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Economic Developments and Outlook

DeNederlandscheBank

EUROSYSTEEM

Economic Developments and Outlook

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This publication contains a translation of the Dutch-language publication, except where indicated otherwise. In the event of discrepancies between the original Dutch-language version and this translation, the Dutch text shall prevail.

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Summary

The Dutch economy should gain steam in 2015 on the back of a pick-up in domestic demand, with growth projected at 2%, the highest rate since 2008. Economic growth in 2016 and 2017 will average 2% per annum. There is a marked contrast between the outlook for 2015-2017 and the developments seen over the past six years. Various domestic factors that have stood in the way of growth have now lost prominence or turned into growth drivers. For example, consumer and producer sentiment improved, the housing market bottomed out, rationalisation of government finances now requires fewer sacrifices, unemployment is declining rather than increasing, and real disposable income is growing rather than falling. In addition, the recovery is supported by the improving international environment, as evidenced by accelerating growth in relevant world trade and lower oil prices. Moreover, exporters have seen their price competitiveness improve on the back of the depreciated euro.

GDP growth is projected to outpace the potential growth rate several years in a row for the first time since the credit crisis erupted. This will cause the output gap to narrow gradually, although it will not be closed in the last year of the forecast. Forecast inflation will edge up, from 0.2% in 2015 to 1.2% in 2016 and 1.4% in 2017, driven, among other factors, by the narrowing output gap and higher import prices. Unemployment is set to decline slowly, causing the labour market to remain slack. This will help negotiated wages develop at a moderate pace during the projected horizon, at 1.6% per annum on average.

In an alternative scenario, the consequences of stronger divergence between US and European interest rates for the Dutch economy are analysed. The consequences of the lift-off in the federal funds rate will be limited, with positive and negative economic effects largely cancelling each other out. For instance, the impact of a slowdown in world trade will be mitigated by improved price competitiveness resulting from a lower effective euro exchange rate.

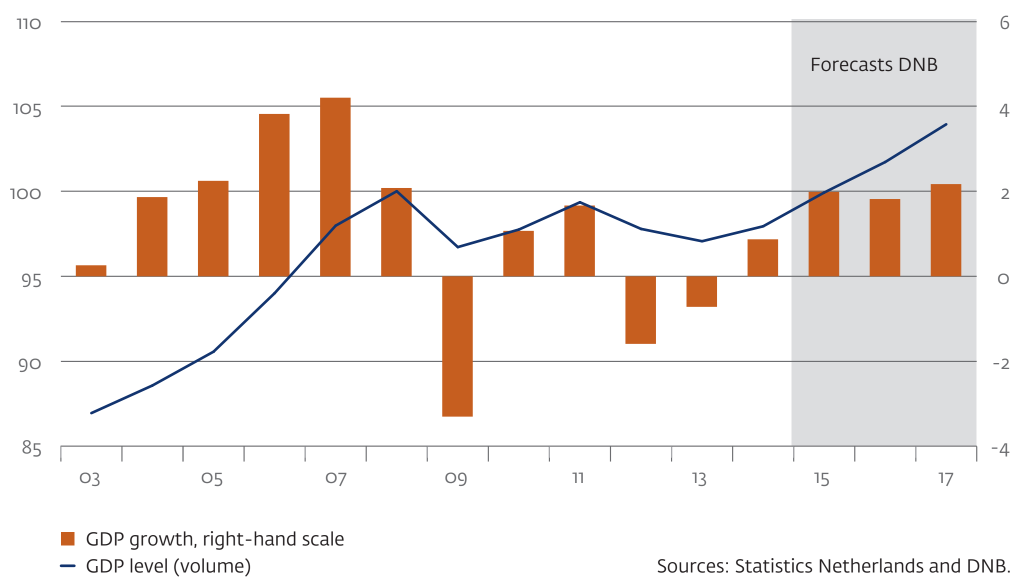
1 The Dutch economy in 2015-2017

Economy to gain steam

Following a period of seven lean years, which lacked any growth in the real gross domestic product (GDP) on balance, the Dutch economy is projected to gain steam in 2015. Economic growth should accelerate by more than one percentage point, from 0.9% in 2014 to 2.0% in 2015. This pick-up in pace will be driven mainly by the upswing in domestic spending, notably in private consumption, business investment and residential investments. Temporary tax incentives made the revival in residential investment somewhat more pronounced in late 2014 and early 2015. GDP growth will slow down somewhat in 2016, to 1.8%, but the underlying growth rate should increase to 2.2% in 2017, the highest figure seen in ten years (see Chart 1). Thanks to the euro's depreciation, exporting companies have seen their price-competitive position improve, which should benefit the Dutch economy through additional exports of goods and services.

Chart 1 Gross domestic product

2008 = 100 and year-on-year percentage changes



Sources: Statistics Netherlands and DNB.

Quarterly growth to pick up gradually

Quarterly GDP growth averaged more than 0.3% in 2014, with an 0.8% outlier recorded in the fourth quarter. This growth spike resulted in part from the termination of the temporary relaxation of the gift tax exemption regime on 1 January 2015, pushing up the number of housing transactions at a spectacular rate. This helped residential investments in the final quarter of 2014 reach a level 15.5% above that seen in the previous quarter. Quarterly GDP growth is expected to pick up speed gradually throughout the projection horizon, from an average 0.4% in 2015 to 0.5% in 2016 and 0.6% in 2017. This growth rate will see real GDP top the level recorded just before the credit crisis for the first time at the end of 2015.

Brighter economic outlook than previously foreseen …

Cumulative GDP growth is expected to end up over 1 percentage point higher in 2015-2016 than projected in our previous issue of *Economic Developments and Outlook* six months ago. In particular, we have adjusted growth projected for 2015 upward, by 0.8 percentage point. Of that adjustment, roughly half can be attributed to higher than expected GDP growth in the fourth quarter of 2014, while the remaining half results from more favourable estimates for some key fundamentals in the economic outlook. For example, long-term interest rates were lowered by 0.4 percentage point, the exchange rate fell by over 10% (USD 0.13 per euro) and oil prices dropped by 25% (nearly USD 22 per barrel of UK Brent). In addition we revised the assumption for growth in relevant world trade upward by 0.5 percentage point. These improved international factors have had a positive impact on projected business investment and exports, in particular.

… supported by the expansion of the ECB's purchase programme

To a large extent, these adjustments ensued from the expansion of the Eurosystem's purchase programme as announced by the ECB on 22 January 2015. The exact extent is difficult to pinpoint, as it is unknown how the Dutch and other economies would have developed had this quantitative easing (QE) not taken place. The main qualitative effects of QE are more obvious. The most important channel for the open Dutch economy are the depreciation of the euro, which benefits the price-competitive position of Dutch exporters, and the higher economic growth recorded in the euro area. Furthermore, lower interest rates fuel the demand for loans among households and businesses, driving up private consumption, business investment and residential investments. Through the same channel, house prices and the number of housing transactions are pushed up, which also works out favourably for private consumption and residential investment. Moreover, QE is likely to lead to higher equity prices, which will also benefit consumption growth through higher net financial assets of households and improved consumer confidence. By contrast, real disposable incomes will develop less favourably due to higher inflation and higher pension contributions – prompted by lower interest rates – which should dampen private consumption. On balance, however, the expected impact of QE is positive. The QE announcement is projected to have increased projected annual GDP growth for 2015-2017 by 0.2 percentage point on average.

Economic growth to outstrip potential growth

Potential growth, which is GDP growth adjusted for cyclical influences, is projected at around 1.25% per annum. The Dutch economy's production level has been below its potential since 2009, causing the output gap to widen steadily to -4.4% in 2014. Our projection implies that the Dutch economy will – for the first time since the credit crisis – outstrip its potential several years in a row, starting in 2015. This will halve the output gap during the projection horizon, to -2.3% in 2017. On average, therefore, the economy will not yet be in top gear in the coming two years. Underutilisation of the potential labour force and the stock of capital goods will, however, show a steady decrease, thereby reducing the downward cyclical impact on inflation and wage movements.

Domestic spending should show vigorous recovery

Table 1 lists the economic key data for 2014-2017.[1] During the projection horizon, domestic spending will develop substantially more favourably than in the past few years. This is true especially for private consumption. Its projected annual growth rate of more than 2% on average in 2015-2017 is in stark contrast with the decline of almost 0.8% per annum seen between 2009 and 2014. The contrast is even greater for residential investments, with average annual growth of 8.4% foreseen during the projection horizon against average annual declines of 7.8% in the preceding six years. Business investment will also show strong recovery, with average annual growth projected at 5.3%, causing the investment ratio to rise sharply (see Chapter 2). The upturn in the trend of domestic spending can also be seen from the contributions that the various spending components make to GDP growth (see Chart 2). In 2012 and 2013, all components of domestic spending had a negative effect on GDP growth. During the projection horizon, however, the components of domestic spending are expected to contribute positively to economic growth on balance, but exports should remain the principal contributor.

1 The assumed trends in relevant world trade, exchange rates, international commodity prices and interest rates were formulated by the ECB in consultation with experts of the national central banks. They were based on information available on 19 May 2015.

Table 1 Key data in forecast for the Dutch economy

Percentage changes, unless stated otherwise

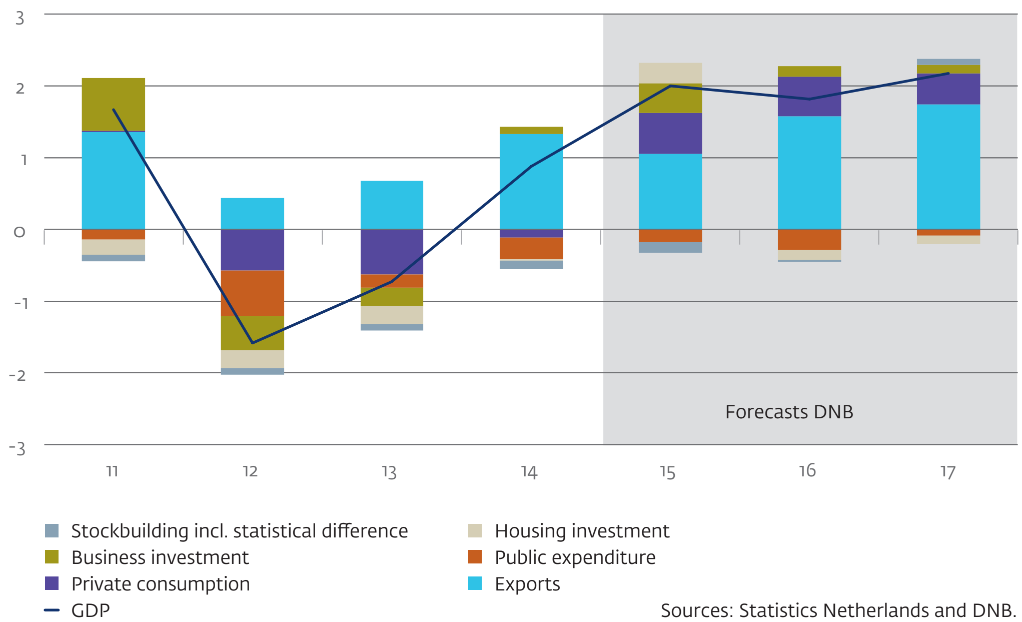
	2014*	2015	2016	2017
Volume of expenditure and output				
Gross domestic product	0.9	2.0	1.8	2.2
Private consumption	0.1	2.0	2.3	2.0
Public expenditure	0.0	-0.1	0.5	1.5
Business investment	3.3	6.4	4.8	4.6
Housing investment	5.6	17.3	2.7	5.2
Exports of goods and services	4.0	3.1	5.4	6.0
of which domestically produced	3.5	3.4	3.1	3.5
of which re-exports	4.6	2.8	8.3	9.0
Imports of goods and services	4.0	3.3	6.8	6.9
of which domestically used	3.5	3.1	4.5	4.4
Wages and prices				
Negotiated wages, private sector	1.1	1.3	1.6	1.9
Compensation per employee, private sector	1.5	1.4	2.6	2.7
Unit labour costs	0.3	0.3	1.0	0.9
Prices of domestically produced exports	-1.5	-2.9	2.1	1.7
Harmonised consumer price index	0.3	0.2	1.2	1.4
House prices, existing own homes	0.9	2.3	3.7	4.2
Labour market				
Employment (persons, growth)	-0.3	0.9	0.6	0.7
Labour supply (persons, growth)	-0.1	0.5	0.4	0.5
Unemployment (persons x 1,000)	660	628	618	605
Unemployment (% of labour force)	7.4	7.0	6.9	6.7
Public sector				
EMU balance (% of GDP)	-2.3	-1.6	-0.9	-0.6
EMU debt (% of GDP)	68.8	68.9	67.2	64.9
Other				
Current account (% of GDP)	9.9	8.0	9.0	9.4
International assumptions				
Volume of relevant world trade	3.4	4.0	5.2	5.5
Volume of GDP US	2.4	2.6	3.1	2.7
euro area	0.9	1.5	1.9	2.0
emerging markets	4.5	3.9	4.8	4.9
Short-term interest rate in the euro area (%)	0.2	0.0	0.0	0.2
Long-term interest rate in the Netherlands (%)	1.5	0.7	1.1	1.2
Euro exchange rate (USD)	1.33	1.12	1.12	1.12
Competitor prices	-0.8	3.6	1.9	1.9
Oil price (UK Brent in USD per barrel)	99.3	63.8	71.0	73.1
Commodity prices excluding energy (USD)	-6.2	-13.6	2.9	4.9

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.

Chart 2 Sources of GDP growth

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 categories.

Lending to households and businesses will rebound

The positive trend in domestic spending is also reflected in the pick-up in lending. On the back of the revival in the housing market, mortgage indebtedness will increase by an average of 3.2% during the 2015-2017 period, having declined in the past two years (adjusted for securitisations). As a percentage of GDP, mortgage indebtedness will not grow further, stabilising at just over 97%. Lending to non-financial corporations is projected to gain ground rapidly, in line with the recovery in business investment. Following last year's 4.9% contraction, corporate lending will pick up, with growth accelerating from 0.7% in 2015 to 6.7% in 2017 (adjusted for securitisations).

In the projected scenario, banks will be able to meet the demand for loans among businesses and households. In the 2014-2018 period, total lending is projected to grow by around 2.3% each year, on the assumption that the expected growth in lending seen in 2017 continues into 2018. This growth in lending is in line with the base scenario for potential credit supply, as presented last year in *Bank lending and capital* (DNB Occasional Study no. 3, 2014). Under that scenario, potential credit supply increases by 3.1% per annum between 2014 and 2018. In the unhoped-for event that banks make less progress in strengthening their capital positions or experience more difficulties in raising capital market funding, the potential credit supply may at some point in time hamper the demand for loans.

International economy shows upward trend

Economic recovery in the euro area is starting to gain momentum, fuelled by low oil prices and the depreciated euro. Similarly, the structural reforms undertaken by a number of countries over the past years are beginning to bear fruit. In Europe, the pick-up in growth is increasingly driven by a rise in private consumption. The US economy, despite having gone through a relatively bad first quarter of 2015, is expected to show robust growth in the 2015-2017 period, at a rate averaging 2.8% per annum. Its labour and housing markets are showing clear signs of recovery. The emerging economies have divergent economic prospects. Whereas India and China are expected to continue posting substantial growth figures, the outlook for Russia and Brazil is less favourable. Most of the economic downturn foreseen for Russia can be attributed to the fall in oil prices and the conflict situation in Ukraine. On balance, global trade relevant for the Netherlands will end up at almost 4.0% in 2015 and subsequently edge up to 5.5% in 2017. Viewed against long-term growth in relevant world trade of 5% per annum, the international economy should develop at a moderate pace between 2015 and 2017.

The global economic outlook is subject to various uncertainties, examples of which include mounting tensions in Ukraine and the Middle East, and the rising financial stress levels in the euro area over the political developments in Greece. Other uncertainties are those with regard to the impact of the ECB's QE programme on the real economy and inflation in the euro area, and future monetary policy in the United States. Chapter 3 sets out an exploratory scenario which deals with these subjects.

Sharp fluctuations in oil prices and effective exchange rate

In the second half of 2014, UK Brent prices plummeted by nearly 60% from peak to trough, to reach USD 47 per barrel. This has had a strong downward effect on inflation across the globe. Some recovery followed in the first months of 2015 and the assumption, based on market expectations, is that oil prices will creep up further over the projection horizon. This will bring the average for 2015 to almost USD 64 per barrel, which is still more than 35% below the average for 2014. Similarly, the effective exchange rate of the euro, whose movements largely depend on those of the euro-dollar exchange rate, has shown great dynamism over the past year. The price that had to be paid for a euro was almost USD 1.40 in early May 2014, whereas it was less than USD 1.05 just over ten months later. This has given the price-competitive position of exporters a boost. The depreciation of the euro accelerated around the time of the QE announcement, after which some recovery set in from mid-April 2015 onwards. Our projections assume a steady euro-dollar exchange rate of 1.12 from mid-May 2015 onwards.

Labour market shows tentative recovery …

The Dutch labour market has bottomed out, showing modest recovery since mid-2014. The number of employed persons has gone up since the second quarter of 2014, but there are significant differences between sectors. Employment rose particularly sharply in business services, a sector that includes employment agencies. Sectors such as the manufacturing industry and construction saw the number of employed persons stabilise, following a period of contraction that had lasted over five years. The number of hours worked by temporary staff increased by 6.6% in 2014, pointing not only at recovery, but also at ongoing flexibilisation in the labour market. The decline in applications for dismissal permits and the growing number of vacancies also reflect the labour market's budding recovery.

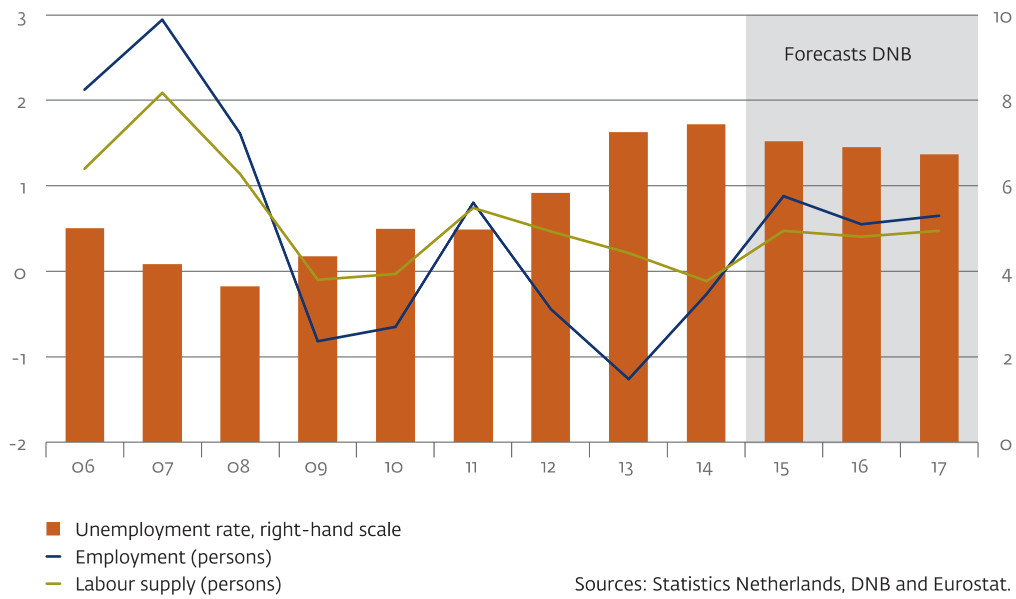
… but unemployment will remain high for some time to come

Viewed against the background of the vigorous economic recovery, the decline in unemployment remains modest. Having peaked at 7.8% in the first quarter of 2014, the unemployment rate edged down to reach 7.1% in the first quarter of 2015. Among young people (aged between 15 and 25), the jobless rate declined at three times the average pace, but it remains relatively high. Expectations are that unemployment will hover around 7% throughout 2015, creeping down to 6.7% on average by 2017 (see Chart 3).

This means that unemployment, after having peaked in early 2014, is declining at a much slower rate than the pace at which it grew in the years up to the peak. One of the causes is that the supply of labour should grow somewhat more vigorously during the projection horizon than in the preceding years, when entering the labour market was discouraged more, due to diminishing chances of finding a suitable job. In addition, the need for additional workers is depressed because employee productivity is increasing, cyclical fluctuations aside. Lastly, the sharp decline in employment seen in the general government during the years of rising unemployment will not be followed by an equally sharp increase in subsequent years. The number of people in government service is expected by stabilise by and large during the 2015-2017 period. All in all, the labour market will have ample supply for the moment, although some tension has arisen in specific segments, for example among technically skilled staff and ICT experts, since some time.

Chart 3 Labour market supply and demand

Year-on-year percentage changes and percentage of labour force



Sources: Statistics Netherlands, DNB and Eurostat.

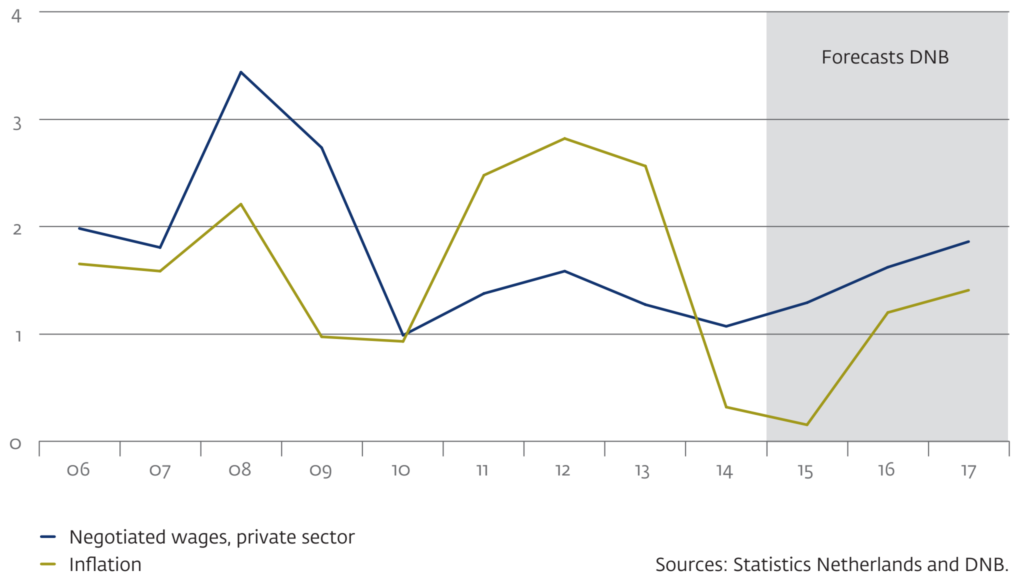
Moderate wage trend

Negotiated wages in the private sector have shown consistent increases, moving between 0.9% and 1.7%, over the past twenty quarters. This is remarkable, given that inflation rates have fluctuated heavily over the same period, moving between 3.4% and -0.7% (see Chart 4). This has obviously caused major swings in real negotiated wages, which strongly influenced household purchasing power and, hence, consumption volumes. Negotiated wages have outpaced inflation since early 2014, with real wage increases steadily accelerating as a result.

Inflation reached a trough in the first quarter of 2015, when real negotiated wages increased by 1.7%, the largest growth in over five years. Expectations are that negotiated wages in the private sector will continue to develop modestly, mainly on the back of ample labour market supply. They will, however, show slightly higher increases in 2016 (1.6%) and 2017 (1.7%) relative to the preceding six years, fuelled mainly by higher growth in labour productivity, the recovery in the labour market and mounting inflation.

Chart 4 Negotiated wages and inflation

Year-on-year percentage changes



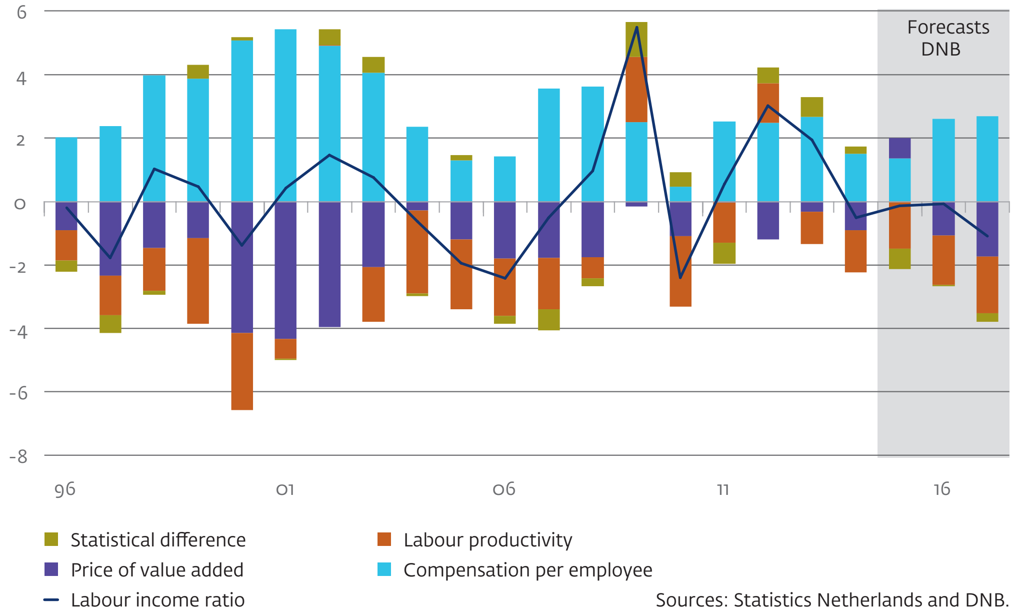
Sources: Statistics Netherlands and DNB.

Labour income ratio should decrease slowly

Employer's labour costs are determined not only by negotiated wages, but also by incidental wage costs and the social insurance contributions they pay. 2015 will see labour costs per employee rise almost in line with negotiated wages, with the upward impact of higher incidental wage costs being almost entirely cancelled out by lower employers' social insurance contributions. The latter decrease results mainly from the tightening of the rules on tax relief for pension contributions, which is discussed in more detail in Box 1. By contrast, pension contributions and, hence, employers' social insurance contributions, are set to grow in 2016 and 2017, driven in part by lower interest rates. This is the main factor in the near doubling of the increase in compensation per employee, from just under 1.4% in 2015 to more than 2.6% per annum on average in 2016 and 2017. Chart 5 illustrates the increase in compensation per employee in the private sector less movements in producer prices and labour productivity, thus showing movements in the labour income ratio. Since the credit crisis broke out, the labour income ratio in the private sector has climbed by 6.5 percentage points, to reach 80.5% in 2013, the highest figure recorded since 1980. It should gradually soften to 79% in 2017, as productivity growth did not fully translate into higher wages in 2014 and is not expected to do so in the 2015-2017 period.

Chart 5 Labour income ratio, private sector

Percentage changes and contributions in percentage points



Sources: Statistics Netherlands and DNB.

Box 1 The impact of the tightening of the Witteveen framework on pension contributions

A delayed taxation system in the Netherlands, dubbed the reversal rule, makes pension contributions tax deductible, whereas pension benefits are taxed. The scope of the reversal rule has been restricted by the Witteveen framework, named after its principal author, former DNB Executive Director Dirk Witteveen. This set of rules has been rationalised by capping the maximum annual pension accrual rate at 2.15% in 2014 and 1.875% in 2015, from 2.25% in 2013. These percentages apply to average pay-based pension schemes. Furthermore, the standard retirement age was raised from 65 to 67 in 2014, and income exceeding EUR 100,000 has no longer been eligible for tax-relieved pension accrual since 1 January 2015.

DNB argued in 2013 that these rationalisation measures presented a unique opportunity for simultaneously improving government finances and raising disposable incomes, without impairing price competitiveness. The economic impact could be reinforced by making the released contributions available to the employees, given that both employees' and employers' pension contributions are in fact deferred income components.

With contribution levels having been set for 2015, the question arises how these measures have worked out in terms of contributions. This question cannot be answered simply, as many factors affect the annual movement in pension contributions. These include, besides the tightening of the Witteveen framework, movements in a pension fund's membership base and interest rates, changes in recovery contributions and enhancements or rationalisations of pension schemes. For this reason, DNB held a survey among pension funds to gain insight into how the tightening of the Witteveen framework had affected pension contributions for 2015. The survey does not show the extent to which the scope for wage increases that resulted from the rationalisation translated into lower employee contributions, higher wage increases, more generous fringe benefits and lower labour costs.

The survey shows that the tightening of the Witteveen framework means that, in aggregate, pension funds need around EUR 2.4 billion less in pension contributions in 2015. Part of this release, some EUR 0.7 billion, is used to enhance pension schemes.[2] Likewise, the expiry of obligations relating to the payment of recovery contributions has depressed contribution levels. Conversely, falling interest rates and continued population ageing have pushed up contributions. On balance, the pension funds surveyed reduced pension contributions by EUR 1.9 billion for 2015.

The tightening of the Witteveen framework also had a downward effect on pension contributions in 2014. It is difficult to estimate the impact, however, as the data needed are unavailable, but it is likely to be of the same order as in 2015. This is because contributions for all pension funds combined fell by around EUR 3.0 billion in 2014, roughly EUR 0.6 billion of which can be attributed to recovery contributions no longer being payable.[3]

2 Survey held among 158 pension funds, accounting for 93% of the total volume of pension contributions.
3 In 2015, contributions for all pension funds combined fell by EUR 2.1 billion, EUR 0.9 billion of which was caused by recovery contributions no longer being payable.

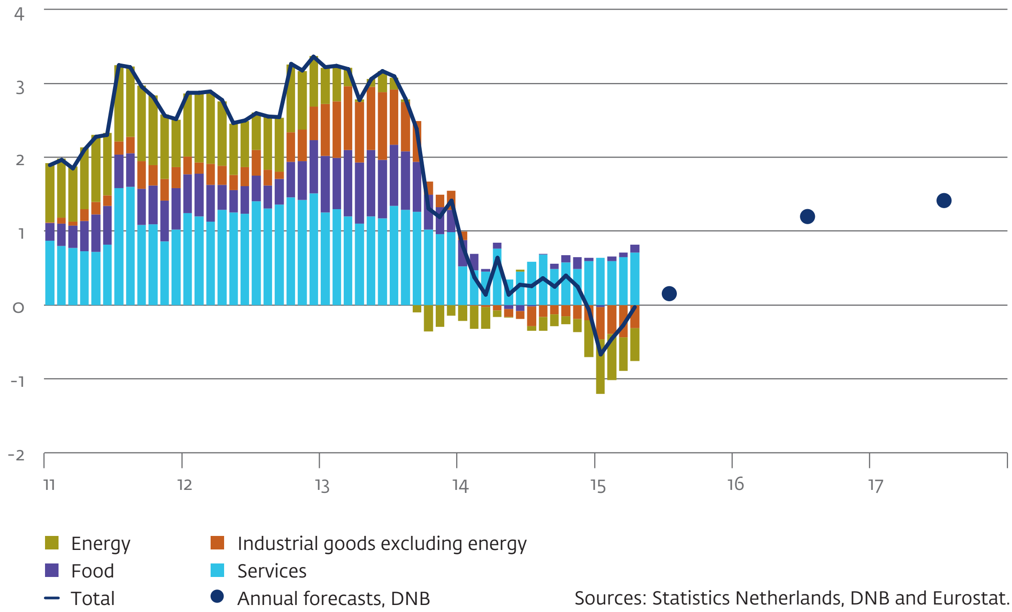
Inflation will increase but remain subdued

In 2014, HICP inflation came to 0.3%, the lowest annual figure since the HICP measure was introduced in 1997.[4] Inflation took a nosedive towards 0% in early 2014, owing to global slides in food and energy prices, the disappearance of the price increasing effects of tax measures

4 CPI inflation has been substantially above HICP inflation since early 2014. This is mainly due to the fact that, unlike CPI, HICP does not include the costs of the home, which have increased relatively strongly recently. The CPI therefore allocates a rental amount to home owners equalling the amount of rent they would have to pay if they were to rent their house.

Chart 6 HICP inflation

Percentage changes and contributions in percentage points



Sources: Statistics Netherlands, DNB and Eurostat.

and the sluggish economic recovery. Despite hovering just above that level for a few months, it dropped even further – in parallel with oil prices – in late 2014, hitting a -0.7% low in January 2015. Inflation crept up in subsequent months, returning to 0% in April 2015 (see Chart 6).

Falling prices are not exceptional in themselves, and for some components in the consumption basket they are the rule rather than the exception, such as PCs and TV sets. A remarkable feature, however, is the fact that prices eased across a wide spectrum of products in 2014 and early 2015. In 2014, services almost exclusively contributed positively to inflation throughout the year, be it modestly, viewed from a historical perspective. Inflation has been below the ECB's target rate of close to but below 2% for some time, and inflation expectations also fell. To bring actual and expected inflation closer to 2%, the ECB announced the QE programme in late January. This has fuelled inflation expectations since mid-February 2015 and caused the euro to depreciate. An immediate effect of the depreciation is a hike in prices of imported products, particularly from outside the euro area. Subject to a small delay, this will lead to higher consumer prices, all other things remaining equal. Through this channel, QE is estimated to have an upward impact on HICP inflation of 0.1 to 0.2 percentage point in all three years of the projection. Furthermore, the downward effect which the sharp decline in oil prices of late 2014 had on inflation will fade out towards the end of 2015. These developments, supported by the narrowing output gap, will see projected inflation edge up, from 0.2% in 2015 to 1.2% in 2016 and 1.4% in 2017.

2 A closer look at spending and public finances

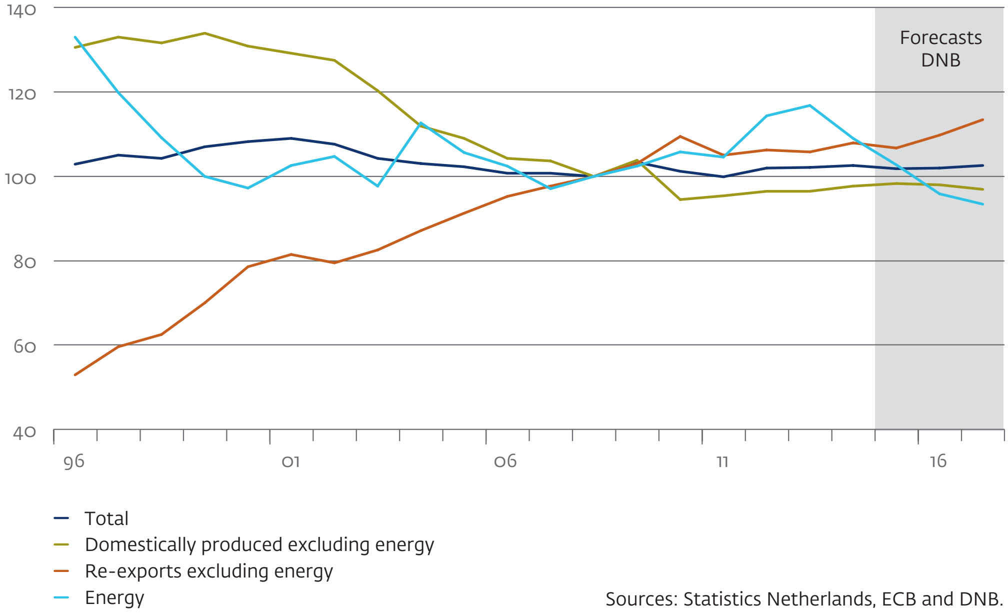
Exports to benefit from international recovery and lower euro

Total export volumes are expected to grow by more than 15% over the projection horizon, exactly keeping pace with growth in relevant world trade over the same period. Over the past two decades, the Dutch market share also showed fairly stable development (see Chart 7). This steady trend masks strongly divergent movements in the three key export components, however. These are domestically produced exports, re-exports and energy exports.

The growth in the world market for Dutch products has gone up a notch each year since 2012. It will remain below the 5% long-term average in 2015 and show slightly stronger growth in 2016 and 2017, at 5.2% and 5.5%, respectively. This pick-up in world trade will benefit domestically produced exports, excluding energy (see Table 2). In 2015, those exports are even set to marginally outstrip relevant world trade on the back of the improved price-competitive position, caused mainly by the euro's depreciation. While prices of domestically produced exports (excluding energy) will go up by 1% in 2015, those of foreign competitors will increase by 3.6%, measured in euros. It will take some time for relative price changes to filter through completely, which means that domestically produced exports will still benefit in 2016 and 2017, be it less so than in 2015. In 2016 and 2017, the improved competitive position of the

Chart 7 Market share of exports

2008 = 100; volume



Sources: Statistics Netherlands, ECB and DNB.

Index is the category in question divided by relevant world trade.

Table 2 Dutch exports and competitiveness

Percentage changes, unless stated otherwise

	2014	2015	2016	2017
Volume				
Relevant world trade (1)	3.4	4.0	5.2	5.5
Exports of goods and services (2)	4.0	3.1	5.4	6.0
of which domestically produced	3.5	3.4	3.1	3.5
of which re-exports	4.6	2.8	8.3	9.0
Exports of goods and services excl. energy	5.1	3.8	6.3	6.4
of which domestically produced (3)	4.7	4.6	4.9	4.4
of which re-exports	5.6	2.8	8.3	9.0
Price				
Competitor prices (4)	-0.8	3.6	1.9	1.9
Exports of goods and services	-1.7	-1.6	3.3	1.5
of which domestically produced excluding energy (5)	0.3	1.0	1.2	1.7
Competitiveness				
Price competitiveness (4-5)	-1.2	2.6	0.6	0.2
Trade performance (2-1)	0.6	-0.8	0.2	0.5
Market performance (3-1)	1.2	0.6	-0.3	-1.0

Sources: ECB and DNB.

Netherlands will not prevent the market share of domestically produced goods from declining, something that is closely related to intensifying globalisation.

By contrast, re-exports (excluding energy) should benefit from ongoing globalisation. Growth in re-exports is projected to show a strong upswing in parallel with the revival of international economic developments. During the projection horizon, re-exports (excluding energy) should increase by 6.7% per annum on average, thereby continuing the historical trend of an expanding share in relevant world trade (see Chart 7). Energy exports have their own dynamics. Exported energy volumes are set to shrink over the 2014-2016 period, partly due to the production ceiling in mining of natural gas. The demand for natural gas also slipped in 2014, owing to mild weather conditions. Energy exports had grown by 3.3% on average per annum during the six preceding years. Expectations are for energy exports to grow again in 2017, be it less than relevant world trade.

Current account balance to grow following year-end 2014 dip

After the outbreak of the credit crisis, the current account balance (expressed as a percentage of GDP) more than doubled to 9.9% in 2014 from 4.5% in 2008. This was attributable to both the sharp rise in the income balance and flagging domestic spending, which dampened growth in imports. The current account surplus fell to 7.5% of GDP in the final quarter of 2014. This could be attributed entirely to the primary income balance, which had gone into the red for the first time since 2009. This was caused primarily by the sharply lower profits Shell had posted due to lower oil prices. As domestic spending picks up, the trade surplus should edge down from the peak reached in the first quarter of 2015. The primary income balance is projected to creep up, pushing up the current account balance (expressed as a percentage of GDP), which in 2017 should, however, remain slightly below the high level seen in 2014.

Private consumption rebounds

A five-year period characterised by annual declines in private consumption of nearly 1% on average ended in 2014, mostly on the back of strongly improved consumer confidence and the revival of the housing market. Following marginal 0.1% growth in 2014, 2015 will see the first substantial increase in private consumption since the credit crisis, at 2%. This acceleration from last year's growth is fuelled mainly by the favourable development in real disposable income of households. In addition, consumption willingness has gone up, as unemployment has been in a gradual slide since early 2014, which reduces uncertainty among households. Consumption should also grow by roughly 2% per annum in 2016 and 2017, when consumption growth will enjoy even greater support from the rise in real disposable income than in 2015. The positive impact of increased consumer confidence and reduced labour market uncertainties will then have worn off. Furthermore, households will spend more in 2016 and 2017 as their net assets grow. In particular, the increase in net housing wealth will have a positive impact on consumption growth, but the rise in net financial assets, such as equities and bonds, will also contribute.

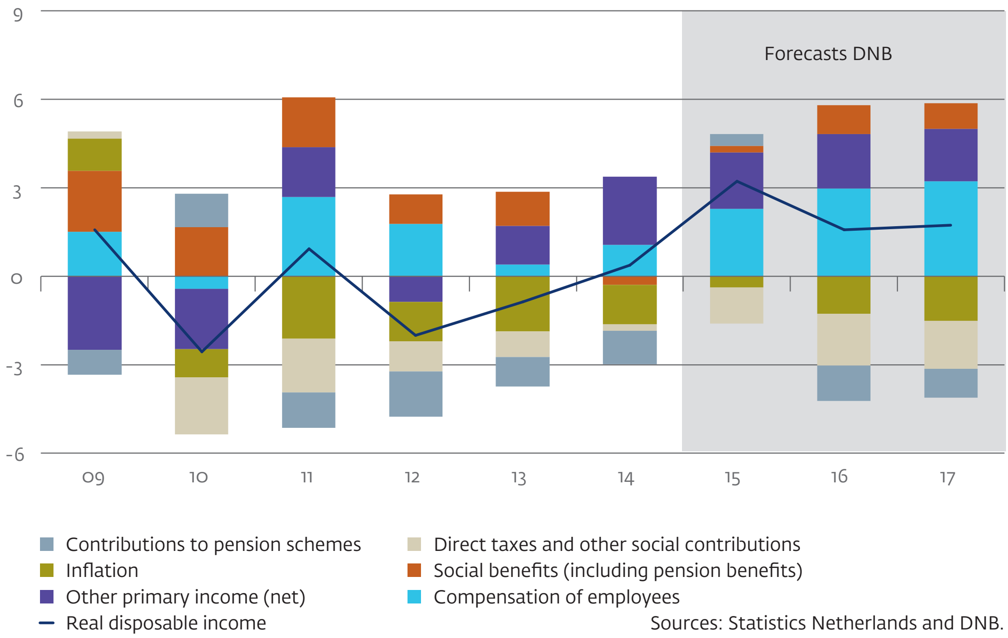
Real disposable income of households should grow vigorously in 2015

Real disposable income should grow by 3.2% in 2015, the strongest increase in 14 years. This represents a stark contrast with the trend seen in the past five years, in which this income dropped at a rate of 0.8% per annum on average (see Chart 8). The sharp increase projected for 2015 is driven not only by higher employment, but also by low inflation. Moreover, pension contributions will be lower due to the tightening of the rules on tax relief for pension savings (the Witteveen framework). Real disposable income will also grow in 2016 and 2017, be it at half the rate of 2015, averaging 1.7% per annum. The lower growth rate is related to rising inflation and a renewed increase in pension contributions. Prompted in part by low interest rates, pension funds will face the need to increase their income from contributions in 2016 and 2017.

Other primary income is set to grow steadily in all three years in our projection, owing mainly to the ongoing rise in the number of self-employed people and their incomes. A further factor contributing to the growth of other primary income is the improved ratio between interest

Chart 8 Real disposable household income

Percentage changes and contributions in percentage points



Sources: Statistics Netherlands and DNB.

Note: The size of each coloured area in a column indicates the contribution of an income component to total growth. Inflation is based on the private consumption deflator.

income and interest expenses. In 2008, households paid over EUR 15 billion more in interest than they received, whereas amounts paid and received should be roughly equal in 2015. Since 2008, interest paid by households has dropped much more sharply than interest income, even though deposit rates are currently at historic lows.

Changes in individual and collective savings will cancel each other out

Households tend to bring their consumer spending in line with disposable income only gradually, which is why the sharp growth in income in 2015 will not fully translate into additional consumer spending in the same year. The implication is that the individual savings ratio is set to rise steeply in 2015 and go down again in 2016 and 2017 (see Chart 9). Collective savings, which represent pension contributions less pension benefits, will show the reverse pattern. On balance therefore, the total savings ratio, which represents individual and collective savings expressed as a percentage of disposable income, will remain stable during the projection horizon, hovering around 8.5%.

Chart 9 Individual and collective savings

Percentages of disposable income (including adjustment for net equity in pension funds reserves)

Sources: Statistics Netherlands and DNB.

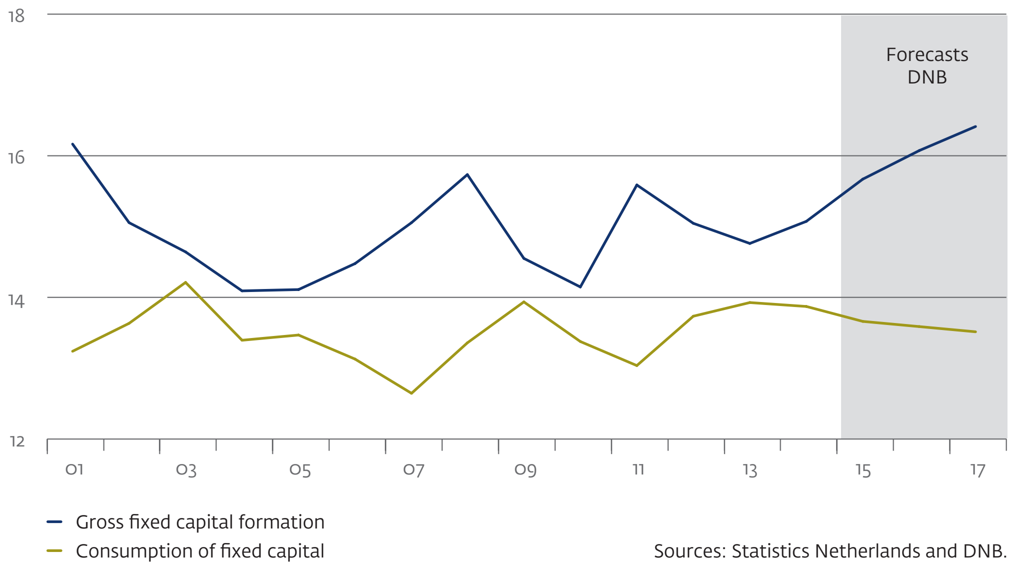
Businesses step up their investments

Business investment showed a robust recovery in the second half of 2014, driven by accelerating production growth and low cost of capital. This will also be reflected in investment growth in 2015. Furthermore, with producer confidence having risen uninterruptedly since early 2013, previously shelved replacement and expansion investments will still be made. All in all, 2015 will see a sharp increase in business investment of 6.4%. Expectations are that businesses will intensify their investments in 2016 and 2017 as well, but investment growth is set to slow down somewhat, averaging 4.7% per annum, mainly due to production growth slightly decelerating. Average corporate profitability should, however, improve, which is expected to push up business investment.

The private sector investment ratio will gradually rise to 16.7% in 2017 (see Chart 10), a high level viewed from a historical perspective, topped only in the late nineties during the past couple of decades. The net investment ratio, which is adjusted for depreciation, will increase even more strongly, suggesting growing expansion of the stock of capital goods. The extent to which this expansion boosts labour productivity will in part depend on the breakdown of investments according to type of goods. Over the past decades, the share of information and communication technology (ICT) in total investments has shown strong increases in almost all private sectors, at the expense of non-residential buildings, and machinery and equipment

Chart 10 Business investment

Percentages of GDP; volume



Sources: Statistics Netherlands and DNB.

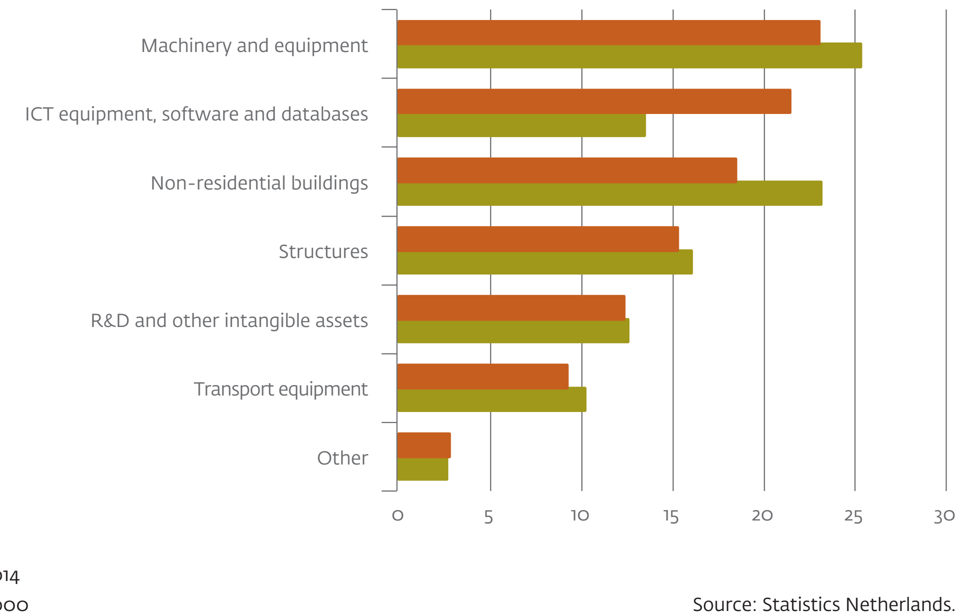
(see Chart 11). This trend is expected to continue going forward, benefiting structural productivity growth and, hence, potential growth.

Housing market and construction sector revive

Conditions in the housing market turned around in the summer of 2013. This is reflected in a sharp increase in sales, not only of existing homes (see Chart 12, right-hand graph), but also of newly-built homes. 80% more new-built homes were sold in 2014 relative to the year before. In the fourth quarter of 2014, the number of housing transactions was almost 43% up on the same quarter of the preceding year. An important factor in this increase was the termination of the temporary relaxation of the gift tax exemption regime on 1 January 2015, which had been linked to the purchase of a home or the repayment of a mortgage loan. The turnaround in the housing market is related to improved affordability, favourable economic prospects, rising rents and the boost in consumer confidence. The indicator compiled by the Dutch Home Owners Association reveals that confidence in the housing market is even above levels recorded in the years leading up to the credit crisis. Exceptionally low mortgage interest rates have strongly improved the affordability of houses. In line with expectations, the number of housing transactions receded from the late-2014 peak in the first quarter of 2015. Still, the slowdown in the number of houses sold remained modest, with 19% more transactions relative to the first quarter of 2014, indicating a sustained recovery in the housing market in early 2015. This is

Chart 11 Breakdown of non-residential gross investment

Percentages



Source: Statistics Netherlands.

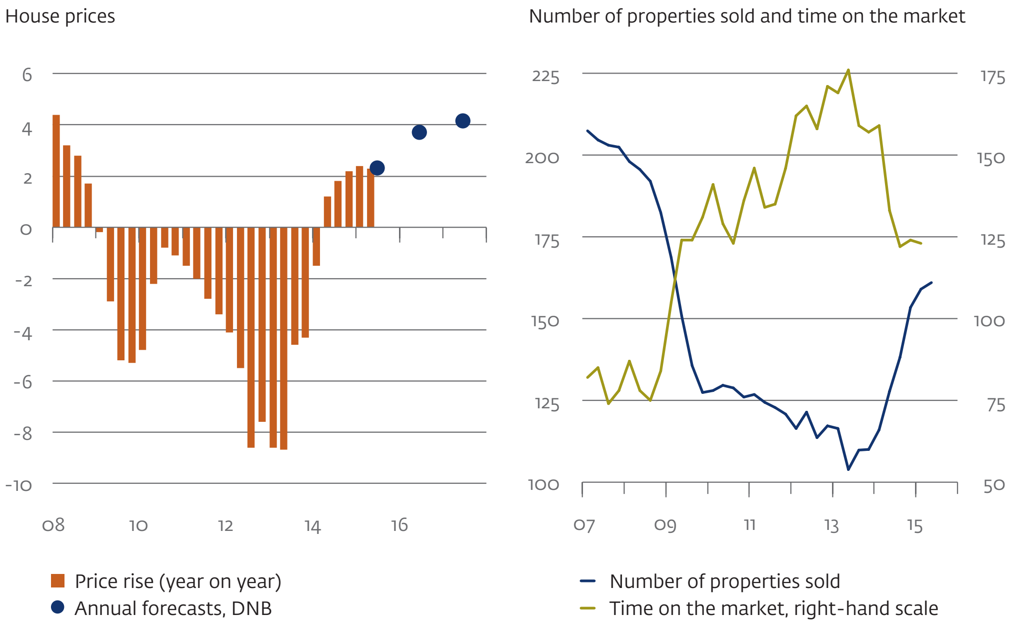
also visible in the construction sector, in which the volume of production in the first quarter of 2015 was more than 8% above that of a year earlier. This made construction the second fastest growing sector. This strong growth is related in part to the fact that the temporary reduction of the 21% VAT rate to 6% for labour costs in home improvements and repairs is to be scrapped on 1 July 2015. The projections have therefore factored in slightly slower growth in residential investment in the second half of 2015.

Rise in house prices accelerates steadily

The turnaround in the number of housing transactions has had a knock-on effect on average house prices with the usual time lag of around three quarters. Selling prices have risen and price rises have increased since the second quarter of 2014 (see Chart 12, left-hand graph). The first quarter of 2015 saw house prices rise in all provinces of the Netherlands for the first time since 2008, which indicates that the housing market's recovery now has a broader basis. However, large regional differences remain. Expectations are for the average house price to rise by 2.3% on average in 2015, accelerating throughout the projection horizon to over 4% in 2017. Factors that drive house prices upwards include higher disposable income, low mortgage interest rates, increased consumer confidence and catch-up demand relating to postponed purchases. Conversely, house prices are depressed by tighter credit conditions, such as a lower

Chart 12 Housing market: prices and transactions

Percentage changes, four-quarter sums in thousands and number of days



Note: Price increase 2015Q2 = April 2015; number of houses sold 2015Q2 = twelve-month sum through April 2015.

Sources: Statistics Netherlands, DNB and NVM.

LTV ratio (mortgage loan amount expressed as a percentage of the value of the house), stricter standards prescribed by the National Institute for Family Finance Information (NIBUD) and a lower ceiling for eligibility for the Dutch national mortgage guarantee scheme (NHG). Likewise, the large number of households that have underwater mortgages weighs down on house prices. The underwater issue is expected to ease very gradually during the projection horizon as the number of households with underwater mortgages will decline further on the back of the expected rise in house prices and sustained low interest rates, which will encourage early redemption of mortgage debt. Their number fell from 33% to 28% of all households between late 2012 and late 2014.

Recovery of government finances is proceeding

The upswing in the economy, which emerged in the course of 2014 and is expected to continue this year, is reflected in government finances. Unemployment benefit expenditure is declining, while private consumption, which generates relatively high tax revenues, is showing substantial growth for the first time in many years. Furthermore, the government benefits from the ECB's QE programme in terms of lower interest expenses. Policy measures are another important driver behind the improving budget balance. Cutbacks in curative care and reforms in long-term care will put a cap on rising expenditure, while the tightening of the Witteveen framework limits foregone tax revenues. The government will, however, slightly ease the burden for households in 2015 by lowering the rate for the lowest tax bracket. With regard to natural gas, the assumption is that the annual 39.4 billion cbm production ceiling set in January will be maintained, which implies a production increase in the second half of 2015, given that a 16.5 billion cbm cap was imposed for the first half. The Minister of Economic Affairs will decide on maintaining or lowering the annual maximum in July. Lowering the ceiling to 33 billion cbm, which means extending the maximum that applies during the first half, would reduce government revenues by 0.2 percentage point of GDP. All in all, the budget deficit is set to shrink from 2.3% of GDP in 2014 to 1.6% of GDP in 2015, which is the lowest level since 2008, comfortably below the European 3% standard (see Table 3). This will bring the structural balance, as defined by the European Commission, to -0.3% of GDP, slightly above the medium-term target of -0.5% of GDP. The increase in government debt will virtually come to a standstill in 2015. At 68.9% of GDP, it will have reverted to the level of 1997.

Table 3 Public sector key data

Percentages of GDP

	2014	2015	2016	2017
Public expenditures	46.6	45.6	44.8	44.0
Taxes and social security contributions	37.9	38.0	38.2	38.1
Other income	6.4	6.0	5.6	5.4
Primary balance	-0.8	-0.2	0.4	0.6
EMU balance	-2.3	-1.6	-0.9	-0.6
Structural balance (EC-method)	-0.3	-0.3	-0.2	-0.5
EMU debt	68.8	68.9	67.2	64.9

Sources: Statistics Netherlands and DNB.

The budget deficit will shrink further in 2016 and 2017, as the increase in government spending lags behind nominal GDP growth. Unemployment benefit spending will decline a bit further, while the number of civil servants should remain more or less level and interest expenses continue to fall somewhat. Taxes and social insurance contributions will be virtually unchanged throughout the projection horizon, hovering around 38% of GDP. The debt to GDP ratio is set to decline to below 65% in 2017, on the back of the falling budget deficit, sustained economic growth and inflation that will be somewhat higher than in the preceding years. The assumption is that ABN AMRO will remain state-owned. Once the announced sale has been effected, public debt may drop further.

3 An alternative scenario for the Dutch economy

Monetary policies in United States and euro area diverge

Monetary policies diverge internationally. The Federal Reserve recently ended the programme it had started in late 2008 under which it purchased US treasury bonds, and it is considering an increase in its federal funds rate, dubbed the 'lift-off', subject to specific conditions. By contrast, the ECB decided in January 2015 to ease monetary conditions by substantially extending the scope of its asset purchase programme (EAPP) and keeping it in place until September 2016 in principle. This divergence between international monetary policies creates additional uncertainties, not only about the timing and pace of policy adjustments, but also about their impact on the economy. Our projections assume a slightly widening differential between European and US interest rates, based on the situation currently prevailing in the financial markets. The underlying expectation is that the federal funds rate creeps up from late 2015 onwards. Current interest-rate and other expectations in the financial markets are reflected in exchange rates, which are kept constant in the projections from the date of their completion – 19 May 2015 – in line with common practice.

This alternative scenario explores the effects that wider divergence between US and European interest rate movements than currently foreseen could have on the Dutch economy. It is based on the assumption that the lift-off of the federal funds rate will take place in the third quarter of 2015, prompted by sustained recovery of the US economy, and that US interest rates will rise more strongly than foreseen in the projections. The more rapid increase is based on the projections drawn up by the members of the FOMC, which is the Federal Reserve's monetary policy committee, which have been substantially above market expectations for some time (see Chart 13).[5] This discrepancy may cause a faster and earlier policy normalisation in the United States to go hand in hand with additional financial turmoil. The scenario accounts for this effect by assuming a global fall in equity prices of 10% in the third quarter of 2015.[6] The scenario also foresees that the international divergence between interest rates will be accompanied by lower long-term and short-term interest rates in the euro area, assuming a short-term interest rate of 0% through the third quarter of 2016, slightly below the rate assumed in the projections. The European long-term interest rate in 2015 is 25 basis points below that in the projections, but the difference narrows over the years. Table 4 depicts the international assumptions and the resulting assumptions for the Netherlands, based on the global NiGEM model.

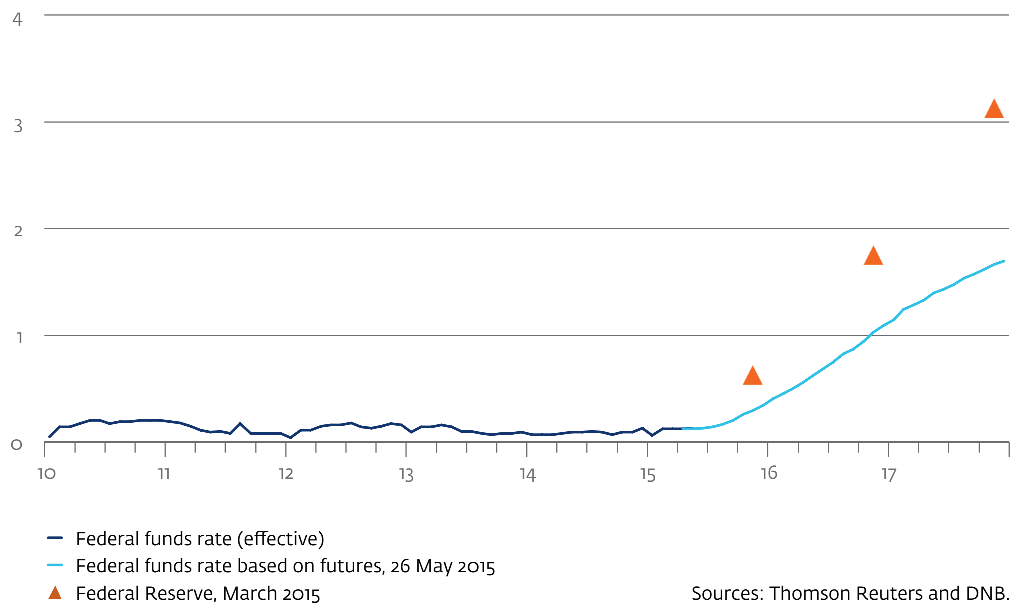
The stronger lift-off and the related higher future short-term interest rates should see the US long-term interest rates surge by over 40 basis points almost overnight in the third quarter. In addition to causing lower economic growth in the United States in 2016 and 2017, higher long-term interest rates will change international capital flows. In the emerging economies,

5 Market expectations are based on prices of federal funds futures with various maturities.

6 This global fall in equity prices is similar to the one prompted by the 'taper talk' of May 2013, announcing that the US purchase programme would be tapered off.

Chart 13 Expectations for the federal funds rate

Percentages



Sources: Thomson Reuters and DNB.

Table 4 Scenario assumptions

Percentage deviations from baseline scenario, unless stated otherwise

	2015	2016	2017
International:			
Short-term interest rate US (bps)	14	57	109
Long-term interest rate US (bps)	21	37	29
Short-term interest rate in the euro area (bps)	0	-5	0
Long-term interest rate in the euro area (bps)	-15	-5	-5
Netherlands:			
Volume of relevant world trade	0.0	-0.4	-0.4
Euro exchange rate	-2.9	-4.0	-3.7
Competitor prices	0.0	-0.6	-0.9
Oil price	-1.0	-1.9	-2.2
Equity prices	-3.8	-0.8	1.1

Source: DNB.

Note: Assumptions for the Netherlands are based on the NiGEM macroeconomic model.

capital outflows will go hand in hand with currency depreciations. Lower equity prices and sluggish international demand will subsequently put pressure on economic growth in these emerging economies. At the end of the day, growth in relevant world trade in 2016 and 2017 will end up 0.4 percentage points lower than in the projections. In the euro area, the wide interest rate differential with the United States will likewise cause the euro to depreciate. This effect will decline in late 2017 only, due in part to lower GDP growth in the United States.

The stronger lift-off in the United States will have limited consequences for the Dutch economy. The lower growth in relevant world trade will depress GDP through exports, but this adverse impact will largely be offset by lower oil prices and the lower effective exchange rate of the euro, which should benefit the price-competitive position of exporters. Declining equity prices will cause consumer confidence to fall back, mainly in 2015, depressing private consumption. On balance, economic growth should be 0.1 percentage point lower than in the projections, in 2016 only (see Table 5). Lower production growth will put a brake on business investment, but the consequences for inflation, unemployment and the budget balance are minor in this scenario.

Table 5 Effects of diverging monetary policies

Percentage changes, unless stated otherwise

	2015	Deviation from projection	2016	Deviation from projection	2017	Deviation from projection
Gross domestic product	2.0	(0.0)	1.7	(-0.1)	2.2	(0.0)
Private consumption	2.0	(0.0)	2.2	(-0.1)	2.1	(0.1)
Business investment	6.3	(-0.1)	4.9	(0.1)	4.3	(-0.3)
Exports of goods and services	3.2	(0.1)	5.1	(-0.3)	5.8	(-0.2)
Imports of goods and services	3.4	(0.1)	6.5	(-0.3)	6.7	(-0.2)
Consumer confidence (level)	-2.8	(-0.7)	1.1	(0.1)	2.0	(0.2)
Harmonised consumer price index	0.2	(0.0)	1.2	(0.0)	1.2	(-0.2)
Unemployment (% of labour force)	7.0	(0.0)	6.9	(0.0)	6.8	(0.1)
EMU balance (% of GDP)	-1.6	(0.0)	-0.9	(0.0)	-0.7	(-0.1)
Current account (% of GDP)	8.0	(0.0)	8.6	(-0.4)	8.9	(-0.5)

Source: DNB.

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