July 2006
IMF Country Report No. 06/283

Kingdom of the Netherlands—Netherlands: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Kingdom of the Netherlands—Netherlands, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 9, 2006, with the officials of the Kingdom of the Netherlands—Netherlands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 29, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of July 26, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 26, 2006 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

KINGDOM OF THE NETHERLANDS—NETHERLANDS

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives
for the 2006 Consultation with the Netherlands

Approved by Juha Kähkönen and Michael T. Hadjimichael

June 29, 2006

The 2006 Article IV discussions were held in Amsterdam and The Hague during April 27-May 9, 2006. The staff team comprised Messrs. Feldman (head), Daal, and Nadal De Simone, and Ms. Yelten (all EUR). It met with the minister of finance, the governor and other representatives of the central bank (DNB) and financial supervision, senior staff of several government ministries and agencies, including the Bureau for Economic Policy Analysis (CPB), the Competition Authority (NMa), and the Social and Economic Council (SER), representatives of labor unions and employer organizations, the financial sector, including banks and pension funds, and academics.

Parliamentary elections are due in May 2007.

The Netherlands has accepted the obligations of Article VIII (Appendix I). It subscribes to the SDDS, and economic data are adequate to conduct effective surveillance (Appendix II).

The authorities released the mission's concluding statement, organized a press conference at the end of the mission, and agreed to the publication of the staff report.

Contents Page

Main Websites for Dutch Data

Statistics Netherlands (CBS).. http://www.cbs.nl

De Nederlandsche Bank (DNB).. http://www.dnb.nl

Ministry of Finance.. http://www.minfin.nl

Bureau for Economic Policy Analysis (CPB).. http://www.cpb.nl

Additional information on Dutch economic statistics can be found at the Fund's SDDS website http://dsbb.imf.org/Applications/web/sddscountrycategorylist/?strcode=NLD

and at the Statistics Netherlands Data Portal:
http://statline.cbs.nl/StatWeb/Start.asp?lp=Search/Search&LA=EN&DM=SLEN.

EXECUTIVE SUMMARY

Background: After a period of slow or negative growth, a recovery is taking hold, with growth this year and next likely to be well above potential of about 2 percent. Notwithstanding the lackluster economic activity of the recent past, the general government accounts were still brought close to balance in 2005—the result of significant underlying structural fiscal adjustment of over 2 percentage points of GDP—after breaching the Maastricht deficit ceiling just two years earlier. While much has been accomplished on the structural front—such as reform of health care, disability, and financial supervision, and by strengthening the administration of social benefits by local authorities—the merits of doing more to buttress labor participation and raise productivity were recognized. Meanwhile, the financial sector has been performing well overall—though issues have arisen with regard to rapid mortgage credit growth and deteriorating credit quality and pension supervision.

Policy discussions focused on the following areas:

- ***Fiscal policy.*** In light of fiscal requirements in the medium term and with the upturn in train, staff urged the authorities to safeguard the structural fiscal adjustment of the past two years by pursuing at least a neutral fiscal stance in 2006 and 2007. While preliminary plans suggested that fiscal policy would turn somewhat expansionary in 2007, the authorities also recognized the benefits of directing any budgetary overperformance to deficit reduction. Looking further ahead, population aging requires a combination of further fiscal adjustment during the next government's term (2008–11) and other sustainability-enhancing measures. The authorities are well aware of the policy requirements for dealing with aging, based on the CPB's study on the topic; difficult political and economic decisions nevertheless lie ahead.

- ***Financial sector.*** Staff supported efforts to strengthen the code of conduct for mortgage lending. There is, however, a need to ensure that compliance is monitored and that appropriate action is taken if violations were to occur. A new Financial Supervision Act is expected to come into force at the start of 2007. It clarifies and strengthens the supervisory framework and therefore contributes to generally strong supervision continuing to get better. One important issue is the appropriate length of the recovery period if a pension fund falls below the minimum coverage ratio. Staff supported the supervisors in arguing for an ex ante period of one year but also emphasized that escape clauses are indispensable to ensure needed flexibility. Though the authorities are not necessarily committed to a policy move, all agreed on the importance of ongoing research on phasing out the tax deduction for mortgage interest payments while minimizing disruptive effects.

- ***Structural reforms.*** While recognizing that several, not always easy, measures have been taken to raise labor participation, additional measures were discussed related, for example, to inactivity traps, the minimum wage, and unemployment benefits. Several avenues were also identified to boost productivity growth.

I. BACKGROUND

1. **The Netherlands is coming out of a period of slow or negative economic growth** (Figure 1). Average annual growth in 2001–03 was ½ percent. This was well below the euro area average and the slowest rate in the Netherlands in any three-year period since the beginning of the 1980s. Deteriorating external competitiveness, combined with weak foreign demand, restrained exports and growth overall (Figure 2 and Text Table).

The Netherlands: Exports and Overall Growth, 2000–05
(In percent change in real terms)

	2000	2001	2002	2003	2004	2005
Export market 1/	10.9	2.2	1.3	3.8	7.5	5.5
Export of goods and nonfactor services	11.3	1.6	0.9	2.0	8.5	5.9
GDP	3.5	1.4	0.1	-0.1	1.7	1.1
Memorandum item:						
Euro area GDP	3.8	1.9	0.9	0.7	2.1	1.3

Sources: Dutch official publications; and IMF staff estimates.

1/ WEO data on the real imports of goods and services by trading partners.

2. **A hesitant recovery started to take hold during 2005.** Employment and consumption through end-2005 were weak compared with previous expansions (Figure 3), with a recovery at the start of 2004 failing to gather steam and growth below the euro area. But with foreign demand more robust, exports, though tempered by the lagged effects of real exchange rate appreciation, drove a mild recovery. Perhaps most important, the growth of private consumption, investment, and GDP gained traction in the second half of 2005 (Figure 4). Business and consumer confidence also strengthened. Employment in 2005 recorded a more sustained rise than at any time since 2001.

3. **Inflation remained in check, with little pressure from wages as the social partners sought to boost external competitiveness** (Table 1). Year-on-year CPI inflation averaged 1.6 percent in January–February 2006 (1.7 percent in January–May, using data available after the mission). Wage growth has been subdued: the economy-wide wage moderation agreement for 2004–05 explicitly targeted low wage growth with competitiveness in mind. Recent economic performance, including relatively rapid export growth in relation to the export market, suggests that competitiveness is not a particular threat to sustaining economic recovery, a point reinforced by the current account surplus.

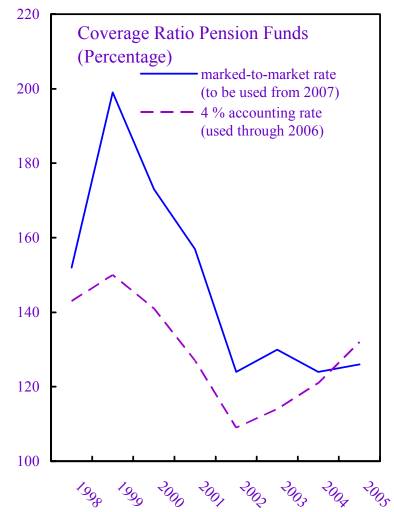
4. **After breaching the Maastricht deficit ceiling in 2003, the authorities achieved considerable fiscal consolidation** (Table 2). The general government deficit narrowed to 0.3 percent of GDP in 2005 from 3.2 percent in 2003, reflecting underlying structural adjustment of 2½ percentage points of GDP. Contributing expenditure measures included

a virtual freeze on public wages, reduced coverage of public health insurance, changes in disability and other social benefits, adjustments by local governments, and other smaller measures. In addition, revenue measures were implemented, including an increase in excise duties and contribution rates for health care and disability insurance, and natural gas revenues increased (together contributing ½ percentage point of GDP to structural adjustment).

5. **Monetary conditions started tightening in late 2001, before easing last year** (Figure 5). With the ECB having lowered interest rates through virtually the entire period since late 2000, the tightening was essentially due to the real effective exchange rate effect, with higher real interest rates also contributing as inflation fell in the Netherlands. Most recently, a moderate depreciation of the real effective exchange rate has reversed about half of the monetary tightening.

6. **The financial sector is generally sound but colored by developments largely related to real estate** (Tables 3–7).

- Banks' capital adequacy remains strong. Other indicators, such as return on equity, noninterest expenses to gross income, and nonperforming loans for large banks, have been improving. Pension funds are, on average, close to their required coverage ratios that come into effect in January 2007, with only one fund reportedly below the minimum ratio of 105 percent (Text Figure).[1] In the insurance sector, earlier stress tests performed for the FSSA[2] indicated that shocks, except the most extreme ones, could be absorbed. If anything, the situation has recently

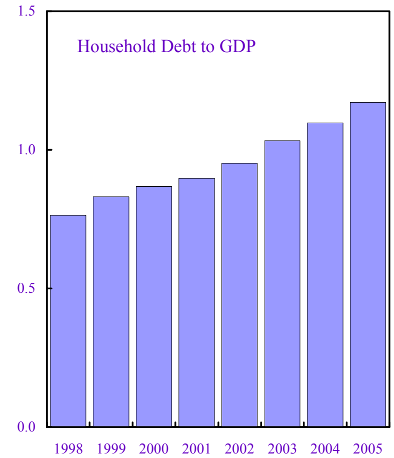


Source: DNB.

[1] Under the new requirements, pension funds will be required to achieve a coverage ratio (i.e., the ratio of the present value of assets over liabilities, based on marked-to-market calculations) implied by a 97½ percent probability of meeting their obligations. In cases where the indexation of benefits to inflation/wages is not guaranteed, this implies a coverage ratio, on average, of 130 percent, to be met within a period agreed on with the supervisor not exceeding 15 years (the required coverage ratio would be higher if funds provided guarantees). However, if the ratio falls below 105 percent, it has to be restored within a given time period (likely between one and three years, but this is being discussed in parliament), except at times of severe macroeconomic downturns or systemic risk.

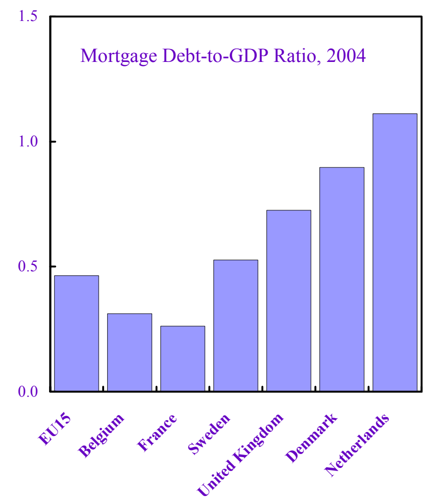
[2] *The Kingdom of the Netherlands—Netherlands: Financial System Stability Assessment*, IMF Country Report No. 04/312, September 2004.

improved, partly reflecting higher equity prices than when the stress tests were performed. Moreover, while life insurance profitability has been adversely affected by the low long-term interest rate environment, prospects are improving with expectations of rising interest rates.[3]

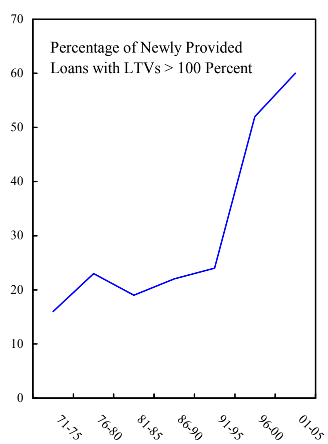


Source: DNB.

- Despite tight interest rate margins on mortgages, reflecting heavy competition between banks for borrowers, continued demand has held up profits. However, credit quality has reportedly deteriorated with the continued expansion of mortgages. Households have also become more sensitive to interest rate changes: the ratio of mortgage debt-to-GDP is high at more than 100 percent and increasing (Text Figures); reports by the DNB indicate that the proportion of mortgages subject to an interest rate adjustment within two years increased from 21 percent in 2003 to 31 percent in 2005, and the percentage of newly provided loans with loan-to-value ratios (LTVs) exceeding 100 percent has also been increasing significantly (Text Figure). In addition, a small bank failed in December 2005, without systemic repercussions.



Source: European Mortgage Federation.



Source: DNB.

[3] While too early to judge the financial effects, the introduction of a new health care system at the start of 2006 is prompting significant changes in the health insurance sector and careful monitoring by the authorities. Basically, in the new system, insurance is provided by private health funds—though the funds are obliged to accept all customers and offer a standard insurance package at a standard premium applicable to all policyholders, defined by law. The change in the health insurance system will lead to a shift in financing run through the fiscal accounts and, relatedly, a shift from private to public consumption. A system of risk equalization makes the acceptance obligation possible. The funds can provide themselves or negotiate the purchase of medical services, offer additional packages, and adjust premiums, introducing competition into the system.

II. Report on Policy Discussions

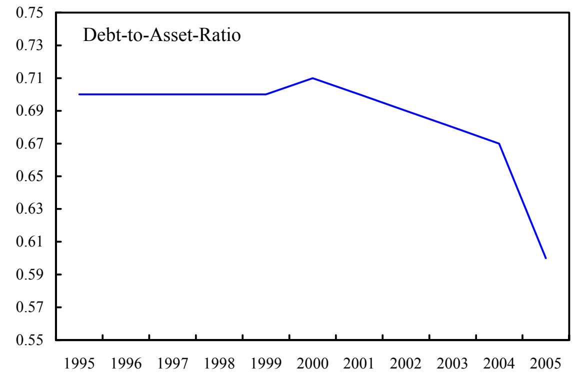
7. **In addition to the near-term outlook, the discussions focused on key measures to ensure fiscal sustainability with population aging, while building a solid foundation for sustaining growth and safeguarding financial stability.** The discussions benefited from CPB studies on related issues. The discussions also drew on staff's Selected Issues papers (on potential growth and productivity, housing, and high volatility in fiscal revenues), and past analytical work.[4] Box 1 summarizes the implementation of previous IMF recommendations.

> Box 1. The Netherlands: Past Fund Policy Recommendations and Implementation
>
> **Fiscal Policy:** Past recommendations included structural fiscal adjustment of at least ½ percentage point of GDP per year during the government's term, taken upfront in view of the election cycle, closer coordination between the central government and the local governments, and refinements to enhance the transparency of the fiscal framework. Fiscal consolidation of over 2 percentage points of GDP, in structural terms, was already achieved in 2004–05. The authorities have improved coordination between various levels of government. Any decisions on the fiscal framework would not be taken before a new coalition agreement, although preparatory analysis is being done.
>
> **Labor Market Reform:** Broadly in line with Fund advice, but sometimes to a lesser extent than recommended, unemployment benefits were tightened; fiscal incentives for early retirement abolished; inactivity traps gradually reduced; disability revamped; and reform of employment protection legislation (EPL) is being discussed. Recommendations not yet taken on board include adjusting the minimum wage and taking into account life expectancy in determining the retirement age. Calls for greater wage differentiation have not resulted in notable changes.
>
> **Product Market Reform:** The Fund has generally supported the authorities' liberalization program, including the unbundling of the energy market, the reduction in required licenses and permits, and, more generally, the efforts to increase competition. The powers of the competition authority have been gradually and continually increased. The government is well set to achieve its goal of a 25 percent reduction in the administrative burden by 2007.
>
> **Financial Sector:** The authorities have made significant progress in implementing the recommendations from the 2004 Financial Sector Stability Assessment (FSSA).

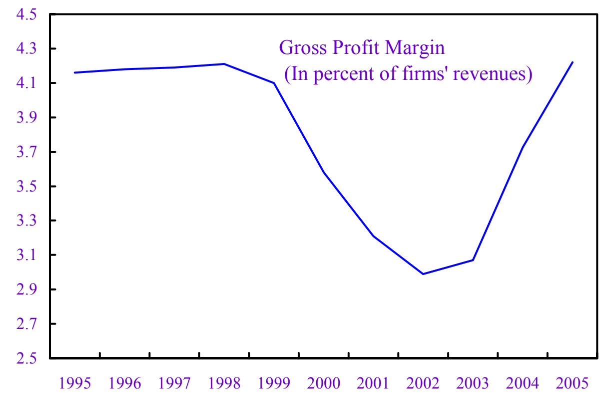
[4] Summarized in Appendix III.

A. Near-Term Outlook

8. **There was consensus on projecting a pickup in growth to well above potential rates in 2006 and 2007.** Growing employment bodes well for private consumption. Further improvements in competitiveness supported by wage moderation are also expected to help exports in circumstances in which foreign demand is expected to be strong. Meanwhile, stronger corporate balance sheets (Text Figures) alongside export growth support higher investment. In all, the official growth forecast is 2¾ percent in 2006 and 3 percent in 2007. With higher projected oil prices (in line with WEO assumptions), staff projected lower growth: 2.6 percent in 2006 and 2.8 percent in 2007 (higher than euro area growth). While not an immediate issue, staff stressed, and the authorities concurred, that continued wage moderation to support external competitiveness would allow the Netherlands to take full advantage of the global upturn—an issue that could take on increasing importance as the recovery gathers force.



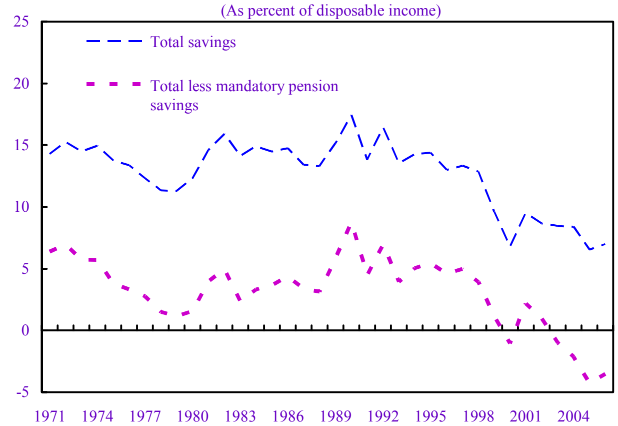
Source: DNB.



Source: DNB.

9. **Both upside and downside risks were apparent.** Further oil price hikes, a significant appreciation of the euro, and slower-than-expected growth of trading partners could dampen the upswing (including in the euro area, a major destination for Dutch exports, where the projected strength of the recovery is not yet assured). Drawing on its empirical work, staff also pointed to downside risks from a possible interest rate-led house price decline.[5] However, most officials, appealing to supply constraints, felt there was little risk of house prices falling significantly. There was also some concern that a bounce-back in household saving might hold back consumption (Text Figure). All agreed, in any event,

Household Savings, 1971-2005
(As percent of disposable income)



Source: CPB.

[5] The accompanying Selected Issues paper on housing, among other things, updates previous work on the determinants of house prices and continues to find a high sensitivity to interest rate changes.

that private consumption was also subject to considerable upside potential in the face of a strengthening economy. Indeed, officials pointed to above-budgeted revenues in the first quarter as an early indication of the upside materializing.[6]

B. Fiscal Policy

10. **The recent fiscal consolidation is in accord with economic requirements.** With an eye to contributing to fiscal sustainability and resilience to population aging, staff had recommended cumulative structural fiscal adjustment of at least 2 percentage points of GDP during the government's term (2004–07)—an amount already achieved in 2004–05 (¶4). While such a tightening may not have been ideal in the face of some weakness in economic activity, the risks were judged acceptable. The marked deterioration in the public finances during 2000–03 contributed to declining confidence. Though difficult to quantify, subsequent fiscal consolidation likely helped reverse this, especially when consolidation was needed to prepare for aging. Moreover, with the impact on activity probably moderate in a small open economy, and benefits because of aging, the authorities and staff concurred that the policy was sensible. Staff also emphasized the merits of upfront adjustment in light of the election cycle.

11. **The fiscal stance for the remainder of the government's term may turn somewhat expansionary.** The budget implies about a neutral fiscal stance in 2006. But preliminary plans suggested that fiscal policy—reflecting business-related tax cuts and various expenditures on economic structure and security, and to raise the purchasing power of lower income groups—would turn somewhat expansionary in 2007 (deteriorating structurally by 0.3 percentage point of GDP according to staff estimates). In light of longer-term fiscal requirements (¶13) and with the upturn in train, staff urged the authorities to pursue at least a neutral stance. At a minimum, staff urged that any revenue overperformance or below-budget expenditures outturns for cyclical reasons go to deficit reduction—an approach the authorities already had in mind.

12. **The authorities are well aware of the policy requirements for dealing with population aging.** In the CPB's benchmark analysis, achieving fiscal sustainability requires either a structural general government surplus of 3 percent of GDP by 2011 or other sustainability-enhancing measures to compensate in present value terms for any shortfalls from this. Appendix IV summarizes the CPB's work, which staff commended, and illustrates debt dynamics under different scenarios.

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[6] Quarter-on-quarter GDP growth, released after the mission, was weaker-than-expected in the first quarter of 2006 (0.2 percent). However, this reflected a drop in investment (which tends to be volatile on a quarterly basis) and inventories. Meanwhile, exports were robust and private consumption above expectations. Thus, on balance, these data are seen as broadly in line with staff's full-year GDP projections.

● The discussions revealed a sense that any new government, because of political economy considerations, could encounter difficulties in achieving a fiscal surplus of more than 1 percent of GDP by the normal end of its four-year term (2011). Staff estimated that achieving a surplus of this size in 2011 would represent structural adjustment of about 1¼ percentage point of GDP (assuming a closed output gap by then). Other sustainability-enhancing measures, equivalent in present value terms to about 2 percentage points of GDP, would still be needed to close the remaining sustainability gap. One of various options included in the CPB study is to increase the retirement age by two years, which would reduce the sustainability gap by ½ percentage point of GDP. Staff supported this measure, arguing that changes in life expectancy should be taken into account in determining the official retirement age.

● While difficult decisions lie ahead, staff suggested some guiding principles for the period through the next government. First, in view of the size of remaining measures even when achieving a fiscal surplus of 1 percent of GDP by 2011, the next government should continue fiscal adjustment. Aiming for a 1 percent surplus or more makes sense: this would represent a significant fiscal adjustment in structural terms and take advantage of the favorable environment provided by the economic upturn. In addition, as noted by some officials and staff, this seems feasible in light of the Scandinavian experience. Second, to the extent possible, it is better to identify and implement upfront the other measures needed to close the sustainability gap. This reduces the risk of the size of the problem growing and the risk of reducing intergenerational equity,[7] while also adding to confidence that aging is being dealt with. Third, risks are asymmetrical in the sense that the sensitivity analysis in the CPB study ascribes a greater weight to needing a larger structural surplus than 3 percent of GDP by 2011 than to a smaller one. This only accentuates the importance of upfront action. Finally, any budgetary overperformance in 2007 should be saved and used by the next government as an opportunity to pursue more ambitious fiscal targets, thus applying the targeted adjustment it intends to pursue to a better-than-budgeted base.

13. **An official working group is contemplating a fiscal strategy.**

● This group prepares recommendations for the next government on the fiscal framework and fiscal policy generally.[8] It is too early to tell what its recommendations will be, as it started its deliberations only a few months before the Fund mission and the sense was conveyed to the mission that views on various issues were not uniform. In any event,

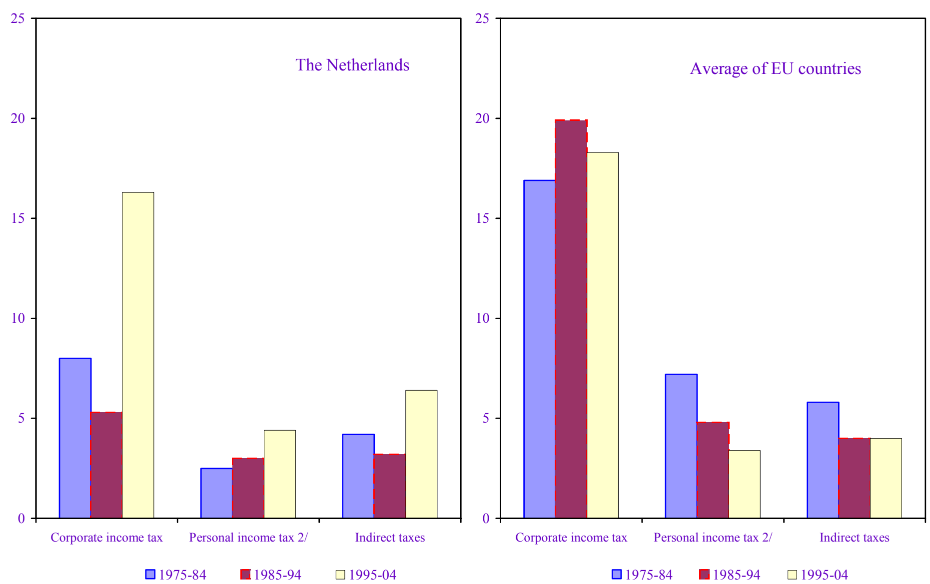
[7] See Appendix IV, paragraph 3.

[8] This group (called the Study Group on the Budget Margin) comprises representatives from various government ministries and the central bank, is formed and starts its work well before a new government comes into power, and has become a regular feature of Dutch fiscal policy.

officials, both in the working group and outside, were broadly supportive of the guiding principles mentioned above.

- The working group, and the finance ministry generally, welcomed the findings of a recent fiscal ROSC.[9] It found that the Netherlands meets or exceeds the good-practice standards against each of the four general principles of the fiscal transparency code. The roles and responsibilities of and within government are clearly defined; the system of fiscal management is open and well understood, with a fiscal framework based on a stable and well-defined set of expenditure rules; the budget and accounts documents are of a high standard and provide comprehensive and timely information on government activity; and the CPB's independent and central role provides a best-practice example of separating the political and technical elements of macroeconomic policy. Nevertheless, with the volatility of tax revenues having increased in recent years, forecasting tax revenues has become more difficult, adding a degree of uncertainty to budgetary policy and the operation of the fiscal framework (Text Figure).[10]

Coefficient of Variation of Tax Revenues
(As share of GDP) 1/



Source: IMF staff calculations using OECD Economic Outlook 78.

1/ Coefficient of variation is defined as the standard deviation relative to the mean.
2/ Including social contributions.

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[9] *Kingdom of the Netherlands—Netherlands: Report on the Observance of Standards and Codes—Fiscal Transparency Module, and the Aide-Mémoire Regarding the Fiscal Framework*, IMF Country Report No. 06/124, March 2006.

[10] See details in an accompanying Selected Issues paper. Business cycle fluctuations, corporate location decisions, and the tax deductibility of changing pension contributions appear to have been contributing factors.

● The ROSC made suggestions for refinements to the fiscal framework. These are summarized in Box 2 and are under consideration by the working group. There were indications that recommendation (1) would be supported, that the role of the FES in (3) would be reexamined, that ambitious fiscal targets would render (6) less important, and that (7) made sense. There was less of a tendency to support (2), to avoid making too many changes, and to incur the resource costs that (5) could entail when the framework was already working well. Tax expenditures in (4) could also be given a more prominent role, but the authorities stressed that these were documented in the material prepared for the budget.

Box 2. The Netherlands: ROSC Recommendations to Strengthen the Fiscal Framework

Key recommendations include:

(1) reporting, with respect to the expenditure ceilings, gross expenditures and nontax revenues separately, in contrast to the current practice of reporting just net expenditure;

(2) including only that part of nontax revenues in the net expenditure ceilings whose inclusion provides incentives for line ministries to collect resources to fund part of their spending that is not funded by budgetary resources;

(3) reexamining the budgetary fund based on gas revenues (FES): while maintaining a separate fund, integrate its operations better into the expenditure ceilings and overall fiscal framework;

(4) formally connecting tax expenditures to the fiscal framework, possibly by setting explicit ceilings for tax expenditures;

(5) more clearly reconciling the reporting on the budget and performance relative to the expenditure ceilings with national accounts standards, with a view to improving monitoring;

(6) to help provide greater room for maneuver for the automatic stabilizers to play and help reduce the likelihood of procyclical policies to remain within the Maastricht deficit ceiling, incorporating somewhat larger buffers in the fiscal framework (through lowering what the authorities call the “signal value,” which triggers corrective measures, and erring on the side of a more ambitious target for the structural balance at the end of a new government’s term); and

(7) enhancing flexibility by allowing tax changes to be phased in differently than planned or permitting offsetting measures, to avoid procyclicality if cyclical conditions turn out differently than initially anticipated.

C. The Financial Sector

14. **The authorities continue to strive to make strong financial supervision even better.** A new Financial Supervision Act, which clarifies and strengthens the framework for financial sector supervision and sets out the requirements that financial services providers must meet, is scheduled to come into force at the start of 2007. While this was a year later than initially planned, the authorities explained that the delay was because it took more time

than expected to prepare the necessary legislation and all the details associated with it. Within the DNB, the Financial Stability Division has started coordinating a new round of stress tests, involving the private sector, and officials felt the Division was contributing to a better overarching view of financial stability issues (including through *The Overview of Financial Stability,* published since December 2004). More broadly, continued efforts were being made to strengthen the risk orientation of supervision, in which greater supervisory resources would be devoted to those institutions having higher risk profiles. With the creation of integrated financial supervision, which has led to an improvement in the overall quality of supervision, this applies to all supervised sectors, comprising the different-sized banks, pension and health funds, and insurance. All this progress has occurred against the conclusion of the 2004 FSSA that the financial sector was already well supervised.

15. **Continual progress is being made on virtually all of the key FSSA recommendations** (Text Table). Of note, the tax deductibility of mortgage interest payments, almost a tabooed subject politically in the past, is now being discussed actively. The authorities do not see strong advantages in prefunding deposit insurance, given the dominance and deposit size of large banks. They explained that they are doubling coverage to €40,000, retroactively after the small bank failure and to move more in line with other European countries. They would like to introduce self coverage for some proportion of deposits over €20,000 to limit moral hazard.

16. **The financial vulnerabilities that have arisen could adversely affect the economy although there is no particular threat to overall financial stability.** The tax deductibility of mortgage interest payments and innovations in mortgage financing have strongly encouraged a rapid run-up of debt. This is particularly evident in an international context (¶6) and has occurred while other indicators, such as high LTVs and increasing household sensitivity to interest rate changes, also raise concerns. An oft-made counter-argument was that these indicators ignore the corresponding assets of households. Staff stressed, however, that house prices seem sensitive to interest rates and that borrowers could therefore be hurt significantly should interest rates rise substantially, both through a fall in asset values and higher interest payments on their mortgages. Indeed, the authorities, like staff, were well aware that newcomers to the market without financial buffers were particularly susceptible.

Netherlands: Status of Implementation of Key FSSA Recommendations

Key FSSA Recommendations	Actions Taken
Spell out clearly the role of the minister of finance, as applicable in those few areas where autonomy is not fully delegated to the supervisor.	Starting in 2004, the approval of the minister of finance (MoF) is only needed if one of the five largest banks or insurers takes a participation in another. The new Financial Supervision Act (FSA), to be enacted on January 1, 2007, defines the role of the MoF in those areas where autonomy is not fully delegated to the supervisor. The minister can revoke autonomy of the supervisor in special situations; for non-EU countries, the minister has to determine that their supervisory policies and practices sufficiently promote the objectives of the FSA, otherwise the supervisor cannot give a financial institution from those countries a permit to open a branch; and the minister has the exclusive power to grant persons and legal bodies the necessary permits, licenses, and exemptions to establish a financial market.
Ensure that the Authority for Financial Markets has the power to cooperate with securities supervisors internationally even when there is no “domestic interest.”	In the FSA, to be enacted on January 1, 2007.
Continue to work with cross-border counterparts to further improve securities settlement arrangements.	Improvements being made through promoting the use of delivery of securities against payment and supporting Euroclear's single settlement platform. The market infrastructure part of the FSA is expected to come into effect on January 1, 2008.
Ensure that the new pension supervisory arrangements allow sufficient flexibility in the specified time frame for making up shortfalls in the coverage ratio to prevent procyclical effects, but without allowing unduly prolonged adjustment.	Forthcoming (see paragraph 20).
Continue the development of the framework for dealing with crisis situations both through (i) further work with other supervisors internationally; and (ii) completion of the review of the domestic deposit guarantee scheme.	(i) Bilateral discussions and coordination at the EU level. In addition, after continued discussions, the DNB, the Belgian central bank, and the Belgian banking, finance, and insurance supervisor signed in May 2006 a memorandum of understanding on crisis management in order to further enhance cooperation. This pertains especially to those financial institutions that have substantial interests in both countries. (ii) Completed, though the authorities opted for keeping their ex-post scheme rather than implementing a prefunding scheme (see paragraph 15).
Continue the development of macroprudential surveillance to help strengthen the early identification of risks	The DNB established a new financial stability division (see paragraph 14) and improved its models and indicators, including by coordinating a new round of stress testing, developing an analytical framework for financial stability, and

and vulnerabilities.	producing financial stability reports bi-annually since December 2004.
Over the medium term, phase out tax deductibility of mortgage interest, avoiding disruptive effects.	Ways to phase out tax deductibility while avoiding disruptive effects are being discussed actively in policy circles (see paragraph 18). The measures taken so far, listed below, are seen as having only a small impact. Since 2001, the interest payments on mortgage loans used for consumption and second homes have been excluded from tax deductibility. Starting in 2004, with a view to preventing the use of "surplus value" on a first house for consumption, the authorities tightened eligibility requirements for the mortgage interest tax deduction. As of January 1, 2005, fiscal incentives for paying off mortgages were strengthened.
In addition, there were a number of secondary FSSA recommendation aimed at strengthening supervision and in the context of AML/CFT	Examples of some additional actions taken follow. The FSA makes a clear distinction between prudential supervision, exercised by the DNB, and conduct of business supervision, exercised by AFM (Authority for Financial Markets, in the finance ministry). In the European context of supervisory disclosure, the Recast Directive (2000/12/EC) includes a section that covers the FSSA recommendation on publishing more information about policies and procedures. In addition, another directive, on reinsurance (2005/68/EC), to be implemented by December 10, 2007, serves to meet another FSSA recommendation, namely that the DNB will supervise reinsurers that are not supervised elsewhere in the EU/EEA. With respect to AML/CFT, customer identification has been strengthened through the regulation on customer due diligence at credit institutions and insurance companies, which came into force on January 1, 2004. The amended Disclosure of Unusual Transaction (Services) Act, which entered into force in May 2006, puts additional obligations on the disclosure of information.

But the authorities, noting supply constraints, were, by and large, less concerned than staff about the risks from a drop in house prices at the current conjuncture.[11]

17. **Worries voiced by the financial supervisors (including in DNB publications) about a deterioration in credit quality in the face of rapid growth of mortgage lending prompted a review of the code of conduct for mortgage lending.** As a result of this review, the code has been strengthened, notably by tightening lending guidelines with respect to judging affordability and informing consumers about risks. Some felt it could also be useful to add an explicit LTV test to the guidelines, because households would carry a large risk of residual debt if house prices fell. But others felt that affordability tests sufficiently

[11] Empirical work at the CPB also suggested that house price adjustments were more sluggish on the downside than upside.

covered the risks to consumers and banks and that an LTV test would provide no value added as macroeconomic risks were not part of the prudential supervision framework.[12] In any event, at this stage, it is not yet clear how the code will be monitored and enforced, though the subject is under active discussion.

18. **With the subject now on the policy radar screen, public debate about policy options for phasing out the tax deduction for mortgage interest payments is intensifying.** A key question—under early discussion by the authorities so they did not have a uniform view—was whether house prices would drop quickly, even if tax deductibility were phased out over a long period of time. The authorities were quite interested in the Selected Issues paper on house prices and policy options for phasing out tax deductibility, which staff hoped could usefully contribute to the debate. The paper suggests that a quick drop in house prices need not necessarily occur if the phase-out takes place over a long period of time. During the discussions, the advantages for the budget of eliminating deductibility were noted, including by providing room for tax cuts, which could also lessen the downward impact on demand and stimulate labor participation. More generally, while not a focus of the mission, severe distortions in the housing market were apparent. This prompted staff to encourage the authorities to study whether other possible improvements could be made to the functioning of the housing market, including by examining whether rent controls and administrative allocation mechanisms appropriately serve their intended social and economic purpose.

19. **Although a bank failed, there was general satisfaction that it had no macroeconomic implications.** While clearly unwelcome, the event was also seen as an opportunity to learn from a real world experience—for example, from the tensions that arose between the requirement to disclose price-sensitive information (under the Market Abuse Act) and the aim to guard over the solvency and liquidity of the institution using emergency regulations (under the Banking Act). These tensions reflect the fact that the release of information pertaining to the implementation of emergency regulations can have counterproductive effects on a bank's viability. The authorities explained that they await the report from "the trustees of the bankruptcy," with a view to seeing if lessons on other issues can be drawn.

20. **Within the framework for pension supervision in the new Financial Supervision Act, one key aspect—the appropriate recovery period when a pension fund's coverage ratio falls below the minimum requirement of 105 percent—is still under discussion.** One consideration is to avoid unduly punishing pension holders, for example because of having to take actions in the face of temporarily unfavorable market conditions. This has to be balanced against the need of ensuring discipline. It was agreed that the time period

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[12] Imposing direct restrictions on LTVs is not common in industrial countries. In addition, the excess of a loan over 75 percent of the liquidation value of the property has a 100 percent risk weighting in calculating required capital.

specified should ensure that corrective actions by a pension fund are not unduly postponed. Intervention would also have to be sufficiently stringent that the threat of it would itself provide a strong incentive to avoid it. In addition, it was noted that pension funds are not subject to the same market discipline as banks in the sense that individuals have no choice on the pension fund to which they contribute. In all, these considerations were generally taken to support the ex ante specification of a one-year recovery period. But the need for flexibility was also recognized. Indeed, it was emphasized that the DNB has already demonstrated flexibility with longer recovery periods and thus supported, along with the ministries involved in financial supervision, appropriate escape clauses.

21. **The authorities recognize that continuity planning is essential to minimizing financial system disruptions if an avian flu pandemic were to occur.** The appropriate issues have been well publicized by the authorities, including by having supervisors ask financial institutions how they are preparing.

D. Structural Reforms and Other Policies

22. **Several, not always easy, measures have been taken to raise labor participation,** which is comparatively low (Figure 6). Earlier reforms of the disability scheme had already reduced inflows significantly, and reassessments of the existing stock have already resulted in reclassifications. The more recent reform distinguishes between partly and fully disabled, enhancing the incentives to participate in the labor market for those who can. Early retirement is now actuarially fair. Still, the operations of the "life-course (tax-free saving) scheme" are not yet fully clear. It would be unfortunate if it effectively became a vehicle solely for subsidizing early retirement. The reduction in the duration of unemployment benefits to three years and reduction in inactivity and poverty traps (following the abolition of the real estate tax and smoothing of the income dependency of the child credit) should further induce higher participation.

23. **Partly drawing on the CPB's study of welfare state reform, there are further measures to consider.** Smoothing the income dependency of the rent subsidy would reduce other spikes in marginal tax rates (and could be designed to lessen costs). Further measures to lower childcare expenses and individualize the tax credit for nonparticipating partners would also be promising avenues to increase participation. A reduction in the minimum wage could be effective in increasing low-skilled employment and would be more acceptable in the context of equity considerations if the negative effects on equity were mitigated through an earned tax credit. On unemployment benefits, staff felt room existed to further reduce duration, still generous by international standards, and taper off replacement rates more rapidly. While the discussions revealed a clear understanding of the potential benefits of these reforms, there was also a sense of reform fatigue setting in and that further reforms needed to await the next government.

24. **Several avenues were identified to boost productivity growth.** Against the background of slowing potential and overall productivity growth—evidenced, for example, in staff's Selected Issues paper—this was seen as an important topic. Thus, the authorities underscored efforts to increase competition, for example by unbundling the energy market and through the NMa's work, including in areas such as construction where earlier staff work on sectoral productivity showed weak growth. The authorities also explained that the goal of reducing red tape by one quarter would be achieved by the end of the government's terms, including by reducing the number of permits and license systems that can adversely affect innovation and experimentation. Staff noted that product market reforms can also facilitate labor market reforms, notably by dampening the impact of the latter on real wages. Like before, staff also encouraged greater wage differentiation (to attract labor to higher productivity companies and sectors, while strengthening the incentives for human capital investment), and less strict EPL (which basically acts as a tax on new hiring and labor reallocation and can therefore also hamper innovation). The latter was under active discussion at the SER. Though the different parties could recognize benefits from less strict EPL, there was no consensus on reforms because of different vested interests; continued discussions were postponed. There was general agreement on the importance of ensuring sufficient space within the budgetary envelope for education, infrastructure, and market-oriented incentives for R&D.

25. **The authorities enthusiastically support overseas development assistance (ODA), continuing to exceed the United Nations' target of 0.7 percent of GNI.**

III. Staff Appraisal

26. **There is reason for optimism.** After a period of slow or negative growth, the economic recovery is gathering steam, broadening to the domestic components of economic activity. While challenges lie ahead, the capability to deal with them has clearly been in evidence in the achievements over the past few years. Among them are reform of health care, disability, and financial supervision, strengthened administration of social benefits by local authorities because of improved incentives, and a turnaround in the public finances.

27. **To ensure a solid foundation for sustaining economic growth over the medium and longer terms, there is a need to deal with a number of key challenges.** These include making sure that the public finances are sustainable in the face of population aging. While competitiveness is not problematic, continued wage moderation to support it would allow the Netherlands to take full advantage of the global upturn, an issue that could take on increasing importance as the recovery gathers force. Furthermore, in addition to safeguarding financial stability, the challenges also include undertaking deeper structural reforms to raise labor participation, hours worked, and overall productivity, without which potential growth could get stuck at a low rate as the population ages.

28. **The impressive fiscal adjustment of the past two years should be safeguarded.** At over 2 percentage points of GDP in structural terms during 2004–05, the adjustment achieved so far during the current government's term has reflected a determined policy effort. In addition, though difficult to measure, this adjustment likely helped reverse the decline in confidence from breaching the Maastricht deficit ceiling. While fiscal policy may turn somewhat expansionary in 2007, it would be preferable to pursue at least a neutral stance in view of fiscal requirements in the medium term and with the upturn well in train. Further rationalizing and restraining unemployment benefits and rent subsidies would be among the measures that could be taken to exploit synergies between fiscal consolidation and structural reforms aimed at raising employment rates and potential growth. At a minimum, any revenue overperformance or below-budget expenditure outturns in 2006 and 2007 should go to deficit reduction.

29. **Looking further ahead, continued fiscal consolidation and other sustainability-enhancing reforms will be essential for securing longer-term fiscal sustainability.** This is well recognized by the authorities and well analyzed in their comprehensive study on aging. Moreover, official efforts to enhance public awareness of aging issues are to be commended. For the next government, aiming for a general government surplus of at least 1 percent of GDP by the end of its term (2011) would be well-placed. This would represent significant structural fiscal adjustment and take advantage of the favorable environment provided by the economic upturn. Even so, a significant sustainability gap would remain. Thus, to reduce the risk that the size of the aging problem will grow and that intergenerational equity will be reduced, it is important to identify and implement upfront other measures to close the sustainability gap. Asymmetrical risks tilted toward needing more adjustment accentuate the case for upfront action and for using any fiscal overperformance in 2006–07 to pursue more ambitious fiscal targets in later years.

30. **The sound fiscal practices in the Netherlands provide a strong framework to help the country achieve its goals, though refinements would help strengthen it further.** It is commendable that Dutch fiscal practices meet or exceed the good-practice standards, a key conclusion of the recent ROSC. Moreover, the CPB's independent and central role provides a best-practice example of separating the political and technical elements of macroeconomic policy. Refinements could still be made in some areas, including by making the reporting and monitoring of the expenditure ceilings more transparent, incorporating in the calculation of the net expenditure ceiling only those nontax items for which there are appropriate incentives to collect resources, and reassessing the role of the budgetary fund based on gas revenues with a view to better assessing the trade-offs faced in allocating spending as part of the general budgetary process.

31. **The financial sector remains sound, and improvements continue to be made to already strong supervision.** The new Financial Supervision Act, the strengthening of the risk orientation of supervision, and the analytical work on financial stability, including a new round of stress tests, are welcome. Financial vulnerabilities have nevertheless arisen,

prompting a review of the code of conduct on mortgage lending. The strengthening of the code, with a view to minimizing these vulnerabilities, is a step in the right direction. But to be effective, monitoring compliance is essential, as is taking appropriate actions if violations occur. While a small bank failed, the event, in broad outline, exemplified the system working: the emerging problems came as no surprise to supervisors and they closed the bank. The event should also add a degree of market discipline by demonstrating to creditors that a bank can fail.

32. **The authorities' responsiveness to the FSSA recommendations is welcome.** Phasing out the tax deductibility of mortgage interest payments is now on the policy radar screen, and it is encouraging that the authorities are trying to find a way to do this that minimizes disruptive effects. There are advantages for the budget from a phase-out, including by providing room for tax cuts, which can lessen the downward impact on demand and stimulate labor participation. In a broader sense, the authorities are also encouraged to study whether rent controls and administrative allocation mechanisms appropriately serve their intended social and economic purposes. On pension funds, when the minimum coverage ratio is not met, the presumption of a one-year recovery period would help ensure discipline, including through the ex ante threat of stringent intervention. At the same time, flexibility is indispensable—for example if macroeconomic distress or systemic pension problems were to occur—so escape clauses allowing for a longer, ex post, recovery period are necessary, too.

33. **Continuity planning is essential to minimizing financial system disruptions if an avian flu pandemic were to occur.** It is therefore commendable that the Dutch authorities are at the forefront of dealing with financial issues related to a possible pandemic.

34. **While there is room for further reforms to raise the economy's growth potential, the authorities have already made considerable efforts to raise labor participation and overall productivity.** Efforts to better align work effort and the return from work, and minimize the negative effects on labor participation of satisfying society's preferences for equity, are well-placed and have been exemplified with disability reform, making early retirement actuarially fair, and lowering unemployment benefits. But the duration of unemployment benefits is still generous by international standards, and a more rapid tapering-off in replacement rates could be introduced. New ways of lessening inactivity traps and stimulating demand for low-skilled labor should also be examined, including through changes in the minimum wage and its links to several social benefits. With respect to enhancing productivity, including by boosting innovation, efforts to increase competition and reduce red tape are among the steps in the right direction, and should be continued. Greater wage differentiation would be helpful in encouraging human capital investment and attracting labor to higher productivity companies and sectors. EPL, which acts as a tax on new hiring and labor reallocation and can hamper innovation, could be made less stringent. All these reforms would be mutually reinforcing in creating employment, enhancing economic growth, boosting competitiveness, imparting flexibility for dealing with

asymmetric shocks in a monetary union, and achieving fiscal savings to ensure adequate resources for an aging population.

35. **The commitment to ODA, even in the face of budgetary pressures, is commendable.** The Netherlands continues to exceed the United Nations' ODA target.

36. It is recommended that the next Article IV Consultation with the Netherlands remain on the 12-month cycle.

Table 1. The Netherlands: Basic Data, 2001-08

Land area (2005)	41.5 thousand sq. km.	
Population (2005)	16.4 million	
Population characteristics and health:		
Life expectancy at birth (2005)	76.3 (male), 81.5 (female)	
Fertility rate (2005)	1.7 children/woman	
Infant mortality rate (2005)	5.04 per 1,000 live births	
Population per sq. km. of land area (2005)	483 persons	
National accounts 2005	(In billions of euros)	(In percent of GDP)
Private consumption	244.0	48.6
Public consumption	120.5	24.0
Gross fixed investment	97.6	19.5
Stockbuilding	-1.4	-0.3
Exports of goods and nonfactor services	357.5	71.2
Imports of goods and nonfactor services	316.3	63.0
GDP	501.9	100.0

	2001	2002	2003	2004	Est. 2005	Proj. 1/ 2006	Proj. 2007	Proj. 2008
	(Annual percentage change; unless otherwise indicated)							
National accounts (constant prices)								
Private consumption	1.4	0.9	-0.7	--	0.3	-1.0 1/	1.6	2.0
Public consumption	4.8	3.3	2.4	--	0.5	7.7 1/	0.8	1.2
Gross fixed investment	0.2	-4.5	-3.5	2.9	2.2	4.8	4.4	3.4
Total domestic demand	1.8	-0.4	-0.3	0.8	0.2	2.6	2.2	2.1
Exports of goods and nonfactor services	1.6	0.9	2.0	8.5	5.9	6.0	6.5	6.0
Imports of goods and nonfactor services	2.2	0.3	2.0	7.8	5.1	6.2	6.2	5.6
Net foreign balance 2/	-0.3	0.5	0.1	0.9	0.9	0.3	0.7	0.8
Gross domestic product	1.4	0.1	-0.1	1.7	1.1	2.6	2.8	2.7
Output gap (in percent of potential output)	2.7	0.6	-1.6	-1.9	-2.7	-2.1	-1.3	-0.6
Prices, wages, and employment								
Consumer price index (HICP)	5.1	3.9	2.2	1.4	1.5	1.5	1.8	1.8
GDP deflator	9.7	3.8	2.5	0.9	1.6	1.7	1.6	1.8
Hourly compensation (manufacturing)	3.9	3.7	2.7	1.6	0.8	0.8	2.0	2.6
Unit labor costs (manufacturing)	5.0	2.8	2.3	-1.6	-0.3	-0.4	0.8	0.8
Employment	2.1	0.4	-0.4	-0.7	-0.3	1.1	1.4	0.7
Unemployment rate (in percent)	2.5	2.9	4.0	4.9	5.2	4.8	4.3	4.4
Personal sector								
Real disposable income	6.2	-0.3	-0.3	40.7	-0.1	-2.0 1/	2.4	1.9
Household savings ratio 3/	6.8	6.5	6.9	9.0	8.5	7.5	8.4	8.3
External trade								
Exports of goods, volume	-2.0	1.0	6.6	9.0	6.1	6.3	5.8	5.9
Imports of goods, volume	0.4	3.2	2.3	8.5	7.4	6.1	5.6	5.5
Terms of trade	3.3	1.5	1.4	-0.4	0.3	1.2	1.1	0.1
Merchandise balance (percent of GDP)	4.8	4.2	6.6	7.1	7.0	8.0	8.9	9.3
Current account balance (percent of GDP)	2.4	2.5	5.5	8.9	6.4	6.9	7.8	8.1
Public sector accounts (in percent of GDP)								
Revenue	44.9	44.0	43.6	44.4	45.6	45.8 1/	45.5	45.5
Expenditure	45.2	45.9	46.8	46.3	45.8	46.7 1/	46.4	45.8
General government balance	-0.3	-2.0	-3.2	-2.1	-0.3	-0.9	-0.9	-0.3
Structural balance 4/	-1.2	-2.3	-2.4	-1.2	0.1	--	-0.3	--
Primary balance	2.1	0.2	-1.1	-0.1	2.0	1.3	1.2	1.9
Structural primary balance 4/	1.2	-0.1	-0.4	0.8	2.3	2.1	1.8	2.2
General government gross debt	50.7	50.5	51.9	52.6	52.9	52.6	52.0	51.6

Sources: Dutch official publications; IMF, IFS; and IMF staff estimates.

1/ The introduction of the new health insurance scheme in 2006 will cause a significant shift in health care expenditure from private to public consumption, thereby lowering private and raising public consumption growth without changing overall GDP. In a related vein, government revenues will rise and private disposable income fall, without affecting the financial position of the public sector or households' net terms. This is because public expenditure for health care also rises, while the fall in private disposable income is offset by a similar fall in private health consumption, which is now financed through the fiscal accounts.

2/ Contribution to GDP growth.

3/ In percent of disposable income.

4/ See Table 2.

Table 2. The Netherlands: General Government Accounts, 2001-07

(In percent of GDP; unless otherwise indicated)

	2001	2002	2003	2004	2005 1/	2006 2/	2007 2/
Revenues	44.9	44.0	43.6	44.3	45.6	45.8	45.5
Tax revenues and social security contributions	38.4	37.8	37.5	37.8	39.7	39.3	39.3
Tax revenues	24.7	24.5	23.7	23.8	26.2	24.6	24.9
Social security contributions	13.7	13.3	13.8	14.0	13.5	14.7	14.4
Nontax revenues	6.5	6.2	6.1	6.6	5.9	6.5	6.2
Expenditure	45.2	45.9	46.8	46.4	45.8	46.7	46.4
Direct expenditure	26.9	28.1	28.9	28.4	28.1	29.5	29.0
Compensation of employees	9.6	9.8	10.1	10.1	9.9	9.7	9.4
Goods and services (excluding capital formation)	6.9	7.0	7.2	7.0	6.9	6.9	6.8
Fixed capital formation	3.3	3.5	3.4	3.1	3.0	3.0	3.0
Social benefits in kind	7.1	7.8	8.2	8.2	8.3	9.9	10.0
Transfers	15.1	15.0	15.2	15.3	15.3	15.0	14.8
Subsidies (including EU)	1.7	1.8	1.7	1.7	1.6	1.5	1.5
Other transfers	13.4	13.2	13.5	13.6	13.7	13.5	13.3
Households	10.6	10.7	11.1	11.1	11.0	11.0	10.7
Corporations	0.7	0.5	0.5	0.5	0.4	0.4	0.5
Rest of the world	2.1	2.0	1.9	2.0	2.3	2.1	2.1
Interest	3.2	2.8	2.7	2.6	2.5	2.4	2.3
Fiscal balance 3/	-0.3	-2.0	-3.2	-2.1	-0.3	-0.9	-0.9
Memorandum items:							
Primary balance	2.1	0.2	-1.1	-0.1	2.0	1.3	1.2
Structural balance (in percent of GDP) 4/ 5/	-1.2	-2.3	-2.4	-1.2	0.1	0.0	-0.3
Nominal expenditure growth (in percent) 6/	6.5	6.2	4.4	1.3	1.8	6.6	3.4
Real expenditure growth (in percent) 6/	-3.0	2.3	1.8	0.4	0.3	4.7	1.2

Sources: National accounts; ministry of finance; CPB; and IMF staff calculations.

1/ Estimates.

2/ Projections. The introduction of the new health care system in 2006 will have an upward effect on both expenditures and revenues, with no effect on the overall balance.

3/ For 2000, includes UMTS receipts (0.7 percent of GDP); and for 2001, includes purchase of gas rights from DSM (0.3 percent of GDP).

4/ The calculation of the structural balance is based on the standard methodology, which uses fixed elasticities with respect to GDP. Biases can occur, in particular in the context of asset price boom and busts (as discussed for the Netherlands in IMF Country Report 04/301), but also when the components of GDP move differently than the overall aggregate.

5/ For 2000, excludes UMTS receipts (0.7 percent of GDP); for 2001, excludes the purchase of gas rights from DSM (0.3 percent of GDP); for 2005, reflecting the purchase of the gas network, includes a one-off increase of equal size in revenue and expenditure (¾ percent of GDP), which does not affect the structural balance; and for 2005-06, adjusted for corporate tax receipts, which were exceptionally large in the earlier year because of a temporarily high interest rate received on overpayments.

6/ The increase in expenditure growth in 2006 largely reflects the introduction of the new health care system, as in footnote 2.

Table 3. The Netherlands: Indicators of External and Financial Vulnerability, 2000-05

(In percent of GDP; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
External indicators						
Exports goods and services						
(annual percent change, in U.S. dollars)	4.4	-0.7	4.4	16.9	17.7	13.6
Imports goods and services						
(annual percent change, in U.S. dollars)	2.9	-0.3	4.4	22.7	19.3	12.6
Terms of trade goods (annual percent change)	-0.3	3.3	1.5	1.4	-0.4	1.1
Current account balance	2.0	2.4	2.5	5.5	8.9	6.4
Inward portfolio investment	2.4	-3.4	3.4	-4.3	5.2	-12.0
Inward foreign direct investment	17.2	13.0	5.7	4.0	0.1	6.5
Official reserves (in billions of U.S. dollars)	17.6	16.9	19.0	21.6	21.2	20.5
Foreign assets of the banking sector						
(in billions of U.S. dollars)	163.9	211.4	256.2	308.2	376.9	408.8
Foreign liabilities of the banking sector						
(in billions of U.S. dollars)	206.1	250.1	305.8	328.2	392.5	416.4
Official reserves in months of imports	0.9	0.8	1.0	1.0	0.9	0.7
Exchange rate (per U.S. dollar, period average)	1.08	1.12	1.06	0.88	0.80	0.80
Financial market indicators						
Public sector debt (Maastricht definition)	55.9	50.7	50.5	51.9	52.6	52.9
Government bond yield	5.5	5.2	5.0	4.2	4.1	3.4
Government bond yield (real)	3.2	0.1	1.1	1.9	2.7	1.9
Stock market index	100.0	81.9	63.1	45.7	51.0	57.9
Spread of government bond yield with Germany	0.27	0.47	0.39	0.37	0.34	0.19
Financial sector risk indicators						
Residential mortgage loans to total loans (in percent)	0.79	0.79	0.79	0.78	0.78	0.80
Nonperforming loans net of provisions in percent of capital 1/	31.34	31.13	31.22	24.32	19.19	15.66
Classified loan to total loans (in percent) 1/	2.22	2.28	2.38	1.99	1.54	1.22
Foreign credit exposure (in percent of own funds)						
Central and Eastern Europe	16.7	16.6	17.1	17.3	16.2	18.4
Latin America	20.6	19.0	14.8	11.9	9.3	11.6
Asia	28.2	25.6	23.5	26.1	27.6	25.2
Contingent and off-balance-sheet accounts						
to total assets (in percent)	21.9	20.3	19.5	16.7	15.3	14.6
Risk-based capital-asset ratio	11.3	11.4	11.9	12.1	12.1	12.3

Sources: Data provided by the authorities; and IMF, *IFS*.

1/ Average of the three largest banks.

Table 4. The Netherlands: The Core Set of Financial Soundness Indicators, 1998-2005

(In percent; unless otherwise indicated)

Indicator	1998	1999	2000	2001	2002	2003	2004	2005
Deposit-taking institutions								
Regulatory capital-to-risk-weighted assets	11.41	11.18	11.25	11.44	11.86	12.05	12.07	12.35
Regulatory Tier I capital-to-risk-weighted assets	8.53	8.43	8.62	8.51	8.98	9.39	9.76	10.05
Nonperforming loans net of provisions to capital 1/	30.05	32.32	31.34	31.13	31.22	24.32	19.19	15.66
Nonperforming loans to total gross loans 1/	2.72	2.48	2.22	2.28	2.38	1.99	1.54	1.22
Sectoral distribution of loans to total loans								
Households	49.85	50.85	50.20	50.92	50.80	50.26	49.94	49.39
Nonfinancial companies	37.79	35.96	35.94	34.48	32.60	31.51	29.62	28.56
Insurance companies and pension funds	1.33	1.10	1.08	1.63	1.43	0.99	1.67	1.95
Other financial institutions	11.03	12.10	12.78	12.97	15.17	17.24	18.77	20.10
Return on assets	0.44	0.57	0.60	0.43	0.35	0.45	0.54	0.54
Return on equity	10.89	14.21	14.79	10.86	9.05	11.68	13.81	14.55
Interest margin to gross income (ratio)	0.60	0.57	0.52	0.56	0.61	0.61	0.58	0.54
Noninterest expenses to gross income (ratio)	0.79	0.74	0.73	0.79	0.82	0.75	0.71	0.69
Net open position in foreign exchange to capital	8.41	9.04	6.15	4.76	4.25	6.11	4.07	0.77

Source: Data provided by the authorities.

1/ Three largest credit institutions.

Table 5. The Netherlands: Encouraged Financial Soundness Indicators, 1998-2005

Indicator	1998	1999	2000	2001	2002	2003	2004	2005
Corporate sector								
Total debt to equity	0.69	0.69	0.70	0.69	0.66	0.65	0.65	...
Return on equity	0.18	0.18	0.16	0.14	0.12	0.12	0.14	...
Earnings to interest and principal expenses	2.37	2.40	1.84	1.46	1.56	1.92	3.47	...
Deposit-taking institutions								
Capital to assets	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04
Geographical distribution of loans to total loans (in percent)								
Europe (excluding Netherlands)	20.67	21.53	21.05	23.29	25.39	26.56	27.62	28.17
America	4.54	4.66	4.33	5.52	4.99	4.36	4.24	4.43
Asia	2.76	2.01	1.19	2.54	1.79	1.64	1.61	1.51
Other (Africa, Middle East, and Oceania)	0.32	0.39	0.37	0.38	0.27	0.37	0.31	0.39
Total	28.29	28.60	26.95	31.73	32.45	32.93	33.78	34.51
Financial derivatives to capital	71	87	84	94	99	99	108	94
Large exposures to capital	0.82	1.17	1.15	1.24	0.77	0.78	0.84	0.66
Trading income to total income	0.07	0.08	0.09	0.08	0.06	0.07	0.08	0.10
Personnel expenses to noninterest expenses	0.50	0.52	0.53	0.52	0.50	0.51	0.54	0.49
Spread between reference lending and deposit rates	3.40	0.72	1.90	1.90	1.19	0.51	0.44	0.43
Customer deposits to total (noninterbank) loans	0.81	0.76	0.76	0.79	0.78	0.82	0.83	0.82
Foreign currency-denominated loans to total loans	0.17	0.16	0.17	0.20	0.17	0.15	0.15	0.20
Foreign currency-denominated liabilities to total liabilities (deposits)	0.23	0.23	0.23	0.28	0.24	0.21	0.20	0.25
Net open position in equities to capital	0.01	0.02	0.02	0.02	0.01	0.02	0.02	0.00
Market liquidity								
Average bid-ask spread in the securities market	0.31	0.09	0.12	0.09	0.06	0.04	0.04	...
Average daily turnover ratio in the securities market	2,290	2,876	4,559	4,131	1,885	1,585	1,695	2,069
Other financial corporations								
Assets to total financial system assets	0.35	0.36	0.34	0.31	0.33	0.30	0.31	0.28
Assets to GDP	1.81	2.03	1.96	1.79	1.84	1.72	1.95	2.17
Households								
Household debt to GDP	0.76	0.83	0.87	0.90	0.95	1.03	1.10	1.17
Household debt service and principal payments to income	0.096	0.108	0.122	0.113	0.109	0.116	0.123	...
Real estate markets								
Real estate prices (in euros)	123,358	142,450	171,058	187,625	199,333	204,417	212,500	222,167
Residential real estate loans to total loans	0.79	0.80	0.79	0.79	0.79	0.78	0.78	0.80

Source: Data provided by the authorities.

Table 6. The Netherlands: Financial System Structure, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Number								
Banks	99	100	104	101	93	93	94	94
Private commercial	68	73	75	69	61	63	64	64
State-owned	2	1	1	1	1	1	1	1
Foreign-owned subsidiaries	29	26	28	31	31	29	29	29
Branches of foreign banks	...	31	35	33	32	31	33	32
Life insurance companies	108	109	101	98	92	87	85	77
General insurance companies	318	337	313	308	297	292	278	275
Pension funds	1,040	1,016	988	963	926	875	839	800
Concentration								
Banks 1/	3	3	3	3	3	3	3	3
Life insurance companies 1/	12	12	11	11	10	10	10	...
General insurance companies 1/	40	40	32	33	32	31	30	...
Pension funds 1/	23	22	24	25	25	25	24	...
Assets (in millions of euros)								
Banks	1,206,632	1,367,120	1,606,591	1,749,569	1,762,511	1,911,343	2,198,404	2,767,526
Foreign-owned subsidiaries	...	...	136,821	154,340	147,213	180,531	215,064	249,948
Branches of foreign banks	24,129	24,551	33,884	29,732	28,396	27,673	31,481	34,523
Securities companies	74,995	103,565	122,650	113,659	91,212	98,420	99,695	107,078
Life insurance companies	212,820	234,144	246,057	251,214	240,571	255,597	267,204	291,871
General insurance companies	31,927	33,934	34,791	35,143	35,441	38,360	42,132	46,021
Pension funds	...	469,440	481,556	474,637	442,734	496,750	550,876	649,635
Deposits (in millions of euros)								
Banks	560,392	637,106	734,462	817,582	838,441	909,748	999,711	1,153,049
Foreign-owned subsidiaries	...	...	49,261	61,551	56,056	69,152	72,502	86,219
Branches of foreign banks	5,193	5,796	5,772	5,531	7,171	6,245	7,740	9,051

Source: National authorities.

1/ Number of institutions with 75 percent of total assets.

Table 7. The Netherlands: Performance of Dutch Pension Funds, 1990-2005

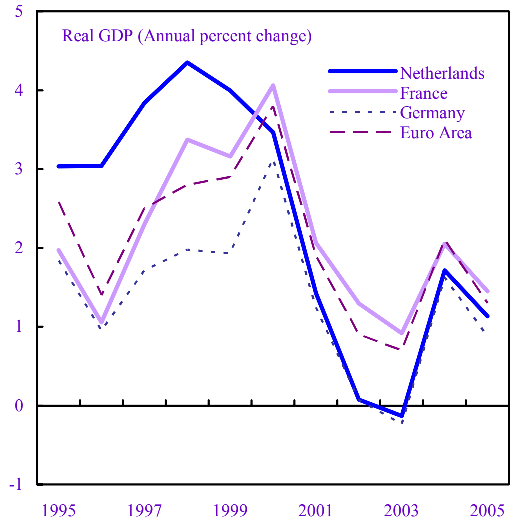
	1990-94	1995-99	2000	2001	2002	2003	2004	2005
Returns (annual average, in percent)	7.3	11.6	2.6	-2.5	-8.0	10.1	9.5	13.0
Contribution rate (in percent of gross wages)	8.5	9.0	9.5	10.0	12.4	15.0	16.5	17.0
Asset-liability ratio (in percent of liabilities) 1/	116	139	141	127	109	114	121	132
Asset-liability ratio (in percent of liabilities, market rate) 2/	...	...	173	157	124	130	124	126
Equity holding (in percent of portfolio)	15.8	32.2	41.8	42.5	35.6	40.6	40.8	42.0

Sources: CPB; and DNB.

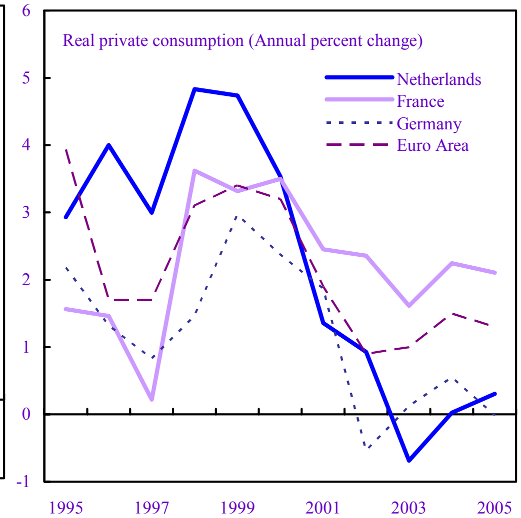
1/ Uses 15-year bond yield as nominal market rate.
2/ Uses accounting rate of 4 percent.

Figure 1. Netherlands: 2001–03—A Period of Weak Economic Performance

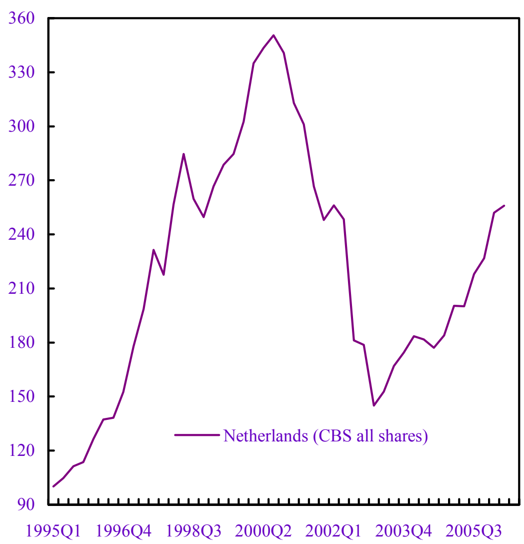
While a posterchild in the late 1980s and 1990s, Dutch economic growth fell sharply into the new millennium. 1/



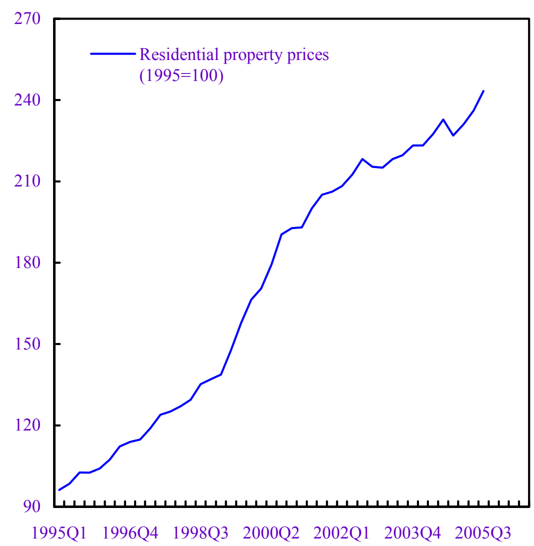
A main reason was weak private consumption, reflecting modest growth of wages and social security benefits.



The collapse of equity prices early in the new century contributed.



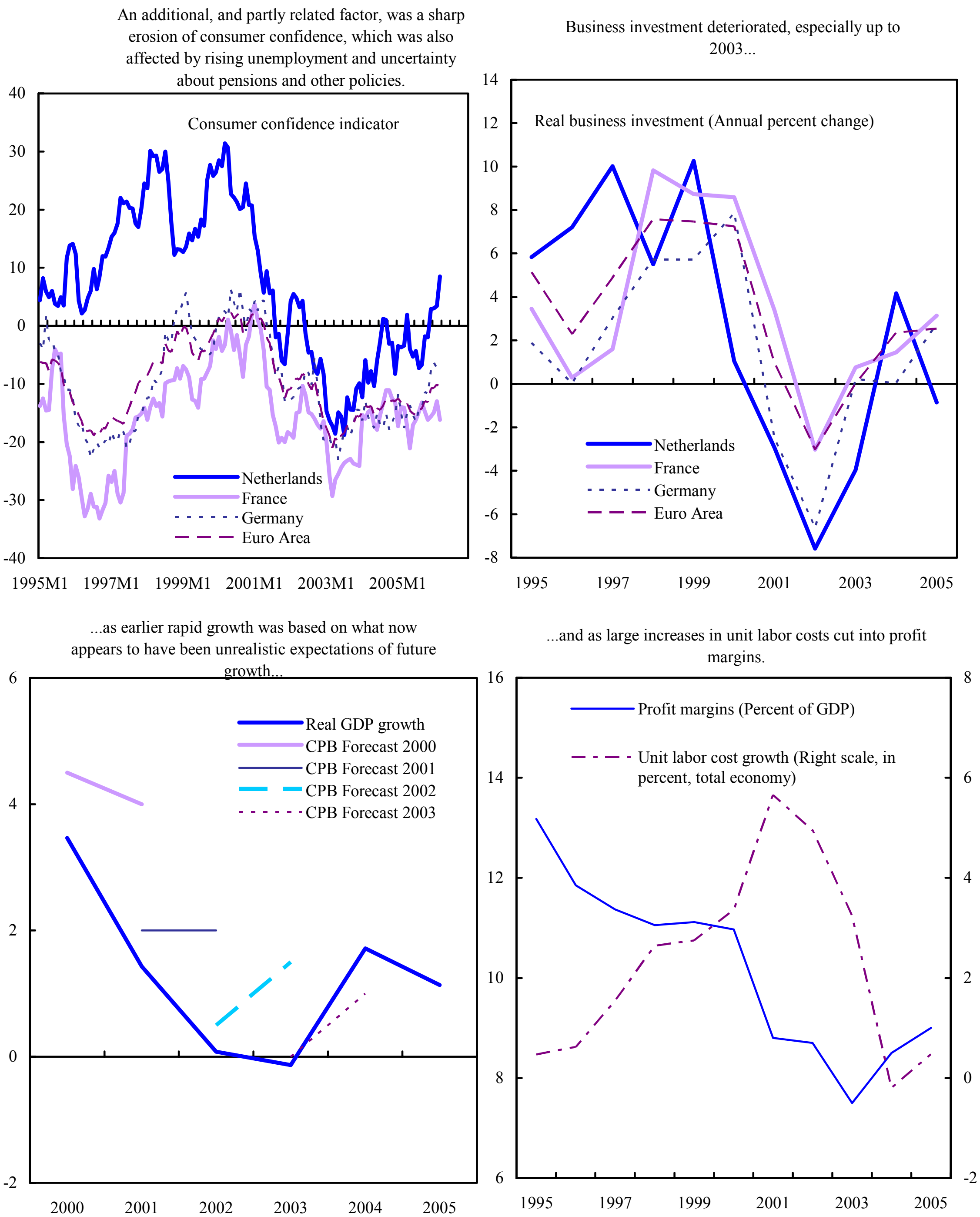
So did some slowdown in the pace of house price increases.



Sources: WEFA; Netherlands authorities; and IMF, *IFS* and WEO.

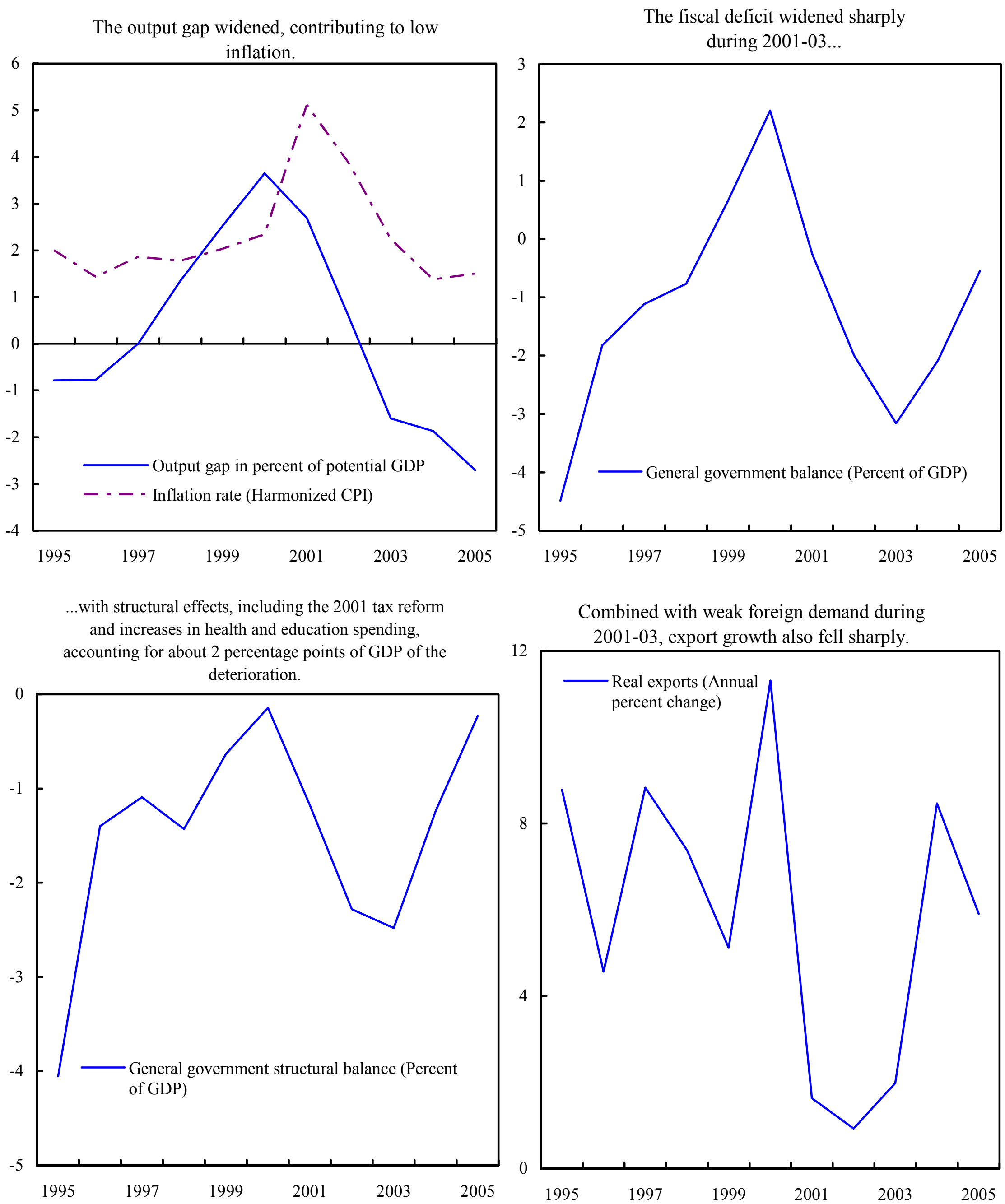
1/ As discussed in the staff report for the 2004 Article IV Consultation (IMF Country Report No. 04/200), wealth and certain policy effects have tended to amplify the cycle in the Netherlands compared with other euro area countries, especially through their impact on private consumption (studied in *L* ong-Run Household Consumption Equilibrium in the Netherlands, IMF Country Report No. 05/225). In addition, while delivering wage moderation on average, the Dutch wage bargaining system has tended to react sluggishly to changes in economic circumstances. This was analyzed in Wage Bargaining in the Netherlands (IMF Country Report No. 03/240) and could also accentuate the cycle.

Figure 1. Netherlands: 2001–03—A Period of Weak Economic Performance (continued)



Sources: WEFA; Netherlands authorities; and IMF, *IFS* and WEO.

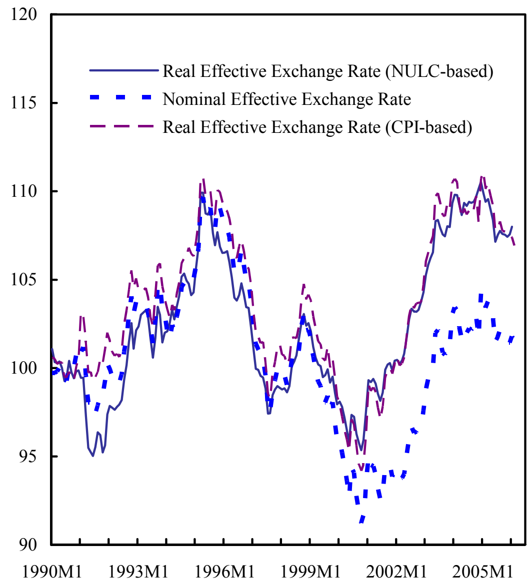
Figure 1. Netherlands: 2001–03—A Period of Weak Economic Performance (concluded)



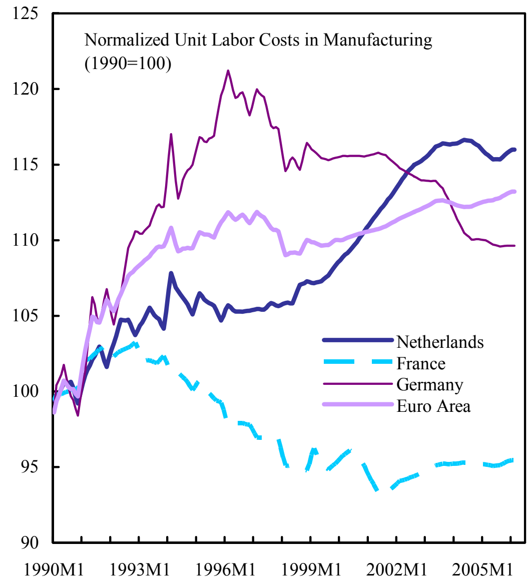
Sources: WEFA; Netherlands authorities; and IMF, *IFS* and WEO.

Figure 2. Netherlands: Competitiveness Indicators

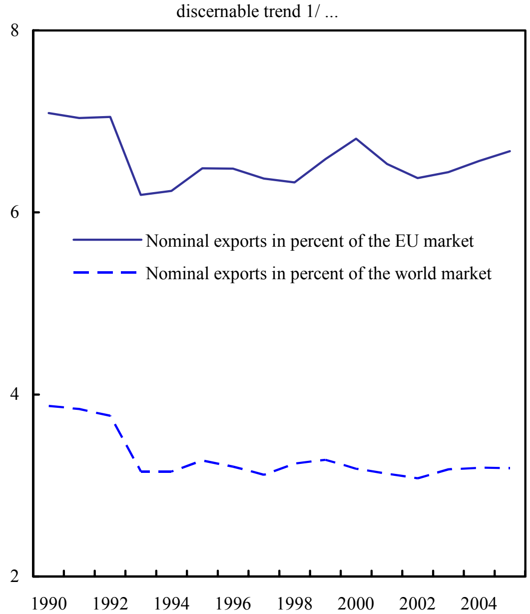
Along with recent real exchange rate appreciation...



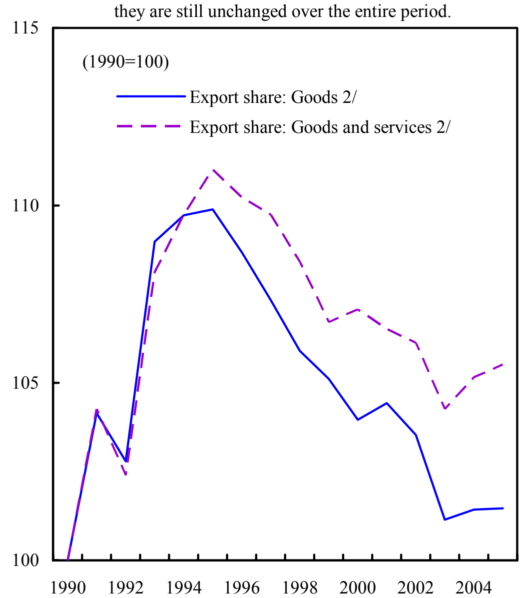
... ULCs rose more rapidly than in other European countries.



While market shares in value terms have shown little discernable trend 1/ ...



falling market shares have been especially apparent in volume terms since the mid-1990s, although even for goods, they are still unchanged over the entire period.

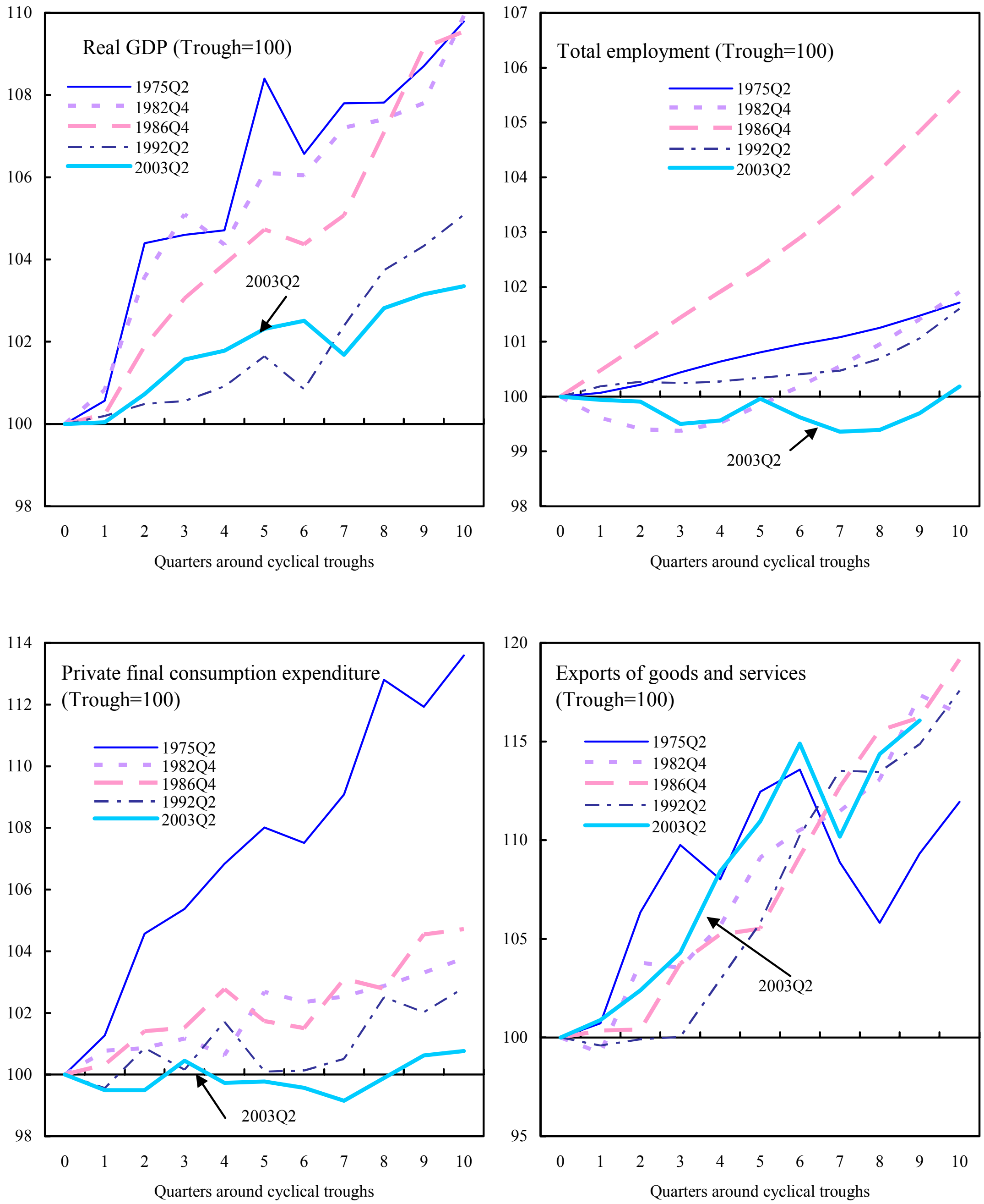


Source: CPB; IMF, *INS*, *DOT*, and WEO.

1/ This may reflect developments in oil and therefore natural gas prices.
2/ As derived from WEO volume data on the growth of exports (and exports of goods and services) and the corresponding growth of import demand in partner countries.

Figure 3. Netherlands: Cyclical Comparisons (Dates indicate cyclical troughs for GDP) 1/

Exports are driving the mild recovery; employment and consumption are weak compared with their position during previous expansions.



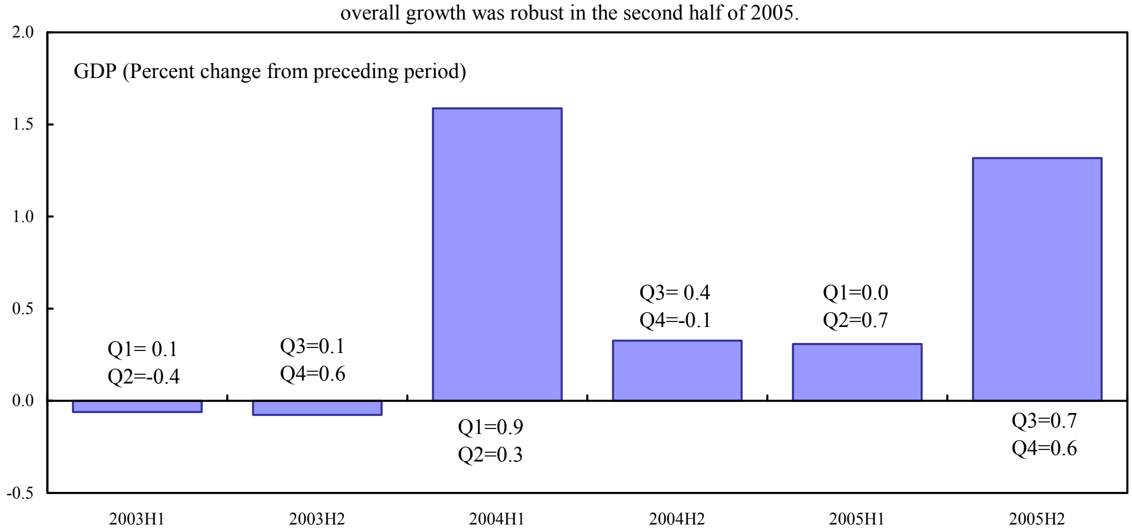
Sources: OECD, analytical database and economic outlook.

1/ Troughs were identified using the methodology of Harding and Pagan (2002), "Dissecting the Cycle: A Methodological Investigation," Journal of Monetary Economics.

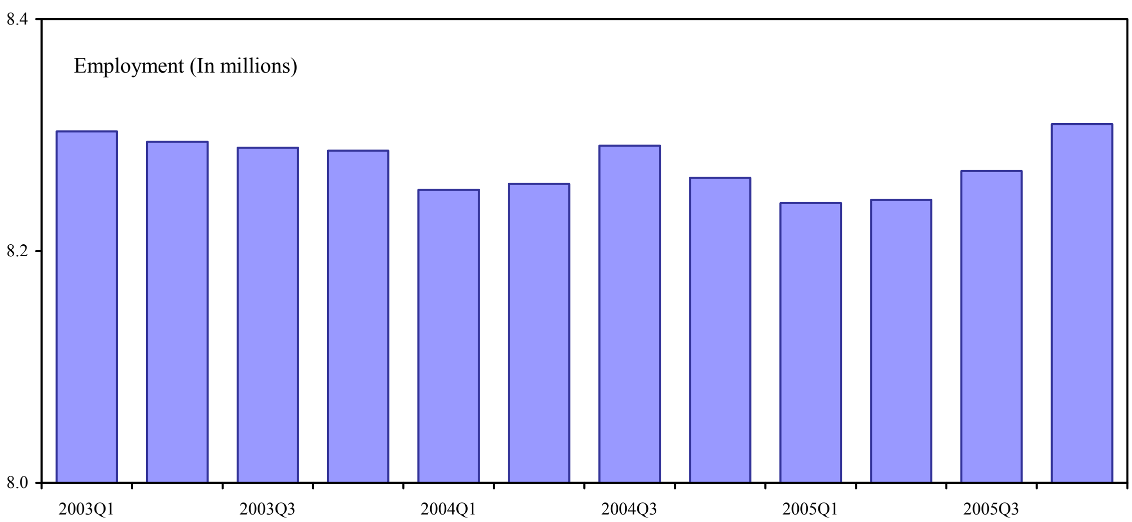
Figure 4. Netherlands: The Beginning of an Upturn?

After a false start in 2004, the recovery gained traction in 2005.

Largely driven by the contribution of net exports,
overall growth was robust in the second half of 2005.



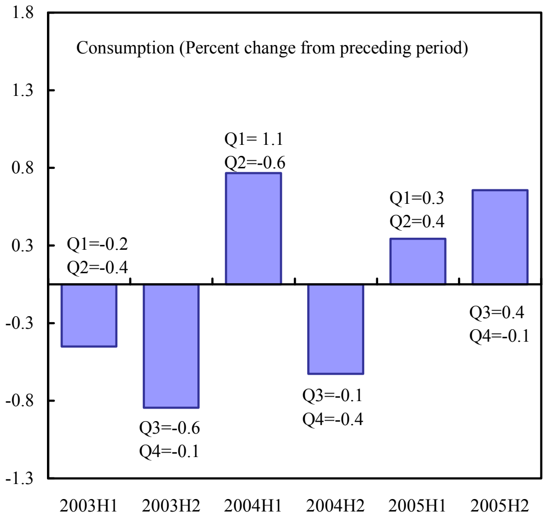
Moreover, quarterly employment recorded a more sustained rise in 2005 than in any year since 2001,
boding well for consumption.



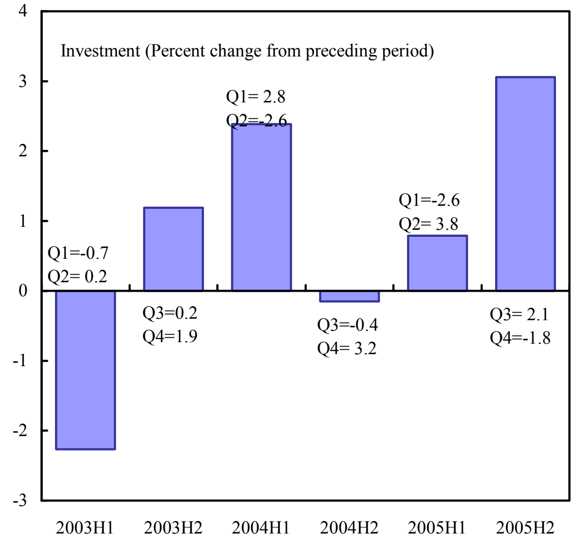
Source: IMF, WEO.

Figure 4. Netherlands: The Beginning of an Upturn? (Concluded)

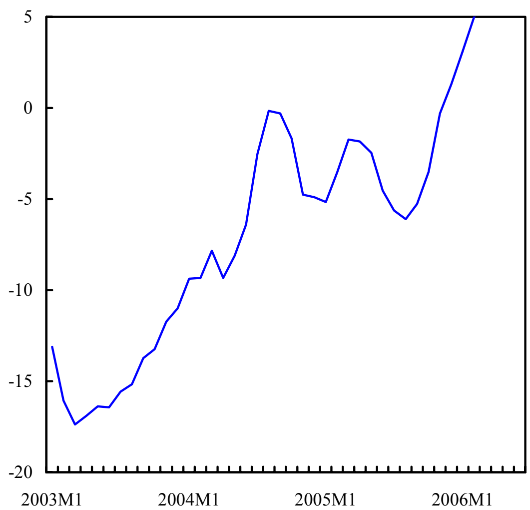
Private consumption, while volatile on a quarterly basis, recorded positive growth in the last three quarters of 2005, rising strongly on average in the last half of the year.



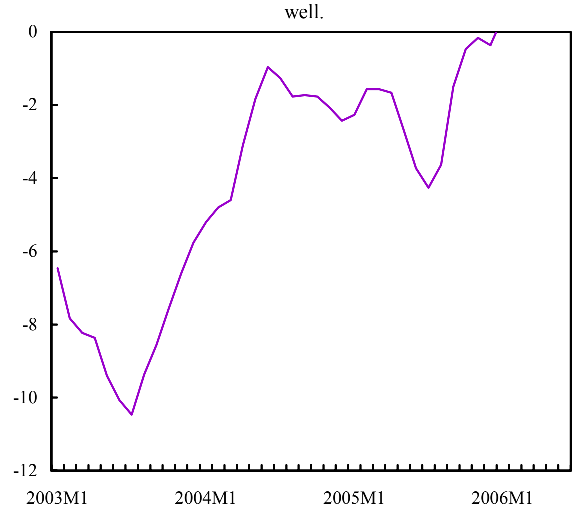
Investment, while also volatile on a quarterly basis, recorded a substantial rise in the second half of 2005.



Consumer confidence has strengthened recently.



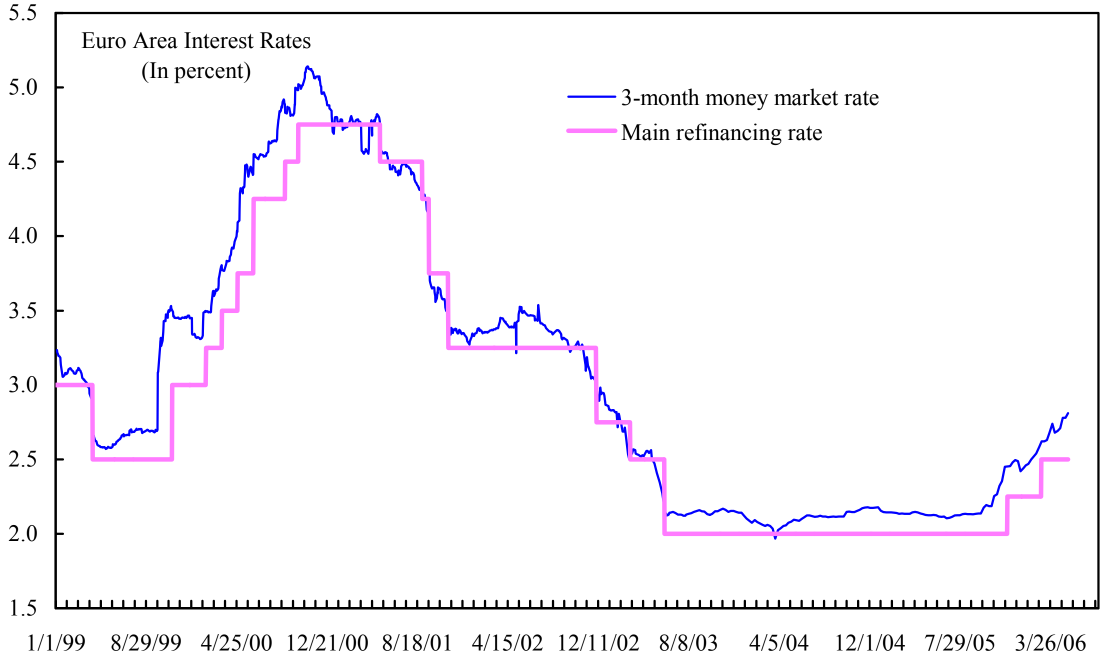
Business confidence has recently strengthened as well.

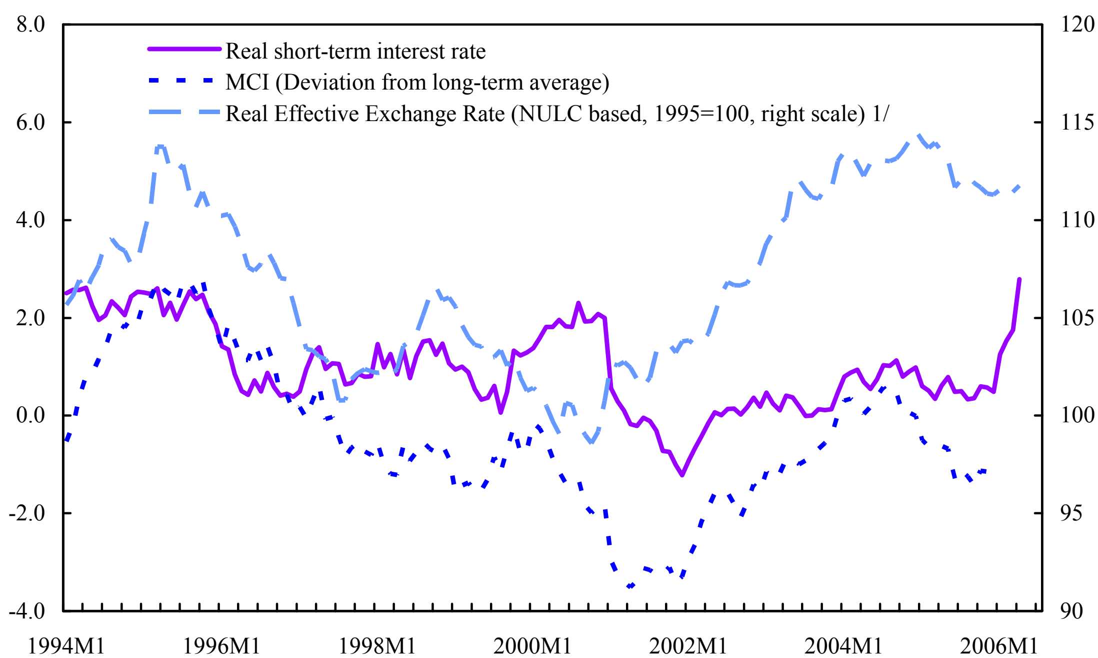


Source: IMF, WEO.

Figure 5. Netherlands: Monetary Conditions

The tightening of monetary conditions after 2000 initially reflected the impact of a lowering of inflation on real interest rates and subsequently an appreciating euro. More recently, monetary conditions have eased as the real exchange rate depreciated.

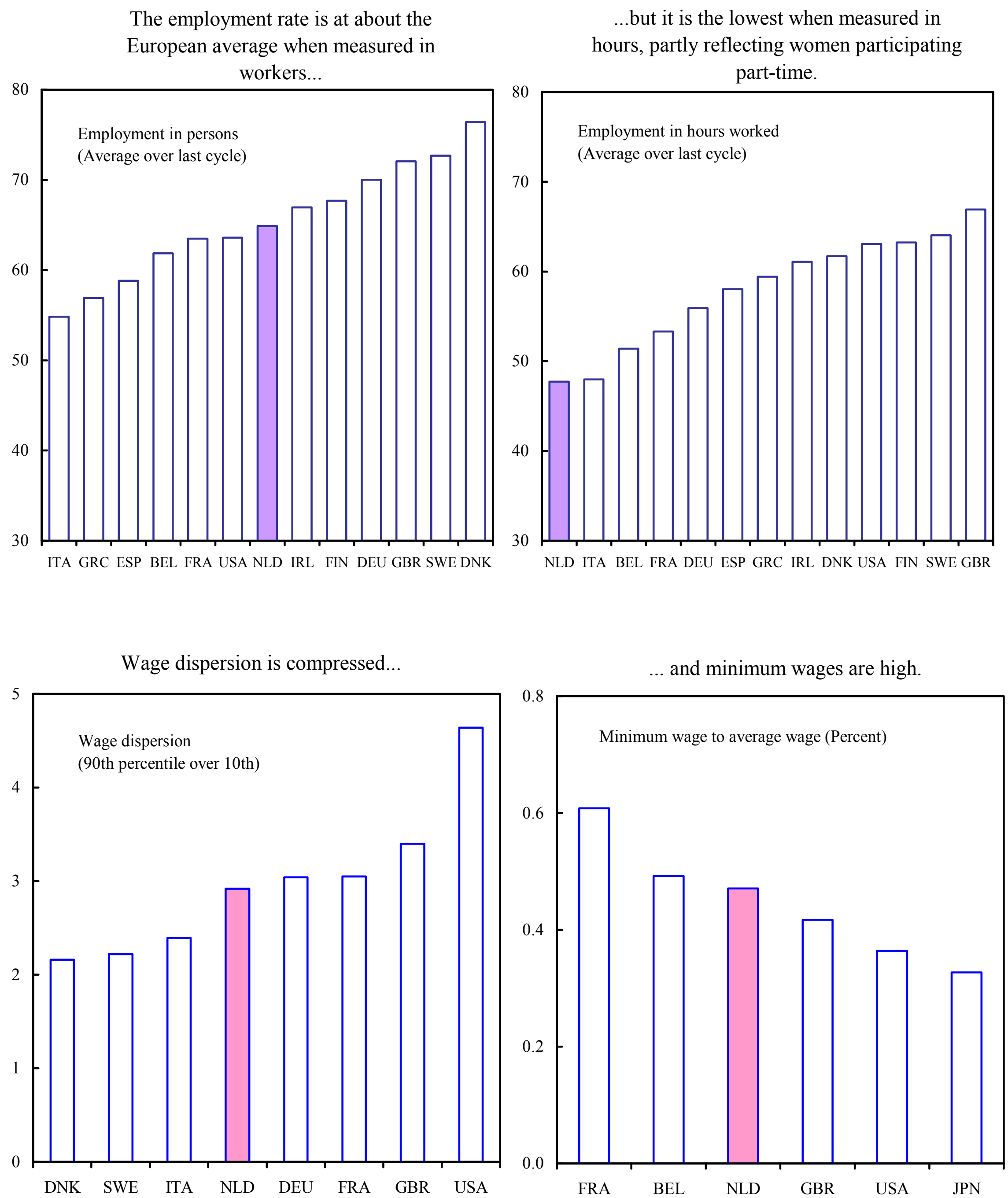




Source: IMF, *IFS*.

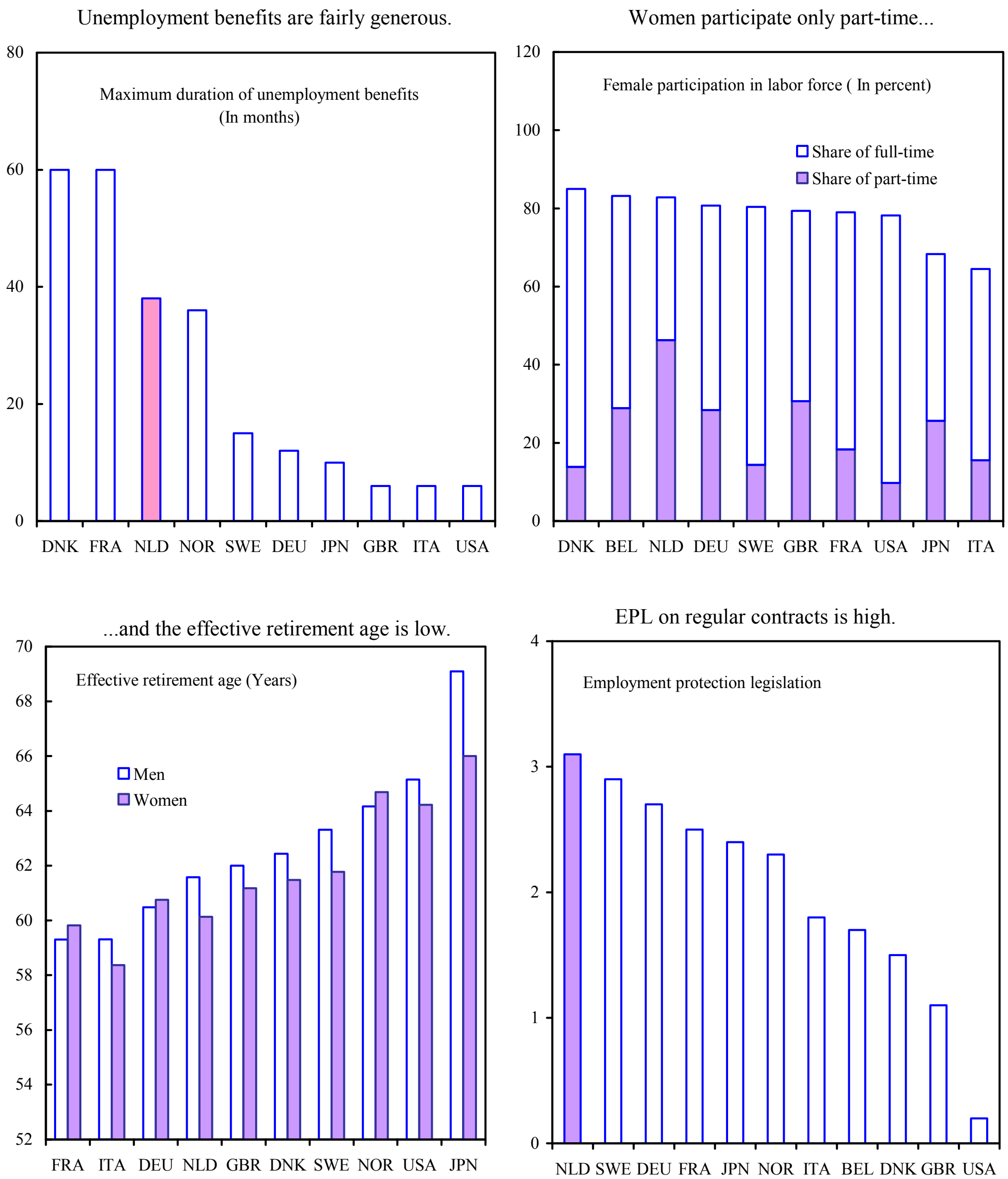
1/ An increase implies less accommodative conditions.

Figure 6. Netherlands: Selected Labor Market Indicators



Source: OECD.

Figure 6. Netherlands: Selected Labor Market Indicators (Concluded)



Source: OECD.

APPENDIX I. Fund Relations

As of April 30, 2006

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

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	5,162.40	100.00
Fund holdings of currency	4,513.86	87.44
Reserve position in Fund	648.59	12.56

III. **SDR Department**

	SDR Million	Percent of Allocation
Net cumulative allocation	530.34	100.00
Holdings	508.54	95.89

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

V. **Latest Financial Arrangements**: None

VI. **Projected Obligations to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/interest	0.53	0.79	0.80	0.79	0.79
Total	0.53	0.79	0.80	0.79	0.79

VII. **Exchange Rate Arrangements**:

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

VIII. **Article IV Consultation**:

Discussions for the 2006 Article IV Consultation were held in Amsterdam and The Hague from April 27–May 9, 2006. The staff report for the 2005 Article IV Consultation (IMF Country Report 05/226) was considered by the Executive Board on June 29, 2005 . The Article IV discussions with the Netherlands are on the standard 12-month consultation cycle.

IX. **Exchange Restrictions**:

In compliance with the relevant UN Security Council Resolutions and/or EU regulations, the Netherlands maintains exchange restrictions vis-à-vis the former government of Iraq; Somalia; Libya; specific persons and entities of Myanmar and Zimbabwe; specific individuals associated with the previous government of the former Republic of Yugoslavia; and certain persons and entities with a view to combating terrorism; Osama Bin Laden, the Al-Qaeda network, and the Taliban. These restrictions are solely for the preservation of national or international security and have been notified to the Fund in accordance with EBD No. 144-(52/51).

APPENDIX II. 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.

As a one-off matter, a number of institutional reforms significantly impact national accounts and other data in 2006. Most importantly, the envisaged reform of health care insurance will cause a significant reclassification of private consumption into public consumption. This shift will have a big impact on the growth rates of the components concerned, but overall GDP will not be affected.

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.

APPENDIX II. Table of Common Indicators Required for Surveillance

(as of June 5, 2006)

	Date of Latest Observation	Date Received	Frequency of Data	Frequency of Reporting	Frequency of Publication
Exchange Rates	05/06	06/01/06	Monthly	Monthly	Monthly
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	01/06	2/21/06	Monthly	Monthly	Monthly
Reserve/Base Money[2]	03/05	4/14/05	Monthly	Monthly	Monthly
Broad Money[2]	03/05	4/27/05	Monthly	Monthly	Weekly
Central Bank Balance Sheet	04/06	5/30/06	Monthly	Monthly	Monthly
Consolidated Balance Sheet of the Banking System	04/06	5/30/06	Monthly	Monthly	Monthly
Interest Rates[3]	05/06	6/01/06	Monthly	Monthly	Monthly
Consumer Price Index	04/06	5/18/05	Monthly	Monthly	Monthly
Revenue, Expenditure, Balance and Composition of Financing[4] — General Government[5]	2003	6/24/04	Quarterly	Quarterly	Quarterly
Revenue, Expenditure, Balance and Composition of Financing[4] — Central Government	03/05	4/29/05	Monthly	Monthly	Monthly
Stocks of Central Government and Central Government-Guaranteed Debt	Q1 2005	4/15/04	Quarterly	Quarterly	Quarterly
External Current Account Balance	Q4 2005	4/6/06	Quarterly	Quarterly	Quarterly
Exports and Imports of Goods and Services	Q4 2005	4/6/06	Quarterly	Quarterly	Quarterly
GDP/GNP	Q4 2004	2/14/05	Quarterly	Quarterly	Quarterly
Gross External Debt[6]	Q4 2004	3/31/04	Quarterly	Quarterly	Quarterly

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Pertains to contribution to EMU aggregate.
[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[4] Foreign, domestic bank, and domestic nonbank financing.
[5] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[6] Including currency and maturity composition.

APPENDIX III. Staff Analytical Work on the Kingdom of the Netherlands, 2000–05

Fiscal Policy

- *Budgetary Policymaking in the Netherlands*, IMF Country Report No. 05/225.
- *Recent Fiscal Developments in the Netherlands*, IMF Country Report No. 04/301.
- *Medium-Term Fiscal Policy,* IMF Country Report No. 02/123.
- *Health Care Reform*, IMF Country Report No. 02/123.

The Financial Sector

- *The Financial Sector in the Netherlands: A Health Check and Progress Report on the FSSA Recommendations,* IMF Country Report No. 05/225.
- *House Prices in the Netherlands,* IMF Country Report No. 05/225.
- *Second Pillar Pensions, Stock Market Returns, and Labor Demand,* IMF Country Report No. 03/240.

Labor Markets

- *Wage Bargaining in the Netherlands,* IMF Country Report No. 03/240.
- *Inactivity and Poverty Traps,* IMF Country Report No. 02/123.
- *Reform of the Disability Program,* IMF Country Report No. 02/123.
- *The Labor Income Tax Credit in an International Perspective,* IMF Country Report No. 01/96.

Growth, Productivity, and Related Cyclical Issues

- *The External Competitiveness of the Dutch Economy: A Short Note on Evidence from both Aggregate and Disaggregate Data,* IMF Country Report No. 05/225.
- *Long-Run Household Consumption Equilibrium in the Netherlands,* IMF Country Report No. 05/225.
- *Recent Productivity Trends in the Netherlands,* IMF Country Report No. 04/301.
- *Estimating Potential Growth and Output Gaps for the Netherlands,* IMF Country Report No. 03/240.
- *Dealing with Cyclical Tensions,* IMF Country Report No. 00/88.

APPENDIX IV. A Summary of the CPB Study on Aging and the Sustainability of Dutch Public Finances

Budgetary measures are necessary. If measures are not taken—now or later—public debt will eventually explode or future generations will be unduly burdened with raising taxes or scaling back public expenditures to secure sustainability. The situation is made more difficult by the expected decline in natural gas revenues as reserves are exhausted over time.

Methodology

To analyze the problem, the CPB uses an applied general equilibrium model with overlapping generations. The model accounts for certain behavioral feedbacks such as the effects of changes in taxation and interest rates on wages, labor supply, and private saving, as well as the impact of demographic changes on private consumption and other components of GDP.[1] Broadly speaking, the model distinguishes between two types of primary government expenditures: (i) an age-related component to expenditure, explicitly affected by demographic shifts, and (ii) a nonage-related component to expenditure, for which the aggregate growth rate moves with GDP and wages. Thus, for example, in the baseline scenario, policies are such that the ratio of health care costs to GDP stays constant except from the effect of health care costs changing with different age groups. Revenues comprise direct taxes, social security contributions, indirect and other taxes, corporate taxes, and revenues from government assets (including natural gas). The growth of direct taxes and social security contributions is based on the dynamics of income and savings during the life cycle of households and therefore endogenous to the model. Indirect and other taxes are divided into that part levied on investments and another part affected by consumer spending.

In the CPB study, attention is paid to tax smoothing—that is, the analysis is performed assuming constant tax rates, with a view to minimizing the distortionary impact of taxation on economic decisions over time. In addition, the analysis ensures intergenerational equity in the sense that the net benefit from government relative to lifetime incomes is meant to be constant for all generations starting from the base year (2006 in the study).[2] In effect, since all generations pay the same tax rates and have the same benefits from government, the baseline and benchmark policy option (see below) are neutral with respect to the intergenerational distribution. If the government defers the measures required to secure

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[1] This contrasts with the recent work of the Aging Working Group of the EU, which does not include such behavior relationships, and holds most components of revenues constant relative to GDP. Thus, the CPB study is more rigorous and comprehensive in the sense that the future development of tax bases is explicitly analyzed. Both studies use the same discount rate and productivity growth of 1.7 percent per year.

[2] Referred to as the "Musgrave criterion."

sustainable public finances, the net benefits from the government will be higher for people who are born before the government takes such action.[3]

The size of the problem

The CPB estimates in its baseline that, absent measures to curb the future cost of aging, a structural general government surplus of about 3 percent of GDP (corresponding to a structural primary surplus of about 4½ percent of GDP) is needed by the end of the next cabinet period (2011). Taking into account various risks, this translates into a band of 2-5 percent of GDP. This band is asymmetrical around the baseline, with a greater weight attached to the upside (i.e., to needing a larger surplus) than the downside with respect to the real interest rate, the increase in life expectancy, and the growth in health care expenditures.[4] Other variables (e.g., productivity growth,[5] higher labor market participation, and demographic changes) are judged to be symmetrical.

The options

The benchmark option is to put into effect an immediate and permanent adjustment to achieve the desired structural surplus. This is implemented technically by cutting public consumption, and more specifically those expenditure items that have no feedback effects (which is why this is the mechanism through which the adjustment is implemented in the model), and thus the burden of adjustment affects all generations equally. It is against this benchmark that other policy options are compared.

(1) One option is to delay adjustment. This benefits current cohorts but leads to increasing debt levels, depending on how long adjustment is delayed, which eventually burden the yet-unborn cohorts. If, for example, adjustment is delayed until 2040, the required surplus to achieve sustainability would then be 4.8 percent of GDP higher than in the benchmark case, assuming that the lost ground in terms of higher debt is fully recovered over a period equal to the length of time over which the delay occurs (i.e., 34 years = 2040 – 2006).

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[3] Note, however, that, in general, generational equity cannot be determined for generations already alive at present, as this would require specific but unavailable data for the past.

[4] The baseline combines a unitary income elasticity of health care demand with an aging effect. Health care costs could, however, be higher because of a higher income elasticity (found by many studies), technological progress, and the so-called Baumol effect (i.e., labor productivity growth is below other sectors but its wage growth keeps pace, resulting in a continued relative price increase in the health sector).

[5] Note that while stronger productivity growth leads to greater prosperity and is therefore desirable, it raises the sustainable surplus. This is because wages rise when productivity increases, and expenditures are tied to wages. It also reflects higher future pension benefits and the higher (tax deductible) pension premiums that result. Restraining expenditures to a given time path in the face of higher productivity would certainly contribute to sustainability, but this is not considered relevant for the baseline because it would impair intergenerational equity as future generations would suffer from lower public expenditure.

(2) In another option, indirect taxation is increased by 2 percent of GDP to achieve sustainable public finances. This is lower than the cut in public expenditure that would be required because revenues from an increase in indirect taxation grow in the future as a result of aging, lifting the share of consumption in GDP. Real income from labor is lower than in the benchmark option; so is labor supply, causing lower employment and output. Older cohorts born between 1940 and 2000 are adversely affected compared with the benchmark policy option. This is because their contribution to consumption tax revenues is higher than their share in benefits from material public consumption.

(3) In a third option, raising taxes on labor income, taxes have to be raised by 4.1 percent of GDP to achieve sustainability. The increase is as high as it is because the drop in disposable income of households results in a partially offsetting decline in indirect tax revenues. Like in the previous option, the labor supply, employment, and output are lower, but to a greater extent—since part of the indirect taxation is paid by pensioners who cannot avoid taxation by reducing labor supply. Older cohorts of those already born are less adversely affected than with indirect taxation because this group's remaining lifetime participation on the labor market is limited.

(4) Pensioners currently enjoy a tax advantage, reflected in the exemption of pension contributions and capital gains from taxation. The option of equalizing the taxation of pensioners by eliminating tax subsidies reduces the needed surplus to achieve sustainability by 0.7 percent of GDP from the benchmark scenario. The intergenerational effects are much smaller than with the other options.

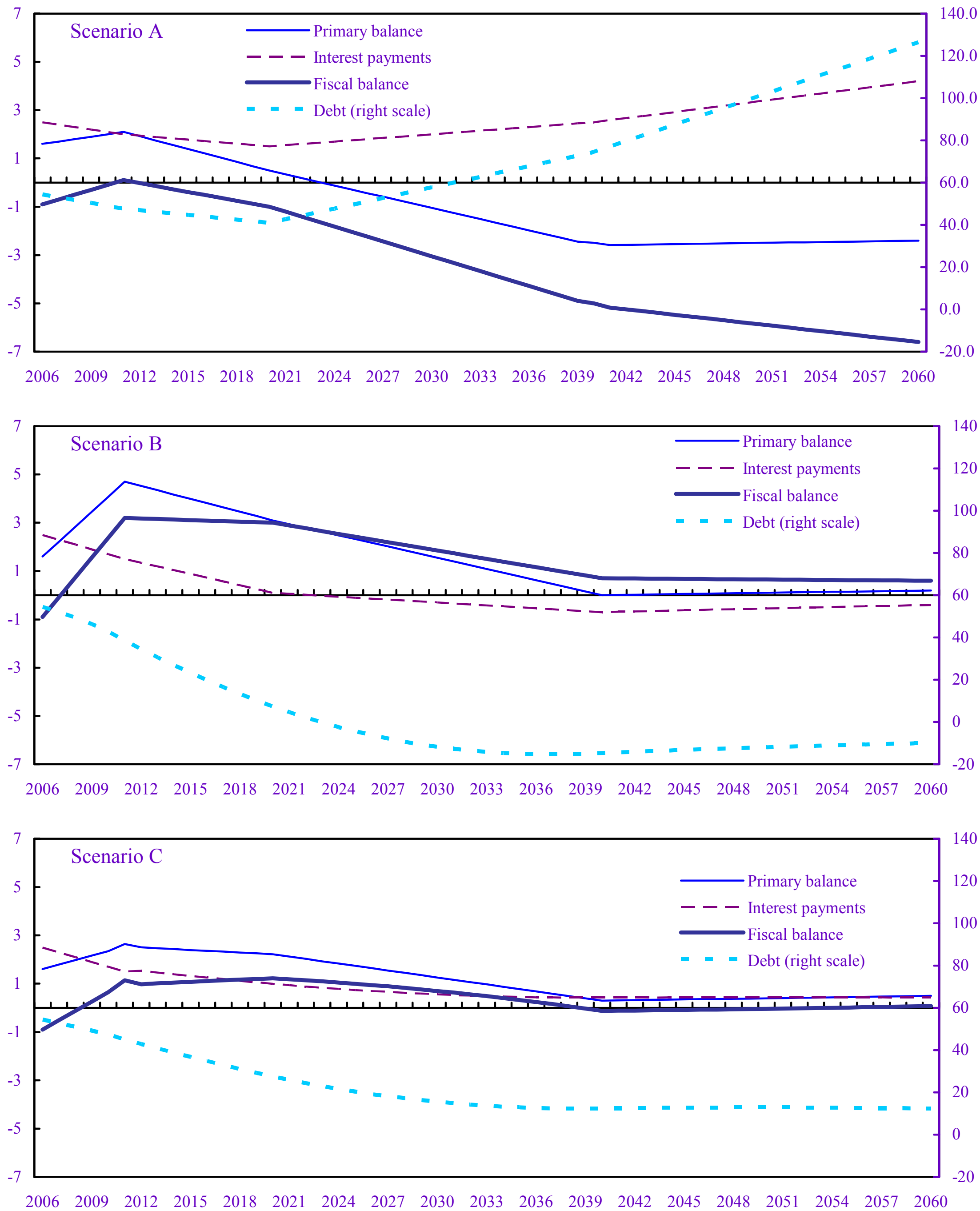
(5) A final option considered is to raise the official retirement age from 65 to 67 years. This reduces the sustainable surplus needed to achieve sustainability by 0.6 percent of GDP from the benchmark scenario. This option has the advantage that lifetime welfare effects are positive for all groups (with the caveat that decreased consumption of leisure is not taken into account), and the intergenerational effects are also much smaller than with Options 1–3.

Debt dynamics

The figures below illustrate debt dynamics under different scenarios. ***Scenario A***, for illustrative purposes, shows the dynamics under a passive scenario with no policy adjustments. Clearly, this would result in unsustainable debt dynamics, with debt levels reaching triple digits. ***Scenario B*** illustrates the dynamics under the authorities' benchmark option, in which a structural surplus of 3 percent of GDP is achieved by 2011. In this case, a sustainable path would be achieved, with government debt falling from about 55 percent of GDP to somewhat below zero. Finally, ***Scenario C*** represents a combination of upfront adjustment (achieving a fiscal surplus of 1 percent of GDP by 2011) along with other longer-term sustainability-enhancing measures (in particular, increasing the official retirement age by 2 years to 67 years and eliminating the implicit tax subsidy for pensioners, which taken by themselves would reduce the sustainability gap by 1¼ percentage point of GDP). Additional expenditure cuts are spread over time to close the sustainability gap. While sustainability is still achieved, debt stabilizes at a higher level than in the previous scenario.

Netherlands: Fiscal Scenarios, 2006-60

(In percent of GDP)



Source: IMF staff calculations, based on the authorities' aging study.

Statement by the IMF Staff Representative
July 26, 2006

1. This staff statement provides information on economic and political developments that has become available since the preparation of the staff report for the 2006 Article IV Consultation. The new information does not alter the thrust of the staff appraisal.

2. **Historical data on real GDP growth have been revised: up on an annual basis for 2003–05, but down slightly for Q1 2006 (Text Table).** The main factor for 2003–05 was higher private consumption. There were also upward revisions to both investment growth (2003) and the contribution of net exports (2004). Although quarter-on-quarter growth in Q1 2006 was revised down, the revision was small (just 0.1 percentage point of GDP) and first quarter developments continue to be seen as broadly in line with staff's full-year GDP projections (as indicated in footnote 6 of the staff report). The new first quarter data show lower government consumption growth than before, while investment growth is now positive instead of slightly negative. Meanwhile, as indicated in the staff report, exports remained robust and private consumption above expectations.

Revised GDP Growth
(In percent)

	2003	2004	2005	Q1 2006 1/
Previous data	-0.1	1.7	1.1	0.2
Revised data	0.3	2.0	1.5	0.1

1/ Quarter-on-quarter growth based on seasonally adjusted data.

3. **Other economic developments are generally in line with a projected recovery.** Employment continues to grow, with 35,000 new jobs created in the first quarter of 2006. Consumer confidence strengthened further in June, while business confidence remained at its higher level.

4. **Year-on-year inflation has remained moderate.** In June, it stayed at 1.8 percent (CPI-HICP), the same rate as in May and April. For January-June, it averaged 1.7 percent.

5. **The CPB in June 2006 revised its growth projection—to 3 percent in 2006 (from 2.7 percent) and 2.8 percent in 2007 (from 3 percent).** This revision mainly reflects stronger consumer spending in 2006 followed by a somewhat slower pace of consumption growth in 2007. Meanwhile, the DNB's forecast, released in June 2006, shows growth of 2.5 percent in 2006 and 2.7 percent in 2007.

6. **The Dutch government resigned after losing the support of the smallest coalition partner (D66).** New elections are scheduled for November 22, 2006. In the meantime, the remaining coalition parties—the Christian Democratic Party (CDA) and the Liberal Party (VVD)—have formed a minority coalition government, which will finalize the 2007 budget preparations. These preparations were already well advanced, supported by D66, and appear to have broader support in parliament.

INTERNATIONAL MONETARY FUND
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International Monetary Fund
700 19th Street, NW
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IMF Executive Board Concludes 2006 Article IV Consultation with the Kingdom of the Netherlands — Netherlands

On July 26, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Kingdom of the Netherlands — Netherlands.[1]

Background

The Netherlands is coming out of a period of slow or negative economic growth. Average annual growth in 2001–03 was 0.5 percent, the slowest rate in any three-year period since the beginning of the 1980s. Deteriorating external competitiveness, combined with weak foreign demand, restrained exports and growth overall.

A hesitant recovery started to take hold during 2005. Employment and consumption through end-2005 were weak compared with previous expansions, with a recovery at the start of 2004 failing to gather steam. But with foreign demand more robust, exports, though tempered by the lagged effects of real exchange rate appreciation, drove a mild recovery. Perhaps most important, the growth of private consumption, investment, and GDP gained traction in the second half of 2005. Business and consumer confidence also strengthened. Employment in 2005 recorded a more sustained rise than at any time since 2001.

Inflation remained in check, with little pressure from wages as the social partners sought to boost external competitiveness. Year-on-year CPI inflation averaged 1.7 percent in January–May 2006. Wage growth was subdued: the economy-wide wage moderation agreement for 2004–05 explicitly targeted low wage growth with competitiveness in mind. Recent economic

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[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.

performance suggests that competitiveness is not a particular threat to sustaining economic recovery, a point reinforced by the current account surplus.

After breaching the Maastricht deficit ceiling in 2003, the authorities achieved considerable fiscal consolidation. The general government deficit narrowed to 0.3 percent of GDP in 2005 from 3.2 percent in 2003. This reflected underlying structural adjustment of some 2.5 percentage points of GDP, largely the result of expenditure restraint.

The financial sector is generally sound but somewhat colored by developments largely related to real estate. Banks' capital adequacy remains strong, and other indicators have been improving. Pension funds are, on average, close to their required coverage ratios that come into effect in January 2007. In the insurance sector, earlier stress tests performed for the IMF's Financial System Stability Assessment (see Country Report No. 04/312) indicated that shocks, except the most extreme ones, could be absorbed. However, credit quality has reportedly deteriorated with the continued expansion of mortgages. In addition, households have also become more sensitive to interest rate changes: the ratio of mortgage debt-to-GDP is high, the proportion of mortgages subject to an interest rate adjustment within two years has increased, and the percentage of newly provided loans with loan-to-value ratios exceeding 100 percent has also been increasing significantly. A small bank failed in December 2005, without systemic repercussions.

In addition to the near-term outlook, the discussions focused on key measures to ensure fiscal sustainability with population aging, while building a solid foundation for sustaining growth and safeguarding financial stability. In this context, the discussions benefited from official studies on related issues. Work on the financial sector included a continued follow-up on the recommendations made in the FSSA.

Executive Board Assessment

Directors were encouraged that the economic recovery is gathering steam, supported by the strong polices of recent years, including a turnaround in public finances and structural reforms in a number of key areas—among them health care, disability, and financial supervision. Looking ahead, Directors agreed that ensuring a solid foundation for sustained economic growth would require in particular ensuring the sustainability of public finances in the face of an aging population, safeguarding financial stability, and undertaking further structural reforms to raise labor participation, hours worked, and overall productivity. Directors also noted that continued wage moderation would help to take full advantage of the global upturn.

Directors welcomed the authorities' comprehensive study on population aging and recommended early action to contain the medium-term risks and to take advantage of the current favorable economic environment. They therefore recommended achieving a general government surplus of at least 1 percent of GDP by 2011. However, to achieve fiscal sustainability in the face of an aging population will also require sustainability-enhancing structural reforms—including, for example, a rise in the retirement age and linking it to changes in life expectancy, and Directors encouraged the authorities to put these reforms in place on a timely basis.

In view of medium-term fiscal requirements and with the upturn well in train, Directors noted that the 2007 budget could turn somewhat expansionary. They encouraged the authorities to pursue at least a neutral fiscal stance this year and next and to use any revenue overperformance or below-budget expenditure outturns for deficit reduction.

Directors commended the strong fiscal framework, noting that it meets or exceeds the good-practice standards according to the recent ROSC. They also welcomed the independent and central role of the Bureau for Economic Policy Analysis (CPB) as a best-practice example of separating the political and technical elements of macroeconomic policy. They nevertheless encouraged the authorities to consider the refinements to the framework recommended by the ROSC related to the operations of the expenditure ceilings and the budgetary fund based on gas revenues.

Directors noted that the financial sector remains sound and welcomed the new Financial Supervision Act, the strengthening of the risk orientation of supervision, and the ongoing analytical work on financial stability, including a new round of stress testing. They noted with concern the emerging vulnerabilities in the mortgage sector, but were encouraged by the authorities' efforts to strengthen the code on mortgage lending and monitoring and enforcing compliance.

Directors appreciated the authorities' responsiveness to the recommendations of the Financial System Stability Assessment. More broadly, they encouraged the authorities to assess whether rent controls and administrative allocation mechanisms for housing appropriately served their intended purposes. On pension supervision, Directors agreed on the merits of specifying a one-year recovery period should shortfalls from the minimum coverage ratio occur, but recognized that escape clauses allowing for a longer period are necessary too.

Directors welcomed the considerable efforts already made by the authorities to raise labor participation and overall productivity, but felt that there is still room for further reforms—regarding, for instance, still generous unemployment benefits. They also encouraged the authorities to find new ways of lessening inactivity traps and stimulating demand for low-skilled labor, including through changes in the minimum wage and its links to several social benefits. Directors also urged the authorities to make employment protection legislation less stringent, noting that it acts as a tax on new hiring and labor reallocation and can hamper innovation. They encouraged the authorities to continue with their efforts to increase competition and reduce red tape as important steps to enhance productivity and boost innovation.
Directors commended the authorities for their strong commitment to Overseas Development Assistance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with the Netherlands is also available.

Netherlands: Selected Economic Indicators

	2001	2002	2003	2004	2005	2006 1/	2007 1/
Real economy (change in percent)							
Real GDP	1.4	0.1	-0.1	1.7	1.1	2.6	2.8
Domestic demand	1.8	-0.4	-0.3	0.8	0.2	2.6	2.2
CPI (harmonized) 2/	5.1	3.9	2.2	1.4	1.5	1.5	1.6
Unemployment rate (in percent)	2.5	2.9	4.0	4.9	5.2	4.8	4.3
Gross national saving (percent of GDP)	25.5	24.7	24.5	28.5	25.6	26.5	27.8
Gross domestic investment (percent of GDP)	21.5	19.7	19.0	19.5	19.2	19.6	20.1
Public finance (percent of GDP)							
General government balance	-0.3	-2.0	-3.2	-2.1	-0.3	-0.9	-0.9
Structural balance	-1.2	-2.3	-2.4	-1.2	0.1	---	-0.3
General government debt	50.7	50.5	51.9	52.6	52.9	52.6	52.0
Interest rates (percent)							
Money market rate 3/	4.3	3.3	2.3	2.1	2.2	2.7	...
Government bond yield 4/	5.2	5.0	4.2	4.1	3.4	3.7	...
Balance of payments							
(Percent of GDP, unless otherwise indicated) 5/							
Trade balance	4.8	4.2	6.6	7.1	7.0	8.0	8.9
Current account balance	2.4	2.5	5.5	8.9	6.4	6.9	7.8
Official reserves, excl. gold (in US$ billion) 3/	9.0	9.6	11.0	10.1	9.1	9.3	...
Reserve cover (in months of imports of GNFS)	0.4	0.5	0.4	0.3	0.3	...	...
Exchange rate							
Exchange rate regime		Member of EMU					
U.S. dollar per euro (May 2006)						1.28	
Nominal effective rate (1990=100) 3/	94.0	95.6	100.9	102.5	102.4	101.8	...
Real effective rate (1990=100) 3/, 6/	99.4	102.3	107.4	109.5	108.2	107.95	...

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

1/ Staff projections, unless otherwise indicated.
2/ In 2001, an indirect tax increase is estimated to have boosted inflation by 1.2 percentage points.
3/ As of April for 2006.
4/ As of May for 2006.
5/ Transactions basis.
6/ Based on relative normalized unit labor costs.