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Kingdom of the Netherlands—Netherlands: Staff Report for the 2000 Article IV Consultation

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

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KINGDOM OF THE NETHERLANDS—NETHERLANDS

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Consultation
with the Kingdom of the Netherlands—Netherlands

Approved by Michael Deppler and G. Russell Kincaid

May 22, 2000

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I. Introduction

1. The Article IV consultation discussions were held in Amsterdam and The Hague during March 10-20, 2000. The mission met with the Minister of Finance, the Governor and the Deputy Governor of de Nederlandsche Bank (DNB), senior officials and staff of these institutions, the Ministries of Economic Affairs, and Social Affairs and Employment, as well as the Netherlands Bureau for Economic Policy Analysis (CPB), the Council of Financial Supervisors, and the Social and Economic Council (SER); commercial bankers; academics; and representatives of employers federations and labor unions.[1]

2. In concluding the last consultation, on October 15, 1999 (SUR/99/122), Executive Directors commended the authorities for their sustained implementation of sound macroeconomic policies and structural reforms, which had been key in achieving a prolonged economic expansion and one of the lowest unemployment rates in the EU. With strong economic growth likely to continue, Directors stressed the need to remain vigilant for signs of overheating, and to sustain the momentum of reforms in product, labor, and financial markets. They supported the conduct of fiscal policy in a rules-based medium-term framework and the planned reduction in the revenue-to-GDP ratio. Most Directors encouraged the authorities to aim for a further improvement in the structural fiscal balance and to avoid any additional fiscal stimulus.

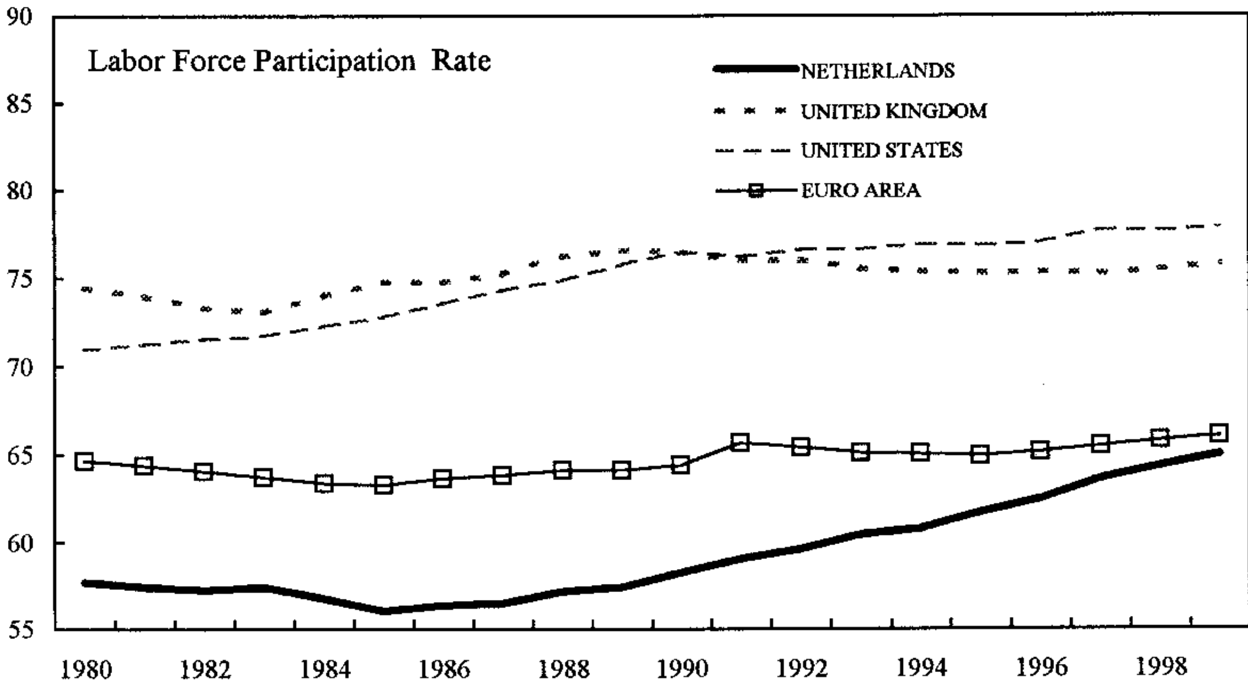
3. The left-right coalition that took office in 1994 is in the middle of its second term. The government is pursuing—through broad consensus—a policy of tax reduction and expenditure restraint, as well as gradual labor and product market reforms. The authorities expressed their intention to continue to participate in the pilot project for publication of the staff report.

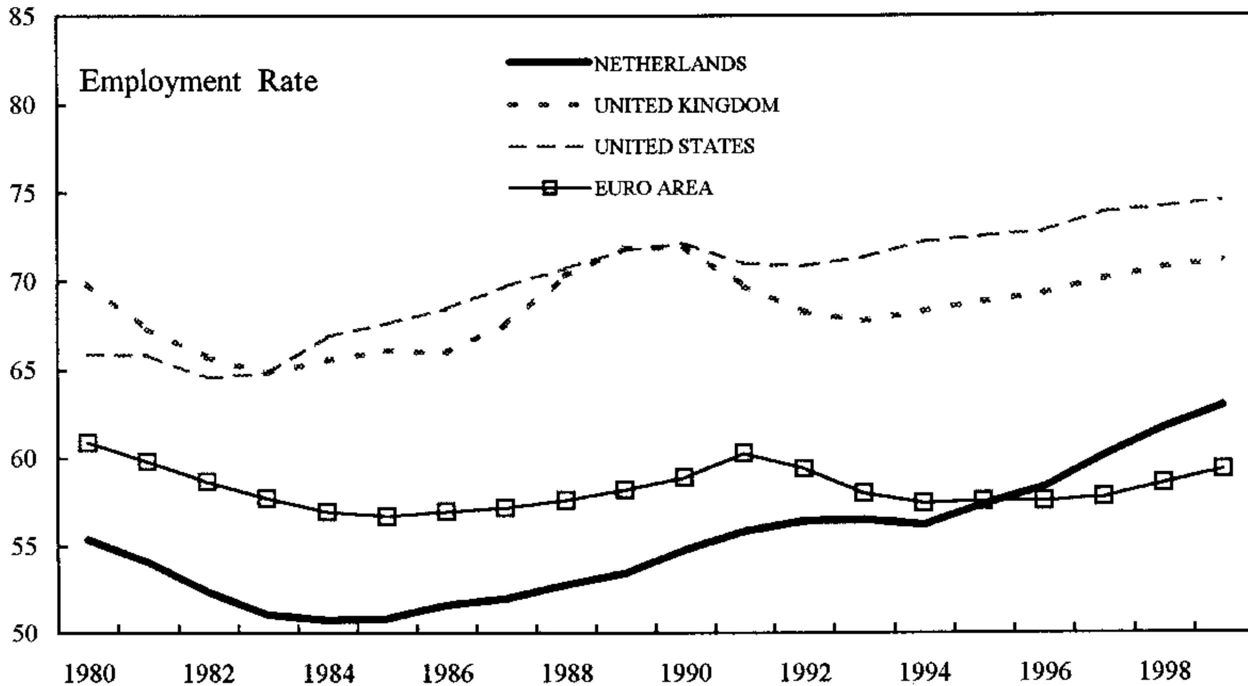
II. Background

4. **The Dutch economy has added another year of job-creating growth and declining unemployment to its extended record of strong economic performance.** Since the mid-1980s, real GDP grew on average by nearly 3 percent per year, substantially above most other European countries. While increases in total factor productivity and capital accounted for two-thirds of this growth, in line with historic averages, this improved performance is mainly due to a positive contribution of labor input, a sharp reversal from a decade earlier. The policy and structural basis of this performance is analyzed in detail in "The Netherlands: Transforming a Market Economy," (IMF Occasional Paper No. 181). In brief, primary budgetary spending was cut by almost 10 percentage points of GDP during the 1990s and labor market reform and wage moderation were key factors in reducing unemployment by half from its previous peak, even as labor force participation rose to the euro-area average (Figure 1). A trend rise in female labor force participation has been encouraged by greater labor market flexibility. These

[1] The staff team comprised Messrs. Ford (Head), Everaert, Ms. Louppe, and Mr. Martijn (all EU1). Mr. Wijnholds (Executive Director), and Mr. Houtman (Advisor) participated in the meetings.

Figure 1. Netherlands: Labor Force Participation and Employment Rates
(In Percent of Working Age Population)





Source: OECD, Economic Outlook Database.

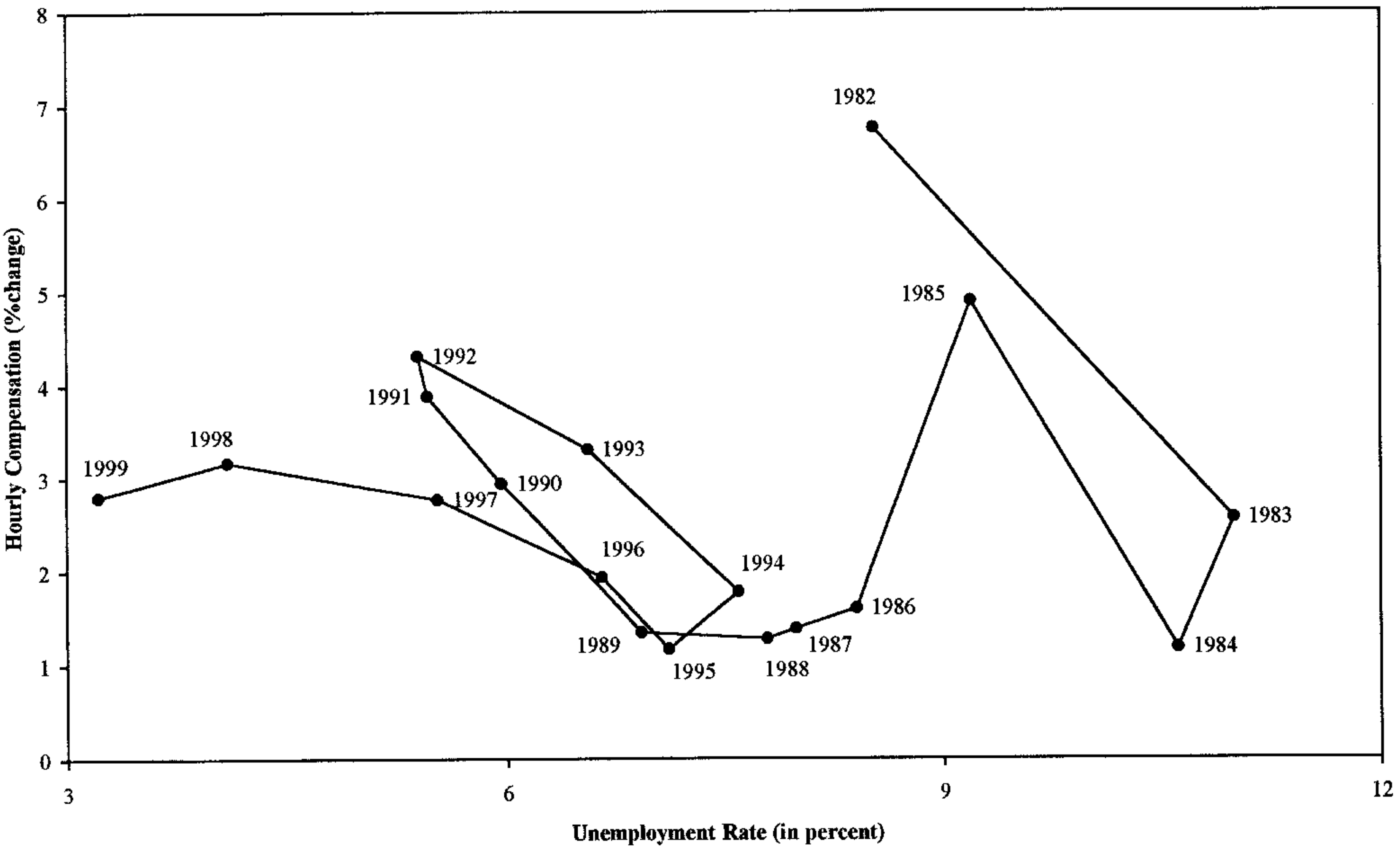
developments have expanded supply and shifted favorably the relationship between inflation and unemployment (Figure 2). Still, significant structural problems remain in the labor market, as indicated by the high incidence of disability and early retirement, and the large number of welfare benefit recipients.

5. **Recently, the Dutch economy has become cyclically advanced compared with its main euro-area trading partners.** During 1996-99, real GDP and employment growth averaged 3½ percent and 2½ percent per year respectively, much faster than in the euro area or the EU (Figures 3-5 and Table 1). Consumer price inflation, on the basis of the harmonized index of consumer prices (HICP), in the Netherlands has been somewhat higher than the euro-area average until recently, when the former dropped down and the latter rose more in response to international price developments (Figure 6). While the current upswing started with a strong contribution from external demand, during the past two years private consumption has been the main driving force of the economy. Consequently, the current account surplus and competitiveness (unit labor cost (ULC) based) vis-à-vis the rest of the euro-area declined moderately in 1998-99, although competitiveness continued to improve with respect to all industrialized trading partners. These developments have been associated with robust credit growth and booming asset markets (Figure 7). In particular, real property prices have been rising sharply—a phenomenon also observed in other cyclically advanced economies (Figure 8). In recent years, wealth effects are estimated by the Dutch authorities to have added about 1 percentage point to private consumption growth, which has been higher than that of disposable household income; that is, a decline in the savings rate (Figure 9).

6. **Strong growth is continuing in 1999-00 and labor markets have become very tight, with producer prices and unit labor costs rising, though there is no evidence yet of accelerating consumer price inflation**. Growth of real GDP is estimated to have been 3.6 percent in 1999, and the unemployment rate fell to 3.2 percent on a registration basis.[2] In early 2000, the unemployment rate stood at 2.8 percent, and vacancies were near record levels, but industrial capacity utilization was only marginally above its historical average. Growth of unit labor costs and wage costs per employee accelerated somewhat in 1999. To a large extent due to the abolition of the television and radio license fee, consumer price inflation on an HICP basis has recently fallen to one of the lowest in the euro area. Excluding indirect taxes and energy prices, Dutch inflation has declined to 1.2 percent in April 2000. Since late 1999, the source of demand growth has been shifting from private consumption to exports. The growth rate of household consumption decelerated from an exceptionally high 4.8 percent in the first quarter of 1999 to 3.5 percent in the last quarter, more in line with, but still above the rise in disposable income. Export volume growth rose from 3.5 percent to 6.9 percent, fueled by the pickup in activity in the core euro area.

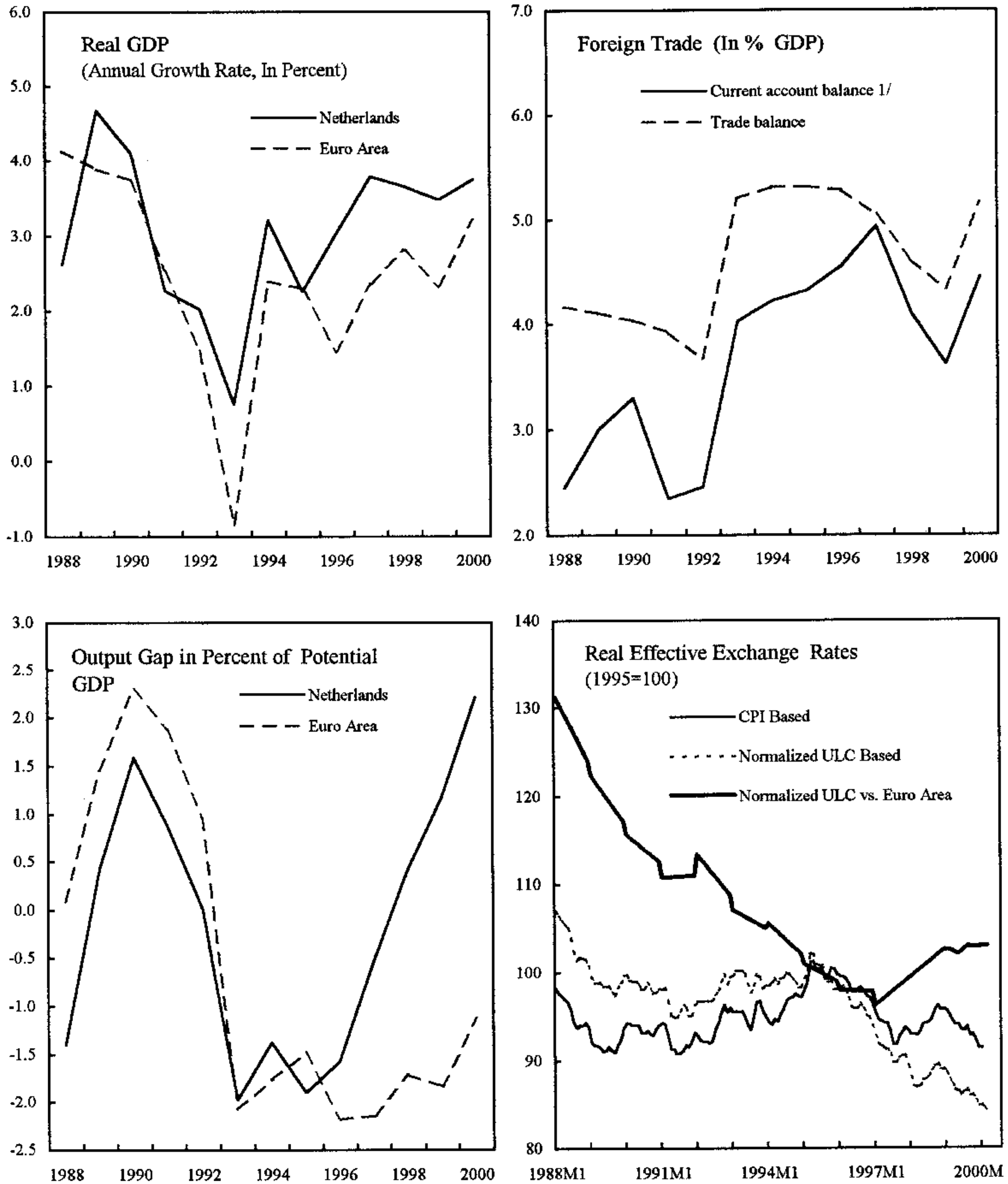
[2] Including unregistered job-seekers, the rate was 4.0 percent.

Figure 2. Netherlands: Hourly Compensation and Unemployment



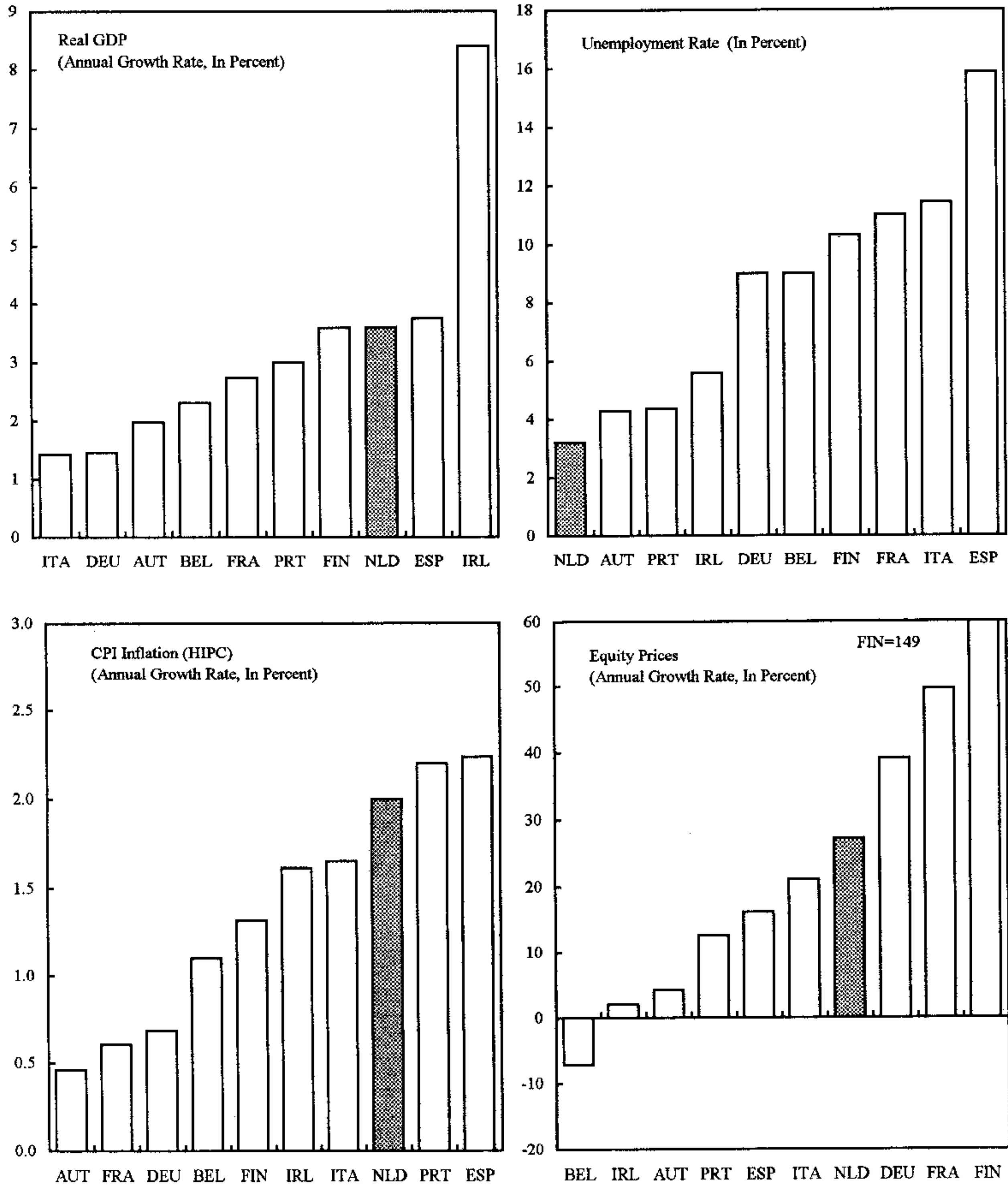
Source: IMF, WEO.

Figure 3. Netherlands: Production and External Sector



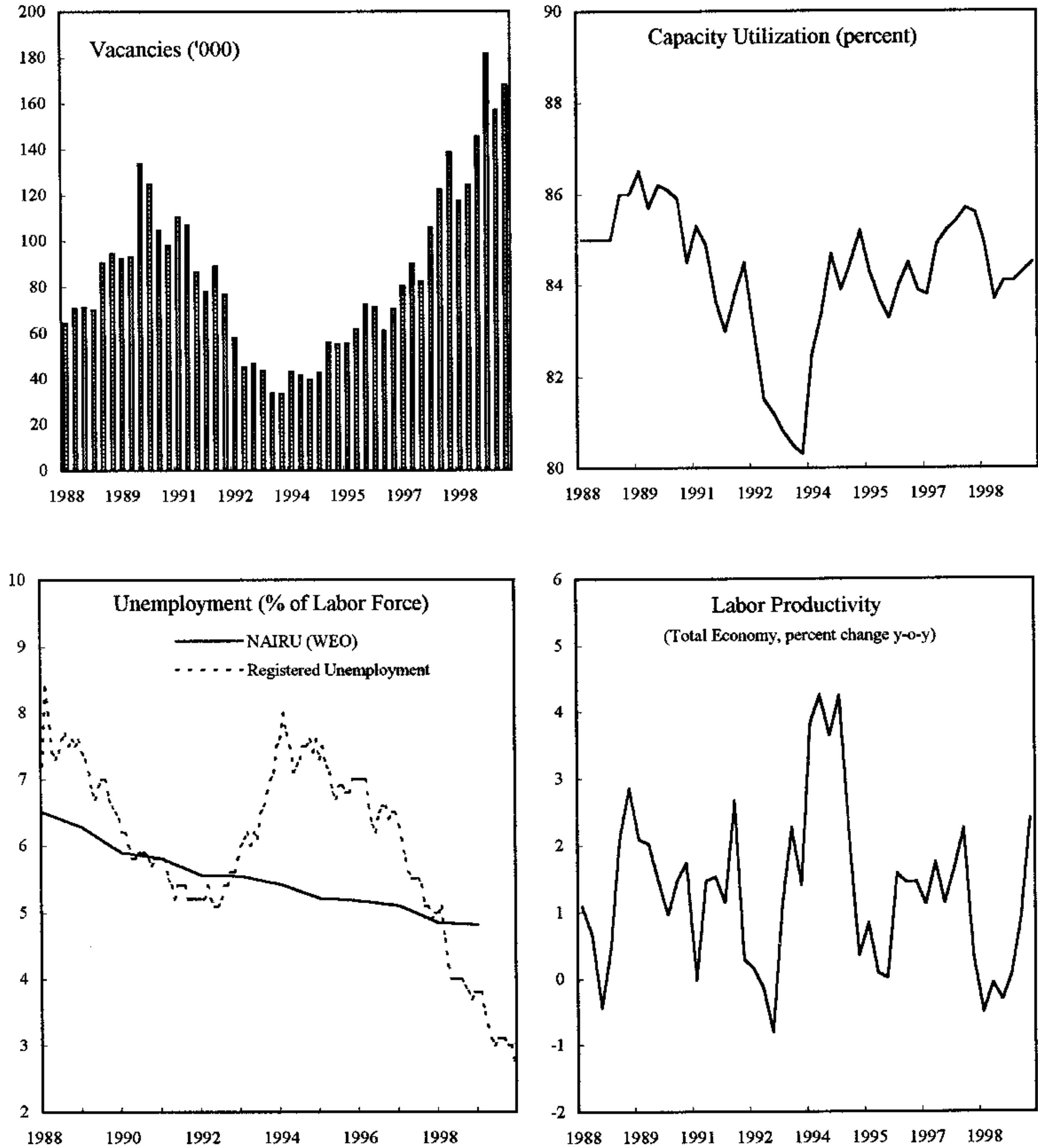
Sources: IMF, IFS and WEO.
1/ Excluding (volatile) factor income.

Figure 4. Netherlands: Key Economic Indicators-Comparison with Euro Area in 1999



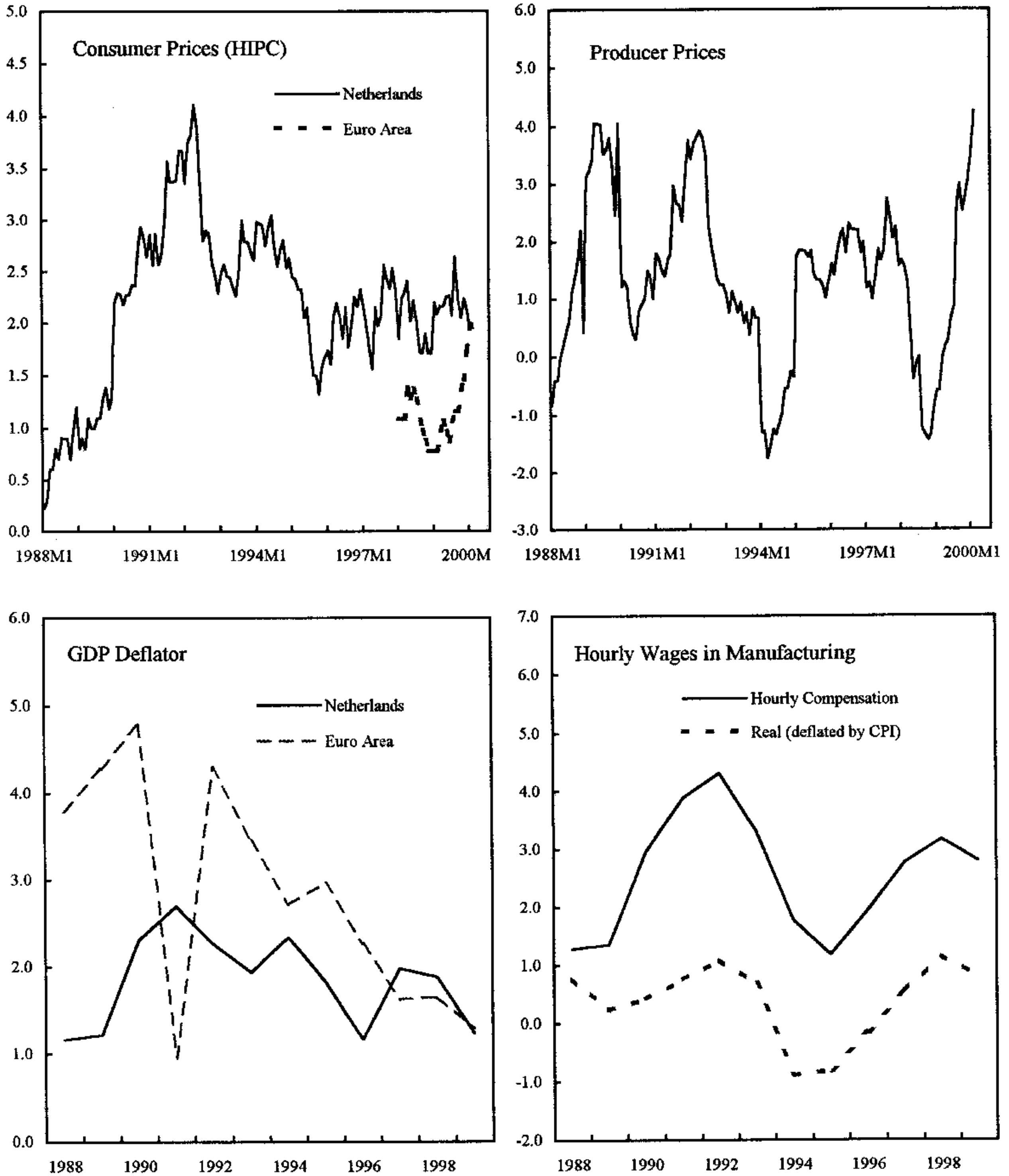
Sources: IMF, WEO; WEFA database; and staff estimates.

Figure 5. Netherlands: Labor Market and Productivity



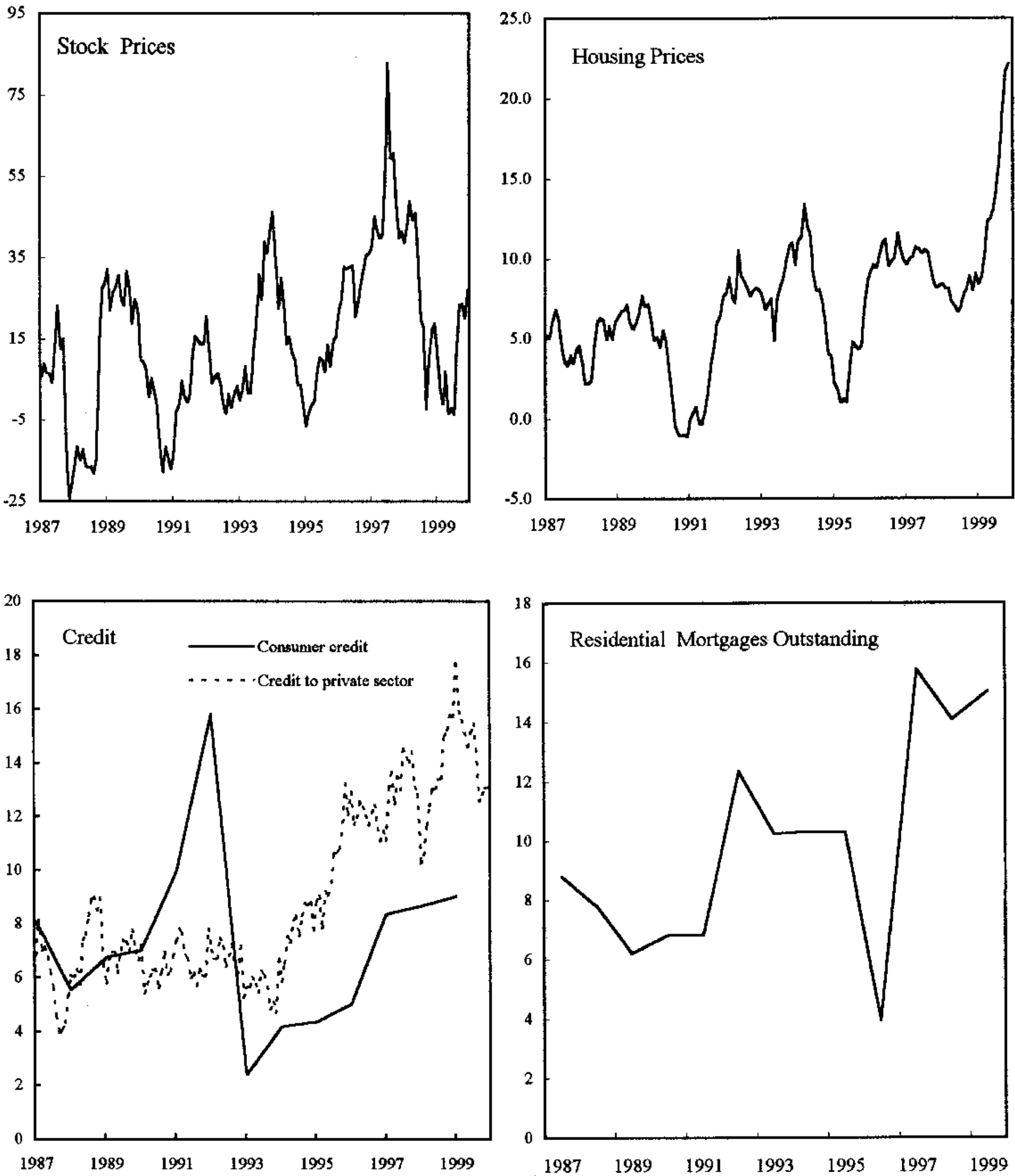
Sources: CBS; IMF; WEO and IFS.

Figure 6. Netherlands: Prices and Wages
(Percent Change over Previous Year)



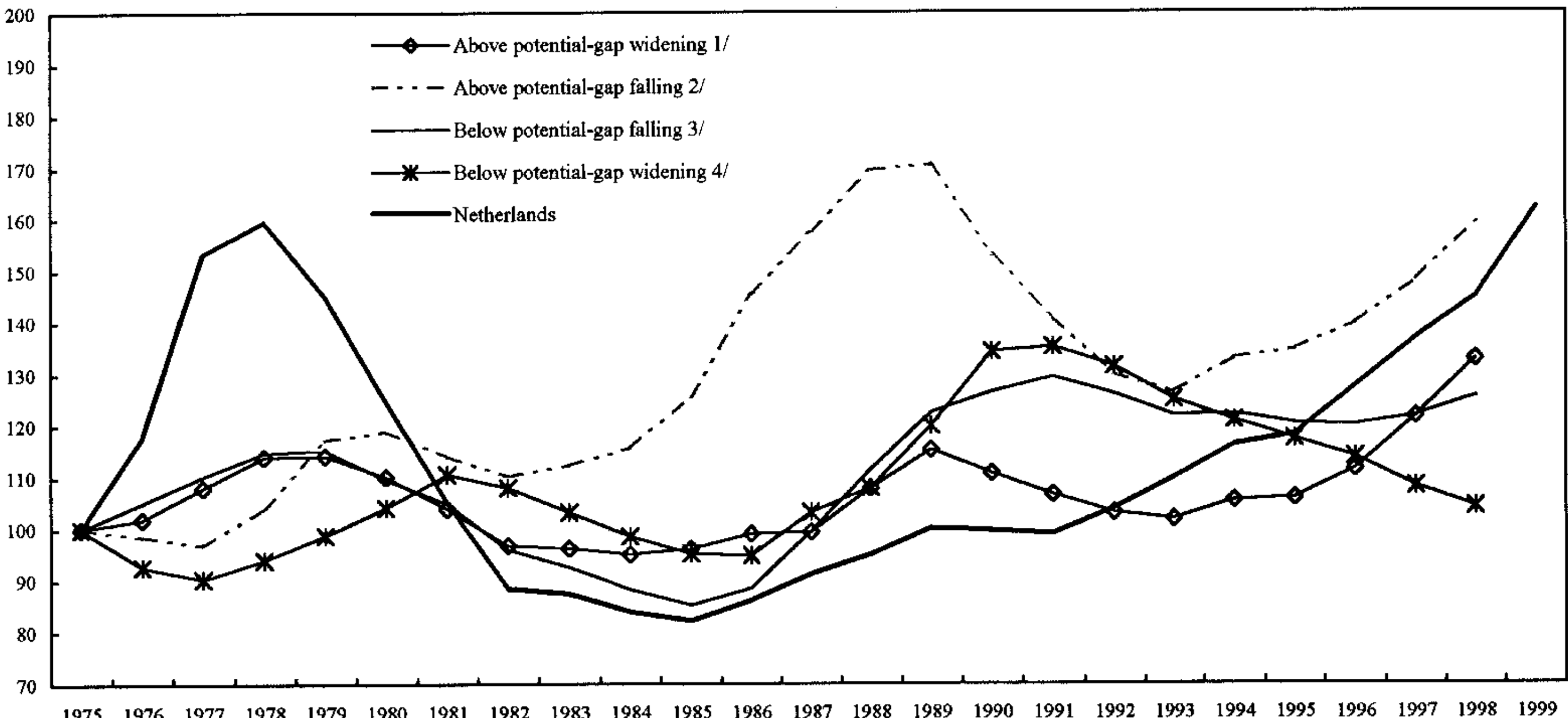
Sources: IMF, IFS and WEO.

Figure 7. Netherlands: Asset Markets and Credit
(Percent change over previous year)



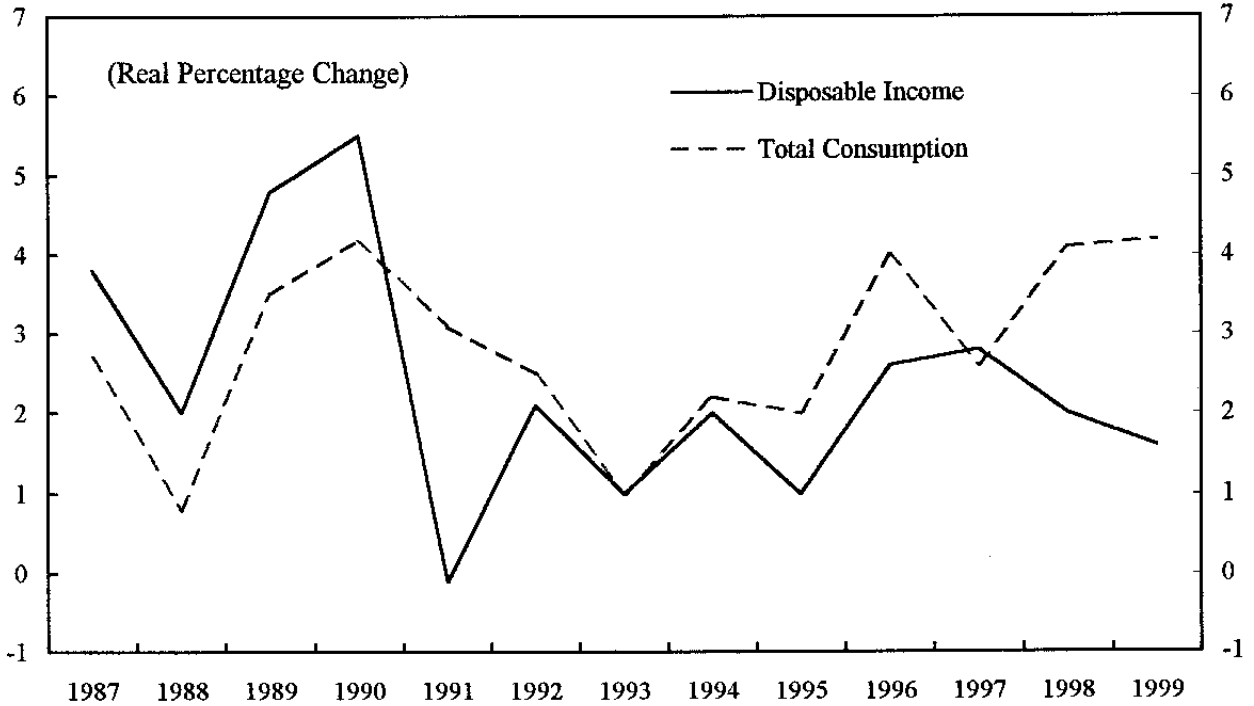
Sources: CBS; IMF, IFS and WEO.

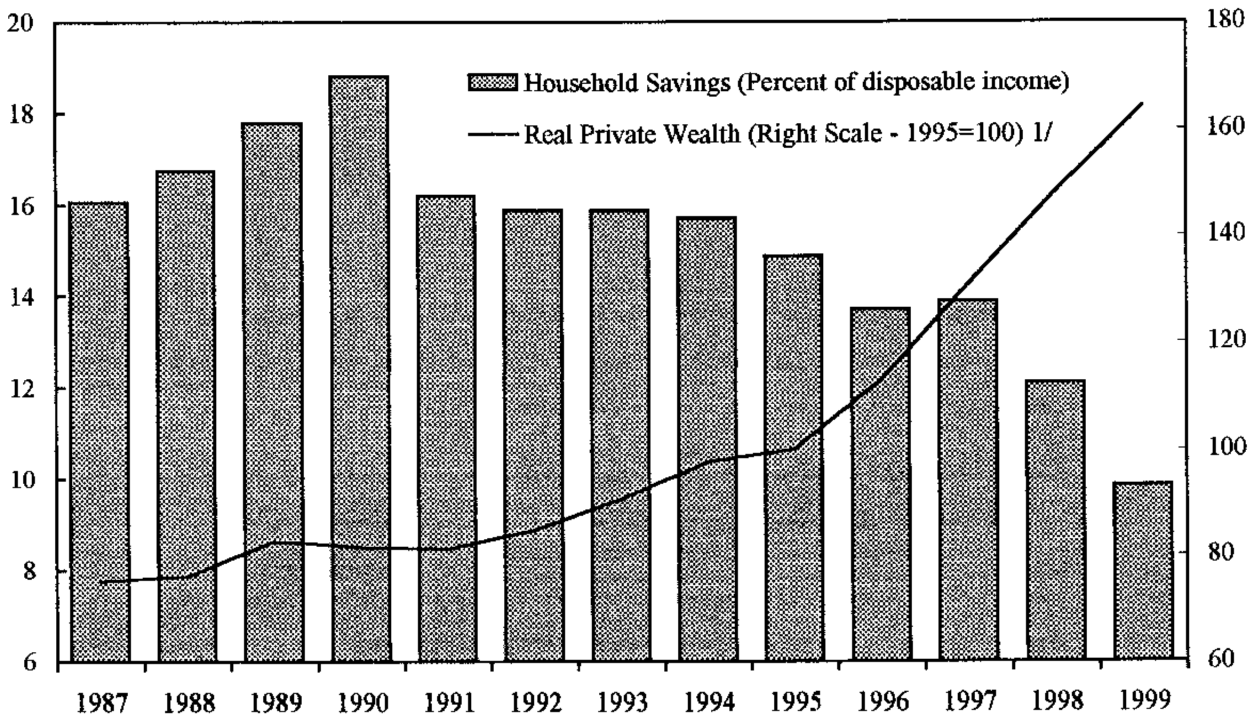
Figure 8. Netherlands: Real Residential Property Prices and the Business Cycle
(Average Index by Country Group According to 1999 Cyclical Position, 1975=100)



Sources: BIS; and IMF, WEO.
1/ Australia, Denmark, Finland, Ireland, Netherlands, United States.
2/ Norway and United Kingdom.
3/ Belgium, Canada, France, Spain, Sweden.
4/ Germany, Italy, Japan.

Figure 9: Netherlands: Disposable Income, Consumption, Savings and Wealth





Sources: IMF, WEO and national authorities.

1/ Real private wealth=weighted average of real estate and equity, deflated by consumer prices.

7. **During 1999 and in early 2000, monetary conditions were highly supportive of demand expansion, but fiscal policy turned restrictive.** Real long-term interest rates rose modestly late in 1999, but the real exchange rate depreciated further, a development that has so far continued into 2000 (Figure 10). In contrast, the budget withdrew demand, as the structural balance improved by more than ¾ of 1 percentage point of GDP in 1999 (Figure 11 and Table 2). This was largely due to the preservation of windfalls on the revenue side that were caused by an unexpected shift of private consumption toward higher-taxed durables, a buoyant housing market, and higher-than-projected dividends. The rule allocating revenue windfalls partly to tax reductions did not result in additional tax relief in 1999.[3] Expenditures remained below the ceiling specified in the framework, as savings on interest, wages, and unemployment benefit outlays were only partly offset by higher spending on asylum seekers and flood damage. As a corollary, for the first time in decades, the budget recorded an actual surplus of ½ percent of GDP in 1999.

III. Discussions

8. Since the last consultation, demand pressures have if anything intensified. Discussions therefore focused on how to assess the current cyclical situation and economic outlook, the adjustment mechanism of the Dutch economy to demand pressures in the context of monetary union, the consequences of upside demand risks, and the policy requirements for a soft landing.[4] Discussions also highlighted the medium-term policies needed to improve further the flexibility of the economy to deal with cyclical tensions and extend its record of strong performance.

A. Cyclical Position and Economic Outlook

9. **In the face of mixed signals, there was still uncertainty as to how much slack, if any, there was left in the economy**. By most estimates, aggregate demand exceeded potential output and actual employment had dropped below the non-accelerating inflation rate of

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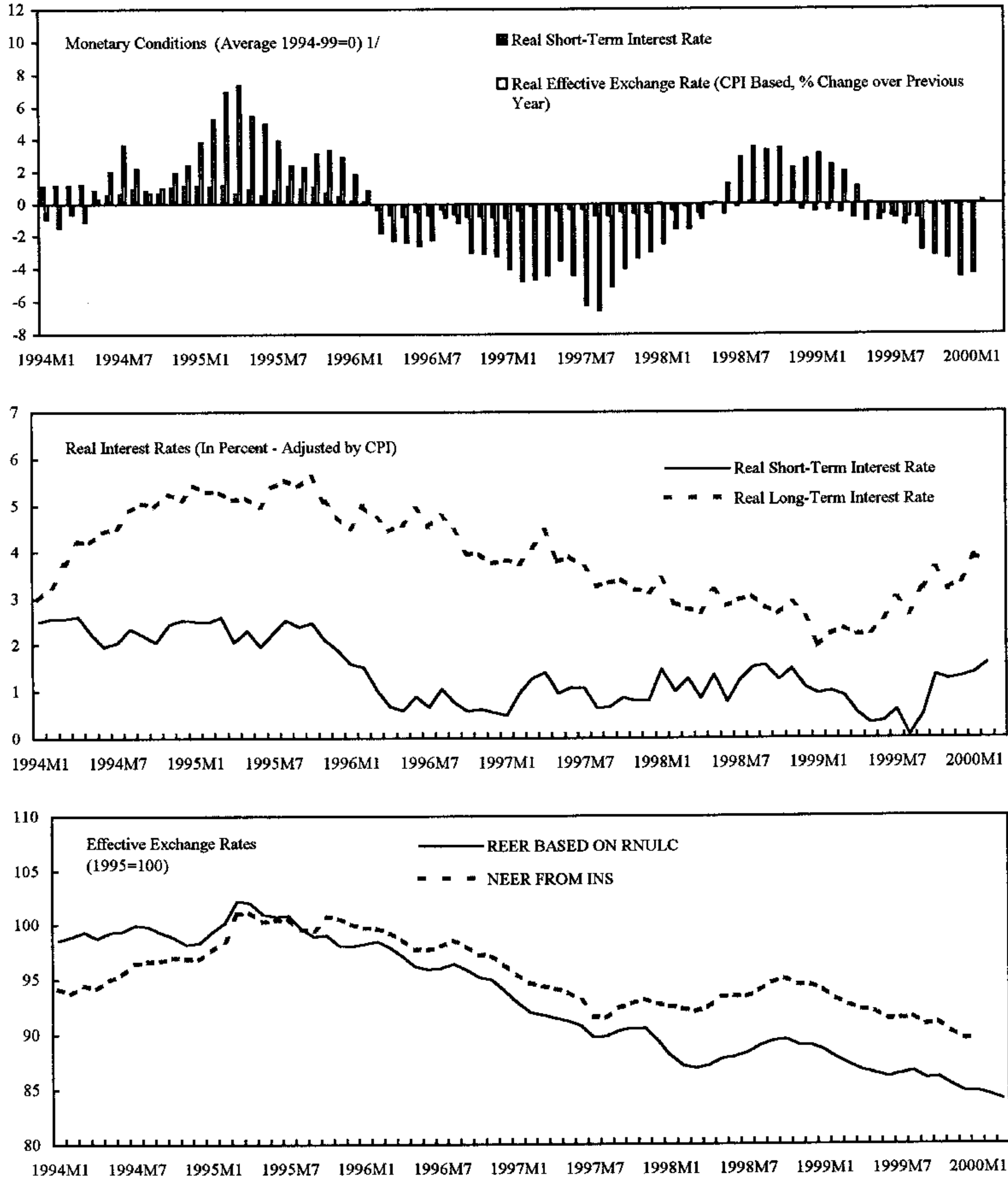
[3] Since 1994, Dutch fiscal policy has operated within a four-year, rule-based framework, which coincides with the government's term. The current rules specify that some tax windfalls be devoted to the deficit and some to tax reductions, though the timing of the tax reductions is left unstated. For a description of the current framework, see the staff report for the 1999 Article IV consultation (SM/99/221, 9/13/99), page 21, Box 2.

[4] A forthcoming cross-country study will examine in greater detail the issues and policy challenges facing those euro-area countries with business cycle recoveries that are more advanced than those of the core (including the Netherlands).

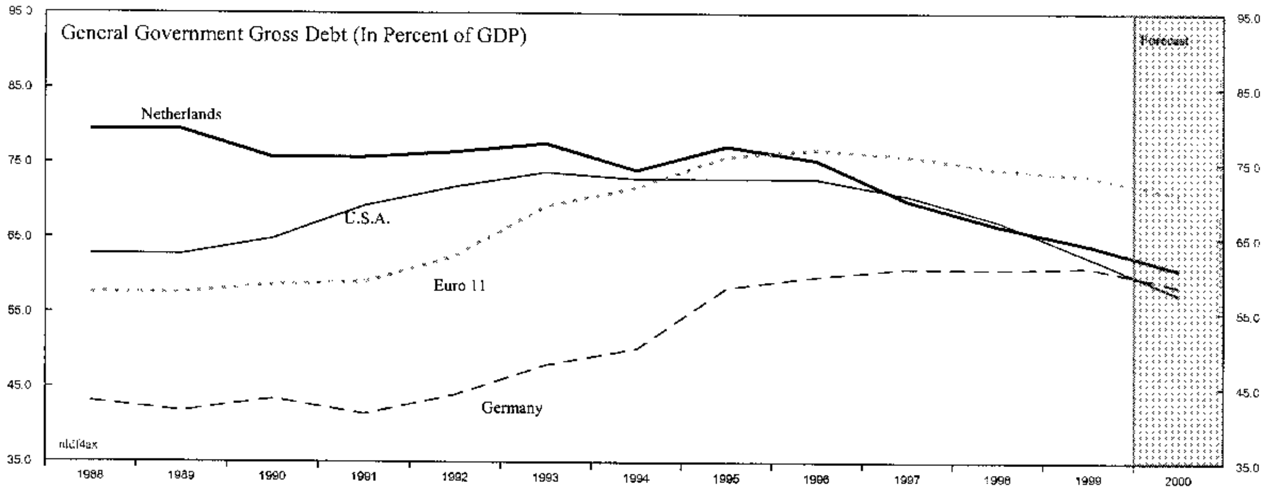
Figure 10. Netherlands: Monetary Conditions

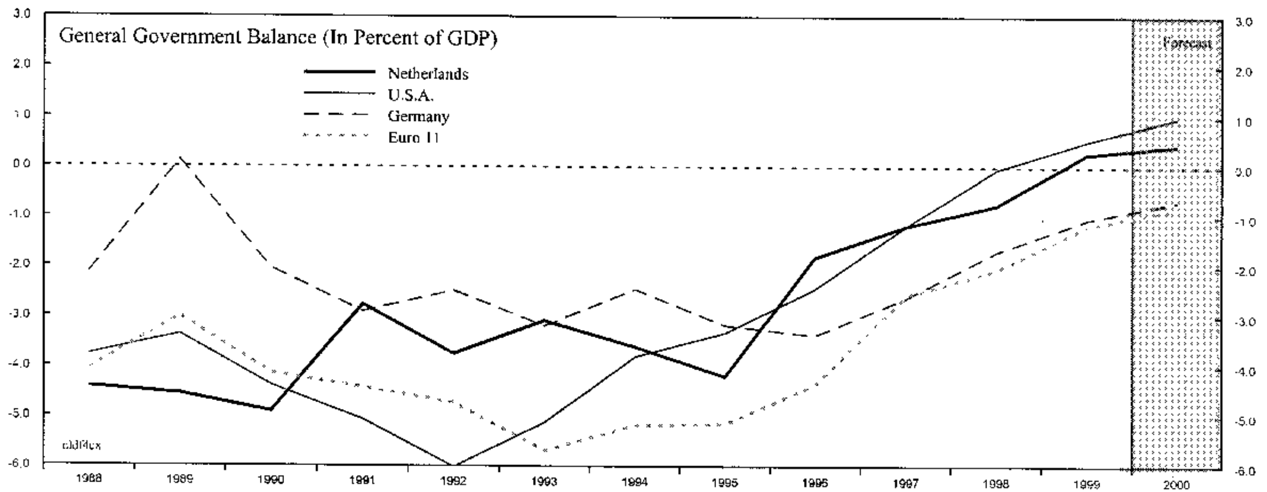


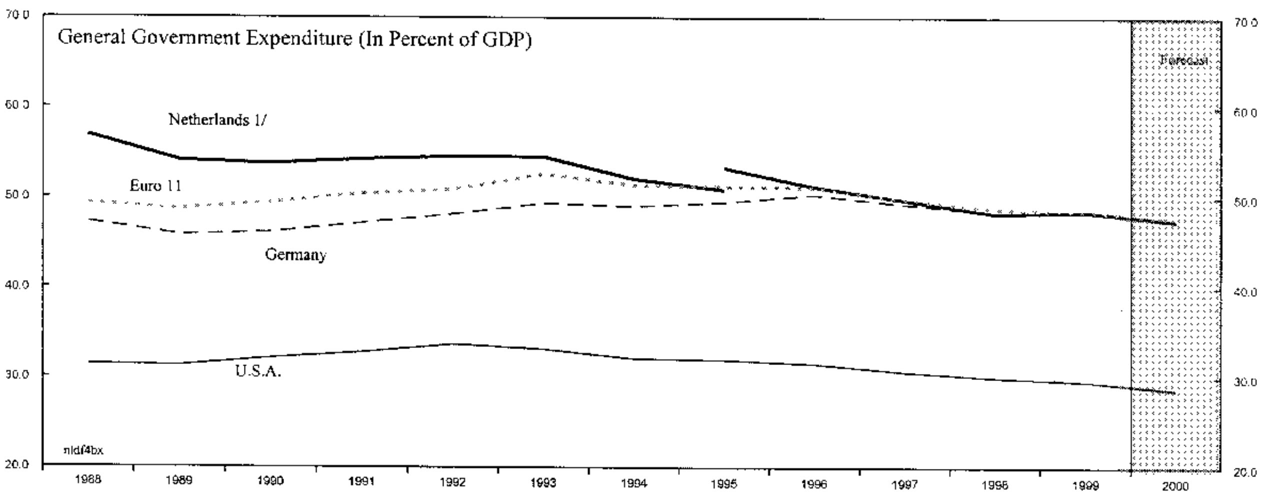
Source: IMF, IFS.

1/ An increase implies less accommodative conditions.

Figure 11. Netherlands: Fiscal Indicators







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

unemployment (NAIRU) (see the Selected Issues paper).[5] There were reports that labor shortages might be spreading more widely through the economy, with wage increases growing larger. CPI inflation, on the other hand, has not accelerated. In addition, the authorities noted that there was still room to increase capacity utilization. The central bank expressed concern about the rapid pace of house price increases, which had not abated much despite the increase in long-term interest rates. Such rapid increases had fueled demand, while at the same time raising the risk of a sharp correction. Staff shared this concern and also pointed to anecdotal evidence of wage drift and the possibility that part of the recent expansion in labor supply was cyclical, rather than structural, which could portend future pressure on labor costs.

10. **The authorities and the staff agreed that the short-term outlook for the Dutch economy was very strong, which therefore risked intensifying demand pressures.** The staff projects real GDP to rise by 3¾ percent and 3½ percent in 2000 and 2001, respectively, based on the spring WEO assumptions. The CPB projects real GDP to grow by 4 percent and 3½ percent, respectively, in 2000 and 2001, the slight difference with the staff projection in 2000 being attributable to stronger assumed export market growth.[6] On the balance, the macroeconomic policy setting is expansionary. Fiscal policy will be broadly neutral this year, but the 2001 tax reform will provide a boost to disposable income which is only partly offset by the increase in indirect taxes (Box 1). Monetary conditions are likely to remain expansionary, despite recent interest rate increases. This was of some concern given that the Dutch economy had pulled ahead of the euro-area core in cyclical terms. The authorities noted, however, that the Netherlands had had considerable experience of policy making in the absence of national monetary policy, owing to the longstanding peg of the guilder to the deutsche mark. The staff and the authorities agreed that higher interest rates would take the steam out of the Dutch property market, which in turn would moderate wealth effects and attenuate consumption growth.[7] At the same time, a solid contribution from external demand is anticipated, fueled by the pickup in economic activity in European trading partners. As a result, the current account

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[5] The staff's estimate of the NAIRU—4¾ percent in 1999—is based on the registered unemployment rate. It is projected to decline to 4 percent by 2003, to a large extent because of the effect of the tax reform scheduled for 2001. Together with further increases in labor force participation and a slight rise in productivity growth, this would raise potential growth to 2.8 percent in the near-term. By comparison, the OECD now estimates potential GDP growth to be 3 percent per year.

[6] The April Consensus Forecasts show growth rates of 3¾ percent and 3¼ percent, respectively.

[7] Interest rates used for the projections are based on market expectations at the time of the Spring 2000 WEO, while the exchange rate is assumed to be constant in real terms. Implied short-term rates have since risen by 60 basis points to 4.68 percent in 2000, while 10-year yields have fallen by 25 basis points to 5.46 percent.

Box 1. 2001 Tax Reform

The 2001 tax reform aims to secure a more stable tax base, shift from direct taxes to indirect and environmental taxes, reduce income tax rates, and improve incentives to work. It is accompanied by a net tax reduction (1¼ percent of GDP), which will provide a largely transitory fiscal impulse in 2001.

Key features of the new system are:

- A broader tax base for income taxes, by eliminating some tax deductions, such as for interest payments on private loans and second residences, and narrowing deductions for occupational savings and life insurance schemes.
- Lower marginal income taxes in all four income tax brackets (the top rate will be reduced from 60 percent to 52 percent).
- Tax credits to replace tax allowances. Non-working partners will be entitled to this credit, removing the disincentive to enter the labor market. For employed persons, a worker's tax credit will be introduced, thus reducing the poverty trap.
- More uniform tax treatment of income from capital through the introduction of a 30 percent tax on imputed income from real and financial assets (excluding a principal residence), assuming a fixed 4 percent rate of return. This tax replaces the wealth tax and the inclusion of dividends and interest receipts in ordinary taxable income. Income from a substantial business interest will remain taxable at a flat 25 percent rate.
- Higher indirect taxes: the standard VAT rate will be raised from 17.5 percent to 19 percent, and environmental levies are being increased (gradually, since 1999).

The net tax reduction consists of a reduction in taxation of labor by 2¼ percentage points of GDP, and increases in environmental, VAT, and capital taxes by ½ percentage point of GDP each. However, since the reduced tax on labor income is felt immediately, while the increased taxation of capital income is not collected until 2002, the impulse in 2001 is equivalent to 1¼ percentage points of GDP. This fiscal impulse is somewhat mitigated, though, by the fact that real primary expenditure growth is kept at ½ percent in 2001. Consequently, the overall fiscal impulse is ¾ of 1 percent of GDP.

surplus is expected to widen, but only this year, after which demand growth will probably be increasingly satisfied by imports, associated with a weakening of competitiveness. Given the large current account surplus and the likelihood that the exchange rate was somewhat undervalued, the authorities noted that this would be a desirable adjustment.

11. **Headline inflation will rise sharply next year, reflecting largely the transitory effects of indirect tax increases.** The staff projects headline inflation to jump from 2¼ percent in 2000 to 3½ percent in 2001, which is slightly higher than the authorities' projection. There are two major transitory influences: the increase in the VAT and environmental taxes associated with the 2001 tax reform, which will add 1¼ percent to the price level; and a fallback in energy prices, which will lower the price level somewhat. Underlying inflation is expected to increase marginally, owing to a rise in wage increases. The staff projection assumes that compensation per employee will rise by 4 percent this year and next, broadly in line with expected labor unions' wage demands.[8] By contrast, the authorities project slower growth of compensation (3¼ percent) in 2001, assuming that the large increase in net disposable household income built into the tax reform will temper wage demands.

12. **Risks to the forecast are balanced, but higher-than-projected demand growth might have adverse consequences.** A more pronounced softening or even a decline in property prices or weaker-than-expected key export markets would slow growth, easing inflationary tensions. On the other hand, demand could be stronger if wealth effects do not abate as projected, activity in trading partners turns out to be stronger, or wage growth accelerates. In this case, adjustment to additional upward demand pressures may not be smooth, triggering a sharp rise in labor costs and prices of non-tradables. The associated temporary boom could then be followed by a sharp slowdown, and a protracted period of adjustment with rising unemployment to bring labor costs back into line with those of trading partners. Such a boom and bust cycle has occurred in the past in the Netherlands, though under much different circumstances (see the Selected Issues paper).

13. **A model-based quantitative assessment of foreseeable upside demand risks suggested, however, that adverse consequences for the economy are likely to be modest** (see the Selected Issues paper). Given the very tight labor market, demand pressures could manifest themselves in higher than foreseen wage increases. Simulations by the authorities indicated that a one percentage point higher wage growth would lead to an output loss of one tenth of one percentage point of GDP in the medium term. Other positive demand shocks, from domestic or foreign origin, would not lead to a significant acceleration of wage and price increases, in part because the external current account would provide a significant relief valve

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[8] Labor unions set the envelope for wage bargaining taking into account the projected increase in sectoral productivity (economy-wide 2¼ percent in 2001), the increase in a consumer price index that excludes indirect tax changes (2¼ percent in 2001), and producer price increases (2 percent in 2001).

for demand pressure. On the basis of these results, the authorities were not overly concerned about the possible adverse consequences of reasonable upside demand risks, though they conceded that the actual response, especially of wages, could be stronger than simulated, since the model parameters had been estimated over a period when labor markets were not as tight as they are now.

14. **With respect to policy settings, monetary multipliers are large, while fiscal multipliers are small.** According to CPB model simulations, the Dutch economy is relatively sensitive to monetary conditions. A 10 percent appreciation of the euro-dollar exchange rate compared to the baseline would cut GDP growth by 1 percentage point after two years, while 100 basis points higher worldwide short- and long-term interest rates would cut it by 1.7 percentage points. To reduce GDP growth by 1 percentage point within the year, expenditure would need to be cut by 1¾ percentage points of GDP or income taxes raised by 2½ percentage points of GDP. To achieve the reduction over two years, the figures would be 1½ percentage points and 1¾ percentage points, respectively. With these magnitudes in mind, the authorities noted the limited feasibility of using fiscal policy for demand management. They also indicated that private sector financial flows had reached the point where they dwarfed those that could be generated by fiscal instruments, which also suggested that fiscal policy would have only limited effect. The staff concurred with these observations.

B. Fiscal Policy from a Cyclical and Medium-Term Perspective

15. **There was agreement that the current economic outlook, and the risks associated with it, called for prudent fiscal policies, but there was some difference between the authorities and the staff as to what this would require in practice.** The authorities emphasized the medium-term focus of their fiscal framework, reflecting their view that fine tuning in the Dutch context was not productive, and perhaps not feasible. In the same vein, they felt that cyclical risks did not warrant postponing or altering the 2001 tax reforms, which had been negotiated as part of the Coalition Agreement that had established the current fiscal framework. Nonetheless, the tax reforms would result in a fiscal impulse of ¾ of one percentage point of GDP in 2001. Therefore, on the revenue side there were indications that the authorities were considering to postpone at least to 2002 any allocation of the considerable windfalls that have become available under the framework (Box 2). On the spending side, calls have arisen to introduce new plans to fill up the room that has recently opened up under the expenditure ceiling. In response, the authorities said they would consider advancing already planned expenditure into 2000 and 2001, still leaving scope to address unforeseen developments in 2002, the last year of the current fiscal framework. On May 9, they proposed to use the entire room under the ceiling in 2000.

16. **Staff supported the medium-term orientation of fiscal policy, but argued that in the present circumstances fiscal policy should be run as tightly as possible.** The fiscal framework approach to policy has proved very successful in instilling a medium-term focus and buttressing policy credibility. In particular, the expenditure ceilings have helped to create the room for substantial reduction in both the deficit and taxes. Regarding the 2001 tax reform, the

Box 2. Budgetary Windfalls

At the core of Dutch fiscal policy is a medium-term framework that stipulates the growth of real public spending at the start of a government period. Accordingly, in the 1999 budget, expenditure ceilings were set—in constant prices—for the central government, social security, and health care, for each year from 1999 to 2002.

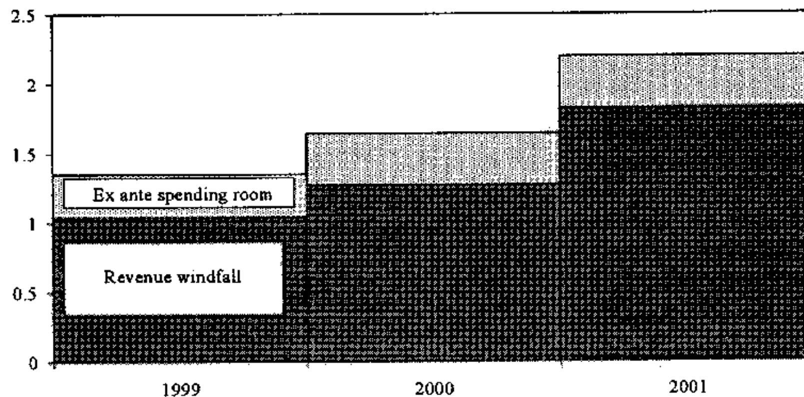
The 1999 fiscal rules also include a baseline path for general government revenue, based on deliberately cautious assumptions for economic growth (2¼ percent, on average) and including tax cuts amounting to 0.6 percent of GDP in 2001—linked to introduction of tax reform. A new rule demands that (as long as the deficit remains below 0.75 percent of GDP), if anticipated revenue exceeds (falls short of) this baseline, half of the windfall (shortfall) is allocated to tax reductions (increases). Such required tax adjustment may be spread over the remaining budget years.

At the time the 2000 budget was formulated, the 1999 balance was still projected to show a deficit of 0.6 percent of GDP. Small anticipated revenue windfalls allowed for expanding planned tax cuts in 2000 to 0.2 percent of GDP. Expenditure was expected to remain under its 1999 ceiling by 0.2 percent of GDP, and the budget proposed to maintain most of this room through 2000.

The economic and budgetary outlook has become much more favorable since the 2000 budget. In May 2000, the Ministry of Finance projected windfalls on the revenue side to rise to 1.3 percent of GDP in 2000 and 1.8 percent of GDP next year. Under the rules, half of the latter amount would be available for additional tax cuts in 2001. However, so far the 2001 tax package has been only modestly increased, to 0.8 percent of GDP. The remaining room would allow for tax cuts in 2002.

On the expenditure side, the CPB projected in April that spending would remain well under the ceiling, by 0.4 percent of GDP in 2000 and 2001, assuming unchanged policies. However, in accordance with the rules, in the May draft of the regular mid-2000 interim budget the government proposed to increase spending up to the limit (and also to use the remaining part of the budgetary contingency)

Budgetary windfalls, 1999-2001
(In percent of GDP)



Furthermore, the Ministry of Finance estimated that the scope for higher annual spending outside the expenditure framework, through the infrastructure fund, amounted to 0.15 percent of GDP. This fund receives the interest savings resulting from asset sales and a proportion of gas revenues. As income from both sources was expected to exceed earlier projections, spending could be augmented without affecting overall deficit projections, and a small increase for 2000 was included in the interim budget.

staff agreed that the benefits of proceeding according to plan outweighed the risk posed by the fiscal impulse. The reform has several desirable structural features: poverty traps will be lowered; the mortgage interest deductibility will be limited to principal residences; and taxation of capital will become more uniform across asset types. The reform would also begin lowering marginal income taxes, which are still burdensome by international standards, especially since the top rate kicks in at relatively low levels of income.[9] Since the private sector had already begun to adjust to the new regime, abandoning the reform at this point might impose considerable costs.

17. **Prudent fiscal policy would thus require preserving all current and prospective windfalls on both the revenue and expenditure sides for the foreseeable future.** Staff expressed support for postponing any reduction in taxes due to the revenue windfalls. However, increasing expenditures to fill up the room under the ceiling as proposed by the authorities will add an additional fiscal impulse of 0.4 percentage points of GDP (during 2000-01) on top of the one associated with the tax reform. And there are other pressures on expenditures, including possible overruns in health care and on public sector wages. For these reasons, the staff urged that the room under the expenditure ceilings be preserved. The authorities' took note of these concerns, but pointed to their track record of overperformance.

18. **Preserving expenditure and revenue windfalls would bring structural balance within reach by 2002.** Staff estimates indicate the budget will be near structural balance this year, before deteriorating next year as a result of the tax reform package. However, if all windfalls are devoted to the budget balance in line with the staff recommendation, structural balance would again be within reach in 2002. This would set the stage for continuing fiscal consolidation beyond 2002 to deal with demographic pressures, a strategy for which public support in the Netherlands is growing.

19. **Beyond 2002, the practice of conducting fiscal policy within rules-based frameworks is expected to continue.** The staff strongly supported this approach, emphasizing the key role of expenditure ceilings. However, the current rules allocating revenue windfalls between the budget balance and further tax cuts are complicated and tend to lead to procyclical policy responses. A framework based on more realistic growth projections and allowing for full operation of automatic stabilizers on the revenue side would be more credible in the long run and preferable from the perspective of cyclical demand management. The staff also suggested

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[9] The highest income tax rate will be reduced from 60 percent to 52 percent, and apply to income above € 45,133. This compares to top rates of 54 percent in Germany (to be lowered to 51 percent in 2001), 54 percent in France, and 46 percent in Italy. In 1998, the income tax wedge (including social security contribution) for average productions workers amounted to 44 percent, somewhat lower than in Germany (52 percent), France (48 percent), and Italy (47 percent).

that the expenditure rules be buttressed by a more explicit view of the medium-term debt position, which would also help to inform markets of the government's medium-term plans regarding the structural balance. The staff recognized the uncertainties involved in long-term projections of health care spending and pension obligations, and the relatively low net debt-to-GDP ratio of the Netherlands.[10] The authorities explained that a discussion of the next framework would not begin until next year. They argued that the current rules provide for full operation of automatic stabilizers within the budget year, since windfalls are not allocated to tax cuts until the following year, at the earliest. Moreover, since the fiscal framework is based on cautious growth assumptions, part of the revenue windfalls reflect the difference between potential growth and that assumed in the framework, rather than differences between potential and actual growth.

C. Structural Reforms

20. **Sustained labor market reforms have been key to the recent strong economic performance of the Dutch economy, but the authorities are well aware that much more remains to be done**. The reforms, together with wage moderation, have increased labor force participation to near the euro-area average, and have been particularly successful in lowering unemployment. Still, participation and employment rates are lagging considerably behind those of the United States or the United Kingdom. Early retirement schemes and disincentives to work have led to very low participation in the 55-64 age group: 30 percent in recent years, compared to 40 percent, 51 percent, and 59 percent in the EU, the United Kingdom, and the United States, respectively. By any international comparison, the incidence of disability and sickness is very high in the Dutch economy, and it appears to be rising again. The number of welfare recipients is also on the high side based on international comparisons.

21. **The authorities and staff agreed that one of the main challenges in the labor market was to raise labor supply further.** Several recent and planned reforms would be helpful. By lowering income taxes and social security contributions, and introducing a workers' tax credit, the 2001 tax reform would promote employment. The progressive shift toward actuarially fair early retirement provisions, and the proposed phasing in of a job-search requirement for older people on unemployment schemes should raise labor force participation of this group, as would implementation of other proposals that have recently been made by social partners (Box 3). These reforms would help ensure that the next cohort will not face undue incentives to leave the labor force prematurely. With respect to tackling disability,

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[10] In 1999, gross general government debt of the Netherlands amounted to 64 percent of GDP, compared to 71 percent for the euro area (Maastricht definition). However, net debt is much lower, since—in contrast with most euro-area countries—the Netherlands has a funded pension system for civil servants, with assets estimated at over 35 percent of GDP. In addition, the public sector also holds other financial assets exceeding 10 percent of GDP.

Box 3. Raising Older Worker Participation

The participation rate of those aged 55 and above is very low by international comparison. This reflects the widespread use of early retirement schemes—with eligibility typically starting at 60 years of age—as well as of social security arrangements for the unemployed and disabled. Since 1997, collective labor agreements have shifted from traditional pay-as-you-go early retirement schemes toward actuarially fair arrangements. The government's target is to increase participation by older workers to more than 50 percent by 2030.

In December 1999, the Social and Economic Council (SER), an advisory body including representatives of unions and employers, presented a range of policy recommendations to the authorities and social partners. The government has taken on board several of these:

- The exemption from the job-search requirement for unemployed aged 57½ and above will be removed as of July 2002.
- An increase in tax incentives to facilitate hiring older unemployed is being considered. This could be done by introducing specific cuts in social security contributions or increasing the eligibility of older unemployed for existing programs (SPAK).
- The tax deductibility of employers' and employees' contributions to new early retirement schemes of the traditional sort will be phased out starting on July 1, 2002.
- More flexible work arrangements for older workers will be encouraged. The government will support the adjustment of pension arrangements to allow older workers to adjust their working hours or workload at a lower pay without excessive reductions in pension rights—which are usually linked to end-of-career wages.
- The introduction of experience rating for unemployment contributions could be considered, aimed at discouraging layoffs of older workers.

The SER also issued a number of recommendations directed at social partners:

- Accelerate the shift to flexible retirement schemes that do not discourage employment up to 65 years of age, and allow for part-time retirement.
- Avoid arrangements that increase the labor cost of older workers, such as additional leave.
- Be cautious in supplementing unemployment and disability benefits with additional bonuses, as this practice renders these schemes more attractive as a substitute for early retirement, and discourages reintegration.

insurance premiums are being differentiated by firm depending on the actual incidence of disability in that firm. The phasing in of this system will be complete in 2003. These measures would gradually raise the potential of the Dutch economy. The staff argued, however, that it was unlikely that they would be effective in the short term in alleviating tight labor market conditions.

22. **The current cyclical situation presents a unique opportunity to make more forceful progress in dealing with long-standing structural labor market problems.** The staff reiterated its suggestion to enlarge the worker's tax credit to deal more decisively with the poverty trap, while tapering it at higher incomes to contain fiscal costs. This would, however, have the disadvantage of raising marginal tax rates at higher income levels, a particular problem in the Netherlands given its already relatively steep income tax schedule. The staff recommended a more vigorous enforcement of the obligations of benefit recipients, and a reduction in the use of public and publicly subsidized job programs, especially in a climate of increasingly tight labor markets (Box 4). To complement the authorities' emphasis on employer incentives and administrative reform, staff advocated measures that would widen the difference between rewards to work and social benefits. In particular, scaling back income-related benefit programs, such as rent subsidies, and lowering replacement rates, would be effective. The authorities acknowledged the merits of these suggestions, but noted that there was no social consensus to reduce social benefits. In the case of sickness, reductions in replacement rates had in the past been largely undone in collective labor agreements between social partners.

23. **The reorganization of the administration of the social security system has the potential to strengthen incentives for reintegration.** The streamlining of access to benefits and reintegration services through the establishment of Centers for Work and Income is proceeding and should foster a more comprehensive approach to moving benefit claimants to employment. Compared to earlier plans, the administration of benefits will not be privatized, out of fear that the system would become too complex. Instead, the five existing public social insurance agencies are to be unified. Reintegration services are to be privatized, however, which promises to generate efficiencies through competition. However, the overall effectiveness of the system will depend crucially on the structure of financial incentives facing these services, as well as the ability of the proposed unified public social insurance agency to manage the reintegration process. The planned increase in the lump-sum proportion of transfers to municipalities to administer welfare benefits is welcome, as it improves incentives for reintegration.

24. **The authorities are committed to expanding product market reforms.** The Netherlands is somewhat ahead of EU directives on telecommunications and electricity, but in other areas, such as public transportation, there is scope to accelerate the introduction of market forces. With respect to competition policy, another key element of the authorities strategy, investigations by the Competition Agency (established only in 1998) are yielding positive results. The authorities reported some gains in reducing the administrative burden, but progress had fallen short of their target. Consequently, the authorities plan to establish an independent advisory body responsible for assessing the administrative burden of new

Box 4. Subsidized and Public Employment Programs

In the 1980s, labor market measures focused on the demand side, but in the 1990s, emphasis was shifted to the supply side and the improvement of job-related skills as a way to enhance reintegration. The concentration of unemployment among low-skilled workers prompted the authorities to create new subsidized jobs for the long-term unemployed (LTU) (programs I-IV in the table below). Subsequently, programs were introduced to integrate these initiatives, including a comprehensive approach to helping all new job seekers (programs VI and VII).

Subsidized and Public Employment Programs

Program:	Target Population	Provisions	Incentives for Employers	Managed by:
I. Inflow-outflow jobs (1994, 1998, and 2000)	LTU	60,000 jobs in public and non-profit sectors, and training	Employment subsidies	Municipalities
II. Experiments with benefits activation (1995-98)	LTU	20,000 jobs for two years in private sector	NLG 18,000 per year per job	Municipalities and Social Security Administration
III. Combining benefit and work (1995-99)	LTU, shorten distance to labor market	Non-profit sector	Publicly funded employment (through benefits)	Municipalities
IV. Cleaning jobs (1998)	LTU, reducing the gray economy	Household sector (800 positions)	NLG 20,000 per year per job	Private firms
V. Jobs for disabled (1998)	Disabled	Full-time regular job or special employment in sheltered workshops	Employment subsidies and job coaching	Municipalities
VI. Job seekers employment (1998) (includes the former schemes II and III)	Youth (up to age 23), benefits recipients, and LTU	Two-year work contract, short-term work-experience positions, social activation, and training	Employment subsidies	Municipalities and Social Security Administration
VII. Comprehensive approach (1999)	All unemployed	Reintegration within 12 months of job loss; support for LTU; using the above instruments.		Public Employment Office, Municipalities, and Social Security Administration

Sources: Sociale Nota and Ministry of Social Affairs and Employment, website.

Overall inflows in subsidized jobs increased steadily since 1990 to 2.3 percent of the labor force in 1999, while public expenditure on these programs rose to 1.8 percent of GDP in 1998 (Table below). An assessment of the cost effectiveness of the programs is not available, but it appears that the main obstacles to reintegrate the targeted groups in mainstream employment are insufficient education, lack of work experience, and hysteresis effects.

Inflows and Cost of Public Employment Programs

	1990	1995	1996	1997	1998	1999 est.
Subsidized programs 1/						
Total inflows (% of labor force)	1.5	2.0	2.2	2.3	2.3	2.3
Public expenditure (% GDP)					0.8	0.8
Active labor market measures (OECD)						
Inflows (% of labor force)	1.4	2.3	2.5	2.6	2.6	2.7
Public expenditure (% GDP)	1.1	1.5	1.6	1.7	1.8	...

Sources: Sociale Nota, 2000; CPB 2000 and OECD Employment Outlook, July 1999.
1/ full-time equivalent.

legislation, and report its results publicly. They also intend to reinvigorate other aspects of the Market Forces, Deregulation, and Legislative Quality (MDW) project, inter alia, by raising its public profile and pushing for stricter timetables for the implementation of recommendations by various working groups.

25. **The authorities reassured staff of the soundness of the financial system, and adequacy of their approach to supervision.**[11] By most indicators, the banking system appeared to be quite strong, with capital adequacy well above international standards and return on assets above historical averages. Loan classification and provisioning had risen somewhat through 1998, but the authorities noted that stress testing had indicated that the banking system could withstand significant adverse shocks (Table 3).[12] In particular, they argued that a sharp decline in property prices would not pose any difficulties.[13] Nonetheless, supervisors have been increasing their focus on mortgage market risks (Box 5). The Council of Financial Supervisors, set up to coordinate the efforts of banking, securities, and insurance and pension supervisors, appears to be working well. The Council—which is not a supervisor itself, but comprises the heads of the banking supervision directorate of the DNB, and the insurance and securities supervisory agencies—had provided guidelines on supervision of financial conglomerates and was responsible for making practical arrangements for such supervision. It had also proposed a legal framework for supervising top holdings (that is, a holding company of a conglomerate that is not now supervised because it is not a financial institution itself) and established a working group to deal with consumer protection.

26. **The Dutch authorities strongly support further trade liberalization in a multilateral context.** Of particular importance are the sectors of transport, financial services, and telecommunications. The authorities also emphasized the need for increasing the participation of the developing countries in the multilateral trade process.

IV. STAFF APPRAISAL

27. **Since the mid-1980s sound economic policies have boosted the potential of the Dutch economy and fostered high employment growth.** The economy's strong performance is in good part due to fiscal consolidation, based on a medium-term fiscal framework, and to a

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[11] A forthcoming cross-country paper will, from a European-wide perspective, discuss financial market developments and supervisory issues.

[12] In 1999, the aggregate capital adequacy ratio of the banking system was 11.2 percent, slightly down from 11.6 percent in 1996-97. Loan loss provisioning increased from 21.5 percent of classified loans in 1996 to almost 27 percent in 1998.

[13] Mortgage credit amounted to about 27 percent of total banking system assets in 1999, slightly less than in 1998, but up from 22½ percent in 1996.

Box 5. House Prices, Mortgage Market, and Financial Sector Risks

During 1994-99, the Dutch mortgage market approximately doubled in size. Compared to other European countries, the Netherlands is among the leaders in value of mortgages outstanding, per capita mortgage debt, and house price increases during the past decade:

International comparison of mortgage market indicators (1998)

	Mortgage debt/GDP	Per capita mortgage debt (in euro)	House price increase(1990=100)	Capital adequacy (BIS ratio) 1/
Netherlands: 1998	63	14,167	180	10.8
1999	68	15,903	208	10.6
Belgium	25	5,448	160	11.0
Denmark	69	19,800	158	10.1
France	21	4,464	107	10.9
Germany	53	12,335	114	10.1
Ireland	27	5,656	190	12.5
United Kingdom	57	11,019	120	12.3

Sources: European Mortgage Federation, BIS, DNB, and the Banker.

1/ Weighted average of 5 largest banks, except Netherlands (3 largest banks), and Belgium, Denmark, and Ireland (unweighted average).

Banks hold most of the mortgage market (63 percent), followed by insurance companies (19 percent), and other institutions (mainly pension and construction funds, 18 percent). A recent study by the DNB has revealed a deterioration of the quality of loan portfolios during the past few years: the number of government guaranteed mortgages declined, the number of loans with a loan-to-value (LTV) ratio in excess of 75 percent tripled, and exposure to (young) owners dependent on rising income to meet mortgage payments rose. The increasing complexity of loan instruments is putting some strain on banks' administrative capacity, potentially aggravating operational risks.

In response to these developments the DNB has put forward in its study a number of measures:

1. Differentiating prudential requirements (e.g., through risk weights) according to the observed loan-to-value ratio in individual bank portfolios.

2. Restricting the maximum mortgage loan to the market value of the property at the time of registration, thus limiting the loan-to-value ratio to 100 percent.

3. Investigating the role of mortgage brokers.

4. Increasing consumer protection.

5. Extending regular reporting to supervisory authorities to include key characteristics of bank mortgage portfolios (e.g., breakdown by type of interest, type of mortgage).

6. Conducting surveys to gauge the extent to which mortgages are being used for purposes other than to acquire or improve real estate (e.g., consumption, equity investments).

The last two measures are already under implementation.

sustained program of labor market reform. These policies, together with a longstanding tradition of wage moderation agreed between the social partners and, somewhat more recently, important product market reforms, have been key to improved competitiveness and high employment creation.

28. **The economy has also enjoyed a cyclical upswing and, on balance, the evidence suggests that activity is now above sustainable levels.** In 1999, real GDP growth exceeded potential for the third year running. Buoyant domestic demand and supportive monetary conditions within the euro area have been fundamental. Rapid growth in house prices, which has in some other countries proved to be an indicator of demand pressure, has boosted domestic consumption through wealth effects. Labor markets are now quite tight, with sharp declines in unemployment rates to below estimates of the NAIRU, the emergence of near record high vacancy rates, and anecdotal evidence of widening labor bottlenecks. There are some signs of wage pressures and higher producer prices, but consumer price inflation has remained very modest.

29. **Strong growth is likely to continue, though the pace should slow next year.** Demand growth is likely to be based on accelerating exports, fueled by the pickup in Europe, and robust household consumption. Monetary conditions are anticipated to remain too supportive for the Netherlands' cyclical position, but recent and prospective short and long-term interest rate increases are expected to moderate the rise in housing prices significantly in 2000-01, which will help to slow consumption demand growth by reducing the wealth effect. There are downside and upside risks to this outlook. Slower growth than envisaged would ease the incipient pressures. However, the vulnerability of the economy to a sharp house price correction has increased. On the other hand, further upward demand pressures are equally possible and could, in the context of an already strong outlook, lead to a much steeper rise in costs and underlying inflation, and an increased likelihood of a disruptive downturn.

30. **Actual and prospective demand pressures will entail market responses as part of the adjustment mechanism.** Productive capacity can be increased somewhat—even in the short term—through greater labor force participation and higher labor productivity. As capacity constraints bite, however, higher imports will satisfy domestic demand and upward pressure on labor costs relative to trading partners will result. These factors should reduce demand and slow growth to sustainable rates, as external competitiveness and the current account surplus are reduced. Changes in monetary conditions could significantly affect the adjustment path, but fiscal multipliers are small, thus constraining the effectiveness of fiscal policy for demand management.

31. **Prudent fiscal policy will nevertheless be needed to promote a soft landing and fiscal stimulus should be avoided.** The structural improvement of the budget deficit that occurred in 1999 is most welcome and should be preserved over the remainder of the current cycle. The actual budget surplus that emerged recently is also welcome, but it must be emphasized that it reflects mostly the buoyant state of the economy, and that the fiscal position adjusted for the business cycle is now just in rough balance. On the tax side, accumulated and

prospective revenue windfalls should be devoted to the balance, and the staff supports the authorities pragmatic approach of postponing tax cuts financed by revenue windfalls. But the recently proposed increase of expenditure to fill the room under the expenditure ceiling will add a fiscal impulse of nearly ½ percentage point of GDP to already buoyant demand, thus intensifying cyclical tensions. Moreover, given the potentially adverse consequences of upside demand risks, fiscal policy requirements will need to be reassessed on a regular basis.

32. **The staff shares the authorities' view that the fiscal agreement made at the beginning of the current government should be retained, despite the cyclical risks.** The framework approach has been an important, and in most respects successful, ingredient of Dutch fiscal policy. Actual and currently anticipated cyclical pressures should be manageable within the current framework, although this judgment may be tested by developments. Implementing the tax reform will have positive benefits overall, but it will be important not to add to the fiscal impulse it implies.

33. **Looking forward, structural fiscal consolidation should continue, governed by a medium-term framework.** In line with cyclical policy requirements, it would be desirable to achieve structural balance in 2002, equivalent to an actual surplus of 1 percent of GDP on current projections. Regarding the framework that might replace the current agreement after 2002, expenditure restraint should remain at the core, since it is a prerequisite for combining sustained reductions in the tax burden with improvement in the fiscal balance. An explicit consideration of a desirable medium-term public-debt position (and thus a medium-term path for the structural balance) would enhance transparency and reinforce the medium-term fiscal anchor. However, such a goal should not preclude the use of automatic fiscal stabilizers. Indeed, in contrast to the formula under the current framework, it would be preferable to allow full automatic stabilization on the revenue side.

34. **Further efforts are needed to address remaining labor market weaknesses, in particular to lift participation rates and reduce the large number of disability and welfare recipients.** Several measures that have been implemented are helpful, as are others that are planned or have been proposed, notably the reduction in the labor tax wedge, the introduction of a workers' tax credit (both part of the 2001 tax reform), the promotion of actuarially fair early retirement schemes, and increased reliance on incentives for firms to limit sickness. Still, more should be done to sharpen the incentives to work. To further reduce the poverty trap, the worker's tax credit should be enlarged and various income-related benefit programs scaled back. Obligations of benefit recipients need to be more vigorously enforced and effective replacement rates for sickness and disability lowered. Subsidized job programs should be de-emphasized in the current climate of tight labor markets. To fulfill the promise offered by the reorganization of the social security system, a comprehensive view needs to be taken to move benefit claimants to employment and to ensure that reintegration service providers face strong financial incentives.

35. **It is vital to push ahead with measures to improve product market performance, an area that seems vulnerable to reform fatigue.** It is commendable that in some sectors EU

requirements have been exceeded. Recent work by the competition authority has also been a force of beneficial change. The important MDW project should move forward: initiatives to analyze the costs and benefits of specific reforms and to increase the involvement of stakeholders are promising. Similarly, the establishment of an independent advisory body to assess the effects of legislation on administrative burden is welcome, but progress in reducing the burden itself should be accelerated.

36. **The soundness of the financial system has underpinned economic prosperity and continued vigilance will safeguard its health.** In response to emerging financial conglomerates and to promote a level playing field, the Council of Financial Supervisors was established last year. The Council has made headway in fulfilling its mandates, particularly in the area of supervision of conglomerates, and consumer information and protection. In light of the macroeconomic tensions and risks related to the housing market, supervisors must keep a watchful eye on the financial system. In addition, the rapidly evolving structure of financial markets, both in the Netherlands and worldwide, will pose ongoing supervisory challenges.

37. The authorities' support for trade liberalization on a multilateral basis for the WTO process is welcome, as is their substantial level of development assistance, which exceeds the United Nations target. Current Dutch practice is consistent with the OECD Convention on Combating Bribery, though it has not yet been ratified. The Netherlands provide core macroeconomic data to the Fund in a comprehensive fashion with data quality and timeliness generally accurate for effective surveillance. There is room for further improvement in linking general government fiscal data on a budget basis with that on a national accounts basis.

38. It is proposed that the next Article IV consultation take place on the normal 12-month cycle.

Table 1. Netherlands: Basic Data

Land area (1998)	41.5 thousand sq. km.
Population (1998)	15.7 million
Population characteristics and health:	
Life expectancy at birth (1997)	75.2 (male), 80.6 (female)
Fertility rate (1997)	1.6 children/woman
Infant mortality rate (1997)	5.0 per 1,000 live births
Population per sq. km. of land area (1998)	462 persons

National accounts (1998 at current prices)	(In billions of guilders)	(In percent of GDP)
Private consumption	384.4	49.5
Public consumption	178.2	23.0
Gross fixed investment	168.6	21.7
Stockbuilding	1.4	0.2
Exports of goods and nonfactor services	472.9	60.9
Imports of goods and nonfactor services	429.5	55.3
GDP	776.2	100.0

	1995	1996	1997	1998	1999 Est.	2000 Proj.	2001 Proj.
National accounts (constant prices)							
Private consumption	2.1	4.0	2.6	4.1	4.2	3.5	4.1
Public consumption	0.7	-0.4	3.3	3.3	2.6	2.0	2.0
Gross fixed investment	4.6	6.3	5.9	5.2	5.8	5.1	4.4
Total domestic demand	2.6	2.8	3.5	4.2	3.8	3.6	3.7
Exports of goods and nonfactor services	6.5	4.6	9.0	6.4	4.7	7.4	7.1
Imports of goods and nonfactor services	7.7	4.4	9.0	7.7	5.1	7.6	7.9
Net foreign balance 1/	-0.2	0.4	0.6	-0.3	--	0.3	-0.1
Gross domestic product	2.3	3.0	3.8	3.7	3.6	3.8	3.4
Output gap (in percent of potential output)	-2.0	-1.7	-0.7	0.3	1.2	2.2	2.9
Prices, wages, and employment							
Consumer price index (year average)	2.0	2.1	2.2	2.0	2.0	2.3	3.5
GDP deflator	1.8	1.2	2.0	1.9	1.3	2.8	3.2
Hourly compensation (manufacturing)	1.2	1.9	2.8	3.2	2.8	3.5	3.5
Unit labor costs (manufacturing)	-2.5	-0.9	-2.0	1.3	1.7	1.2	1.5
Employment	2.4	2.0	3.4	2.9	2.6	2.3	1.8
Unemployment rate (in percent)	7.1	6.6	5.5	4.1	3.2	2.3	2.0
NAIRU	5.2	5.6	5.5	5.3	4.8	4.6	4.4

	1995	1996	1997	1998	1999 Est.	2000 Proj.	2001 Proj.
Personal sector							
Real disposable income	1.0	2.4	2.7	2.0	1.8	3.0	5.3
Household savings ratio 2/	14.9	13.6	13.6	12.2	11.7	11.3	12.3
External trade							
Exports of goods, volume	7.3	5.0	7.1	5.8	5.4	9.5	8.5
Imports of goods, volume	9.9	4.7	8.4	7.4	5.9	9.7	9.6
Terms of trade	1.7	-0.6	0.1	0.6	-0.1	1.4	1.5
Merchandise balance (percent of GDP)	5.3	5.3	5.2	4.9	4.7	5.8	6.4
Current account balance (percent of GDP)	5.8	5.6	7.4	5.6	5.2	5.9	6.2
Money and credit (end-period)							
M3H	4.4	5.8	7.4	9.6	...	...	...
Domestic credit	9.7	10.0	13.1	16.2	...	...	...
Exchange rates (1995=100)							
Nominal effective rate	100.0	98.1	93.5	93.4	92.1	...	...
Real effective rate (relative RULC based)	100.0	96.4	90.9	88.3	86.5	...	...
Public sector accounts							
General government balance	-9.1	-1.8	-1.2	-0.8	0.5	0.4	-0.1
Structural balance	-8.1	-1.0	-0.9	-0.9	-0.1	-0.7	-1.5
Primary balance	-4.4	2.9	3.2	3.4	4.4	3.8	3.0
Structural primary balance	-3.3	3.7	3.5	3.3	3.8	2.7	1.6
General government gross debt	77.2	75.3	70.3	67.0	63.7	60.1	56.7

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

1/ Contribution to GDP growth.

2/ In percent of disposable income.

Table 2. Netherlands: Fiscal Scenarios

(In percent of GDP)

	1997	1998	1999	2000	2001	2002	Real average annual growth rate 1998-2002
Staff projection 1/							
Revenue	47.4	46.7	48.2	47.3	45.3	44.6	2.1
Of which: windfalls 2/			1.0	1.1	1.6	1.3	
Expenditure	48.6	47.5	47.6	46.9	45.4	44.5	1.6
Covered by framework (gross) 3/			43.5	42.5	41.2	40.3	
Room under the ceiling 4/			0.3	0.0	0.0	0.0	
Other			4.2	4.4	4.2	4.2	
Balance	-1.2	-0.8	0.5	0.4	-0.1	0.0	
Primary balance	3.2	3.4	4.4	3.8	3.0	3.0	
Structural balance	-0.9	-0.9	-0.1	-0.7	-1.5	-1.2	
Structural primary balance	3.5	3.3	3.8	2.7	1.6	1.8	
Gross debt	70.3	67.0	63.7	60.1	56.7	54.4	
Memorandum item							
Real GDP growth (in percent)	3.8	3.7	3.6	3.8	3.4	2.5	3.1
Staff scenario 5/							
Revenue	47.4	46.7	48.2	47.3	45.3	45.0	2.3
Of which: windfalls 2/			1.0	1.1	1.6	1.8	
Expenditure	48.6	47.5	47.6	46.5	44.8	44.0	1.4
Covered by framework (gross) 3/			43.5	42.2	40.8	40.0	
Room under the ceiling 4/			0.3	0.3	0.3	0.4	
Other			4.2	4.3	4.0	4.0	
Balance	-1.2	-0.8	0.5	0.8	0.4	1.0	
Primary balance	3.2	3.4	4.4	4.2	3.5	4.0	
Structural balance	-0.9	-0.9	-0.1	-0.3	-1.0	-0.2	
Structural primary balance	3.5	3.3	3.8	3.1	2.1	2.7	
Gross debt	70.3	67.0	63.7	59.6	55.8	52.6	
Memorandum item							
Real GDP growth (in percent)	3.8	3.7	3.6	3.8	3.4	2.5	3.1

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

1/ For the period up to 2001, based on projections published by the Netherlands Bureau for Economic Policy Analysis, in April 2000 (these cash-based data ware adjusted to match the national accounts), with adjustments reflecting the May 2000 draft Interim Budget. In addition, it is assumed that in 2002 one quarter of the (ex ante) revenue windfalls will be reflected in additional tax cuts.
2/ Measured relative to the predefined 1999-2002 baseline path, which was based on cautious growth assumptions.
3/ Derived from the expenditure framework, which relates to "net" expenditure, as it deducts most nontax revenues.
4/ Room relative to the 1999-2002 constant price ceiling for net government expenditure.
5/ Relative to the first scenario, this one excludes the accelleration in expenditure included in the Interim Budget, and leaves out the additional tax cuts in 2002.

Table 3. Netherlands: Indicators of External and Financial Vulnerability 1/
(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000	
						Latest estimate	Date
External indicators							
Exports (annual percent change, in US dollars)	22.2	0.1	-3.4	3.4	-0.1	4.1	
Imports (annual percent change, in US dollars)	22.5	0.6	-3.4	4.4	0.4	3.0	
Terms of trade (annual percent change)	1.7	-0.6	0.1	0.6	-0.1	1.4	
Current account balance	5.8	5.6	7.4	5.6	5.2	5.9	
Inward portfolio investment	1.5	3.2	4.7	9.1	19.6		
Inward foreign direct investment	2.9	3.7	3.9	10.7	8.5		
Official reserves (in US dollars, billions) 2/	47.1	40.3	33.8	31.4	19.1	18.3	March
Broad money to reserves (ratio)	3.1	3.5	4.0	5.0	7.7		
Central bank foreign liabilities (in US dollars, billions) 2/	0.1	0.1	0.1	0.7	0.5	2.2	Feb.
Foreign assets of the banking sector (in US dollars, billions) 3/	201.0	204.3	220.0	306.3	292.3		
Foreign liabilities of the banking sector (in US dollars, billions) 3/	198.9	217.9	246.8	284.0	433.3		
Official reserves in months of imports	2.6	2.2	2.0	1.7	1.1		
Total external debt	78.7	77.8	76.2	78.6	n.a.		
Total external debt to exports (ratio)	1.4	1.3	1.2	1.3	n.a.		
Exchange rate (per U.S. dollar, period average)	1.61	1.69	1.95	1.98	2.07		
Financial Market Indicators							
Public sector debt (Maastricht definition)	77.2	75.3	69.9	66.6	63.7	60.1	
Government bond yield	7.2	6.5	5.8	4.9	4.9	5.8	Feb.
Government bond yield (real)	5.3	4.5	3.6	2.9	2.7	3.8	Feb.
Stock market index	100.0	134.4	195.3	261.6	284.6	349.4	Feb.
Spread of government bond yield with Germany	0.70	0.87	0.73	0.48	0.66	0.40	Feb.
Financial Sector Risk Indicators 4/							
Mortgage credit to total assets (in percent) 5/	n.a.	24.0	23.9	30.7	28.3		
Classified loan to total loans (in percent)	n.a.	2.2	2.2	2.8	n.a.		
Provisioning to classified loans (in percent)	n.a.	23.0	19.6	26.7	n.a.		
Contingent and off-balance-sheet accounts to total assets (in percent)	n.a.	14.9	13.0	6.5	7.5		
Risk based capital-asset ratio	11.3	11.0	10.9	10.8	10.6		

Sources: Data provided by the authorities, and IMF, *International Financial Statistics.*

1/ The interpretation of some indicators is affected by the launch of monetary union in 1999.
2/ Reserves and foreign liabilities refer to the Dutch central bank, both before and after EMU. End-of-period.
3/ External positions of banks as reported to the BIS; end-of-period. For 1999, September.
4/ Weighted average for the 3 largest banks
5/ New series starting in 1997.

Netherlands: Fund Relations
As of April 30, 2000

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

II. **General Resources Account**:	**SDR Million**	**Percent of Quota**
Quota	5,162.40	100.0
Fund holdings of currency	3,553.69	68.8
Reserve position in Fund	1,608.72	31.2
Operational budget transfers (net)	-67.00	

III. **SDR Department**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	530.34	100.0
Holdings	546.86	103.1

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

V. **Financial Arrangements**: None

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

VII. **Exchange Rate Arrangements**:

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

VIII. **Article IV Consultation**:

Discussions for the 1999 Article IV consultation were held in Amsterdam and the Hague in June 11–21, 1999. The staff report for the 1999 Article IV consultation (SM/99/221, 9/13/99) was considered by the Executive Board on October 15, 1999 (EBM/99/97). The Article IV discussions with the Netherlands are on the standard 12-month consultation cycle.

IX. **Exchange Restrictions**:

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

Netherlands: Statistical Data Issues

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

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

Netherlands: Core Statistical Indicators
As of May 15, 2000

	Int'l Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	External Government Debt	GDP/GNP
Date of Latest Observation	5/5/00	5/5/00	5/5/00	3/00	5/15/00	4/00	2/00	Q4/99	3/00	1996	Q4/99
Date Received	5/9/00	5/9/00	5/5/00	5/2/00	5/15/00	5/12/00	4/26/00	3/00	5/00	9/97	02/24/00
Frequency of Data	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Annually	Quarterly
Frequency of Reporting	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Annually	Quarterly
Source of Update	DNB	DNB	DNB	DNB	Reuters	CBS 2/	CBS 2/	DNB	MoF	MoF	CBS 2/
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Weekly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Monthly	Annually	Quarterly

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

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/41
FOR IMMEDIATE RELEASE
June 16, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with the Kingdom of the Netherlands—Netherlands

On June 12, 2000, the Executive Board concluded the Article IV consultation with Kingdom of the Netherlands - Netherlands.[1]

Background

The Netherlands has enjoyed strong growth and employment performance since the middle of the 1990s, based on sustained fiscal consolidation, ongoing structural reforms, notably in labor markets, and wage moderation. As a result of this policy effort, labor-force participation has risen to the euro-area average and the unemployment rate has fallen to very low levels. More recently, the Dutch economy has moved somewhat out of step with its main euro-area trading partners, and is now in a significantly more cyclically advanced position.

Economic activity remained strong in 1999, with real GDP rising by 3.6 percent, well above the Euro-area average and registration-based unemployment falling to below 3 percent by the end of the year. Despite labor-market tightness, unit labor costs have risen only modestly and consumer price inflation has been moderate. Although competitiveness has deteriorated somewhat against the euro-area since 1998, overall competitiveness against all trading partners has continued to improve. Monetary conditions remained quite supportive from the point of view of the Netherlands in 1999 and into 2000, while the structural fiscal balance improved by more than ¾ of 1 percent of GDP in 1999, due to the preservation of growth-related windfalls, thus withdrawing demand.

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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. In this PIN, the main features of the Board's discussion are described.

The short-term outlook for the Dutch economy is very strong. Real GDP growth is projected to rise to 3¾ percent this year, and then fall off slightly to 3½ percent in 2001. Fuelled by the pick-up in economic activity in European trading partners, the contribution to growth from external demand should be strong, and the current account surplus is likely to strengthen in the near term. Higher interest rates are expected to take some of the steam out of housing markets this year and next, thereby attenuating the wealth effects that have boosted consumption in recent years. On the other hand, the 2001 tax reform will give rise to a significant fiscal impulse. The reform will also increase value-added and environmental taxes, which will raise the price level significantly. Although this effect will be partly offset by lower energy prices, the outlook is for a temporary increase in headline inflation to 3½ percent in 2001. Underlying inflation is set to rise marginally, owing to higher wage increases reflecting the tight labor market.

Structural reforms, notably in labor markets, have been key to the recent strong performance of the economy, though sickness and disability schemes remain large and there is room to raise participation and employment rates further. The 2001 tax reform will reduce the poverty trap somewhat, and the planned reforms to the administration of social benefits should increase the focus on improving employability. The Netherlands is ahead of EU requirements for product market reform, and the government is expanding its program of deregulation. The banking system has well capitalized institutions and changes to the supervisory structure have helped strengthen consumer protection and supervision of conglomerates.

Executive Board Assessment

Executive Directors commended the authorities for the sustained implementation of sound macroeconomic and structural policies, which has raised potential output, kept inflation low, promoted strong employment growth, and reduced the unemployment rate to one of the lowest among industrialized countries. Much of the credit for the economy's extraordinary performance goes to the credibility-enhancing effects of the fiscal consolidation that has been carried out in a rules-based medium-term framework and the implementation of structural reforms, notably in the labor market.

Directors observed that the economy is now several years into a strong cyclical upswing, benefiting from the pickup of activity in the rest of Europe and monetary conditions that remain relatively easy from the perspective of the Dutch economy. With labor markets already very tight and the prospect of above-trend growth continuing, Directors considered that the economy has become vulnerable to overheating risks, although several noted that there are still no decisive signs of inflationary tensions. Directors agreed that recent and prospective interest rate increases are likely to moderate house price increases, thereby tempering private consumption. A gradual loss of competitiveness, from an initially strong position, would also tend to moderate demand growth to more sustainable rates. Some Directors also observed that demand growth would likely be increasingly satisfied by imports, which would be a desirable adjustment in view of the large current account surplus. Nevertheless, further upward demand pressures could lead to an acceleration of wage, asset, and domestic price inflation as well as an increased likelihood of a disruptive downturn. A significant correction in asset prices might accompany, and exacerbate, such a downturn.

In this context, Directors underscored the need for prudent fiscal policy and welcomed the structural improvement in the budget balance in 1999. Most Directors felt that this improvement should be preserved in 2000. To do so, it would be essential to devote all windfalls on the revenue and expenditure sides of the budget to the fiscal balance. Most Directors further cautioned that the proposed increase in expenditure to exhaust the room under the expenditure ceiling would intensify already strong demand pressures.

Directors noted that the authorities' conduct of fiscal policy on the basis of a rules-based medium-term framework has been instrumental in promoting fiscal consolidation and reducing the tax burden. They agreed that the 2001 tax reform—which has been an integral part of the current fiscal framework since its inception—should proceed as planned. Directors recognized the cyclical risks posed by the associated tax cuts, and several noted that it would be important not to add to the fiscal impulse it implied. Overall, however, they considered that the tax reform would have positive benefits.

In line with cyclical requirements, Directors observed that it would be desirable to achieve structural fiscal balance in 2002. They also encouraged the authorities to continue their medium-term approach to fiscal policy beyond 2002 and, in this context, to permit full operation of automatic fiscal stabilizers at least on the revenue side, and to consider explicitly a medium-term path for the structural balance.

Directors strongly supported the ongoing efforts to address remaining labor market weaknesses, in particular to raise participation rates and reduce the large number of disability and welfare recipients. They welcomed the reduction in the labor tax wedge, the introduction of a workers' tax credit (both part of the 2001 tax reforms), the promotion of actuarially fair early retirement schemes, and increased reliance on incentives for firms to limit claims on the sickness program. To complement this approach, Directors advocated measures that would scale back income-related benefit programs and lower replacement rates, recognizing that it would take time to build consensus to reduce social benefits. They also underscored that, to reap the benefits from the promising reorganization of the social security system, it would be essential to take a comprehensive view of the transition from welfare to work and ensure that proper financial incentives are put in place.

Recognizing that there has already been significant progress in some areas, Directors encouraged the authorities to expand product market reforms further. They welcomed the establishment of an independent body to assess publicly the administrative burden of new legislation, while urging the authorities to ensure steady progress in reducing the burden itself. Directors also supported the initiatives to raise the public profile of the umbrella project for the promotion of market forces, deregulation, and improvement in quality of legislation, and to push for stricter timetables for implementing the recommendations in these areas.

Directors observed that the country's sound financial system has underpinned economic prosperity. In light of the rapidly evolving structure of financial markets, they welcomed the establishment last year of the Council of Financial Supervisors, noting that it has been instrumental in improving the supervision of conglomerates and fostering consumer protection. Directors also urged the authorities to maintain a sharp focus on mortgage market risks.

Directors commended the authorities for their continued support for trade liberalization on a multilateral basis. They also welcomed the substantial level and high quality of official development assistance, which has remained above the United Nations target.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 1999 Article IV consultation with the Netherlands is also available.

Kingdom of the Netherlands - Netherlands: Selected Economic Indicators

	1996	1997	1998	1999	2000 1/
Real economy (change in percent)					
GDP	3.0	3.8	3.7	3.6	3.8
Domestic demand	2.8	3.5	4.2	3.8	3.6
CPI (year average)	2.1	2.2	2.0	2.0	2.3
Unemployment rate	6.6	5.5	4.1	3.2	2.3
Gross national saving (percent of GDP)	26.5	27.6	26.3	26.1	27.4
Gross domestic investment (percent of GDP)	21.3	21.6	21.9	22.1	22.7
Public finance (percent of GDP)					
General government balance	-1.8	-1.2	-0.8	0.5	0.4
Structural balance	-1.0	-0.9	-1.0	-0.1	-0.7
General government debt	75.3	70.3	67.0	63.7	60.1
Money and credit (end of year, percent change)					
Domestic credit	10.0	13.1	16.2	...	...
M3H	5.8	7.4	9.6	...	...
Interest rates (percent)					
Money market 2/ 3/	2.9	3.1	3.2	3.0	3.4
Government bond yield 3/	6.5	5.8	4.9	4.7	5.7
Balance of Payments (percent of GDP) 4/					
Merchandise balance	5.3	5.2	4.9	4.7	5.8
Current account balance	5.6	7.4	5.6	5.2	5.9
Official reserves excluding gold (US$ billion) 5/	26.8	24.9	21.4	10.2	10.0
Reserve cover (months of imports of GNFS)	1.7	1.7	1.5	...	...
Exchange rate					
Exchange rate regime		Member of euro area			
Euro per US $ (May 2, 2000)					0.91
Nominal effective rate (1995=100) 5/	98.1	93.5	93.4	92.1	90.0
Real effective rate (1995=100) 5/ 6/	96.4	90.9	88.3	86.5	84.5

Sources: International Financial Statistics; Dutch authorities; and IMF staff estimates.
1/ IMF staff projections.
2/ Refers to euro rate beginning in 1999.
3/ For 2000, average of the first two months.
4/ On a transactions basis.
5/ For 2000, average of the first three months.
6/ Based on relative normalized unit labor costs in manufacturing.