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Economic Developments and Outlook

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Economic Developments and Outlook

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Summary

The growth rate of the Dutch economy will decrease. Following growth of 3.0% in 2017 and 2.6% in 2018, gross domestic product (GDP) growth is projected to decline to 1.6% in 2019. In 2020 and 2021, growth should be close to potential, at 1.5% and 1.4% respectively. Economic activity remains high during the entire projection horizon: the output gap will remain positive at approximately 1.8%, and conditions on the labour market will remain tight. Unemployment is set to remain at a historic low of 3.3% throughout 2019, 2020 and 2021.

The lower growth rates are largely attributable to international economic developments, which will act as a drag on Dutch export growth. In addition, consumer confidence fell over the course of 2018, dropping from an unusually high peak to levels more in line with the long-term average. The cooling of the Dutch housing market is also restraining growth, and businesses are expected to scale back investment growth sharply in 2020 and 2021. By contrast, the government will boost expenditures, especially in the form of investment. Economic growth in the coming years will therefore largely rely on public and private expenditures. Households will continue to benefit from tight labour market conditions. Recent years have seen incomes rise primarily on the back of rapid growth in the number of jobs.

In the years ahead, wage growth rates increase, driven by low unemployment and higher inflation. Compensation per employee in the private sector should rise by 2.8% in 2019, 3.7% in 2020 and 3.8% in 2021. Inflation (HICP) should reach 2.5% in 2019. Higher VAT and energy tax rates will have a strong impact on price levels this year. Inflation is projected to fall to 1.6% in 2020 and rebound to 2.1% in 2021, fuelled mainly by rising labour costs.

An alternative scenario analyses the consequences of a more pronounced cooling down of the housing market. In this scenario, reduced confidence and lower growth of housing investment, private consumption and business investment depress GDP growth by 0.3 percentage points in both 2020 and 2021. Economic growth will remain at a satisfactory level in this scenario, but house prices will stagnate nearly completely within two years.

1 The Dutch economy in 2019-2021

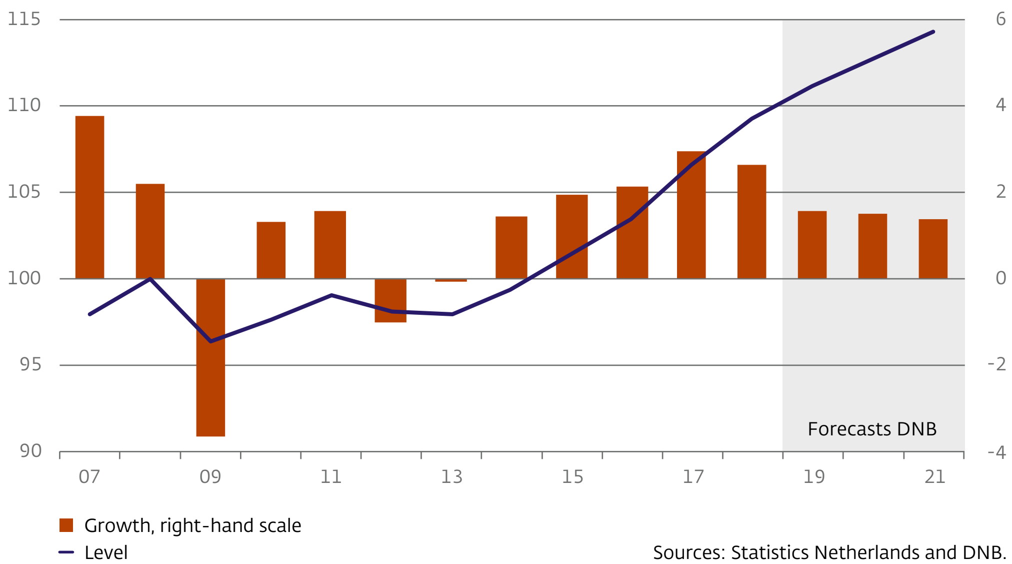
Economic growth to slow down

Dutch Economic growth is set to return to normal rates. Gross domestic product (GDP) growth stood at 2.6% in 2018, following a 2017 peak of 3% (Figure 1). At 1.6%, projected growth for 2019 is significantly lower, although this rate is very close to potential growth. This situation will continue in 2020 and 2021, when GDP growth is projected to stand at 1.5% and 1.4%, respectively. The output gap will remain fairly constant at 1.8%, which is in keeping with times of economic booms. This will also be reflected in the tight labour market. Unemployment is set to remain at a very low rate of 3.3% of the labour force throughout 2019, 2020 and 2021.

The decline in GDP growth is also reflected in the most recent quarterly figures. In the first two quarters of 2018, GDP in the Netherlands continued to grow by 0.7% on average relative to the preceding quarter, only to slow to 0.3% on average in the final two quarters of that year. Although provisional figures indicate that growth recovered to 0.5% in the first quarter of 2019, various factors indicate that economic growth is gradually normalising towards potential, long-run rates. Consumer confidence decreased considerably in 2018, dropping to the long-term average at present. Confidence in the corporate sector (measured according to figures from the Purchasing Managers' Index – PMI) has also decreased sharply since early 2018. The general sentiment in international trade specifically has darkened somewhat due to trade disputes and the consequences of a possible Brexit. The indicator for new export orders among Dutch enterprises has decreased by more than 10 points since early 2018, and stood at 52 as of May 2019 (Figure 2).

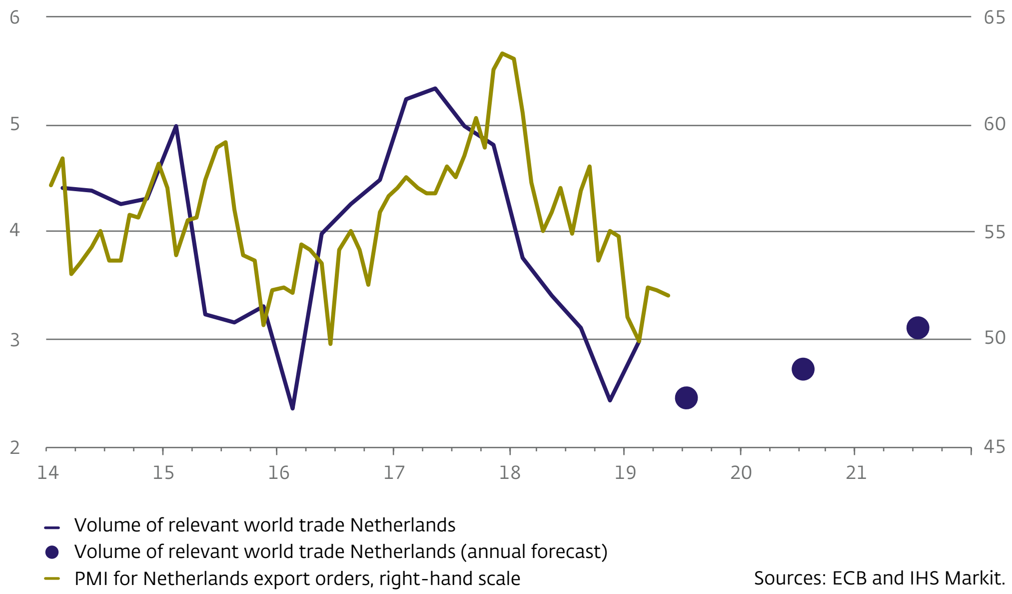
Figure 1 Gross domestic product

Volume; 2008 = 100 and year-on-year percentage changes



Sources: Statistics Netherlands and DNB.

Figure 2 Slowdown in international trade
Year-on-year percentage changes and index



Sources: ECB and IHS Markit.

A significant change in growth composition is expected in the projection years. Nearly half of GDP growth in 2017 and 2018 could be ascribed to the export of goods and services. In 2019, just 0.2 percentage points of the GDP growth of 1.6% will be attributable to exports. Over the remaining projection horizon, the health of the Dutch economy will largely rely on domestic expenditure, which primarily consists of household spending. Furthermore, government spending will contribute substantially to economic growth, while the contribution of housing and business investment will gradually decrease.

International economic activity is weakening

The European Central Bank (ECB) projects global growth, excluding the euro area, to slow from 3.8% in 2018 to 3.3% in 2019.[1] This projection has been adjusted downwards compared to six months ago, driven largely by slower growth in emerging market economies. Global GDP growth is dampened as a result of the escalated trade dispute between the United States and China, which intensified in May 2019 when both countries raised their import tariffs once again. Furthermore, the Chinese economy is experiencing lower growth in domestic expenditure as a result of the country's debt-reduction policy. The economic boom in many developed economies is slowly petering out.

1 The assumptions underlying the development of relevant world trade, exchange rates, international commodity prices and interest rates are based on information available on 21 May 2019.

The projection calls for a recovery of GDP growth to 3.6% in 2020 and 2021, largely attributable to an expected recovery in emerging market economies such as Turkey and Brazil. Conversely, a gradual decrease in growth is expected for China. Moreover, governments in developed economies such as the United States will curtail fiscal stimuli.

The ECB projects GDP growth in the euro area at 1.2% in 2019, and 1.4% in 2020 and 2021. This is lower than the projections six months ago. The lower growth forecast is a result not only of global dynamics, but also of domestic factors. The problems facing the European car industry (due to revised emission requirements), for example, have proved to be more persistent than expected. Over the projection horizon, however, growth in the euro area will benefit from the expansionary monetary policy, increasing wage growth and a modest boost from the public sector. Box 1 below discusses the changing correlation between the Dutch and German economies.

In view of this, an improvement in world trade is unlikely. Growth of world trade relevant to the Netherlands will initially slow, from 3.2% in 2018 to 2.4% in 2019, followed by some recovery in 2020 (2.7%) and 2021 (3.1%) (Figure 2). Risks to world trade projections will remain downward, including the risk of a no-deal Brexit and further escalation of the trade conflict between the United States and China. In May, the United States postponed the decision to raise import tariffs on European cars by six months. Nevertheless, there is a risk that Europe will become involved in a trade conflict with the United States.

Lower interest rates and oil prices assumed

Long-term interest rates in the Netherlands were at 0.6% in 2018, which is very low. Contrary to previous estimates, a further decline to 0.2% has been projected for 2019, reflecting recent adjustments to monetary policy by both the ECB and the Federal Reserve (the Fed). In response to weaker than expected outlooks in the euro area, the ECB decided in March 2019 to postpone what would be the first increase in the main interest rate since 2011. The Fed does not expect to raise the interest rate in 2019 for similar reasons.

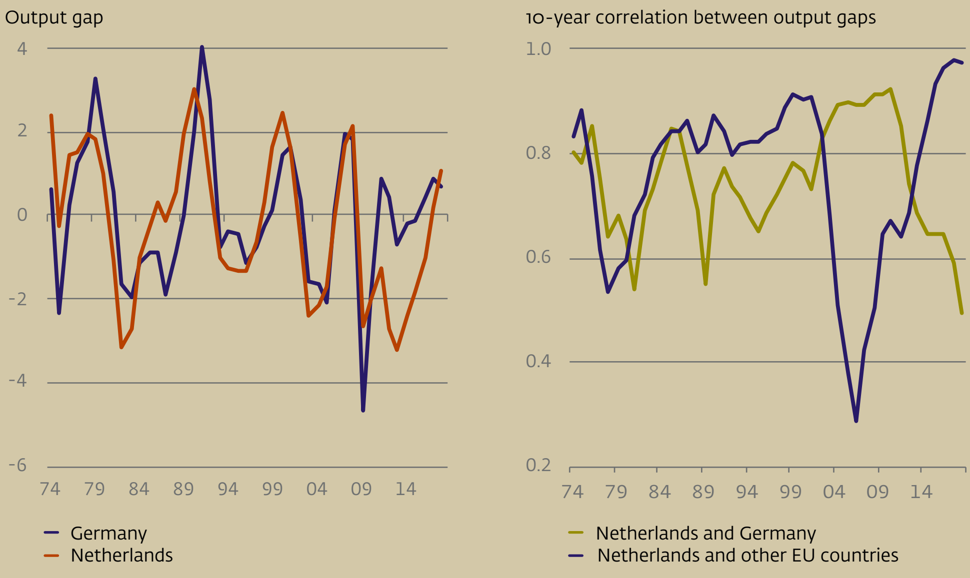
In the previous six months the price of a barrel of crude oil declined to USD 65, after having climbed continuously since 2016. The current projection calls for an increase in oil prices over the coming quarters, partly due to US sanctions imposed on Iran and Venezuela. At the end of the projection horizon, oil is expected to be priced at USD 62.70 per barrel as a result of persistently sluggish economic growth. This will keep down energy inflation. The projection calls for a euro exchange rate of USD 1.12 per euro.

Box 1 Less pronounced correlation between Dutch and German business cycles

The Dutch economy has robust links to the German economy. Germany is the Netherlands' biggest trading partner, taking a quarter of Dutch exports. Now that the German economy seems to be entering a period of stagnation, its potential impact on the Dutch economy is of interest. The output gap can be used to measure the correlation between the Dutch and German business cycles. The output gap expresses the percentage deviation between actual production and potential production, determined by labour supply, structural labour productivity and other factors. The Dutch and German output gaps followed a similar pattern until the financial crisis in 2008 (Figure 3, left). The correlation varied from 0.6 to 0.8, with low points in the 1970s (oil crises) and the late 1980s (German reunification) (Figure 3, right).[2] This connection came to an abrupt end when the financial crisis struck in 2008. The German economy recovered more quickly and robustly than the Dutch economy. Whereas the Dutch construction sector suffered a blow, the building industry in Germany was fairly unaffected. These results are robust to the method applied to calculate output gaps.

Figure 3 Output gaps in the Netherlands and Germany

Percentage of potential gdp (volume)



Sources: European Commission and DNB.

Note: Output gap data from Ameco database, May 2019.

2 A correlation of 1 means full correspondence, 0 means no correspondence, and -1 means fully opposite correspondence.

Starting in the 1970s the Dutch business cycle demonstrated correlation not only with Germany, but also with the other EU Member States. Since 2000, however – simultaneously with the introduction of the euro – this correlation has become significantly weaker), although it recovered rapidly following the conclusion of the financial crisis.

Summing up, there is no guarantee that the business cycle in the Netherlands will track the German business cycle any time soon. In fact, the Dutch business cycle has tended to follow that of the other EU Member States in recent years.

Economy to grow due to household and public spending

Table 1 lists the key data for the Dutch economy for 2019-2021. GDP growth will decline somewhat in 2019-2021, towards the potential growth rate. Growth in private consumption will decline by more than a percentage point to 1.3% in 2019, followed by an increase to 2.2% in 2020 and 1.9% in 2021. Government spending will increase by 2.6% in 2019, surpassing the 2018 increase of 1.5%. Public sector investment will make up a significant part of this increase. In the first quarter of 2019, this investment grew at a rate of 11.7% year-on-year, resulting in a growth forecast of 6.8% in 2019, which is the highest rate of growth since 2006.

Business investment will grow by 4.5% in 2019, which is somewhat higher than the 3.6% growth recorded in 2018. Growth will then drop to 1.7% in 2020 and to 1.1% in 2021, in line with lower GDP growth. Growth in residential investment declined significantly last year (7.7%) following the high growth rate achieved from 2015 through 2017 (an average of 18%). The projection calls for a further slowdown, to 5% in 2019 and an average of 2.7% in the years thereafter. This will be caused by fewer permits for new construction, fewer housing transactions and diminished consumer confidence. Export growth will decline to 1.3% in 2019, primarily due to a sharp contraction of an incidental nature in the fourth quarter of 2018. Export growth will then recover to 2.6% in 2020 and 2.7% in 2021.

Figure 4 shows the composition of GDP growth, whereby the concomitant component of final and intermediate import has been deducted for each expenditure category. The contribution to growth from exports especially is significantly smaller in the projection, with domestically produced exports showing the greatest decline (close to 0% in 2019, then just 0.1 percentage point in 2020 and 2021). The contribution to growth from private consumption will decline in 2019, and then recover marginally in the years to follow. Contributions to growth from business and residential investment have been gradually declining since 2017. This trend is projected to continue, resulting in contributions of around 0.1 percentage point both in 2020 and 2021.

Table 1 Key data in forecast for the Dutch economy

Percentage changes, unless stated otherwise

	2018*	2019	2020	2021
Volume of expenditure and output				
Gross domestic product	2.6	1.6	1.5	1.4
Private consumption	2.5	1.3	2.2	1.9
Public expenditure	1.5	2.6	2.1	1.7
Business investment	3.6	4.5	1.7	1.1
Housing investment	7.7	5.0	2.6	2.8
Exports of goods and services	2.6	1.3	2.6	2.7
of which domestically produced	2.4	0.3	2.1	2.0
of which re-exports	3.0	3.0	3.3	3.7
Imports of goods and services	2.7	2.5	3.5	3.3
of which domestically used	2.5	2.3	3.5	3.1
Wages and prices				
Negotiated wages, private sector	2.0	2.4	2.8	2.9
Compensation per employee, private sector	1.8	2.8	3.7	3.8
Unit labour costs	2.1	3.1	2.5	2.4
Prices of domestically produced exports	2.4	1.6	1.6	1.8
Harmonised consumer price index	1.6	2.5	1.6	2.1
House prices, existing own homes	9.0	5.9	2.8	2.3
Labour market				
Employment (persons, growth)	2.5	1.9	0.5	0.2
Labour supply (persons, growth)	1.5	1.4	0.6	0.3
Unemployment (persons x 1,000)	350	307	313	321
Unemployment (% of labour force)	3.8	3.3	3.3	3.3
Public sector and financial				
EMU balance (% of GDP)	1.5	1.3	0.9	0.5
EMU debt (% of GDP)	52.4	48.9	46.3	44.2
Current account (% of GDP)	10.9	8.4	7.7	7.5
Mortgage loans (based on end-of-period)	2.2	2.1	4.6	4.0
Bank lending to NFCs (based on end-of-period)**	-2.0	-1.1	0.0	1.1
International assumptions				
Volume of relevant world trade	3.2	2.4	2.7	3.1
Volume of GDP US	2.9	2.5	2.0	1.8
euro area	1.9	1.2	1.4	1.4
emerging markets	4.4	3.9	4.5	4.5
Short-term interest rate in the euro area (%)	-0.3	-0.3	-0.3	-0.2
Long-term interest rate in the Netherlands (%)	0.6	0.2	0.2	0.4
Euro exchange rate (USD)	1.18	1.12	1.12	1.12
Competitor prices	0.9	2.8	2.2	2.1
Oil price (UK Brent in USD per barrel)	71.7	68.2	65.8	62.7
Commodity prices excluding energy (USD)	3.9	-3.4	3.9	3.8

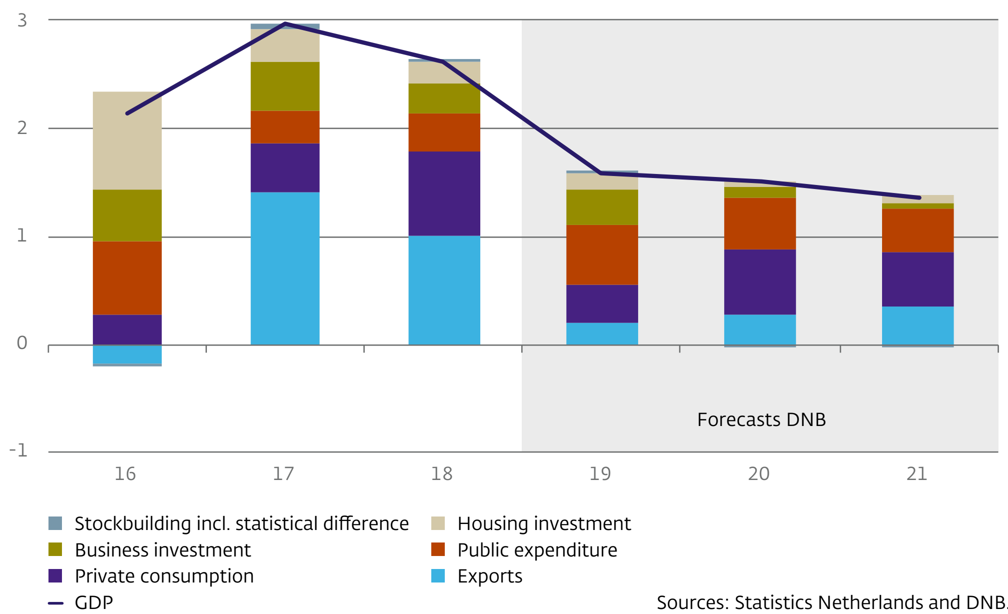
Sources: DNB and ECB.

* Annual figures have been calculated based on seasonally adjusted quarterly figures and may therefore deviate marginally from the most recent National Accounts.

** Excluding cash pooling, adjusted for securitisations and breaks.

Figure 4 Sources of GDP growth

Year-on-year percentage changes and contributions in percentage points



Sources: Statistics Netherlands and DNB.

Note: Net contributions to GDP growth. The final and cumulative intermediary imports have been deducted from the related expenditure categories.

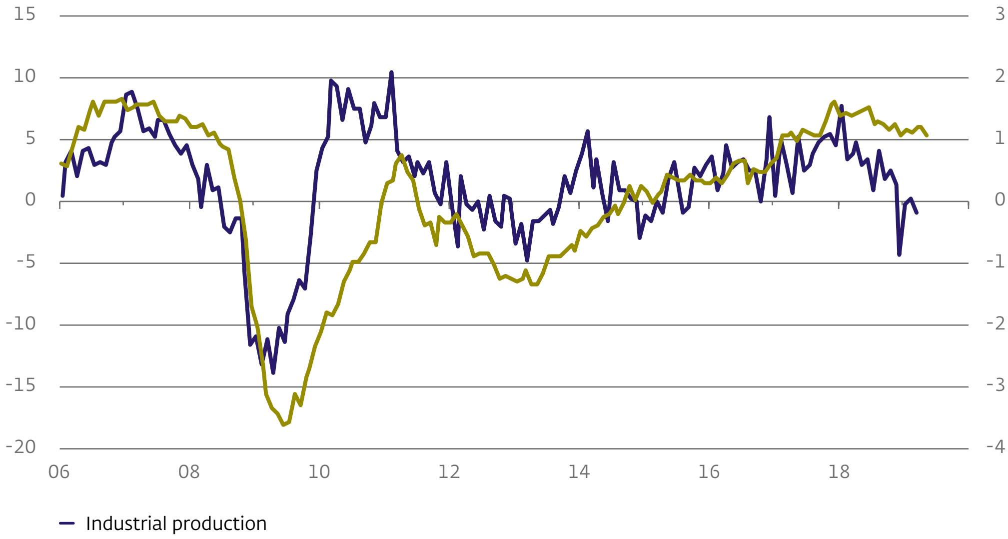
Output gap both stable and high

The output gap improved in 2018 for the fifth consecutive year, climbing from 0.6% to 1.8%, which is an indication that the economy is performing well above its potential. The output gap will remain unchanged through 2021, according to the projections. The manufacturing sector achieved a capacity utilisation rate of 84.3% in the second quarter of 2019, which is higher than the peak reached prior to the financial crisis.

Despite high capacity utilisation rates, recent indications point to a reversal in business activity. Corporate sector orders in the first three quarters of 2018 were at a high level, only to show a mild reversal thereafter (Figure 5). In addition, companies were more positive about the size of their inventories, which they reported as being too limited at the end of 2018. Moreover, slightly fewer companies were facing shortages of labour or other resources. Finally, industrial production experienced a sharp reversal in the course of 2018, from a growth rate of more than 4% to a mild contraction in the first quarter of 2019. It is clear that the economy as a whole is no longer facing constantly increasing production tensions.

Figure 5 Downturn in business activity

Year-on-year percentage changes and standard scores



Sources: Statistics Netherlands and European Commission.

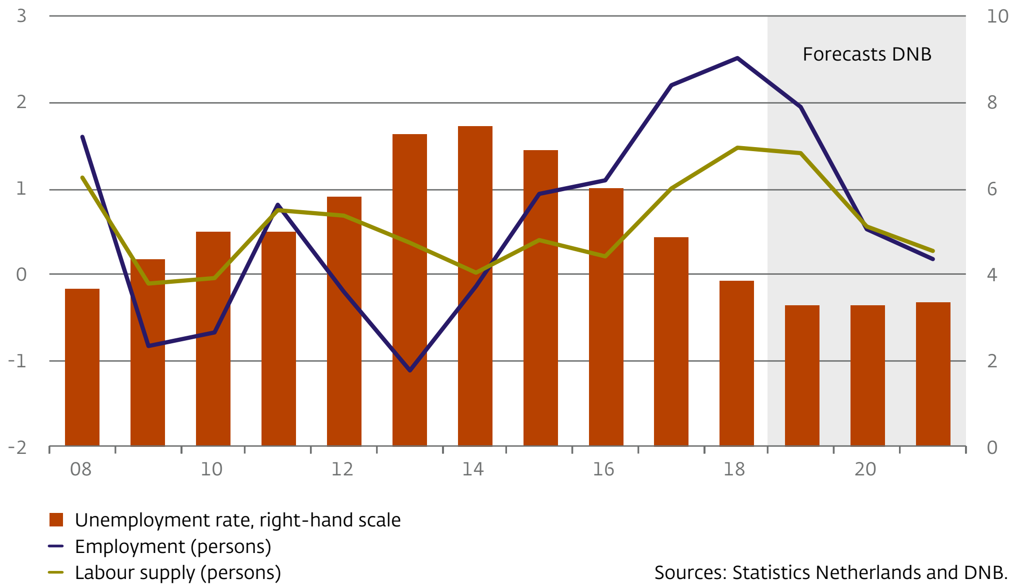
Tensions remain on labour market

The number of employed persons grew by 2.5% to reach a peak in 2018. Since the millennium, 2007 was the only year in which employment growth was more robust. Employment will grow considerably in 2019 as well (1.9%), although a slowdown to 0.2% is projected for 2021 (Figure 6). Over the past four years, growth in labour supply was outpaced by demand, resulting in a steady decrease in the unemployment rate from 7.4% in 2014 to 3.8% in 2018. The trend will continue in 2019, when the unemployment rate will decline further to 3.3%, resulting in severe tightness on the labour market. In the past four decades, only 2001 witnessed similar labour market tension – in all other years unemployment was higher. It is expected that labour market supply and demand will keep pace with each other, and that the unemployment rate will thus remain at the same low level of 3.3% until the end of the projection horizon.

The lower employment gains in 2019-2021 will be a result of weaker economic growth, while also being related to a tight labour market. Employers will have greater difficulty finding the right people for the jobs available. The number of vacancies hit a new record of 277,000 in the first quarter of 2019, while the number of job seekers declined. Currently the ratio of vacancies to unemployed people is 100:114. When the labour market started to recover in 2014, the ratio was 100:700.

Labour supply is also reaching its limits. By 2018, the labour participation rate had returned to the high level reached in 2008: 70.5% of the population of working age. Labour participation

Figure 6 Labour market remains tight
Year-on-year percentage changes and percentage of labour force



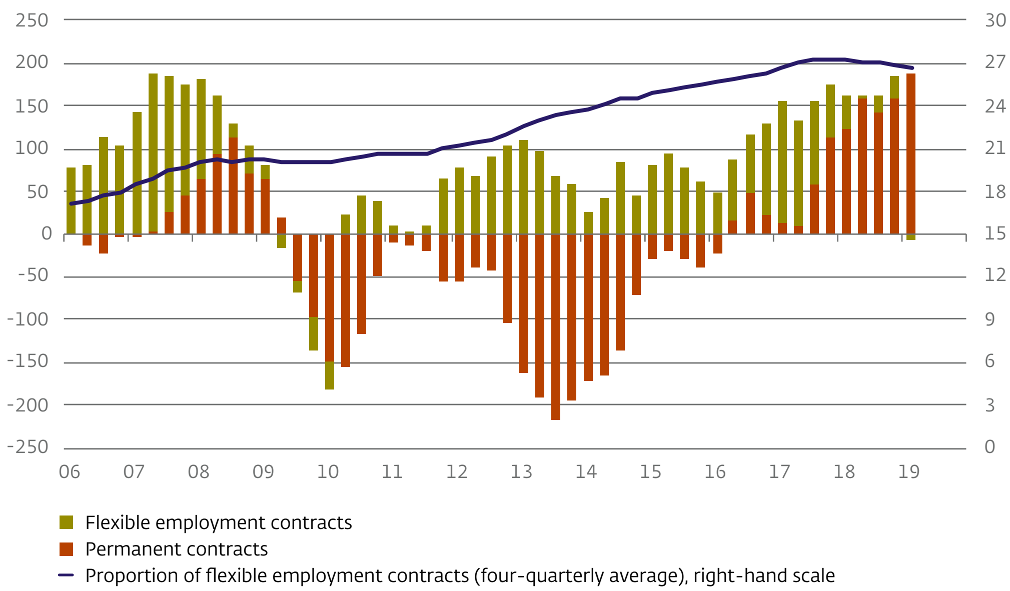
Sources: Statistics Netherlands and DNB.

swelled in particular among those 55 and older, while also showing a slight increase among women and highly educated people in general. In contrast, labour participation was down among men with a low or medium level of educational attainment. If their rate of participation had remained at the 2008 level, then current labour supply would be higher by 100,000 individuals.

More permanent contracts

The number of workers on a permanent contract declined between the second quarter of 2010 and the first quarter of 2016, while the number of jobs with a flexible contract increased. Consequently, in that period the percentage of flexible workers increased from 20% to 26%. Since then, the number of permanent jobs has been on the rise. Moreover, the number of jobs with a flexible contract declined in the first quarter of 2019 for the first time since 2010 (Figure 7). The recent shift from flexible to permanent contracts is partly attributable to increasingly tight labour market conditions, where permanent contracts may serve as a means to tie employees to the company. Since 2017, the number of permanent contracts has been growing especially among those 55 and older. This group is participating in the labour market for longer than before. There has been an additional and considerable increase in the number of permanent contracts among the under-35s, who transition into permanent employment from temporary contracts. With regard to educational attainment level, the strongest growth in permanent contracts has been among the higher educated.

Figure 7 Growth in employees by type of employment relationship
Thousands of persons; year-on-year changes and percentages



Source: Statistics Netherlands.

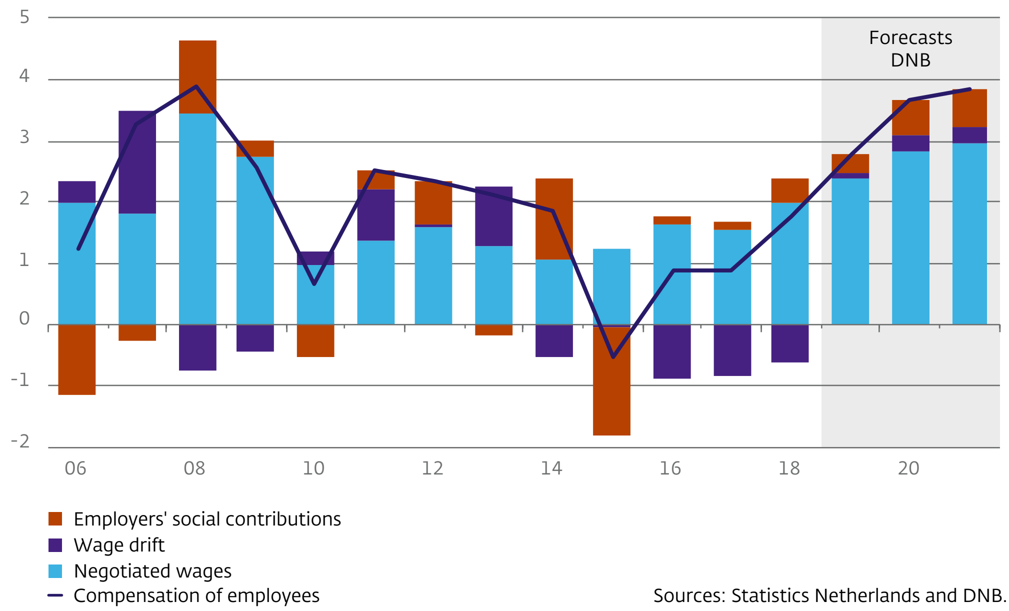
Wage growth outpacing inflation

Compensation increases per employee remained limited over the past three years due to a combination of low contractual wage growth and negative wage drift (Figure 8). The low contractual wage growth can be partly explained by the modest increase in labour productivity and low inflation. In addition, the limited compensation increases can also be attributed to a deteriorating bargaining position among employees, along with developments such as globalisation, technological innovation and labour market flexibilisation. According to the projection, however, labour market tensions will be more keenly felt, and the increase of compensation per employee (businesses) will rise from 1.8% in 2018 to 3.8% in 2021. Inflation is also higher, and this will play an important role, too. Moreover, wage drift will revert to a positive trend in 2019 for the first time in five years. Tightness on the labour market also means that more companies will pay bonuses, and that growth in employment will shift to jobs with on average a higher level of compensation.

Inflation temporarily higher in 2019

Consumer prices are projected to rise by 2.5% in 2019 (HICP inflation). This is a significantly higher rate of inflation compared to the 2018 level of 1.6%. The increase over 2018 can primarily be ascribed to higher indirect taxes, which are likely to be passed on to prices. The projected

Figure 8 Breakdown of wage developments in the private sector
Year-on-year percentage changes and contributions in percentage points, fte



Sources: Statistics Netherlands and DNB.

consumer price rise would have been limited to 1.2% for 2019 if the low VAT rate had not been raised from 6% to 9% and if taxes on energy had remained unchanged. Energy inflation will be 9% in 2019, primarily because of higher energy taxes and the increase in oil prices. Core inflation, which is defined as HICP inflation excluding the volatile components of food and energy, is projected to increase from 1% in 2018 to 1.6% in 2019 (Figure 9).

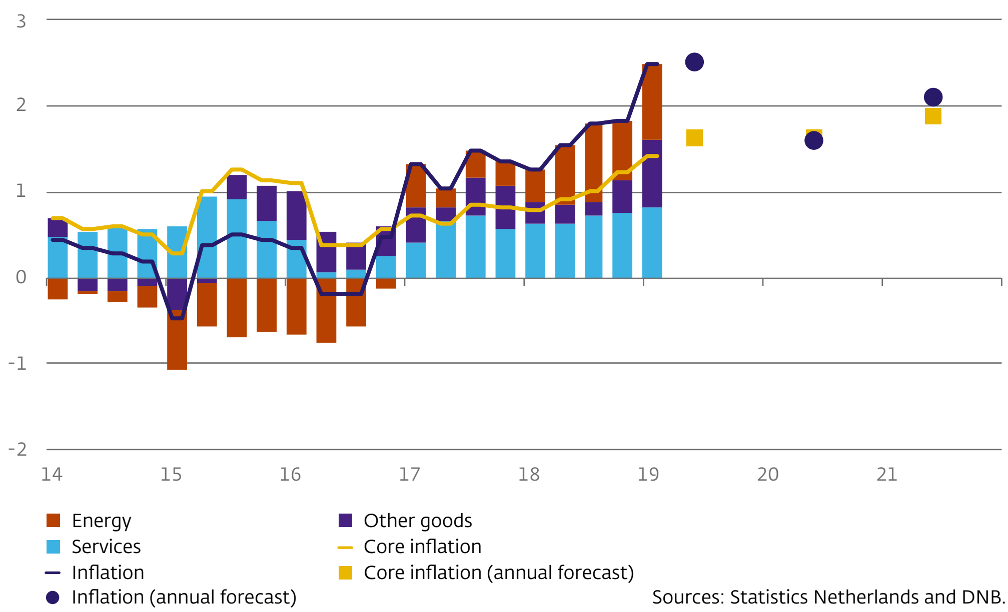
Prices will have adjusted to the direct impact of the VAT and energy tax increases by 2020, and both HICP inflation and core inflation will fall back to 1.6%. At that point, the development of the unit labour cost will be the key determinant for inflation. This factor has a delayed impact on the price of consumer goods. The growth rate of compensation per employee in the business sector increases from 2.8% in 2019 to 3.8% in 2021. Taking account of the projected increase in labour productivity, unit labour costs increase 2.5% in both 2020 and 2021.

Corporate profits up considerably

Enterprises were significantly more profitable in 2018. Pre-tax net profits (non-financial institutions) grew by more than 13% year-on-year in 2018, whereas the rate was 1% and -3% in the preceding years. By retaining more profits, enterprises are able to pay down their debts more quickly while also being less reliant on external financing. Enterprises have in fact

Figure 9 HICP inflation and core inflation

Year-on-year percentage changes and contributions in percentage points



Sources: Statistics Netherlands and DNB.

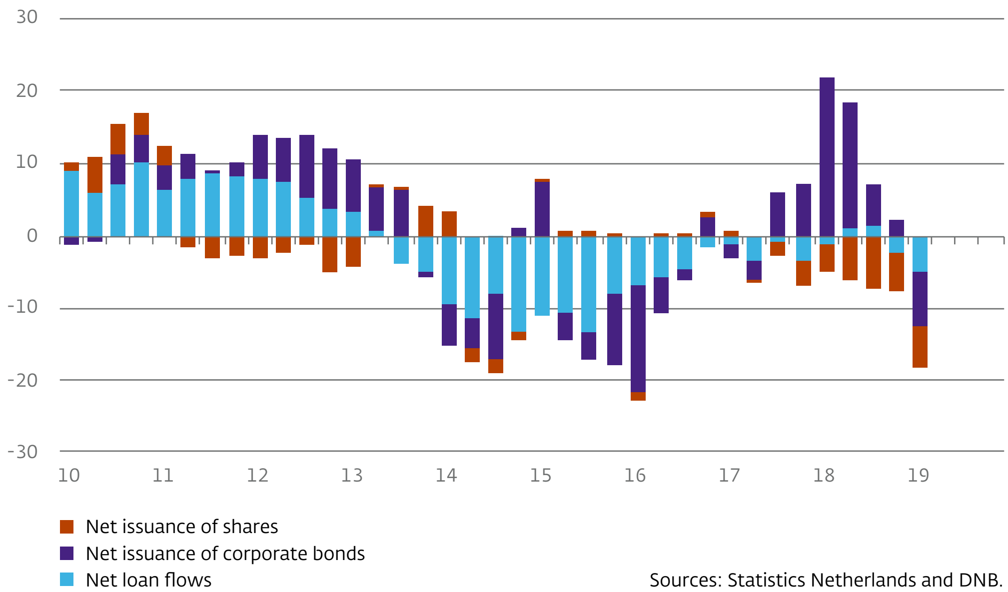
Note: Core inflation = total excluding food and energy.

begun limiting their external financing since early 2018, primarily by reducing the emission of corporate bonds following a notable peak at the start of that year (Figure 10).

Enterprises also continue to repay more bank loans than they take out. The net flow of loans has been negative almost without interruption since 2013. Bank lending to corporations contracted by 2.0% in 2018. A majority of banks indicate that they relaxed their corporate lending criteria as of the second half of 2018, and that they expect to maintain this policy through the first half of 2019. Total growth in bank lending is projected to be negative in 2019, at -1.1%, followed by tentative growth starting in 2021.

Despite lower corporate lending in general, large bank loans (i.e. > EUR 1 million) specifically to SMEs have been on the upswing since late 2017. Lending to SMEs dropped somewhat from 2.4% in the first half of 2018, to 0.8% in the second half of the same year. This may be due to improved profitability and an associated reduction in the need for bank financing among SMEs.

Figure 10 External financing for non-financial corporations
In EUR billion; four-quarter sums



Sources: Statistics Netherlands and DNB.

2 A closer look at expenditure and public finances

Dutch export growth lagging behind world trade

Growth in exports of goods and services from the Netherlands will fall temporarily to 1.3% in 2019. This will be the lowest level of growth since the millennium, with the exception of 2002 and 2009. Export growth will recover and reach 2.6% in 2020 and 2.7% in 2021, meaning it will lag behind relevant world trade during this period (Table 2). The sharp slowdown in export growth in 2019 is primarily attributable to domestically produced exports, excluding energy. Expected growth will drop to 0.2% in 2019 from a level of 3.0% in 2018. This drop is partly the result of a particular multinational company moving part of its operations abroad in the fourth quarter of 2018.[3] The carry-over effect means that this move will primarily influence export growth in 2019, while having no impact on future years. Nevertheless, growth of domestically produced exports will lag behind relevant world trade in 2020 and 2021 as well, meaning the Netherlands' market share will shrink even further. This is not a new trend. It is related to a variety of factors, including globalisation, in which the market share of developed economies is slowly appropriated by emerging market economies.

Table 2 Dutch exports and competitiveness

Percentage changes

	2018	2019	2020	2021
Volume				
Relevant world trade (1)	3.2	2.4	2.7	3.1
Exports of goods and services (2)	2.6	1.3	2.6	2.7
domestically produced	2.4	0.3	2.1	2.0
re-exports	3.0	3.0	3.3	3.7
Trade performance (2-1)	-0.5	-1.1	-0.1	-0.4
Exports of goods and services excl. energy	3.3	1.3	2.8	2.7
domestically produced (3)	3.0	0.2	2.4	2.1
re-exports	3.7	3.0	3.3	3.7
Market performance (3-1)	-0.2	-2.2	-0.3	-1.0
Price				
Competitor prices (4)	0.9	2.8	2.2	2.1
Exports of goods and services	2.1	1.8	1.4	1.3
domestically produced, excl. energy (5)	1.0	1.4	1.9	2.4
Price competitiveness (4-5)	-0.1	1.4	0.3	-0.3

Sources: DNB and ECB.

3 In and of itself, this move has no effect on Dutch GDP due to an equivalent impact on imports.

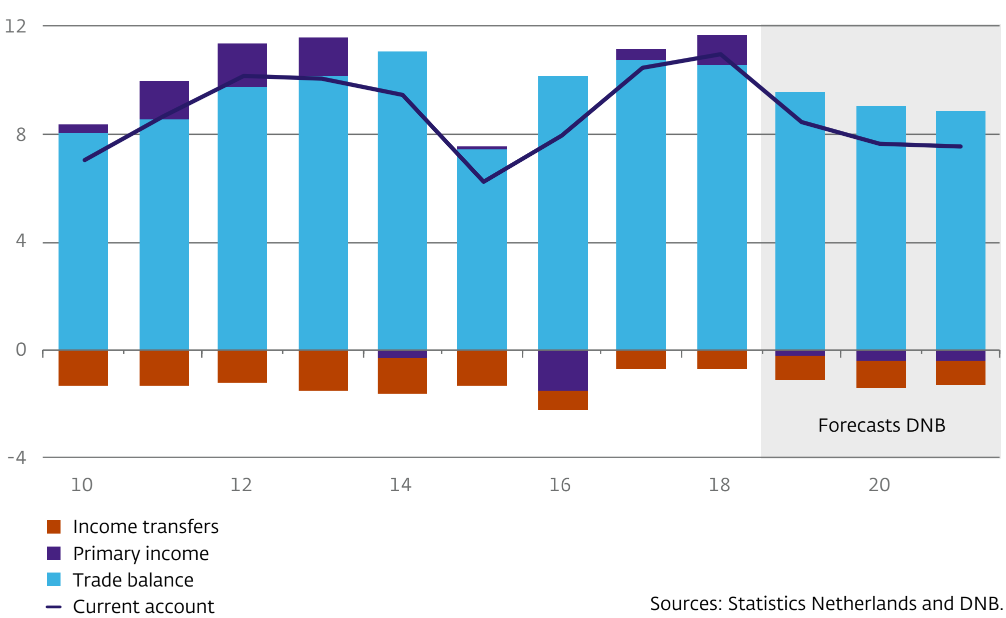
Furthermore, Dutch exports are also driven by energy exports and re-exports. During the projection horizon, it is expected that energy exports will have a positive effect on overall Dutch exports, following two years of negative growth. The projected growth rate of re-exports is relatively stable, and as usual is above the rate for relevant world trade.

Lower current account balance

The surplus on the current account of the Dutch balance of payments reached a new record of 10.9% of GDP in 2018 (Figure 11). This increase stems from a higher primary income balance, which was particularly pronounced in the fourth quarter of the year. Earnings of Dutch firms from interest, dividends and retained profits on their foreign assets exceeded those of foreign firms from Dutch assets in that quarter by almost EUR 8 billion. Foreign dividend payouts to Dutch firms were relatively high as a result of the booming worldwide economy. By contrast, Dutch dividend disbursements remained essentially unchanged due to the relatively strong presence of Royal Dutch Shell in dividend payouts. The company's policy focuses on ensuring stable dividends over time. In addition, the trade surplus is projected to decline over the projection horizon as imports of goods and services outpace exports. This will result in a lower surplus on the current account of 7.5% of GDP in 2021.

Figure 11 Lower current account surplus

Percentage of GDP



Sources: Statistics Netherlands and DNB.

Note: Income transfers include correction of changes in pension rights.

Temporary drop in consumption growth in 2019

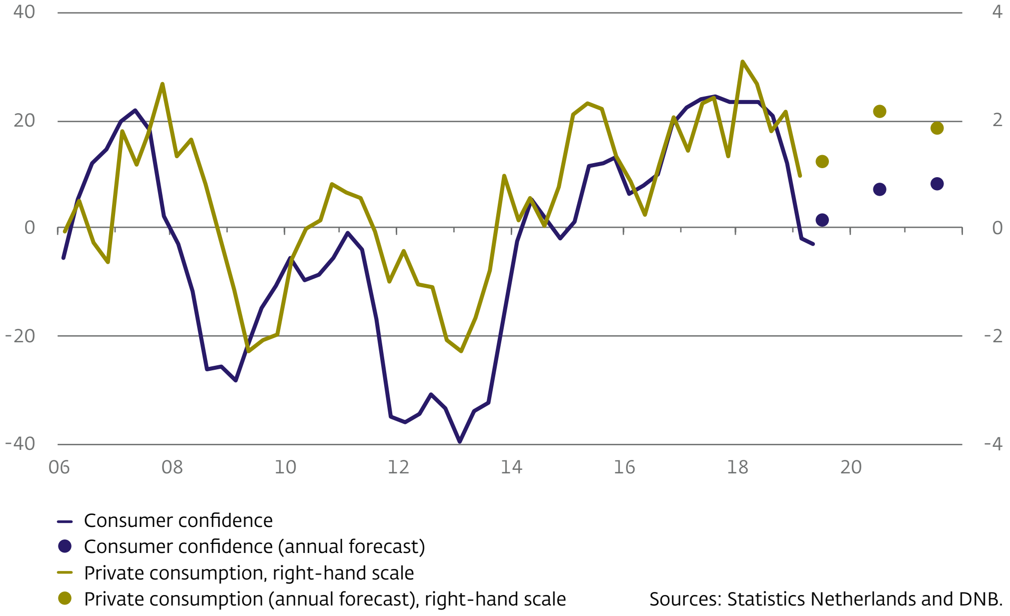
In 2018, private consumption grew at the highest rate (2.5%) since 2001. This growth was primarily driven by strong increases in employment, a buoyant housing market and high levels of consumer confidence. Consumption is expected to grow at a slower pace (1.3%) in 2019 (Figure 12). This growth slowdown is partly attributable to weather conditions in the first quarters of both years.

The cold winter of 2018 led to higher energy consumption (natural gas) than usual. The relatively high temperatures during the winter of 2019 had the opposite effect. Moreover, consumer confidence declined sharply in the second half of 2018 from a very high level at the start of the year to an average level at the year's end. Box 2 discusses the backdrop of this sharp decline. Consumer confidence is expected to recover gradually in 2020 and 2021, driven for a large part by low unemployment. Consumption is projected to grow considerably in both 2020 (by 2.2%) and 2021 (by 1.9%).

Household spending power will increase, primarily as a result of rising incomes. In the projection years 2019-2021, real disposable income is set to gain 1.9% annually on average, primarily as a result of higher wages. Moreover, employment gains will also boost growth in household incomes, especially in 2019. However, inflation in 2019 will temper this growth.

Figure 12 Consumer confidence and private consumption

Balance of positive and negative answers and year-on-year percentage volume changes; seasonally adjusted



Sources: Statistics Netherlands and DNB.

The effect of employment gains will be considerably less pronounced starting in 2020. Inflation will also be lower, and households will benefit from lower income tax rates. Real income growth is then projected to stand at 2.5%. Household income growth will drop to 1.2% in 2021, due to higher inflation and the gradually diminishing effects of the tax cut.

Box 2 Sharp drop in consumer confidence in 2018

Consumer confidence dropped from an average of 24 in the second quarter of 2018 to -2 in the first quarter of 2019, matching the three biggest drops since the millennium (in 2001, 2008 and 2011). The drop in Dutch consumer confidence is considerable when seen in an international perspective; Ireland is the only other EU country where consumer confidence took an even bigger hit.[4]

The economic fundamentals, such as share prices, housing prices and household income, cannot fully explain the drop in consumer confidence. Figure 13 shows consumer confidence over time and the proportion of confidence that can be explained by fundamentals based on equations in DELFI, DNB's macroeconomic model. The unexplained proportion of the change in consumer confidence can be labelled as 'animal spirits'.[5] These are psychological motivations and instincts that work alongside the fundamentals to influence consumers in their economic choices. Consumer confidence regularly deviates from what would be expected based solely on fundamentals. The current deviation is remarkable, however. Moreover, fundamentals in the Dutch economy have not developed to a worse degree than fundamentals in other EU countries.
A breakdown of consumer confidence by demographics provides a greater understanding of the nature and causes of the drop in confidence. Consumers throughout the population share this negative outlook. This suggests that the drop in consumer confidence is associated with phenomena that are felt throughout the population such as the increase in the low VAT rate, Brexit and the trade conflict between the United States and China. It is likely that the open character of the Dutch economy makes consumers more sensitive to international developments. This could also provide an explanation for the decline in consumer confidence in Ireland, which is likely to take the most severe hit in the case of a no-deal Brexit.

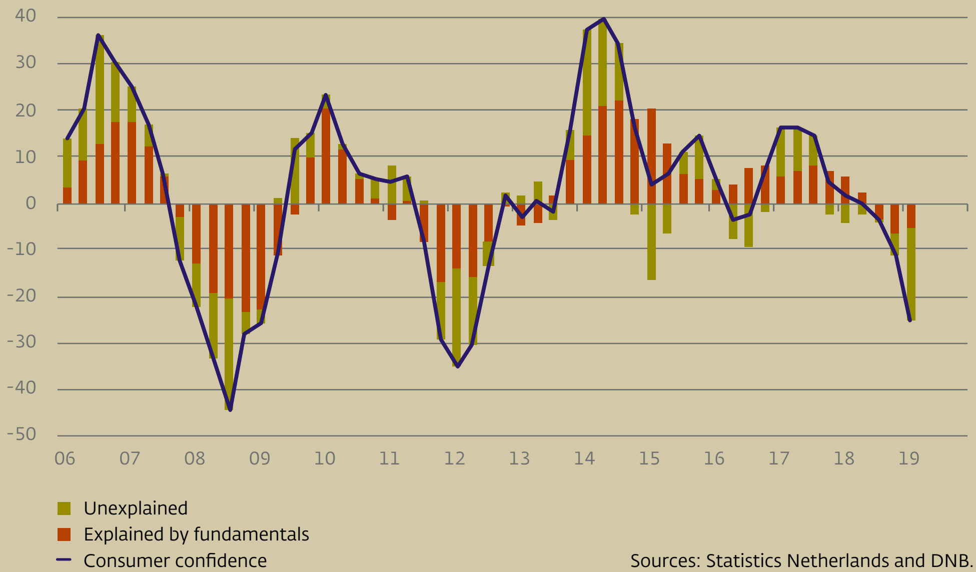
4 Data on consumer confidence in EU countries comes from the European Commission. This data corresponds well with Statistics Netherlands (CBS) data on consumer confidence in the Netherlands.

5 Öztürk and Stokman (2019), *Sporen van animal spirits in particuliere consumptie*, ESB no. 4773.

Although the drop in confidence is broad-based, it is more acute among certain groups of the population. Pensioners have lost more confidence than employed people. The failed pension negotiations of the autumn of 2018 may be to blame for this drop. Confidence among home owners has deteriorated more sharply than among those renting their homes. This may be related to developments in house prices, which are currently rising more slowly.

Figure 13 Development of consumer confidence

Balance of positive/negative answers; year-on-year changes



Sources: Statistics Netherlands and DNB.

Subdued investment growth

Corporate investment (excluding housing) rose by 3.6% in 2018, which is close to the long-term average. Enterprises invested less in ICT equipment than in previous years, and investment in tangible assets and machinery also dropped in the final quarter of the year. These drops were more than fully compensated for by expenditures on vehicles. The effects of the relatively strong growth in the final quarter of 2018 will continue to be felt in investment growth in 2019, which is projected at 4.5%. Recent surveys indicate a slowdown in the course of 2019, however. Companies in the industrial sector indicate that they plan to restrict expanding their investment quite severely. Projected investment growth will decline to 1.7% in 2020 and to 1.1% in 2021. This decline is partly attributable to more sluggish economic growth, which logically influences investment, which is referred to as the accelerator mechanism. Moreover, corporate profit margins will shrink, as higher wage costs will not be fully reflected in prices.

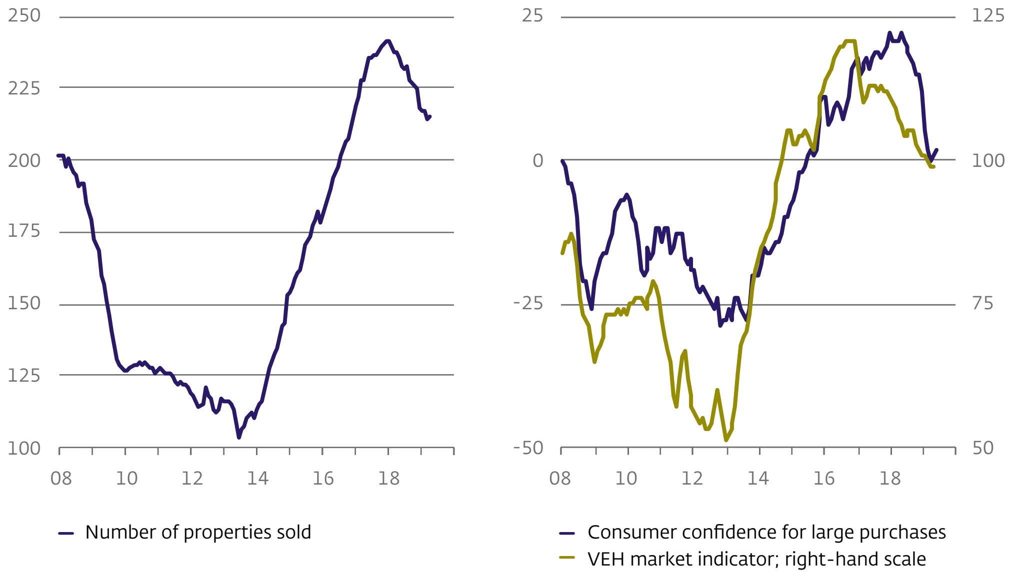
Housing market cooling to be reflected in prices

This year, the average selling price of a home topped EUR 300,000 for the first time ever. The house price index (PBK) for April 2019 was 7% higher than in August 2008, when house prices began to decline. This means that the Dutch housing market has fully recovered from the severe crisis that lasted until mid-2013. The accelerating price increases of recent years seem to have stalled for the time being, however. Following an average house price increase of 9% last year, the increase for 2019 has been projected at 5.9%, dropping to 2.8% in 2020 and 2.3% in 2021. Section 3 discusses a scenario involving a steeper decline than projected.

The housing market cool-down that started last year was heralded by a turnaround in the number of homes sold. Transaction volume has dropped by more than 10% since January 2018 (Figure 14, left). Moreover, homes are now on the market for longer, and this duration is gradually increasing. Homes were on the market for 43 days in the third quarter of 2018, and 41 days in the fourth quarter. In the first quarter of 2019, the average time on the market increased to 47 days. The decline in the number of housing transactions corresponds with confidence indicators among home buyers. The Dutch Home Owners Association's market indicator has been dropping since 2017, dipping beneath the 'neutral value' of 100 in the first quarter of 2019 (Figure 14, right). The drop in confidence is related to high housing prices and a lack of suitable supply to meet demand.

Figure 14 Housing market shows signs of cooling

Twelve-month sums in thousands, balance of answers and index



Sources: Statistics Netherlands, Kadaster and Dutch Home Owners Association VEH.

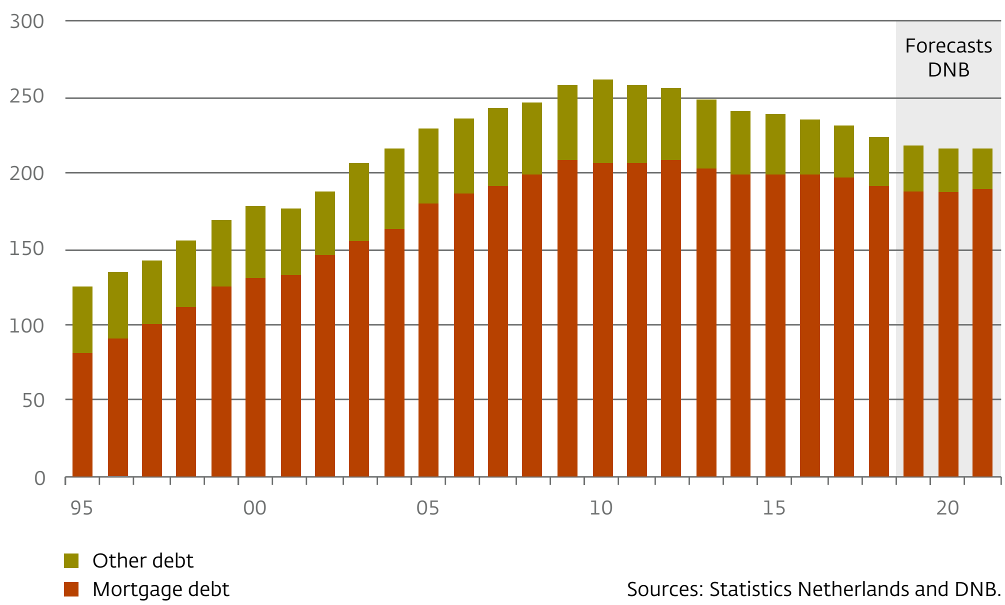
Note: VEH market indicator: value between 0 and 200, in which 100 represents a "neutral sentiment".

Despite the recovery in the housing market, mortgage lending growth has been moderate in recent years. Many homeowners have opted to repay their mortgages early in response to low interest rates on savings deposits and increasing household incomes. Mortgage lending has also been reined in by the tightening of the maximum loan-to-value ratio and the more generous gift tax exemption. Currently, these measures are having a less pronounced effect. Projected mortgage debt will grow by 2% in 2019, followed by growth of more than 4% in 2020 and 2021. Total mortgage debt against disposable household income will thus increase slightly from 188% in 2019 to 190% in 2021. Total household debt (including short-term debts) will decline to 215% of household income. This percentage stood at 261% in 2010 (Figure 15).

The recent slowdown in housing investment growth reflects the decline in activity on the housing market. Declining transaction volume also depresses the transaction costs (e.g. civil-law notaries and estate agents) that are allocated to housing investment. The number of newly issued building permits over the past twelve months to March 2019 amounted to 65,500, which is nearly equal to two years ago. In addition, the construction sector continues to struggle with a labour and materials shortage. The drop in consumer confidence is an important factor in the projections, along with developments in the number of building permits. Following several years of vigorous catch-up growth, the increase for 2019 has been projected at 5.0%, dropping to 2.6% in 2020 and 2.8% in 2021. Although this amounts to a considerable deceleration, the projections still call for growth well above the long-term average of 1.8%.

Figure 15 Household indebtedness is falling off

Percentage of disposable income



Sources: Statistics Netherlands and DNB.

Public debt to return to pre-crisis levels

The 2018 budget surplus was 1.5% of GDP, the highest surplus since 1953. Although public finance will benefit from favourable economic conditions in the years to come, the budgetary surplus will steadily drop over the projection horizon to 0.5% of GDP in 2021 (Table 4). Underlying this drop, the structural balance will also deteriorate over the same period, from a surplus of 0.9% of GDP in 2018 to a deficit of 0.2% of GDP in 2021.

Public expenditures as a percentage of GDP will increase on balance over the projection horizon, primarily due to increased spending in healthcare, education and defence. The burden of taxes and social insurance contributions will go up in 2019, on the back of the cyclical upswing and measures aimed at raising taxes and contributions, including the hike in the low VAT rate. The burden of taxes and social insurance contributions will become lighter in 2020 and 2021 as a result of policy measures such as a further reduction in corporation tax and income tax. Public debt is set to shrink to 44.2% of GDP in 2021 from 52.4% in 2017. The underlying cause is twofold: the numerator effect (budget surpluses) and the denominator effect (economic expansion). Debt to GDP ratio will thus return to levels not seen since shortly prior to the financial crisis of 2007-2008.

Table 3 Public sector key data

Percentage of GDP

	2018	2019	2020	2021
Public expenditures	42.1	42.6	42.5	42.7
Taxes and social security contributions	38.8	39.4	39.0	38.8
Other income	4.8	4.5	4.5	4.4
Primary balance	2.4	2.2	1.7	1.3
EMU balance	1.5	1.3	0.9	0.5
Structural balance (EC method)	0.9	0.6	0.4	-0.2
EMU debt	52.4	48.9	46.3	44.2

Source: DNB.

3 More pronounced cooling down of housing market: an alternative scenario

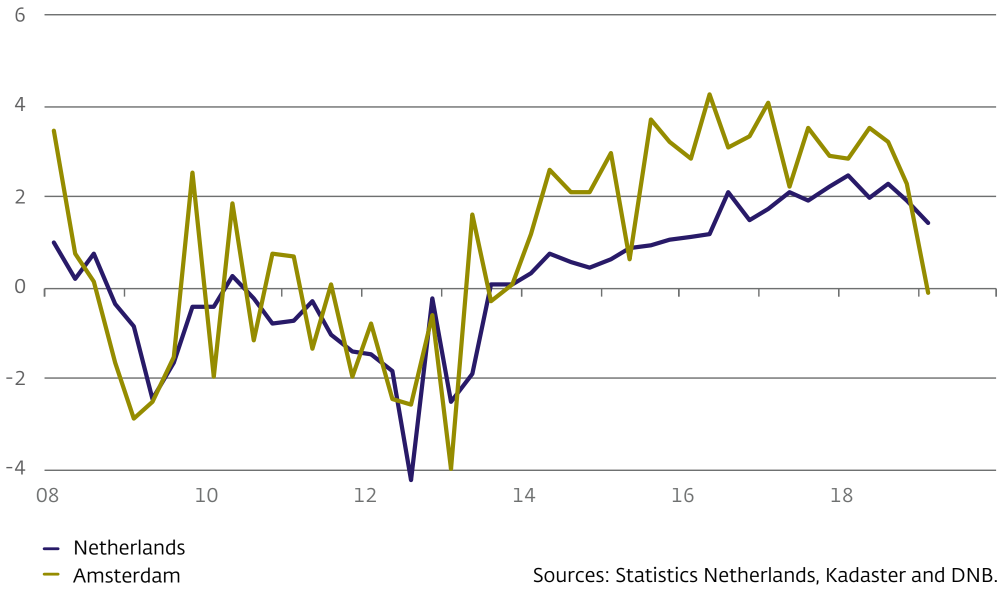
According to projections, the Dutch housing market has surpassed its peak and annual price rises will drop to 2.3% in 2021 from 5.9% in 2019 (see Section 2). This Section discusses the possible results of a scenario in which the housing market cools down faster and more drastically than projected.

Current price trends make clear that the Dutch housing market is cooling down, and the market in Amsterdam is of particular prominence in this regard. Price changes in the Dutch capital tend to serve as a prelude for changes in other regions.[6] The increase in the Amsterdam house price index has been roughly halved over the past two years. Prices fell by 0.1% in the opening quarter of 2019 relative to the final quarter of 2018 (after seasonal adjustment, Figure 16). This abrupt deceleration may be a harbinger for price fluctuations in other Dutch regions.

The sharp price increases in recent years have reduced housing affordability, which in turn has further undermined confidence in the housing market. In view of the cooling trend in the economy, along with continuing market uncertainty and volatility, it is possible that the sentiment on the housing market could rapidly turn into pessimism. If an increasing number of potential buyers wait until their own home has been sold, then the market cool-down could become more rapid and steep. This would not be the first time that the housing market's

Figure 16 House prices: Netherlands and Amsterdam

Quarter-on-quarter percentage changes; seasonally adjusted



Sources: Statistics Netherlands, Kadaster and DNB.

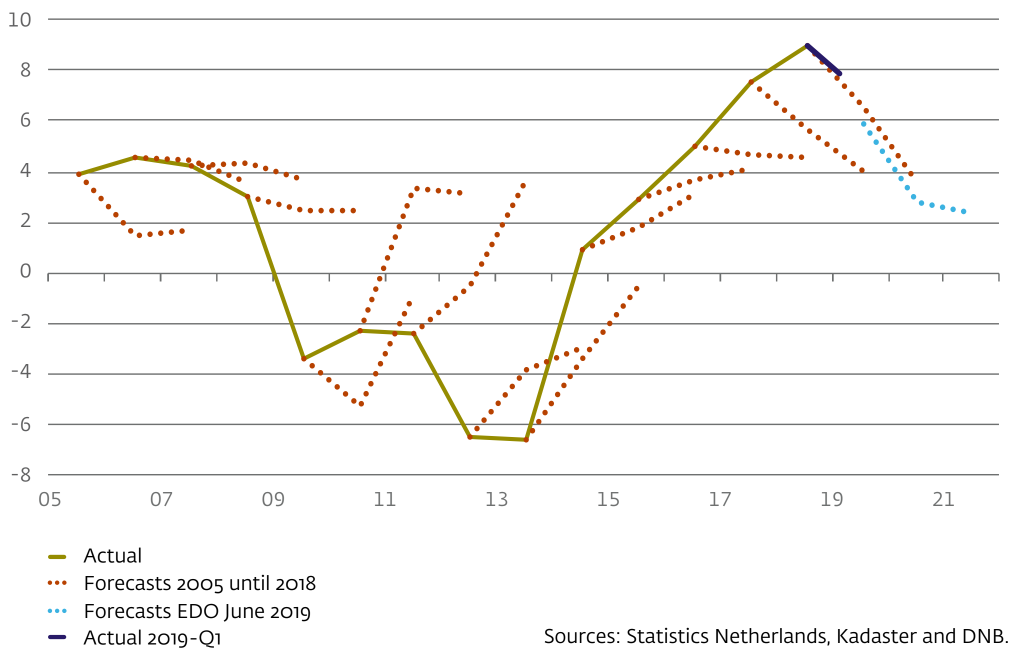
6 See D. van Dijk and G. Mesters (2018), "*Amsterdam bepalend voor woningprijzen*" in ESB.

cyclical nature has been underestimated. Figure 17 shows that projected price changes in ascending and descending phases on the housing market are often too conservative.

The assumption has been made in the scenario that transaction volume over the entire projection horizon will gradually return to pre-crisis levels and that the number of building permits issued will stagnate. This will result in a drop in housing investment, which largely consists of new construction and renovations, including transaction costs. Moreover, lower housing investment is often accompanied by a reduction in expenditures on home furnishings and household appliances.[7] Consumer confidence will reverse in 2019 and drop to the average in the 2000-2008 period.[8] The average annual increase in house prices will be 1.8 percentage point lower than projected in 2020 and 2021, approaching 0% at the end of the projection horizon (Table 4).

Figure 17 House prices and DNB forecasts

Year-on-year percentage changes



Sources: Statistics Netherlands, Kadaster and DNB.

Note: June 2005 – June 2018 forecasts are for 1 and 2 year ahead.

7 Home furnishings and household appliances made up 4.3% of private consumption in the 2000-2008 period.

8 Based on the number of building permits stabilising at 75,000 per year and the number of housing transactions declining to 195,000 per year (roughly the average in the 2000-2008 period). Average consumer confidence was -4.4 in the 2000-2008 period.

Table 4 Effects of the housing market scenario

Percentage changes, unless stated otherwise

	2019	Deviation from projection	2020	Deviation from projection	2021	Deviation from projection
Gross domestic product	1.5	(-0.1)	1.2	(-0.3)	1.1	(-0.3)
Private consumption	1.2	(-0.1)	1.7	(-0.5)	1.3	(-0.6)
Business investment	4.5	(0.0)	1.3	(-0.4)	0.6	(-0.5)
Housing investment	2.2	(-2.8)	-3.8	(-6.4)	-2.3	(-5.1)
Consumer confidence (level)	-5.2	(-6.5)	1.4	(-5.7)	3.1	(-5.4)
Harmonised consumer price index	2.5	(0.0)	1.6	(0.0)	2.0	(-0.1)
House prices, existing own homes	5.6	(-0.3)	1.4	(-1.4)	0.1	(-2.2)
Unemployment (% of labour force)	3.3	(0.0)	3.4	(0.1)	3.6	(0.3)
EMU balance (% of GDP)	1.3	(0.0)	0.7	(-0.2)	0.2	(-0.3)
Current account (% of GDP)	8.5	(0.1)	8.2	(0.5)	8.5	(1.0)
Mortgage loans	2.1	(0.0)	4.2	(-0.4)	3.1	(-0.9)
Bank lending to NFCs	-1.1	(0.0)	-0.1	(-0.1)	0.9	(-0.2)

Source: DNB.

The smaller price increases will cause private household wealth to develop less favourably than foreseen in the projections, and consumer confidence will also wane further, which will have a negative impact on private consumption. With the somewhat delayed effects on household wealth and confidence, the consequences will manifest themselves primarily in 2020 and 2021. Lower house prices and housing investment will have an impact on mortgage lending, which will drop by 0.9 percentage points in 2021. The negative effects on housing investment, private consumption and business investment will depress economic growth, which will be 0.3 percentage points below projections in 2020 and 2021. Unemployment will rise to 3.6% of the working population in 2021, and the budget balance will drop to 0.2% of GDP from a projected 0.5%. The decline in domestic spending will cause imports to slow down more than exports, resulting in a higher current account balance than projected. Although there are adverse real effects of a more rapid cooling of the housing market, this scenario indicates that the pace of growth of the Dutch economy will remain relatively stable.

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