50.7	50.1	49.0	49.2	49.1	47.7	46.7	0.9
Covered by framework (gross)	48.0	46.7	45.5	45.5	45.4	44.7	44.1	1.3
Covered by framework (net)	44.0	43.2	42.0	42.3	42.3	41.7	41.2	1.6
Other	2.7	3.3	3.5	3.7	3.7	3.0	2.6	-5.4
Deficit	-2.0	-0.9	-0.9	-1.1	-0.9	-1.4	-1.2	
Primary balance	2.7	3.6	3.1	2.7	2.4	1.7	1.8	
Structural primary balance	3.1	3.7	2.6	2.4	2.4	1.9	2.3	
Memorandum item								
Real GDP growth	3.1	3.6	3.8	2.3	2.0	2.0	2.0	
Staff projection 2/								
Revenue	48.7	49.2	48.1	48.1	48.1	46.4	45.8	1.2
Expenditure	50.7	50.1	49.0	48.9	48.6	47.5	46.6	1.2
Covered by framework (gross)	48.0	46.7	45.5	45.2	44.9	44.1	43.4	1.2
Covered by framework (net)	44.0	43.2	42.0	42.0	41.8	41.1	40.5	1.5
Other	2.7	3.3	3.5	3.7	3.6	3.4	3.2	0.2
Deficit	-2.0	-0.9	-0.9	-0.8	-0.5	-1.1	-0.8	
Primary balance	2.7	3.6	3.1	3.0	2.8	1.9	2.1	
Structural primary balance	3.1	3.7	2.6	2.5	2.3	1.5	1.8	
Memorandum item								
Real GDP growth	3.1	3.6	3.8	2.6	2.5	2.4	2.3	
Balanced budget scenario 3/								
Revenue	48.7	49.2	48.1	48.1	48.1	46.4	45.8	1.2
Expenditure	50.7	50.1	49.0	48.7	48.3	46.7	45.8	0.7
Covered by framework (gross)	48.0	46.7	45.5	45.0	44.7	43.3	42.6	0.8
Covered by framework (net)	44.0	43.2	42.0	41.8	41.6	40.3	39.7	1.0
Other	2.7	3.3	3.5	3.7	3.6	3.4	3.2	0.2
Deficit	-2.0	-0.9	-0.9	-0.6	-0.2	-0.3	0.0	
Primary balance	2.7	3.6	3.1	3.2	3.0	2.7	2.8	
Structural primary balance	3.1	3.7	2.6	2.7	2.6	2.3	2.5	
Memorandum item								
Real GDP growth	3.1	3.6	3.8	2.6	2.5	2.4	2.3	

Sources: Data provided by the authorities; and Fund staff projections.

1/ The authorities' cautious growth scenario, which assumed 3 percent growth in 1999, was updated to reflect the current official growth projection for 1999 and fiscal projections and measures for this year announced by the Ministry of Finance. Also, the authorities' scenario did not include separate data for 2000 and 2001.

2/ This scenario differs from the first scenario by assuming higher growth, higher gas prices, higher projected 1999 inflation (reducing real wage costs), and a higher growth rate of total gross expenditure relative to the growth of net expenditure covered by the expenditure framework.

3/ Relative to the second scenario, this one includes less growth of covered expenditure during 1999–2002, in order to achieve budget balance by 2002.

Box 3. The 2001 Tax Reform

A large-scale tax reform is to be introduced in 2001. The draft laws are to be published in the fall of 1999, and parliamentary discussion is scheduled to be completed by the end of the year, to allow sufficient time to prepare the implementation of the new tax plans.

The main goals of the reform are to:

- generate a broader and more stable revenue base, by shifting from direct taxes to a higher value added tax, and by limiting exemptions and deductions;
- stimulate labor participation and employment, by lowering the taxation of labor and introducing tax incentives to strengthen labor supply; and
- promote durable economic growth, through shifting toward environmental taxes and higher fees for utilities.

The tax plan is likely to have the following features:

- The two highest income tax rates, of 50 percent and 60 percent, will be lowered to 41–43 percent and 51–53 percent; the lowest tax bracket, with a rate of 36 percent, will be split into two brackets with rates of 35–37 percent and 31–33 percent. These reductions will be partly financed by a broadening of the tax base, inter alia, by limiting deductions. However, the largest income tax deductions (for mortgage interest and pension premiums) will be maintained.
- Labor participation of women is to be encouraged by a change in the treatment of partner income, with the conversion of the (transferable) personal tax deductions into an individual tax credit. The introduction of a modest earned income tax credit for those earning at least 50 percent of the minimum wage will reduce the very steep marginal effective tax rates experienced when entering the labor market at this level.
- The top VAT rate will be raised from 17.5 percent to at least 19 percent. Environmental taxes will be doubled in three equal steps during 1999–2001.
- The tax on net wealth will be replaced by a capital gains tax. With a flat 30 percent tax on an imputed rate of return of 4 percent, the new regime amounts to a 1.2 percent wealth tax (with interest income now included under this tax instead of under the income tax).

limit imposed by the SGP, and would be a first step in preparing for the impact of population aging on the public finances. A balanced budget could be attained by increasing the headroom already available under the four-year expenditure ceiling.[11] This would imply reducing the growth rate of overall government expenditure to 0.3 of 1 percentage point a year in 2000–02 (compared with 0.6 of 1 percentage point under the authorities' fiscal scenario). This extra restraint would still allow the revenue-to-GDP ratio to fall by 2¼ percentage points.

27. **The authorities and the staff agreed that the announced expenditure savings would be subject to several risks.** The authorities indicated that the emerging slack under the expenditure ceiling could serve as a buffer to absorb expenditure overruns—an approach that would run counter to the staff's suggestion to accelerate consolidation. The staff expressed concerns about the frontloading of expenditure increases, which limited the scope to recover from overruns. In addition, there were already pressures to bring forward the tax cut scheduled for 2001. The main spending risk was that the wage moderation projected in the medium-term budget—an increase of only ½ of 1 percent per year in 2001 and 2002—would not occur. Indeed, unions confirmed that they did not consider it realistic. Further concerns related to the healthcare budget which had exhibited overruns in the past as a result of rising costs of drugs, inadequate incentives for hospitals to limit spending growth, and demographic changes. The authorities had recognized this issue, and raised the allowed growth for healthcare expenditure under the 1999–2002 framework, compared to that under the previous one. Finally, projected savings on social security expenditure have been predicated on the timely implementation of social security reforms. The authorities indicated that the risks on this front were mitigated by an improved incentive structure for both health care and social security which could, in principle, yield savings well beyond current targets.

28. **Beyond the horizon of the framework, the staff advocated moving to a small fiscal surplus, in light of future demographic pressure on the budget.** The CPB has projected that by 2040 population aging would lead to additional budgetary outlays on healthcare and old-age pensions of around 7½ percent of GDP, assuming no change in participation rates or benefits. A recent study by the CPB has shown that structural policies increasing participation rates would reduce this burden substantially, to the point where a small surplus from 2002 onward would avoid the need for a tax increase or benefit cuts as the population ages.[12] Simulations by the staff suggest that a surplus of 1 percent of GDP from 2001 would more than eliminate the Dutch national debt by 2040 and, compared to the situation in 1999, yield savings of nearly 5 percent of GDP in interest payments.[13] The

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[11] The staff's balanced budget scenario is presented in Table 2.

[12] European Economy (forthcoming).

[13] A balanced budget from 2001 onwards would result in the national debt falling to 13 percent of GDP and interest savings of almost 4 percent of GDP by 2040.These simulated results assume real GDP growth of 2.5 percent and a real interest rate of 3.5 percent.

authorities noted that current medium-term goals included moving to a balanced budget after 2002, and added that the creation in 1998 of a fund earmarked for future outlays on the basic public pension had already helped raise public support for deficit reduction.

29. **An innovation to the fiscal framework are rules that limit the scope for discretion in the event of revenue surprises; these rules will also reduce the automatic stabilizers.** Under the new framework, part of the annual deviations of projected revenue from a baseline path is allocated to changes in net tax cuts (Box 2). The staff expressed concern that, for a country in a monetary union, these rules might unduly limit the degree of stabilization on the revenue side; this in a system that had no stabilizer on the expenditure side. The authorities, while acknowledging this point, argued that revenue-based automatic stabilization was both prudent and widely accepted, and that fiscal consolidation was insufficiently advanced to allow more powerful automatic stabilizers.

C. Structural Reforms

30. **The authorities were well aware that much remained to be done on the structural front and had been developing new policy proposals in this light.** However, they felt that it would not be easy to replicate the favorable results achieved over the past several years. It had become increasingly difficult to identify clearly the benefits of additional reforms and, consequently, to generate the necessary support. The staff welcomed the progress achieved thus far and stressed that it would be essential to maintain a comprehensive approach and to ensure that past accomplishments not lead to complacency.

31. **Sustained labor-market reforms had been credited with considerable success in raising labor-market participation over the past decade and a half.** Still, the authorities agreed that insufficient headway was being made toward improving the job prospects of minorities, those over 55 years of age, and the low-skilled. The large number of disability benefit recipients also continued to be a major policy issue. They noted that government policies had first focused—successfully—on reducing the inflows into unemployment and disability, and that the emphasis was now shifting toward promoting (re-)integration of benefit recipients into regular employment.

32. **The staff encouraged further strengthening of the ongoing and planned labor-market reform initiatives, while pointing to three areas where greater effort could be made.** First, the system of taxes and transfers had blunted incentives for work, particularly among the unskilled, by creating very high marginal effective tax rates (METR)—a "poverty trap"—at the low end of the wage distribution. Second, there were still substantial disincentives to continue working beyond the age of about 55. And third, policies for the integration of the long-term unemployed and the disabled had not proved sufficiently effective.

33. **An important initiative to reduce the "poverty trap" is the planned introduction of an earned income tax credit (EITC), as part of the 2001 tax reform.** This is a clear step forward, but as the authorities explained the credit would be too small to fully solve the

problem, and a significant increase would be fiscally too costly. The staff suggested the credit be targeted more specifically at the lower income levels by withdrawing it from those with higher earnings.[14] Although this would involve trading a lower METR at low wages for a higher one further up the wage schedule, the staff argued that there would be an overall gain in employment incentives as a result. The authorities opposed the increase in the METR at higher wage levels, particularly as marginal income tax rates were already judged to be high.

34. **The authorities were also aware of the need to change the incentives that result in many older workers leaving employment prematurely.**[15] These have taken two major forms. First, the structure of early retirement schemes, which are negotiated between employers and unions, have since the early 1980s been a disincentive to continuing to work. Recently, however, these schemes have begun to be replaced by actuarially fair ones that level the playing field for the retirement decision. The staff urged the authorities to encourage this shift (which would already be facilitated by changes in tax laws taking effect in mid-1999) notably through ongoing discussions with the social partners. Second, unemployment and welfare claimants over 57½ years old have not been required to look actively for work. The staff argued that the authorities should consider eliminating this dispensation and assign higher priority to reintegration for this group.

35. **To promote labor-market reintegration, the authorities have proposed significant reforms to social security administration.** These measures include partial privatization and the streamlining of access to benefits and reintegration services through the Centers for Work and Income (CWI; see Box 1). Although the details had yet to be fully fleshed out, the staff supported the general thrust of these reforms, which ought to improve administrative efficiency and strengthen opportunities to enter employment or training. The authorities and staff concurred that a key to success would be the adequacy of the financial incentives that the privatized agencies would face to move claimants from benefits into employment. In this connection, the staff advised that strong incentives should be instituted for municipalities as well. The authorities noted that a pilot project had already been planned to provide such incentives through the use of lump-sum transfers from the central government to municipalities for welfare outlays. They noted that determining the size of these transfers, which had to be done on a case-by-case basis, was likely to prove difficult.

36. **The staff argued that, in the years ahead, consideration should be given to still closer integration of the various programs for unemployment, sickness, disability, and welfare.** For example, municipalities (rather than the privatized agencies) are to continue to

[14] This is the approach taken in the U.S. EITC.

[15] These incentives have been analyzed extensively for the OECD countries by S. Blondal and S. Scarpetta (1997) "Early Retirement in OECD Countries: The Role of Social Security Systems," OECD Economic Studies, No. 29.

handle welfare claims; and the sickness program is to remain separate from the disability programs. The staff argued that a more unified approach to benefits would simplify the social security system and offer greater possibilities to sharpen administrative and financial incentives. The authorities were hesitant, however, since integrating the welfare program with the rest of the social security system would be difficult, and they judged the benefits of doing so to be relatively small.

37. **Public-sector employment programs had been introduced to rebuild human capital and reduce marginalization, while producing value added in themselves.** Although they have absorbed substantial numbers of long-term unemployed, few participants had succeeded in graduating to regular employment. In light of this, the staff expressed considerable skepticism regarding the long-term effectiveness of these programs in terms of labor-market goals. The authorities were aware of possible problems and planned to evaluate the programs, but argued that jobs in public employment programs were in any case valued because they reduced social marginalization.

38. **Regarding product-market reforms, the authorities noted that the process was far from complete and expressed their determination to push forward.** However, progress had become more difficult as many of the most obviously needed reforms had been completed or were underway, and opposition had formed against other proposals. In the context of the umbrella program, the authorities were developing new proposals, some of which had originated in the private sector. As a result, they expected progress on retail regulations (including zoning regulations), franchises, the bankruptcy law, and tradable emission rights. The staff supported these initiatives and urged the authorities to broaden the scope of reform and to ensure that initiatives already proposed be finalized and implemented. The government has also made efforts to reduce the administrative burden of public regulation. While there was some evidence that these had borne fruit, the perception in both government and the private sector was that more needed to be done.

39. **In response to financial-sector consolidation and emerging consumer-protection issues, the authorities have moved to strengthen cooperation among supervisors.** The financial sector is now dominated by a few conglomerates, which are internationally diversified and offer myriad new financial products. The staff raised the possibility of establishing a unified financial supervisor, perhaps along the lines of the new U.K. Financial Services Authority, to replace the independent supervisory bodies for banking, insurance, and securities with a fully integrated structure. The authorities had considered this option, but decided that adequate coordination and coverage would be provided by the newly established Council of Financial Supervisors (CFS). The CFS would have particular mandates to improve the supervision of conglomerates and to address issues related to consumer protection. The staff welcomed this step, underscoring the importance of promoting more unified and comprehensive supervision. In addition, the staff and the authorities agreed that the supervision of pension funds, which have diversified into nontraditional assets, needed to be strengthened.

40. **On trade policy, the Dutch authorities remained staunch supporters of further liberalization.** They expected the new WTO round to produce significant benefits for the Dutch economy, commensurate with the scope of its agenda. More generally, they argued that gains could be had from a further strengthening of the WTO, in particular by improving transparency, the dispute settlement system, and the integration of developing countries.

41. **Since 1997 there has been a cooperative approach between the public and private sector to deal with the Y2K issue.** Although not all millennium projects are expected to be completed on time, the authorities felt that progress had advanced sufficiently to prevent disruption.

IV. Staff Appraisal

42. **The sustained implementation of mutually reinforcing structural and fiscal reforms, is commendable and has contributed to increases in trend growth and employment; the authorities now face three principal challenges.** First, in the short term, to contain any inflationary pressures that may be created by the cyclical upswing of the past few years. This will require careful and prudent fiscal management. Second, in the longer term, to ensure fiscal sustainability. In the current economic circumstances, these short- and long-term requirements mesh well. And third, to extend and invigorate the broad program of structural reform in product, labor, and financial markets.

43. **Tight labor markets and the sharp, sustained rise in real estate prices could signal growing macroeconomic imbalances, even though wage and price inflation have not risen.** Although it is difficult to estimate an equilibrium, or non-inflation increasing, unemployment rate for the Netherlands, there now appears to be little or no slack left. Tensions in labor markets are likely to increase as employment continues to expand. The rapid rise in real estate prices, along with the equally rapid increase in credit aggregates and, especially, mortgages, also suggests an expansion of demand that may prove unsustainable. Although it is possible to explain most of the rise in housing prices by fundamentals (such as lower interest rates and higher disposable incomes), the high rates of indebtedness of Dutch households by historical standards are of concern.

44. **Against this backdrop, budgetary restraint will be essential to guard against the emergence of excessive demand pressures, and any positive fiscal impulse, as occurred in 1998, should be avoided.** The outturn for 1999 appears to be better than anticipated by the Budget, and this "windfall" should be preserved. Indeed, it would be prudent for the authorities to apply any further windfalls that arise in the years ahead toward additional deficit reduction. Such opportunities might arise from reduced social-security outlays resulting from higher-than-forecast growth or from lower debt service payments.

45. **Over the current four-year budget horizon, the authorities should aim for a balanced budget, rather than a deficit of about 1 percent of GDP.** This would be consistent with prudent short-term demand management; would increase the credibility of fiscal policy by making concrete the authorities' stated medium-term goal; and would be a step toward dealing with the aging population by accelerating the reduction in the national debt. To preserve the desirable reduction in the revenue-to-GDP ratio, this more ambitious deficit policy would have to be implemented through a slightly slower rate of growth of expenditures than is now envisaged.

46. **However, the fiscal framework, which has proved its worth, should not be reopened; instead, expenditure should be held below the ceiling.** By capping expenditure growth, the framework has contributed to tighter control of government spending and helped to foster sustainable reductions in the tax burden and the public-debt ratio. Opening the framework to allow short-run adjustments to the fiscal stance for purposes of demand management, or even to implement a somewhat tighter medium-term deficit path, would almost certainly weaken fiscal discipline. The danger is that doing so now would make it more palatable to renegotiate the framework in other circumstances and for other purposes, including to increase outlays. But the framework specifies ceilings, not targets, and lower expenditure growth can thus be achieved by budgeting below the ceilings or taking advantage of unexpected spending shortfalls.

47. **The desirability of fiscal prudence is underscored by factors that put the authorities' fiscal program at risk.** The tax reform scheduled for 2001 involves a welcome tax reduction, but there are already pressures to move it forward. These should be resisted, especially as expenditures are already front-loaded. The assumption that the tax reduction will lead to very moderate wage growth may not be realized, thus putting upward pressure on expenditures through the public-sector wage bill. In addition, health care has been a constant source of expenditure pressure, and the target for these expenditures, although now more realistic, may still prove difficult to attain.

48. **In a long-run perspective, population aging could impose fiscal strains that would be partly avoided by moving to a fiscal surplus early in the next decade.** Given the extensive private supplementary pension system in the Netherlands, this problem is less severe than in most other European economies. Moreover, other reforms, such as adjustments to benefits and age of eligibility are likely to be part of a comprehensive approach to this problem. Nevertheless, modest budget surpluses would allow public resources to be redeployed from debt service to pensions. National saving might also be increased, which would help to generate the resources to pay for higher pension obligations, both by increasing the capital stock and by further strengthening the Dutch net foreign asset position.

49. **The staff welcomes the authorities' determination to continue the program of structural reform.** The gains from resolving the remaining major structural problems in the Dutch economy would be substantial. However, there is a danger that enthusiasm may begin

to wane, as some argue that enough has already been done, or that more reform may be too disruptive. A key task in the years ahead will be to sustain the momentum for labor and product-market reform.

50. **The major remaining labor-market issues involve poor employment prospects of the unskilled, the old, and the partially disabled.** In all three cases, incentives for taking and keeping a job need to be sharpened further. Proposals now on the table are a step in the right direction, and should be pursued vigorously. The earned-income tax credit will help to reduce the poverty trap that now exists around the minimum wage, and the authorities should seek to increase the credit. The partial privatization of the social security administration, and especially the increase in incentives to move benefit claimants into employment, are welcome. Performance will have to be monitored closely to ensure that such incentives are sufficient and properly focused. Financial incentives should also be extended to municipalities, which will continue to administer the welfare program. The creation of the CWIs is a welcome step toward an integrated program to promote employment. Indeed, still closer integration of the various parts of the social security system is worthy of attention. Regarding the problem of low employment among the older segment of the labor force, the practice of allowing older workers to draw benefits without the obligation to seek employment until they reach pensionable age should be abandoned, and the focus shifted to improving job prospects. With respect to the long-term unemployed, the staff encourages the authorities to carry out an objective and rigorous assessment of the effectiveness of the public employment programs in promoting reintegration.

51. **Reforms in product markets have been more recent and, so far, less far-reaching than those in labor markets.** Still, they are bearing fruit and need to be extended. It will be important to finalize and implement the many initiatives already proposed, and to continue efforts to reduce the administrative burden on the private sector.

52. **Recent developments in the financial sector are raising challenges for supervisors.** Given continued rapid increases in credit, especially to households, the quality of loan portfolios must be carefully monitored. The new Council of Financial Supervisors should increase cooperation among the three agencies and thereby help to ensure that conglomerates are adequately supervised. In the longer term, the authorities should continue to assess the adequacy of the supervisory structures and, given increasing integration across lines of business and across borders, ensure sufficient coordination. Consumer protection should be an increasing focus of supervisors. Finally, supervision of pension funds should be enhanced.

53. **The authorities' support for the principles of free international trade is welcome, as is their support for multilateral trade negotiations and particularly the WTO process.** Development assistance has remained at 0.8 percent of GDP, above the United Nations norm.

54. **The macroeconomic database of the Netherlands is of high quality and the authorities provide all the core data to the Fund (Appendix II).** They subscribe to the

Special Data Dissemination Standard and provide information of data and dissemination practices on the IMF Dissemination Standards Bulletin Board. A large part of Dutch macroeconomic data is available on World Wide Web sites. The staff felt it would be helpful to have more timely and comprehensive information on the general government on a national accounts basis.

55. It is recommended that the next Article IV consultation be conducted in accordance with the normal 12-month cycle.

Netherlands: Fund Relations

As of July 31, 1999

I. **Membership Status**: Joined December 27, 1945; Article VIII.

II. **General Resources Account**:	SDR Million	Percent of Quota
Quota	5,162.40	100.0
Fund holdings of currency	3,159.01	61.2
Reserve position in Fund	2,003.41	38.8
Operational budget transfers (net)	-63.00	

III. **SDR Department**	SDR Million	Percent of Allocation
Net cumulative allocation	530.34	100.0
Holdings	552.78	104.2

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: (SDR million; based on existing use of resources and present holdings of SDRs): None

VII. **Exchange Rate Arrangements**:

The Netherlands entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 2.20371 guilder per euro.

VIII. **Article IV Consultation**:

Discussions for the 1999 Article IV consultation were held in Amsterdam and the Hague in June 11–21, 1999. The staff report for the 1998 Article IV consultation (SM/98/97, 5/15/98) was considered by the Executive Board on June 12, 1998 (EBM/98/63). The Article IV discussions with the Netherlands are on the standard 12-month consultation cycle.

IX. **Exchange Restrictions**:

The Netherlands maintains exchange restrictions vis-à-vis Iraq (notified to the Fund under Decision 144-(52/51) in EBD/90/267 (8/27/90) and EBD/94/83 (5/13/94)); and the Socialist People's Libyan Arab Jamahiriya (see EBD/94/83).

Netherlands: Statistical Data Issues

The Netherlands publishes a wide range of economic and financial statistics. Specifically, annual and quarterly national account data are provided by the Central Bureau of Statistics; financial and balance of payments data are provided by De Nederlandsche Bank; and fiscal data are provided by the Ministry of Finance. These data are increasingly available in electronic form. Macroeconomic data are generally of high quality.

The frequency and timeliness of the availability of the core statistical indicators for Fund surveillance purposes are summarized in the attached table. The authorities subscribe to the Special Data Dissemination Standard, providing information about their data and data dissemination practices on the IMF Dissemination Standards Bulletin Board.

Netherlands: Core Statistical Indicators
as of August 12,1999

	Int'l Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	External Government Debt	GDP/GNP
Date of Latest Observation	8/6/99	8/6/99	8/6/99	6/99	8/12/99	7/99	5/99	Q1/99	6/99	1996	Q1/99
Date Received	8/10/99	8/10/99	8/10/99	8/99	8/12/99	8/6/99	7/30/99	7/99	8/99	9/97	7/22/99
Frequency of Data	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Annually	Quarterly
Frequency of Reporting	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Annually	Quarterly
Source of Update	DNB	DNB	DNB	DNB	Reuters	CBS 2/	CBS 2/	DNB	MoF	MoF	CBS 2/
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Weekly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Monthly	Annually	Quarterly

1/ De Nederlandsche Bank= central bank.
2/ Central Bureau of Statistics.

The Impact of Economic Reforms on Growth

This appendix presents a simple growth accounting exercise to assess the growth effect of policy reforms introduced in the early 1980s. As labor market reform was a central element of the package, and because the economic recovery has been typified by a sustained increase in employment, the analysis focuses on the growth contribution of the change in labor input. The results confirm the importance of increased participation and lower unemployment in explaining the relatively high levels of economic growth recorded since 1984.

To determine the growth effect of changes in employment, overall GDP growth was decomposed using a Cobb-Douglas production function:

$$\ln(Y) = \alpha*\ln(L) + (1-\alpha)*\ln(CAP) + TFP$$

Based on empirical estimation, the labor share parameter, α, was set at 0.68. Total factor productivity (TFP) was derived from the above equation using actual figures for real GDP (Y), labor input (in hours; L), and the capital stock (CAP). Next, labor input was decomposed as follows:

$$L = POP*(LF/POP)*(1-UN)*(YRS/PERS)*(HRS/YR)$$

POP	= working-age population
LF/POP	= participation rate
UN	= unemployment rate
YRS/PERS	= average full-time equivalent per worker
HRS/YR	= standard working hours per year

From this decomposition of GDP, the contribution of the individual components to GDP growth were derived. Finally, an adjustment is made for the business cycle, which in principle affects all the inputs into the production process. This is done by applying the staff estimates of the output gap for each year. The final three columns in the table summarize the results by presenting the growth contributions of the "exogenous factors" (working-age population, the capital stock, and productivity), the "cyclical effects," and the "reform effects" (labor input relative to the working-age population).

The following conclusions emerge from this exercise:

- Labor market performance has been crucial to the sustained recovery. If labor input (relative to the working-age population) had been maintained at its 1983 level, average annual growth during 1983–98 would have been 0.1 of 1 percentage point lower. But in previous years there had been a sharp decline in labor input; if the reforms are credited with reversing this trend, they raised average annual growth by 1.2 percentage points.

- A sustained rise in participation (LF/POP) and a decline in unemployment (UN) accounted for the increase in labor input, raising the growth rate by 0.7 of 1 percentage point.

- An increase in part-time work (YRS/PERS and HRS/YR) reduced growth by 0.4 of 1 percentage point.

While the increase in employment as a result of the reforms has been crucial in boosting activity, the impact of the reforms has not been limited to this channel. Without the reduction of wage costs and the return to macroeconomic stability, the pickup of investment since 1985 would not have occurred. Thus, some of the growth in the second-to-last column should be attributed to the reforms.

Netherlands: Contribution to Economic Growth

(In percent)

Year	GDP Growth	Decomposition of GDP Growth							Effects of		
		POP	LF/POP	UN	YRS/PERS	HRS/YR	CAP	TFP	POP, CAP and TFP	Cycle	Reforms
1970	5.7	0.9	0.0	0.0	-0.2	-1.6	1.4	5.0	7.4	1.8	-3.5
1971	4.2	1.0	-0.2	-0.2	-0.2	-0.9	1.2	3.5	5.7	0.6	-2.1
1972	3.3	0.9	-0.8	-0.5	-0.2	-0.7	1.0	3.7	5.6	-0.1	-2.2
1973	4.7	0.8	-0.6	0.0	-0.2	-0.9	1.1	4.4	6.4	1.4	-3.2
1974	4.0	0.9	-0.4	-0.2	-0.2	-1.7	1.1	4.5	6.5	1.0	-3.5
1975	-0.1	1.0	-0.8	-0.6	-0.2	-1.6	0.9	1.2	3.1	-2.8	-0.4
1976	5.1	1.0	-0.5	-0.1	-0.4	1.0	0.7	3.3	5.0	2.6	-2.5
1977	2.3	0.9	-0.5	0.1	-0.4	-0.6	0.9	1.9	3.7	0.1	-1.5
1978	2.4	0.9	-0.5	0.0	0.2	-0.8	0.9	1.7	3.5	0.3	-1.4
1979	2.2	1.0	-0.2	0.1	0.2	-0.5	0.9	0.9	2.7	0.4	-0.8
1980	1.2	1.0	-0.3	-0.2	0.1	0.0	0.7	0.0	1.7	-0.5	0.0
1981	-0.5	0.9	-0.4	-1.4	0.0	-0.2	0.4	0.2	1.5	-1.9	-0.1
1982	-1.2	0.8	-0.7	-1.7	-0.1	0.2	0.3	0.2	1.2	-2.3	-0.1
1983	1.7	0.8	-0.7	-1.3	0.0	-0.6	0.3	3.3	4.4	0.3	-3.0
1984	3.3	0.8	-0.3	0.0	-0.4	-1.5	0.4	4.4	5.6	1.5	-3.7
1985	3.1	0.7	-0.2	0.8	0.0	-1.7	0.6	3.0	4.3	0.9	-2.1
1986	2.8	0.7	0.5	0.2	0.0	-0.4	0.8	1.0	2.4	0.2	0.2
1987	1.4	0.6	0.6	0.0	0.0	-0.2	0.7	-0.3	1.0	-1.2	1.6
1988	2.6	0.5	0.4	0.0	0.1	-0.1	0.7	0.9	2.1	0.0	0.5
1989	4.7	0.4	0.4	0.5	-0.1	-0.2	0.8	2.7	3.9	1.8	-1.0
1990	4.1	0.4	0.7	0.5	0.0	0.1	0.9	1.5	2.8	1.2	0.2
1991	2.3	0.4	0.5	0.3	-0.3	0.0	0.9	0.5	1.8	-0.7	1.2
1992	2.0	0.4	0.5	-0.1	-0.2	0.0	0.8	0.5	1.7	-0.9	1.2
1993	0.8	0.4	0.3	-0.8	0.0	0.0	0.7	0.2	1.2	-2.0	1.6
1994	3.2	0.3	0.5	-0.7	-0.3	0.0	0.7	2.8	3.7	0.6	-1.1
1995	2.3	0.2	1.1	0.3	-0.6	0.0	0.8	0.5	1.5	-0.5	1.3
1996	3.1	0.2	0.8	0.5	-0.2	-0.3	0.9	1.2	2.3	0.4	0.4
1997	3.6	0.2	0.9	0.7	-0.1	-0.5	1.0	1.3	2.5	0.8	0.3
1998 1/	3.8	0.0	0.9	1.0	-0.1	N/A	N/A	1.9	1.9	1.1	0.8
Averages											
1970-74	4.4	0.9	-0.4	-0.2	-0.2	-1.1	1.2	4.2	6.3	1.0	-2.9
1974-83	1.5	0.9	-0.5	-0.6	-0.1	-0.4	0.7	1.4	3.0	-0.4	-1.1
1983-98	2.9	0.4	0.5	0.2	-0.1	-0.3	0.8	1.5	2.6	0.2	0.1

Source: Fund staff calculations.

1/ For 1998, the contributions of the changes in the working week (HRS/YR) and the capital stock (CAP) are included in the impact of total factor productivity (TFP).

Netherlands: Macroeconomic Significance of House Price Developments

Price increases on the Dutch residential property market have exceeded 8 percent per year since 1992, except in 1995, and have accelerated recently. During 1996–98 they averaged 10 percent annually and in the first quarter of 1999, the average price of an existing house was 15 percent higher than a year before (Figure 9). As a result, in April 1999, real house prices (deflated by the consumer price index) were at the level of their previous historical peak (1979), when they proved to be unsustainably high. This note presents evidence suggesting that, this time, residential property prices may be only mildly overvalued, if at all. However, an unabated continuation of the recent pace of price increases would be a cause of concern.

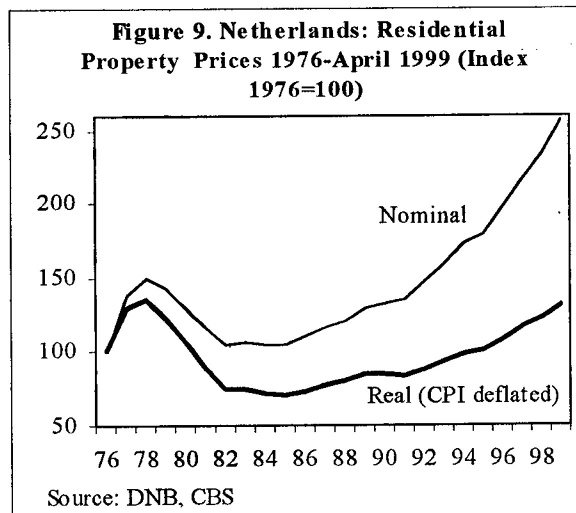


Figure 9. Netherlands: Residential Property Prices 1976-April 1999 (Index 1976=100)

Source: DNB, CBS

With 57 percent household wealth invested in own residential property (and only 15 percent in shares), changes in house prices are bound to have significant macroeconomic effects, and more so than changes in other asset prices. Simulations with CPB and DNB models confirm that wealth effects have contributed about 1 percentage point to private consumption growth annually since the mid-1990s, of which three quarters is due to house price changes. Thus, symmetrically, a mild house price correction would have limited, but not insignificant macroeconomic effects. Given the nature of these models, though, the effects of a sudden or sharp price correction cannot be obtained by simple extrapolation.

Explaining the boom in residential property prices

House prices are influenced, inter alia, by interest rates, household income, building costs, demographics, the structure of land and real estate markets, and government policy regarding taxation, rent control, and land use (Figure 10). In the case of the Netherlands, econometric estimates by van Rooij and de Vos (1999) and van Rooij (1999) for the period 1976–99, brought out the importance

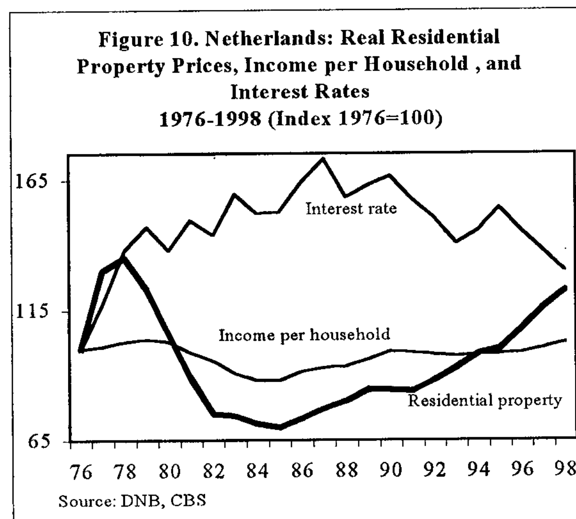


Figure 10. Netherlands: Real Residential Property Prices, Income per Household , and Interest Rates 1976-1998 (Index 1976=100)

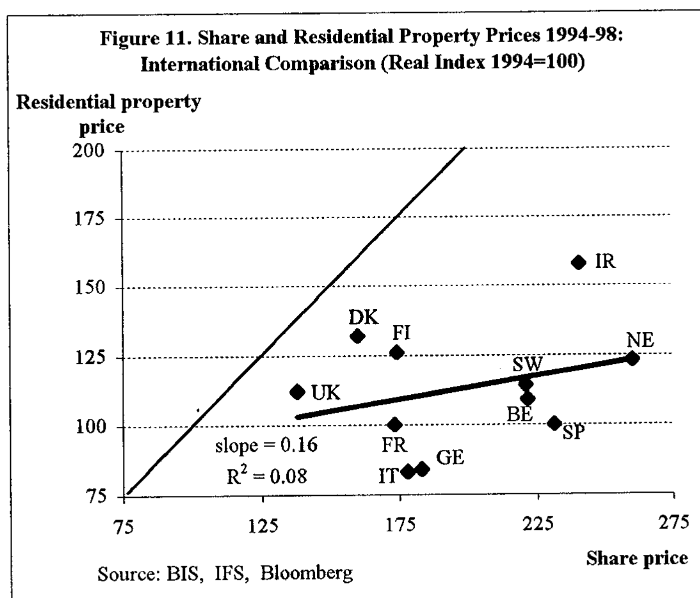
Source: DNB, CBS

of long-term interest rates (with a semi-elasticity of minus 5¼, on average), rents (with an elasticity of 1.4, on average), and real household incomes (with a near unit elasticity). The significance of rents is likely to be linked to the existence of rent controls, which were gradually phased out during the 1990s and completely removed in 1998. Confidence factors—proxied by the unemployment rate and perhaps indicative of permanent income—have also had a significantly positive effect on residential property prices, while supply factors, such as the cost of building and the addition to the housing stock, were found to have had only transient effects.

Recently, house price increases have begun to exceed the pace consistent with the decline in real interest rates and the rise in rents and real household incomes. The model estimated by van Rooij (1999) has been underpredicting house prices, though only slightly, since 1997, by a cumulative 5–7 percent through the first quarter of 1999.[16] Short-term deviations of asset prices from fundamentals are not uncommon, though. One explanatory factor could be the change toward more liberal lending behavior by banks in 1997.[17]

There is no evidence of a significant direct causal link between share values and residential property prices. International comparison shows that while equity markets across countries have kept broadly in step in recent years, house price developments have diverged widely, suggesting that domestic factors dominate (Figure 11). In the Netherlands, both markets posted sharp gains during the 1990s (Figure 3), but formal causality tests did not show a relationship between

Figure 11. Share and Residential Property Prices 1994-98: International Comparison (Real Index 1994=100)



Source: BIS, IFS, Bloomberg

[16] The model did not predict any of the rapid increase in residential property prices observed in the late 1970s and subsequently reversed.

[17] Banks begun to take into account all household income, even from part-time work, to determine eligibility; raised the maximum loan to execution value ratio; and offered innovative mortgage products which allow balloon payments of the principal, backed by investments in other assets. These factors are likely to have outweighed the restrictive effect of a slight increase in the risk premium charged on mortgages since 1997–98.

the two (van Rooij and de Vos 1999). Recently, however, channels have opened up which could portend the emergence of a closer link between the residential property market and the equity market. Households appear to be cashing in on capital gains on residential property by increasing their outstanding mortgage debt, in part to invest in shares, while banks have been offering new mortgage instruments which can be backed by investments in shares. So far, the importance of these channels appears to have been negligible (van Aartsen 1998).

Macroeconomic effects of residential property price changes

Wealth effects induced by house price increases are estimated to have contributed ½ to ¾ of 1 percentage point annually to the growth in private consumption since the mid-1990s. Simulations by the DNB—which took into account the indirect effects on investment in residential structures—estimated that house price increases during 1995–98 boosted GDP by a cumulative 1.3 percent and private consumption by a cumulative 2.1 percent. Simulations by the CPB yielded somewhat stronger results, with private consumption amplified by a cumulative 3 percent.

An exogenous decline in the house price by 10 percent is projected to lower GDP by 0.3–0.6 of 1 percentage point and private consumption by 0.5–1.1 percentage points with a lag of two to four years. In the CPB simulation, which uses the low end of this range, the effect is complete after two years. In the DNB's model, the effects are stronger, but take somewhat longer to accrue. It should be noted that the first-year effects on GDP and consumption are very small in both simulations.

House prices themselves appear vulnerable to a deterioration in macroeconomic fundamentals. In comparison with neighboring countries, estimated interest rate, income, and "confidence" elasticities are relatively high in the Netherlands. A deterioration in the employment outlook, for example, could turn the residential property market bearish, and trigger adverse wealth effects. A significant increase in long-term interest rates could have similar effects.

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INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS—NETHERLANDS

Staff Report for the 1999 Article IV Consultation
Supplementary Information

Prepared by the European I Department

(In consultation with other Departments)

Approved by Susan Schadler and G. Russell Kincaid

October 12, 1999

1. This supplement provides information on data revisions and economic and budgetary developments since the staff report (SM/99/221) was issued and updates the staff projections. Economic activity is proving to be significantly stronger than had been anticipated by the authorities and the staff. This does not change the staff assessment, but underscores the risks associated with emerging macroeconomic imbalances and building inflationary pressures discussed in the staff report.

Data revisions

2. Dutch national accounts since 1995 have been revised to conform to the methodology of the harmonized European System of Accounting. Consequently, the data presented in the tables of this supplement start in 1995 and are not comparable with the data of the staff report. In addition, the revision causes a trend break in the figures in 1995. The revisions imply a higher level of GDP—by 4.2 percent in 1998, for example—thus lowering all ratios to GDP.

3. Other changes in methodology affected estimates of the budget deficit in a non-systematic manner, but do not affect the staff's assessment of the fiscal stance in recent years. For example, the deficit was revised upward in 1997 by 0.3 percentage points of GDP, but downward in 1998 by 0.2 percentage points of GDP. For 1999, a precise estimate of the effect of methodological changes on the budget deficit is not available. The staff scenarios presented in this supplement therefore start from the authorities' estimate of the 1999 outcome (based on the new methodology) and are not affected by the change in accounting method.

Recent economic and policy developments

4. The latest cyclical indicators make clear that the pace of Dutch economic activity is stronger than had been previously projected. Following real GDP growth of 3.2 percent in the second quarter of 1999, indices of both consumer and producer confidence rose during the summer. Producers were encouraged by the recovery of industrial production, the increase in orders and prices, and the more favorable external environment. Consumer sentiment was bolstered by continuing rapid rises in housing prices and further declines in the unemployment rate (to about 4 percent in the three months ending August). Consequently, the Central Planning Bureau (CPB) raised its growth forecast for 1999 and 2000 to 2¾ percent and 2½ percent, respectively. Compared to other national forecasters, the CPB projection is still on the low side.

5. The 2000 budget—submitted to parliament in mid-September—is firmly within the four-year fiscal framework. A more favorable starting position, reflected in a deficit for 1999 that is much lower than planned, carries over into 2000 when, based on a conservative assumption of 2 percent real GDP growth, the deficit is expected by the authorities to fall to 0.5 percent of GDP. Under the rules of the framework, half of the higher-than-expected tax revenues goes toward tax reduction. On the expenditure side, the room that became available under the ceiling in 1999 is partially spent in 2000, mainly on labor market programs. The 2000 budget anticipates that, in later years, expenditure will rise fully to the ceilings.

6. The legislation underpinning the 2001 tax reforms—recently submitted to parliament—is broadly in line with earlier proposals. The overall tax reduction included in the package is somewhat higher than planned initially—guilders 5 billion instead of guilders 4½ billion—using some of the revenue windfall. One of the key objectives of the package, an improvement in the functioning of the labor market, is supported by the introduction of an earned income tax credit and other measures to reduce tax wedges and the replacement rate, as well as the elimination of anomalies in the treatment of partner income. The earned income tax credit remains broad based and insufficiently targeted at the lower income levels to fully solve the poverty trap. For example, at the level of the minimum wage, a single employee will experience an increase in take home pay of 6.3 percent, compared with a loss in income of 10 percent from moving from unemployment to minimum wage employment.[2]

Revised staff projections and fiscal outlook

7. The upside risks to the staff's growth projection noted in the staff report appear to have materialized. Consequently, the staff now expects real GDP growth of 3¼ percent in 1999 and 3 percent in 2000 (Figure 1 and Table 1), which compares with 2.6 percent for both

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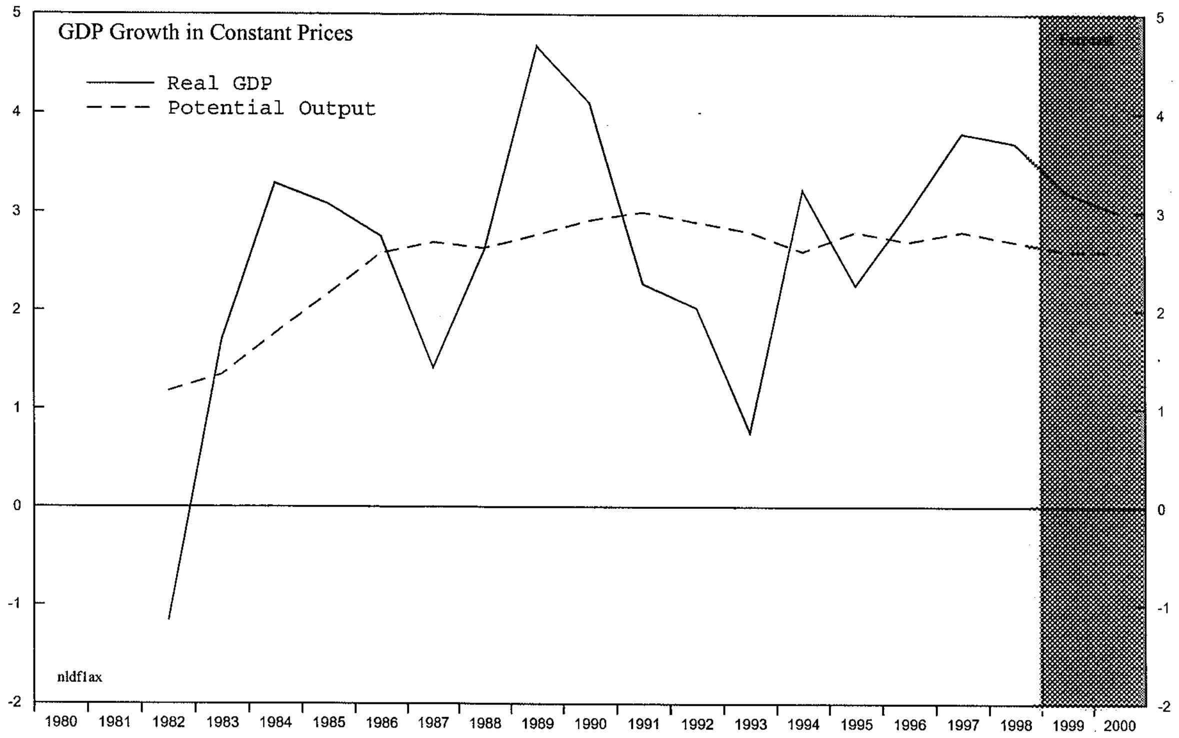
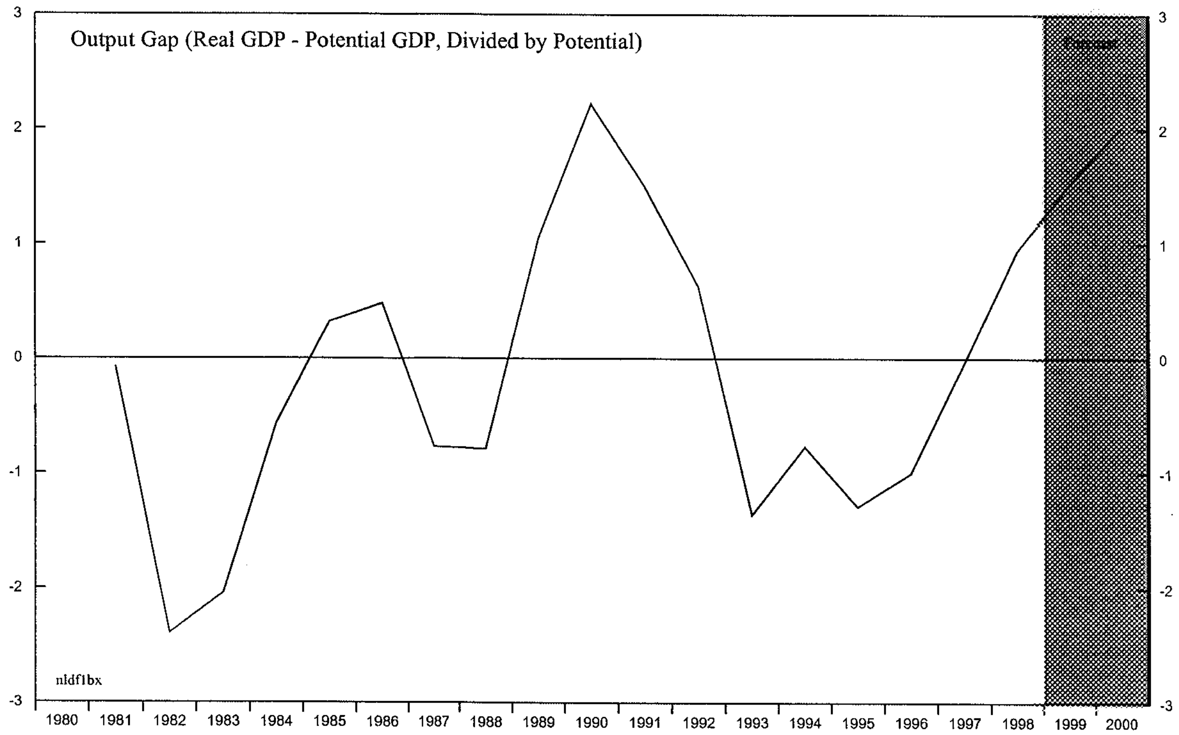
[2] Van Wijnbergen, S. "Fiscaliteit, onderwijs, en inactiviteit" *Preadviezen van de Koninklijke Vereniging voor de Staathuishoudkunde 1998.*

Figure 1. Netherlands: Real Output





Source: IMF, World Economic Outlook

Table 1. Netherlands: Basic Data

Land area (1998)	41.5 thousand sq. km.	
Population (1998)	15.7 million	
Population characteristics and health:		
Life expectancy at birth (1997)	75.2 (male), 80.6 (female)	
Fertility rate (1997)	1.6 children/woman	
Infant mortality rate (1997)	5.0 per 1,000 live births	
Population per sq. km. of land area (1998)	462 persons	
National accounts (1997 at current prices)	(In billions of guilders)	(In percent of GDP)
Private consumption	419.0	59.1
Public consumption	96.9	13.7
Gross fixed investment	141.9	20.0
Stockbuilding	1.5	0.2
Exports of goods and nonfactor services	396.7	56.0
Imports of goods and nonfactor services	347.0	48.9
GDP	709.0	100.0

	1995	1996	1997	1998	1999 Proj.	2000 Proj.
National accounts (constant prices)						
Private consumption	2.0	4.0	2.7	4.2	3.9	3.5
Public consumption	0.8	-0.4	3.3	3.3	2.1	2.0
Gross fixed investment	4.8	6.3	5.9	5.3	5.1	3.7
Total domestic demand	2.4	2.8	3.5	4.3	3.7	3.1
Exports of goods and services	6.7	4.6	9.0	6.4	4.1	5.5
Imports of goods and services	7.5	4.3	9.0	7.7	5.2	5.9
Net foreign balance 1/	0.1	0.4	0.6	-0.3	-0.4	0.1
GDP	2.3	3.0	3.8	3.7	3.2	3.0
Prices, wages and employment						
Consumer prices (annual average)	2.0	2.1	2.2	2.0	2.3	2.3
Hourly compensation (manufacturing)	1.1	1.9	2.5	2.8	2.8	3.0
Unit labor costs	-2.5	-0.9	-2.0	1.3	2.0	1.8
Employment	2.4	2.0	3.4	2.9	2.3	1.7
Unemployment rate (in percent)	7.1	6.6	5.5	4.1	3.1	2.7

Table 1. Netherlands: Basic Data (Continued)

	1995	1996	1997	1998	1999 Proj.	2000 Proj.
Personal sector						
Real disposable income	1.5	2.3	3.1	4.5	3.1	2.4
Household saving ratio (in percent)	11.6	11.7	11.9	11.9	12.0	11.6
External trade						
Exports of goods, volume	7.3	5.0	5.7	6.5	4.0	5.8
Imports of goods, volume	9.5	4.7	7.7	7.7	5.6	6.7
Terms of trade	1.4	-0.6	0.4	0.2	1.6	0.4
Merchandise balance (percent of GDP)	5.5	5.3	4.9	4.4	4.4	4.7
Current account (percent of GDP)	6.0	5.6	5.9	5.3	5.3	5.7
Money and credit (end-period)						
Domestic credit	9.7	10.0	13.1	16.2	...	...
M3H	4.4	5.8	7.4	9.6	...	...
Exchange rates (1995=100)						
Nominal 2/	100.0	98.1	93.5	93.4	92.9	...
Real (relative RULC based) 2/	100.0	96.5	91.0	90.1	89.6	...
Public sector accounts 3/						
Revenue	46.6	47.3	47.0	46.5	46.9	46.3
Expenditure	50.8	48.9	48.2	47.3	47.2	46.2
General government balance	-4.2	-1.6	-1.2	-0.8	-0.4	0.1
Structural balance	-3.6	-1.0	-1.2	-1.3	-1.2	-1.0
Primary balance	0.5	2.9	3.1	3.0	3.3	3.2
Structural primary balance	1.0	3.5	3.1	2.4	2.4	2.1
General government gross debt	75.7	74.3	68.7	65.0	62.4	59.1

Sources: Ministry of Finance; Netherlands Bank; International Financial Statistics; and Fund staff calculations.

1/ Contribution to GDP growth.
2/ For 1999, average over the first six months.

years projected in the staff report, and potential growth of about 2½ percent. The slightly lower growth in 2000 is premised on a softening of consumer spending in response to an expected moderation of wealth effects and a deceleration of employment growth. Consumer price inflation is projected at 2.3 percent in both years, which represents a slight upward revision for 2000, due to greater demand pressures.

8. The extent of inflationary pressure underlying the revised projection remains difficult to assess, given the beneficial impact of recent structural policies on the functioning of labor and product markets. Nevertheless, the inflation risks to the projection are greater than before. A burst of wage inflation could sustain consumption-driven demand pressures, leading over time to higher price inflation and a deterioration in competitiveness followed by a downturn in economic activity. Similarly or concurrently, if house price increases do not abate, strong consumption growth would be expected to continue in the short term, though the risks of a sharp correction are also increased. Moreover, with capacity stretched, investment demand may be stronger than anticipated.

9. The revisions to the staff projection have important implications for the budget outlook, though the observations on the authorities' fiscal strategy noted in the staff report remain valid. With higher growth than assumed by the authorities this year and next, the staff expects a budget surplus of 0.1 percent of GDP in 2000, owing to higher tax revenues and lower social security outlays (Figure 2 and Table 2).[3] Thereafter, in the staff's view, the deficit is likely to increase again, since the staff expects gross expenditure not covered by the framework to remain constant in real terms in 1998–2002, as opposed to the authorities' assumption of an annual decline in real terms of 5.3 percent over the same period.

10. With the higher expected output and associated revenue windfall, the fiscal deficits in 2000–02 are now projected to be significantly lower than in the staff report. It is worth emphasizing, however, that this is the result of higher output levels rather than a tightening of the underlying fiscal position. Indeed, according to staff estimates—which are subject to considerable uncertainty—output has been above potential since 1998 and the upward revision in growth prospects, if they materialize, will aggravate this situation.[4] In these circumstances, the fall in the deficit will eventually be reversed when output returns to potential. This point is reflected in the staff's revised projections of the structural deficit, which account for the estimated effect of deviation in output from estimated potential. The structural deficit, on the staff's projection, is set to fall only slightly in 2000 and the primary structural balance indicator implies a positive fiscal stimulus. In view of the strong growth prospects, it would be prudent to avoid an expansionary fiscal impulse and err instead on the side of fiscal tightening.

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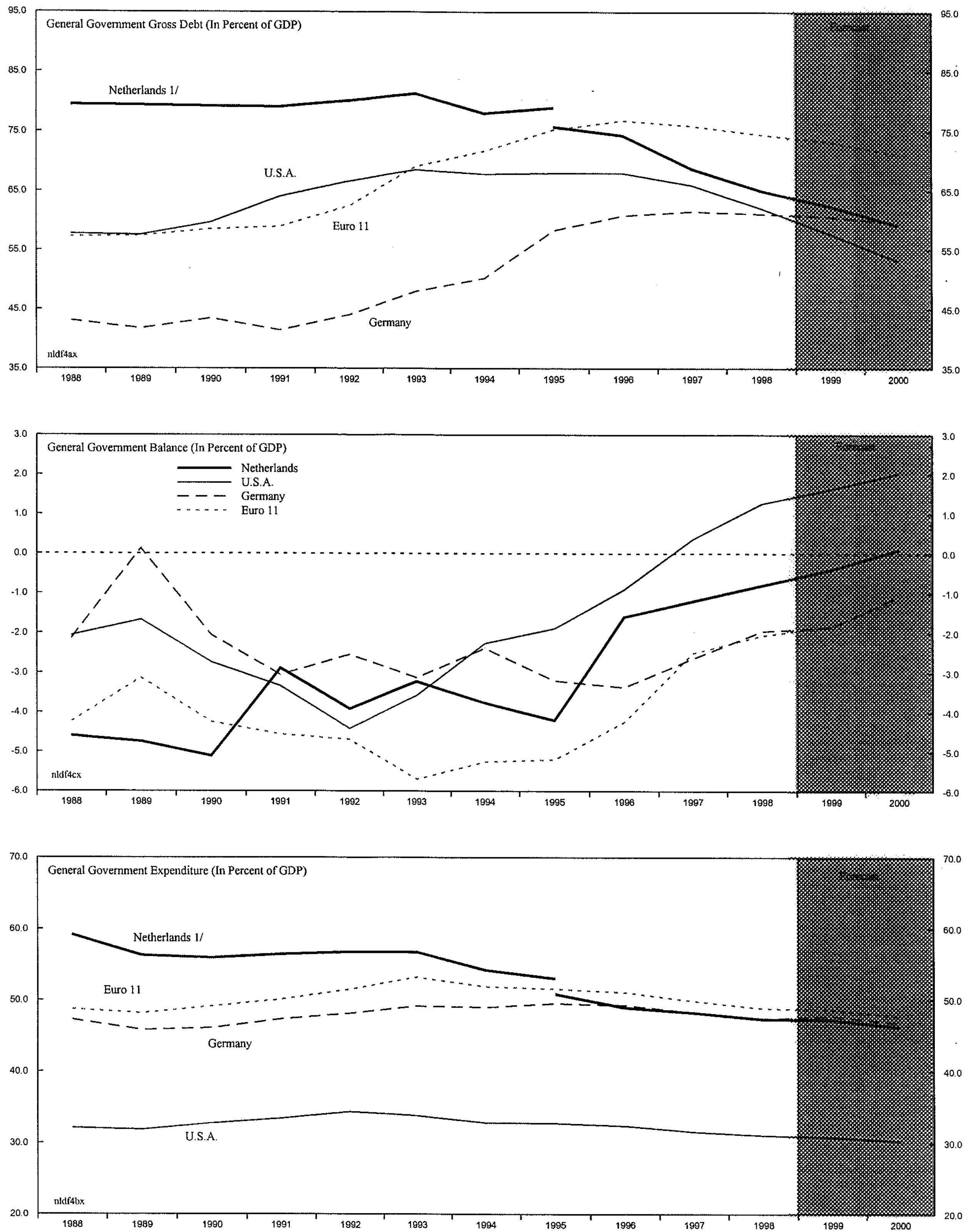
[3] The staff also estimates a lower deficit outcome for 1999.

[4] This point is separate from the issue of the national accounts revisions, which do not affect the staff's assessment of the cyclical position.

Figure 2. Netherlands: Fiscal Indicators



Source: IMF, World Economic Outlook.
1/ Break in series due to a revision in the national accounts.

Table 2. Netherlands: Three Fiscal Scenarios

(In percent of GDP)

	1996	1997	1998	1999	2000	2001	2002	Real Average Annual Growth Rate 1998-2002
Staff update of the authorities' cautious growth scenario 1/								
Revenue	48.7	49.2	48.1	48.1	48.2	46.3	45.6	0.7
Expenditure	50.7	50.1	49.0	49.2	49.1	47.7	46.7	0.9
Covered by framework (gross)	48.0	46.7	45.5	45.5	45.4	44.7	44.1	1.3
Covered by framework (net)	44.0	43.2	42.0	42.3	42.3	41.7	41.2	1.6
Other	2.7	3.3	3.5	3.7	3.7	3.0	2.6	-5.4
Deficit	-2.0	-0.9	-0.9	-1.1	-0.9	-1.4	-1.2	
Primary balance	2.7	3.6	3.1	2.7	2.4	1.7	1.8	
Structural primary balance	3.1	3.7	2.6	2.4	2.4	1.9	2.3	
Memorandum item								
Real GDP growth	3.1	3.6	3.8	2.3	2.0	2.0	2.0	
Staff projection 2/								
Revenue	48.7	49.2	48.1	48.1	48.1	46.4	45.8	1.2
Expenditure	50.7	50.1	49.0	48.9	48.6	47.5	46.6	1.2
Covered by framework (gross)	48.0	46.7	45.5	45.2	44.9	44.1	43.4	1.2
Covered by framework (net)	44.0	43.2	42.0	42.0	41.8	41.1	40.5	1.5
Other	2.7	3.3	3.5	3.7	3.6	3.4	3.2	0.2
Deficit	-2.0	-0.9	-0.9	-0.8	-0.5	-1.1	-0.8	
Primary balance	2.7	3.6	3.1	3.0	2.8	1.9	2.1	
Structural primary balance	3.1	3.7	2.6	2.5	2.3	1.5	1.8	
Memorandum item								
Real GDP growth	3.1	3.6	3.8	2.6	2.5	2.4	2.3	
Balanced budget scenario 3/								
Revenue	48.7	49.2	48.1	48.1	48.1	46.4	45.8	1.2
Expenditure	50.7	50.1	49.0	48.7	48.3	46.7	45.8	0.7
Covered by framework (gross)	48.0	46.7	45.5	45.0	44.7	43.3	42.6	0.8
Covered by framework (net)	44.0	43.2	42.0	41.8	41.6	40.3	39.7	1.0
Other	2.7	3.3	3.5	3.7	3.6	3.4	3.2	0.2
Deficit	-2.0	-0.9	-0.9	-0.6	-0.2	-0.3	0.0	
Primary balance	2.7	3.6	3.1	3.2	3.0	2.7	2.8	
Structural primary balance	3.1	3.7	2.6	2.7	2.6	2.3	2.5	
Memorandum item								
Real GDP growth	3.1	3.6	3.8	2.6	2.5	2.4	2.3	

Sources: Data provided by the authorities; and Fund staff projections.

1/ The authorities' cautious growth scenario, which assumed 3 percent growth in 1999, was updated to reflect the current official growth projection for 1999 and fiscal projections and measures for this year announced by the Ministry of Finance. Also, the authorities' scenario did not include separate data for 2000 and 2001.

2/ This scenario differs from the first scenario by assuming higher growth, higher gas prices, higher projected 1999 inflation (reducing real wage costs), and a higher growth rate of total gross expenditure relative to the growth of net expenditure covered by the expenditure framework.

3/ Relative to the second scenario, this one includes less growth of covered expenditure during 1999–2002, in order to achieve budget balance by 2002.

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700 19th Street, NW
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IMF Concludes Article IV Consultation with Kingdom of the Netherlands - Netherlands

On October 15, 1999, the Executive Board concluded the Article IV consultation with the Kingdom of the Netherlands—Netherlands.[1]

Background

The Netherlands posted a strong economic performance during the 1990s, based on sound macroeconomic policies and complementary and interlocking reforms to fiscal policy, social security, and labor and product markets. Robust real GDP growth was combined with strong job creation and falling unemployment, as well as increasing labor participation rates. After three years of above trend growth, activity is set to return to a more sustainable path in 1999 and 2000.

Economic activity remained strong in 1998, with real GDP expanding 3.8 percent. A slowdown that started mid-year (associated mainly with reduced foreign demand) was temporary, and growth picked up again towards the end of the year. Capacity utilization rates have fallen slightly since their peak in 1998, but tensions have appeared in segments of the labor market as the unemployment rate has continued to fall. Partly as a result, labor costs increases in manufacturing outpaced productivity gains for the first time in five years. Despite the tight labor market, however, consumer price inflation remained broadly unchanged, and indications are that wage demands have moderated somewhat. Competitiveness remained strong overall in 1998, although it declined somewhat vis-à-vis the euro area. Due to buoyant imports and a temporary slowdown in exports, the current account surplus fell to 5¼ percent of GDP.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

Fiscal developments proved better than expected, as the deficit fell to 0.8 percent of GDP in 1998, despite a small overrun in expenditures above the real ceilings set in the medium-term fiscal framework. Although revenues were buoyant due to strong consumption growth, tax cuts resulted in a deterioration of the underlying fiscal position and provided a fiscal stimulus. In the latest projections, the deficit for 1999 will fall to below ½ percent of GDP.

With the cyclical position of the economy more advanced than most of the euro area, **monetary conditions** may pose difficulties for Dutch macroeconomic management. Monetary aggregates have continued to increase strongly: growth in private-sector credit accelerated to over 16 percent in 1998, and although mortgage credit expansion slowed through most of 1998, it accelerated again towards the end of the year, with growth rates remaining above 15 percent. House prices and the stock market index continued to post sharp gains, even though the latter has moderated recently.

Structural reforms, which have underpinned medium-term growth in output and employment, were extended and deepened in 1998. To promote further the reintegration of the long-term unemployed, schemes for temporary public-sector and subsidized employment were expanded, progress was made in formulating proposals for creating a single gateway for those seeking benefits, and new laws providing better protection for temporary and part-time employees were prepared. Progress in product-market reform has been slower, although in 1998 a strengthened Competition Law was enacted and the utilities sector was further liberalized.

The outlook for the Dutch economy remains favorable. **GDP growth** is expected to decline only marginally to around 3 percent by 2000, reflecting some easing of domestic demand. With the global economy picking up steam, export demand has recovered in the course of 1999, setting the stage for an improvement in the net foreign balance in 2000. **Inflation** is projected at 2¼ percent in 1999, with the increase over 1998 mainly due to higher import prices, as a result of the weaker euro and higher oil prices. Inflation is not expected to decline in 2000, as demand pressures continue to build. In fact, the continued tightness in the labor market imparts a risk of putting upward pressure on wages and prices, eventually undermining profitability and competitiveness. A correction in housing prices could adversely affect consumption. On the other hand, high rates of capacity utilization together with a revival in export markets could stimulate investment more than expected.

Executive Board Assessment

Executive Directors commended the authorities for their sustained implementation of sound macroeconomic policies and comprehensive structural reforms. Directors noted that the mutually reinforcing effects of these policies and the broad consensus among social partners on key policy reforms had contributed to a prolonged economic expansion, accompanied by substantial job creation and a decline in the unemployment rate to one of the lowest in the EU. At the same time, firm expenditure restraint had permitted tax reductions to proceed along with fiscal consolidation, with favorable implications for public debt dynamics.

Directors agreed that the Dutch economy was likely to continue to grow at above trend rates in the near term, benefiting from recovery in world demand and high consumer confidence, and monetary conditions that from the perspective of the Dutch economy, are relatively easy. Under the present circumstances, most Directors considered that the authorities should closely monitor the possibility of intensifying inflationary pressures and sustain the momentum of their structural reforms in product, labor, and financial markets. Although wage inflation had not risen, labor markets had continued to tighten. Some Directors pointed to the rapid rise in real estate price and credit aggregates, especially mortgages, as evidence of possible incipient overheating. Other Directors noted, however, that inflation remained subdued, and the signs of possible overheating are difficult to assess; they considered that what the situation requires is vigilance.

Directors supported the authorities' approach of conducting fiscal policy within a medium-term framework with transparent rules. They agreed that by capping expenditure growth in real terms, the framework had contributed to tighter control over spending and facilitated fiscal consolidation in recent years. With strong growth and improved revenue prospects, most Directors encouraged the authorities to aim for a further improvement in the structural fiscal balance and to avoid any additional fiscal stimulus. They felt that further deficit reduction would be consistent with the short-term demand management requirements and the authorities' medium-term objectives. In particular, it would constitute a useful step toward dealing with the fiscal challenges associated with an aging population, by accelerating the reduction in the public debt-to-GDP ratio and allowing more room for the automatic stabilizers to operate. Directors supported the planned tax reforms and the accompanying reduction in the revenue-to-GDP ratio. They welcomed the objectives of broadening the tax base while shifting the tax burden from direct and indirect taxes, which will improve incentives. Some Directors also recommended that the large tax deductions for mortgage interest should be reviewed. Directors urged the authorities to resist pressures to move forward the tax reform scheduled for 2001.

Directors commended the authorities' progress in improving the functioning of the labor market. They agreed that the challenge now is to enhance the employment prospects of the unskilled, the old, and the partially disabled. They welcomed the various initiatives under way to provide financial incentives for workers to make the transition from welfare to work. Directors welcomed the institution of an earned income tax credit and urged the authorities to ensure that the credit is well targeted and sufficiently large to reduce the very high marginal tax rates. They also supported the authorities' plans to reform the social security administration and emphasized that sufficient, coordinated, and properly focused financial incentives would be key to the success of these reforms. Directors felt that with respect to older or partially disabled workers, the focus of attention should shift away from early retirement and income maintenance to improving job prospects. Directors welcomed the authorities' intention to keep the effectiveness of their social programs under review.

Noting that product market reforms had been less far reaching than in labor markets, Directors encouraged the authorities to press ahead to broaden the scope for such reforms, and to ensure that their initiatives are implemented in a timely manner.

Directors noted that recent developments in the financial sector had raised several important challenges for supervisors. In light of rapid growth in credit and strong housing price increases, they urged the authorities to monitor carefully the quality of loan portfolios and assess the financial system's vulnerability to macroeconomic shocks. Many Directors welcomed the establishment of the new Council of Financial Supervisors to increase cooperation among existing supervisory agencies ,while some suggested merging them into a single supervisory agency.

Directors reiterated their praise for the authorities' continued support for the principles of free international trade and their exemplary record in official development assistance, which had remained above the United Nations norm.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Netherlands: Selected Economic Indicators

	1995	1996	1997	1998	1999 1/
Real economy (change in percent)					
Real GDP	2.3	3.0	3.8	3.7	3.2
Domestic demand	2.4	2.8	3.5	4.3	3.7
CPI (year average)	2.0	2.1	2.2	2.0	2.3
Unemployment rate (in percent)	7.1	6.6	5.5	4.1	3.1
Gross national saving (percent of GDP)	24.6	26.5	27.6	27.3	27.5
Gross domestic investment (percent of GDP)	19.1	21.3	21.6	21.9	22.1
Public finance (percent of GDP)					
Central government balance	-3.8	-1.6	-2.2	-2.3	-1.9
General government balance	-4.2	-1.6	-1.2	-0.8	-0.4
General government debt	75.7	74.3	68.7	65.0	62.4
Money and credit (end of year, percent change)					
Domestic credit	9.7	10.0	13.1	16.2	...
M3	4.4	5.8	7.4	9.6	...
Interest rates (percent)					
Money market 2/ 3/	4.2	2.9	3.1	3.2	2.9
Government bond yield 2/	7.2	6.5	5.8	4.9	4.4
Balance of payments (percent of GDP) 4/					
Trade balance	5.5	5.3	4.9	4.4	4.4
Current account	6.0	5.6	5.9	5.3	5.3
Official reserves excluding gold (US$ billion)	33.7	26.8	24.9	22.4	...
Reserve cover (months of imports of GNFS)	2.2	1.7	1.7	1.5	...
Exchange rate					
Exchange rate regime		Member of euro area 5/			
Nominal effective rate (1990=100) 2/	100.0	98.1	93.5	93.4	92.9
Real effective rate (1990=100) 2/ 6/	100.0	96.3	90.6	90.1	89.0

Sources: International Financial Statistics; information provided by the Dutch authorities; and IMF staff estimates.

1/ IMF staff projections.
2/ For 1999, average of first six months.
3/ Refers to Euro rate beginning in 1999.
4/ Transaction basis.
5/ While the guilder to euro rate was irrevocably fixed on January 1, 1999, the external exchange rate of the euro is market determined. The guilder will remain in circulation until 2002, when euro banknotes and coins will be issued.
6/ Based on relative normalized unit labor costs in manufacturing.