CPB Netherlands Bureau for Economic Policy Analysis

Economic recovery after 2012

Budget-deficit 2013: 4.6 %

Central Economic Plan 2012

Chapter 1

(translation)

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1 The economy during 2012-2015

For the second time in hardly three years' time, the Dutch economy has entered into a recession and is expected to shrink during 2012. Recovery will start during the second half of 2012 at a modest rate; the economy is expected to grow by 1¼% during 2013. During 2014 and 2015, growth will slightly increase up to an annual 1½%. On balance, we will lose more than ¼% in annual growth compared with the calculations supporting the government programme and multi-party tolerance accord. This will affect government finance. Without supplementary measures, the budget deficit will decrease to 4.6% GDP during 2012 and 2013, and improve to a 4.1% deficit during 2014 and a 3.3% deficit during 2015. This means that the budget deficit will exceed the 3% norm of the European excessive deficit procedure. Consumer purchasing power is also less favourable during 2011-2015 than foreseen at the time of the government programme and multi-party tolerance accord. The purchasing power decreases by an average of ¾%. The international environment remains uncertain and downward risks are dominant. Regarding the Euro crisis, the assumption is that no major incidents will happen. On the other hand, confidence will not be restored to any substantial degree in the short term.

1.1 Summary and introduction

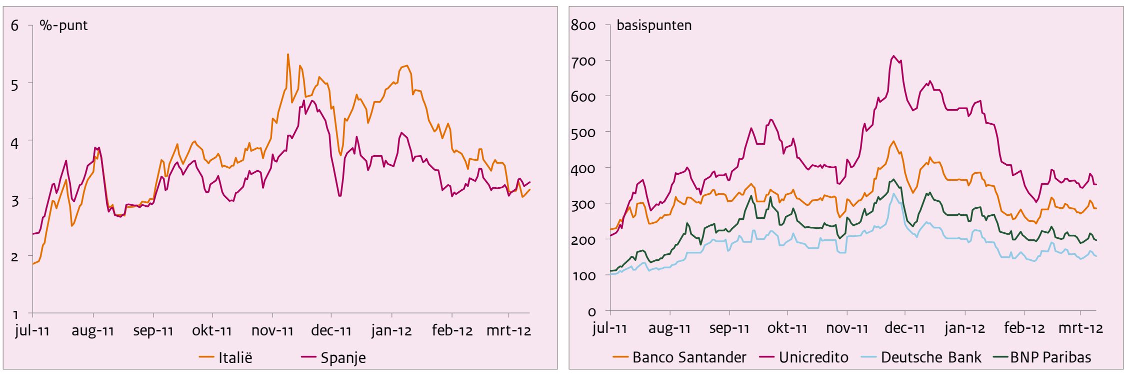
World economy in a dip; hesitant recovery from next year onward

Economic growth slowed down on a worldwide scale during 2011. The pace of growth decelerated strongest in the highly developed economies. During the course of the year, the European economic climate developed significantly less favourably than the American economy. Growth accelerated again in the United States, whereas the Eurozone's GDP shrank during the last quarter of 2011. The Eurozone economy is expected to shrink by ½% during 2012. Hesitant recovery will follow during 2013 and the subsequent years. Given the expected lean growth figures of the United States and the cool-off of the Asian economies, growth of worldwide GDP will slow down to 2¾% during 2012, recovering somewhat to 3¾% during 2013.

Europe - in the eye of the storm?

During 2011, the Euro was under immense pressure, in particular due to the uncertainty on the financial markets regarding political commitment to the Euro. On a few occasions during August, September and November, the European Central Bank (ECB) was forced to intervene to calm down the markets. During the first few months of 2012, the debt crisis in the Eurozone entered calmer waters. The ECB's three-year loans to make more liquid resources available, the three-year longer term refinancing operations (LTRO), government changes and announced reform plans in both Italy and Spain are likely to have played a role in this development. The programme supports commercial banks with central bank liquidity at very low interest rates against collateral. The interest gap with German government bonds decreased, share prices are higher and the share price volatility decreased. The decreased tension is also apparent from the fact the ECB's direct interventions based on the *Securities and Markets Programme* (SMP) have significantly decreased. The figures below show that after the government changes in both Spain and Italy, (November 2011) and the announcement of liquidity expansion measures of the ECB (8 December 2011), the interest gap of both Italian and Spanish government bonds have noticeably decreased compared with the German (left) and five-year CDS premiums for some European banks (right). At the very least, this bought some time for the governments and financial institutions to straighten out the issues.

Figure 1.1 Rays of light in the Euro crisis: interest gap with Germany on Italian and Spanish 10-year bonds (left), five-year CDS premiums European banks (right) on the decrease



In spite of the stabilisation on the financial markets, the economic downturn in the Eurozone is expected to extend through the first half of this year. Leading indicators point out weak production growth within the Eurozone. The development of the German economy is a ray of light. This is good news for the Netherlands, as one quarter of its exports are to Germany. This forecast estimates a modest recovery of the economy from the second half of 2012 onwards. This is based on the very easy monetary policy, the slight improvement of the situation in the financial markets and limited recovery of confidence. Regarding the Euro crisis, the assumption is that no major incidents will happen. On the other hand, confidence will not be restored to any substantial degree in the short term. We presume that the European government leaders will implement adequate measures to prevent escalation of the debt crisis, but that they will not be able to solve the Euro crisis in the short run. The European financial markets will continue to struggle with substantial problems. The required modifications to the Eurozone's economies are so incisive that even when introduced on a very short time scale, it is unlikely for this process to produce major short-term positive effects on the growth rate. In fact, with these assumptions, the 'muddling through' scenario of recent short-term forecasts will be continued into subsequent years.[1] The EMU and EU will remain intact; Italian and Spanish debts do not need restructuring; and the financial sector will not be shaken up by any major new problems. Banks, however, will reduce their balance sheets. As a consequence, investments may be delayed. The assumption is that this will not happen on a large scale within the Dutch banks. This may lead to lower growth of labour productivity. The current budgetary policy is restrictive in many countries, temporarily depressing growth. The additional budget cuts that will probably be necessary to comply with the European budgeting rules have not been taken into account. Please refer to the text box for an uncertainty variation in this respect.

This means there are major *downward risks.* In addition to the downward risk due to additional budget cuts in Euro countries, growth within the Eurozone may be further depressed by the escalation of the Euro crisis. The Greek debt problem has not yet been resolved and the interest on Portuguese bonds has gradually increased during the past few months. The ratings of France, Austria, Italy, Spain and the EFSF emergency fund have all been lowered. There is still a chance of a scenario in which the troublesome situation in both Greece and Portugal will spread to larger member states such as Spain or Italy via the financial markets. A less imminent risk is a 'Japan scenario' with long-term low growth. The European banking sector has not yet resolved the problems. The required recapitalisation will further pressurise residential and commercial loans. The ECB's liquidity expansion by means of the three-year LTRO limits the short-term risk of a credit crunch insofar this liquidity is used for granting credits. It can also have a positive impact on the interest rates on Spanish and Italian government bonds. Banks are able to make a healthy return on drawing money from the ECB at an effective rate of 1% and buying Spanish and Italian bonds (or in any case, not selling them). As long as this situation continues, banks can enhance their financial position.

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[1] See CPB, 2011 forecast of December, 2012 Economic Outlook, CPB Policy Brief 2011/13, page 6 and 2011 OECD, Economic Outlook for a "muddling through" scenario.

Possible additional budget cuts within Europe also affect the Netherlands

Many Eurozone countries, including the Netherlands, have entered the European Commission's excessive budget deficit procedure. According to these rules, most countries must comply with the 3% norm for the EMU deficit by 2013. However, this is expected to require additional efforts (a). The variation discussed in this document is based on the assumption that all these countries will comply with the norm (b). The EMU balance of the Eurozone as a whole will improve by 1% GDP in this variation, based on the technical assumption that half of this percentage will be realised by lower expenditure and half by higher taxes. The resulting macro-economic effects differ. The expenditures have a higher impact on the GDP, but this will disappear (?) in the long term. The effect of higher taxation of the GDP will arise at a later stage, but will continue as a long-term effect. The budget elasticity rates applied for the Euro countries are derived from the European Commission (d).
The table below shows the consequences to the Netherlands. With governments stepping on the brakes, the Eurozone's GDP results are slightly lower, which translates into relevant world trade being 2.8% lower in 2013 (e). Based on the OESO model exercises, the assumption is that some recovery will be realised during 2014 and 2015. Demand for Dutch products within the Eurozone will decrease, slowing down export growth during 2013. The Dutch GDP in 2013 therefore will be 0.7% lower than estimated in the CEP forecast, resulting in a ¾% growth rate. Part of the GDP loss is recovered during 2015 as recovering world trade will cause the GDP growth to exceed the CEP forecast by 0.4% Lower production will, with some delay, also lead to lower employment and higher unemployment, resulting in an unemployment rate of 6½% by 2014. This will also pressurise contractor wages, causing unemployment to slightly decrease by 2015. Household consumption will be slightly slow in responding to lower production and will come out at 0.6% under the central path in 2015. The less favourable macro-economic situation also leads to a more negative EMU balance for the Netherlands. During 2013, this is 0.2% lower. Due to a further decrease in tax income, the 2015 balance will lag behind the CEP forecast a little more: by 0.4%.

	2013	2014	2015
	Cumulative deviations from the CEP forecast as a percentage		
Relevant world trade, volume	-2.8	-2.3	-1.5
Import price of goods	-0.1	-0.4	-0.4
GDP Eurozone, volume	-1.1	-0.9	-0.5
GDP volume	-0.7	-0.7	-0.3
Production market sector, volume	-1.0	-1.0	-0.4
Household consumption, volume	-0.1	-0.4	-0.6
Non-residential business investments, volume	-2.9	-2.3	0.5
Export of goods (exclusive of energy), volume	-2.4	-2.0	-1.4
Import of goods	-1.6	-2.0	-0.9
Employment, labour years	-0.2	-0.7	-0.5
Unemployment (level, % labour force)	0.2	0.6	0.4
Contract wages market sector	-0.2	-1.2	-1.3
Consumer price index (CPI)	-0.1	-0.4	-0.6
EMU balance (% GDP)	-0.2	-0.5	-0.4

(a) Based on the autumn estimate for EMU balances of Euro countries by the European Commission. This was updated based on recent GDP estimates of Euro countries also used for this CEP.
(b) In order to ensure consistency with the rest of the *CEP*, based on the technical assumption that the Netherlands will not do this.
(c) The deadline for both Greece and Ireland is beyond 2013. The simulation does not consider the fact that not realising the budget targets may cause negative confidence effects for some countries (such as Greece), which may lead to downward effects on economic growth.
(d) See budget elasticity rates EC.
(e) The effects of the budgetary shrink on the GDP of the Euro countries was determined on the basis of the OECD's Interlink model (see interlink-model). The effect on world trade and the import prices was calculated using the regular tools of CPB.

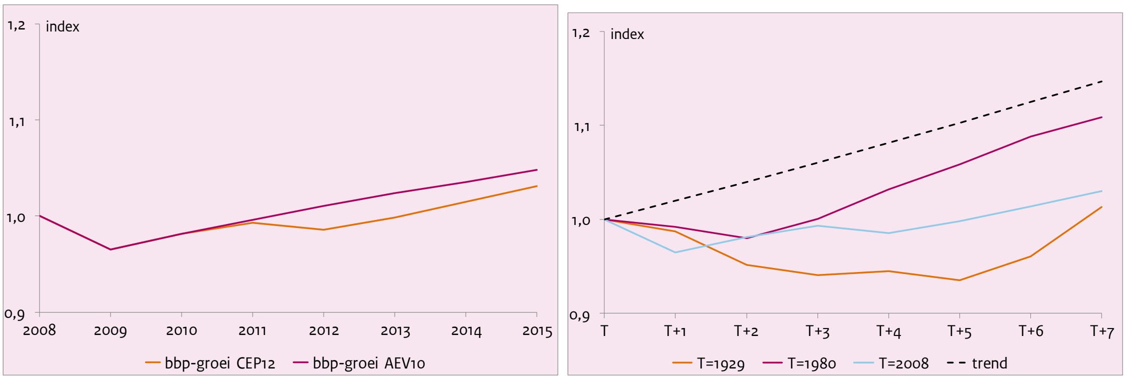
However, there are some disadvantages. The solvency problem of the banks is not resolved and due to cheap liquidity, banks do not have an incentive to restructure their balance sheets. Similar to the Japanese 'zombie banks' in the 1990's, there is a risk that insolvent banks will stay alive, teetering on the brink for many years, resulting in many credit misallocations. If confidence in the European banking sector has not been restored by the time the LTRO term expires, new liquidity support will be required in order to prevent banks from collapsing. The second risk is that if the LTRO causes banks with liquidity from the ECB to buy Italian and Spanish government bonds, the costs of the European banks will be far higher in the case where the Spanish or Italian debts will need restructuring against expectations. If this is concentrated in Southern European banks, which are not in good financial health, this would exacerbate the problem. Therefore, liquidity provision does not resolve this problem. However, the ECB buys time, allowing a better spread of the required restructuring of banks' balance sheets, and allowing countries such as Spain and Italy to straighten out their government finance.

The Dutch economy - moderate recovery after 2012

With two quarters of shrinking in the second half of 2011, the Dutch economy has entered into a recession for the second time in hardly three years' time. This recession will be noticeable in the annual statistics for 2012. This year, the GDP will decrease by ¾%, such after a 1.2% growth during the past year. Based on continued calm in the Euro crisis, a modest economic growth of 1¼% is expected for next year. This does not take into account the effects of any additional budget cuts. During 2014 and 2015, growth will slightly increase to 1½% per year. This growth during two years is estimated slightly higher than in the analysis of the government programme and multi-party tolerance agreement, predominantly because of the catch-up growth effect.[2] However, the GDP will remain below its potential during the entire period. On balance, the growth rate will amount to an annual average of 1% during the period 2011-2015. On balance, we will lose more than ¼% in annual growth (approximately 1½% cumulated) compared with the calculations supporting the government programme and multi-party tolerance accord (figure 1.2 left).

[2] CPB, 2010, Analysis economic effects financial framework, CPB Memorandum, September.

Figure 1.2 GDP-volume compared with previous estimate (left) and previous crises (right)



With two recessions in a short period of time, the economy will not exceed the first quarter of 2008 level until 2014. This means that on balance, the Dutch economy will not have grown for six years. With the exception of World War II, this has not happened since the global crisis during the 1930's. At the time, it was not until 1936 that the GDP volume exceeded the 1929 level (figure 1.2, right). Another way to look at this is comparing GDP growth with trend development. When continuing the trend development of GDP growth from 2001 through 2015 (see figure 1.2, right), it appears that we lost about 6% during 2011. These losses run up to 10% in 2015 due to the 2012 recession. However, this loss of growth is not purely due to the crisis; On balance, the policy will depress growth during the cabinet period. Furthermore, potential growth in this period is lower than in the past due to decreasing growth in employment due to the ageing population and a lesser increase in female labour participation (see Chapter 3.1).

The cyclical dynamics within production mainly translate into a varying income growth within companies.[3] During the past two years, the growth in net national income (NNI) mostly manifested here. In contrast, this year, companies are confronted with a substantial decrease in their actual income (figure 1.3), which is also reflected in the forecast increase in the labour income share. Next year, production is expected to slightly increase. In combination with an improvement in the balance on foreign income, a relatively large share of the income growth will benefit the companies. Negative purchasing power and hardly any increase in employment combined with a limited increase in government consumption attributed to households result in a relatively minor growth of household income. In this forecast, the government hardly shares in NNI growth during the next few years.

[3]In the analysis of the 'national pie', the so-called individualisable government consumption, predominantly consisting of expenditure on healthcare and education, is attributed to households, as these are the direct beneficiaries. Furthermore, the profit income is attributed to companies. Please refer to page 92 of the *2006 Central Economic Plan* for a further explanation of this analysis.

Table 1.1 Main Economic Indicators

	2010	2011	2012	2013	2014	2015
	changes as an annual percentage					
International economic cycle						
Relevant world trade	11.2	4.0	-1¾	4½	6	6
Price level goods import	7.3	5.5	2½	¼	0	-¼
Competitor price	7.7	5.8	3½	-¼	½	½
Oil price (Brent, level in dollars per barrel)	79.5	111.3	111	111	111	111
Euro exchange rate (US dollar per Euro)	1.33	1.39	1.29	1.29	1.29	1.29
Long-term interest rate (level as a percentage)	3.0	2.9	2.3	2.7	3.0	3.3
Volume consumption and foreign trade						
Gross Domestic Product (GDP)	1.7	1.2	-¾	1¼	1½	1½
Household consumption	0.4	-0.9	-½	½	½	¼
Government consumption	0.7	0.6	-1	0	-¼	-¼
Gross non-residential business investments (excluding homes)	-1.4	7.2	-3¼	7½	6¾	5½
Export of goods (excluding energy)	12.8	4.3	-1¾	3¾	6¼	6¾
of which produced domestically	9.4	1.8	-½	3½	4	4
re-export	15.8	6.3	-3	4	8¼	9¼
Imports of goods	12.6	3.7	-1¾	3¼	5	5¾
Prices, wages, purchasing power						
Price level exports of goods (excluding energy)	4.4	1.7	½	¼	-¼	-¼
Price competition position(a)	1.9	-0.7	2¼	-¾	0	0
Consumer price index (CPI)	1.3	2.3	2¼	1¾	2	2¼
Contract wages market sector	1.0	1.4	1¾	1½	2	2¼
Wage rate market sector	1.5	2.5	3¼	1½	2½	2½
Purchasing power, static, median all households	-0.6	-1.0	-1¾	0	-½	-½
Labour market(b)						
Labour force	-0.3	0.0	1¾	¼	0	¼
Working labour force	-1.0	0.0	½	-¼	0	¾
Unemployed labour force (level in k persons)	390	389	500	545	535	495
Unemployed labour force (level as a percentage)	4.5	4.5	5½	6	6	5½
Market sector (c)						
Production	1.3	1.8	-1½	1¾	2	2
Labour productivity	3.0	1.5	-¾	2½	2¼	1¼
Employment in labour years	-1.6	0.2	-¾	-¾	0	½
Price of extra value	2.2	0.5	¾	1	1	½
Actual labour costs	-0.6	2.0	2¼	¼	1½	2
Labour income share	78.7	78.6	81½	79¼	78½	79
Public sector						
EMU balance (as a % GDP)	-5.1	-5.0	-4.6	-4.6	-4.1	-3.3
EMU debt (as a % GDP)	62.9	65.6	70.2	73.0	75.0	76.0
Total tax and social security rate (as a % GDP)	38.8	38.2	38.8	38.6	39.0	39.3

(a) Competitor price minus export price of domestically produced goods.

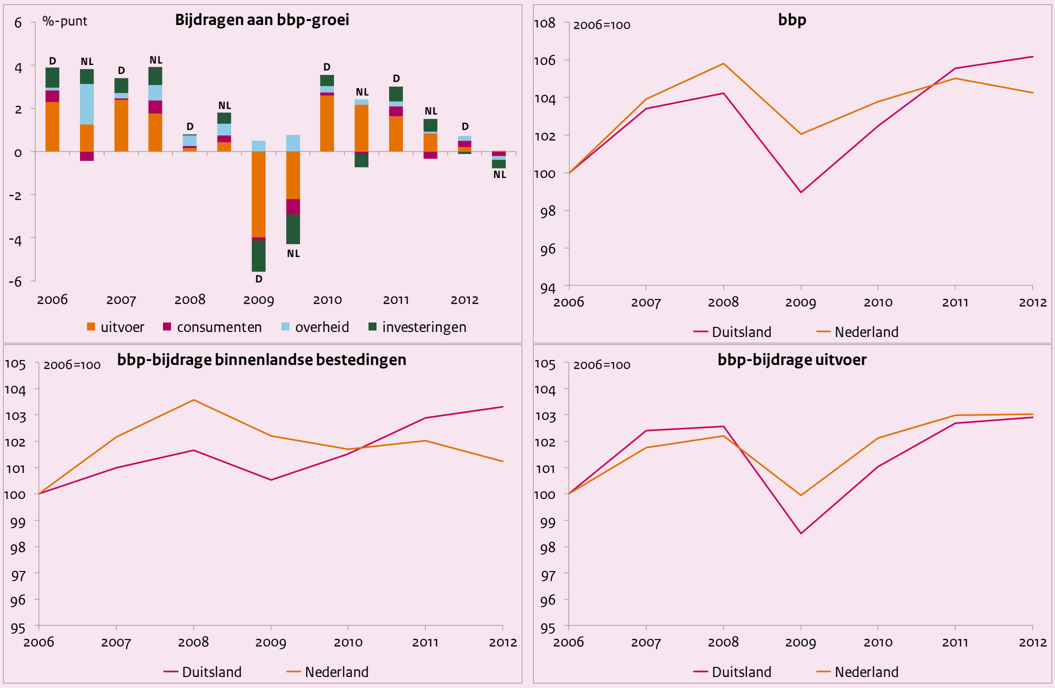
(b) All figures in accordance with the international definition

(c) Businesses, excluding healthcare, natural gas production and property sectors.

Why does Germany perform better?

Both during 2010 and 2011, Germany's GDP growth was higher than that of the Netherlands. The difference in growth amounted to 1¾% during both years. This year's growth forecast for Germany is better again (1¼%). The German economy has not increased stronger than the Dutch economy since the early nineties of the previous century.
The main cause is that German exports reacted to the global recession more sharply than Dutch exports, both in declining and rising (see figure). Compared with 2006, the GDP contribution of exports recovered similarly in both countries last years; however, the higher recovery pace in Germany allowed the German economy to grow stronger during 2010 and 2011. Growth of demand from China for German products contributed an average of ¼% per year to the German growth in GDP during the past few years. Remarkable, although less important to the growth gap than exports, is the disappointing contribution to the GDP of domestic demand in the Netherlands since 2008. In contrast, domestic demand was a slight driver in the GDP volume in Germany since 2010.

Contributions of export and domestic consumption to German and Dutch GDP

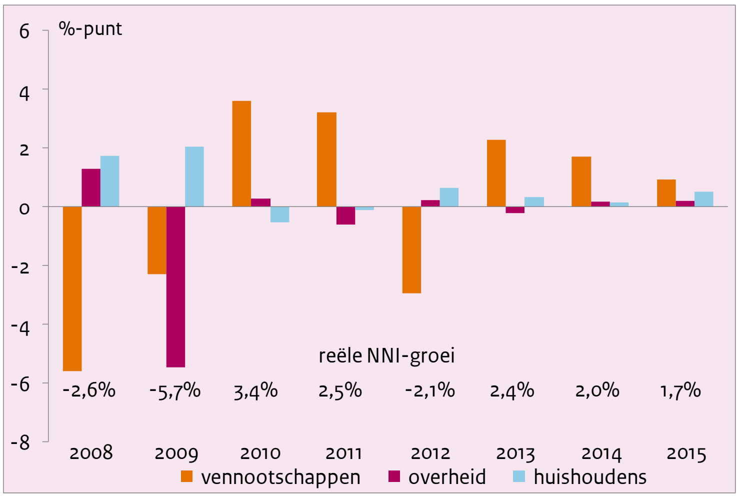


Source forecasts Germany: DIW, January 2012.

In particular the consumers let our country down last year, and household consumption is expected to further decrease this year. Capital losses in households due to the decreasing housing market is a factor in this decrease. For example, the impact on Dutch household consumption of a long-term decrease in capital associated with private homes is estimated at -½% per year (see paragraph 3.2). The effect on GDP growth is -¼% per year, whereas in Germany, this is set off by the start of recovery in prices of residential homes.
The expectation that German growth performance will be better than Dutch growth performance is favourable for our country. As no growth impulse is to be expected of domestic consumption, the exports will have to ensure GDP growth. A full quarter of Dutch exports is headed for Germany.

Decreasing household consumption is a substantial factor in the meagre growth performance of the Dutch economy. Consumption mainly depends on income and capital. This year, the actual disposable income does not rise. Next year will see a minor revival, in particular due to higher wage income. During 2014 and 2015, the actual income rises will be very limited and as a result, the actual disposable income will increase just slightly. No consumption growth will result from capital. The price of existing owned homes decreased by more than 10% from the top in August 2008 to late 2011. In nominal terms, the prices of residential homes are expected to continue to decrease during the next few years. The number of transactions will increase from 2013 onwards, allowing prices to stabilise during subsequent years.

Figuur 1.3 Distribution of NNI growth



Residential capital of households shows a substantial decrease in absolute numbers and this strongly affects consumption. The equity holdings of households does not contribute to consumption growth either. These capital losses affect the household consumption negatively during the period 2011-2015 by -½%. The current and future pension reductions also have a negative impact on consumption as families start saving more to partially recover the pension capital loss. Finally, families are saving up more as a precaution due to their negative expectations for the near future, for example because they are afraid they might lose their job. This results in a strongly increased household saving rate. Low consumption growth is one of the explanations for the significant gap between the Dutch and German economies (see text box).

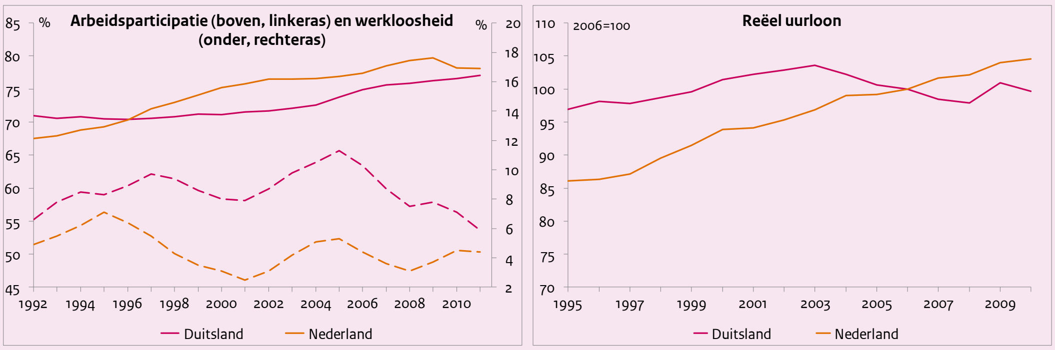
The consumption share (nominal consumption as a fraction of nominal GDP) has been on the decline for some time, from approximately 50% GDP in 2000 to approximately 46% GDP in 2011. The lower consumption growth after 2000 is due to a significantly lower growth rate of employment (and therefore income from labour) compared with the previous decade. Due to disappointing returns on shares from 2000 onwards, pension premiums were increased in both 2004 and 2005, depressing the disposable income and the consumption share. The increase in prices of residential homes was far less exuberant after the millennium, resulting in a lower positive impulse on consumption.

Labour market reforms support German recovery

During the years 2003-2005, Germany implemented extensive labour market reforms. The Netherlands had already completed such reforms during the 1990's. The so-called Hartz reforms significantly limited the rights of the unemployed and income support beneficiaries, promoting flexibility in the labour market. The duration of an unemployment benefit was reduced to a maximum of 24 months for persons of 58 and older, and to a maximum of 18 months for persons younger than 58. Unemployed persons were more actively given incentives to look for a job and their job search and job acceptance behaviour was scrutinised. Furthermore, the rules for temporary contracts, interim jobs and self-employed professionals became less strict. In 2006, the duration of the unemployment benefit was limited further to a maximum of 18 months for persons of 55 and older, and to a maximum of 12 months for persons up to 54 years of age. During the period 2006-2010, the incentive for older persons to continue to work was increased: The threshold age for early retirement of the unemployed rose from 60 to 63 years old; applying for jobs became mandatory for unemployed persons of 58 and older, and since 2010, no new employees were admitted to the scheme of subsidised part-time jobs.

Due to these measures, the incentives to continue working or to get back to work increased, in particular to lower income groups and older employees. Due to the larger supply of people looking for a job, the wages decreased (in particular for lower incomes), the participation degree increased, and unemployment decreased (see figure). The average actual hourly wage in Germany decreased by an average of ½% per year during the period of 2003-2010. In comparison: in the Netherlands, wages rose by an average of 1% per year during the same period.

Labour participation and unemployment in Germany move toward Dutch levels, but actual wages lag behind



Germany was hit much harder by the crisis than the Netherlands (see previous text box), but unemployment rose less sharply. Flexible working hours at company level are an explanation of the relatively minor increase in German unemployment during 2009. Various schemes strongly increased flexible deployment of employees in companies. Many employees accepted temporary shorter working hours and lower wages accordingly, or had saved deferred wage for troubled times through flexible working hours accounts. In the situation of shorter working hours (*Kurzarbeit*), the employee receives a supplement from the government amounting to 60% of the lost net wages; employer premium contribution remains at the normal level, as does the level of the employee's benefit in the case of redundancy. At the climax in May 2009, this scheme was applied to approximately 1.4 million employees. Furthermore, agreements at company level regarding flexible working hours accounts have become very popular in Germany: In 2009, 50% of all German employees had such accounts. During times of cyclical highs, the employee works more hours against partial or no compensation of overtime in order to work shorter hours in times of cyclical lows without losing much wage. The employer has an incentive to keep the employee at work as long as the employee's accounts shows a positive balance and as long as there is enough work relevant to the balance. Upon redundancy, the employee takes the balance with him/her. This flexible, practical solution using working hours at company level has a dampening impact on the German unemployment cycle.

During 2012 and 2013, employment calculated in labour years is set to decrease by ¾%. Given the GDP growth, employment will remain remarkably stable during the entire period of 2011-2015 in comparison with previous crises. During the previous crises in the 1930's and 1980's, approximately 5% of employment had disappeared within two or three years of the onset of the crisis. In spite of a double recession, the cumulative loss of employment is not expected to exceed 2%. Clear recovery is not imminent but employment will remain stable on balance during the period 2012-2015 (see table 1.1).

Due to low economic growth, this and next year employment is expected to fall back and unemployment to go up. Subsequently, lower growth of employment and a slight decrease in demand for labour will lead to a minor decrease in unemployment, down to 495,000 in 2015. Eventually, in 2015, unemployment will have reached a total of approximately 30 thousand persons more than expected at the time of the government programme and multi-party tolerance agreement.

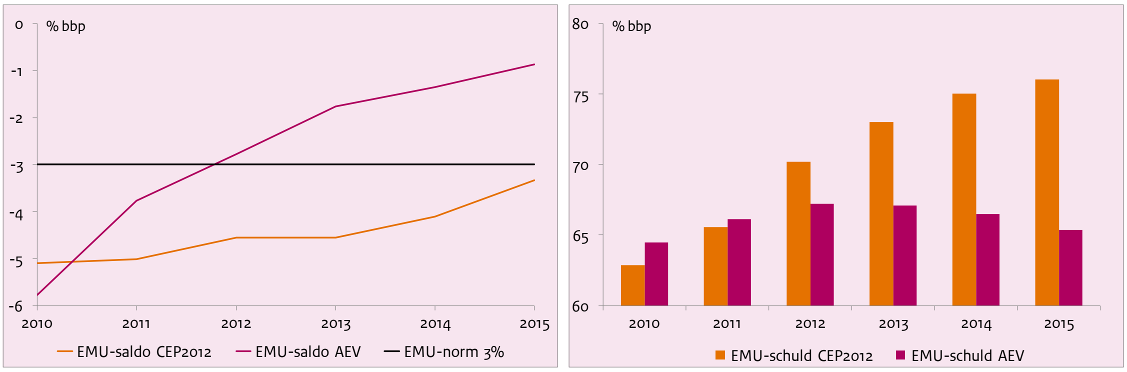
In terms of labour market aspects, Germany has performed better than the Netherlands during the past few years. The second text box compares the labour market performance of the Netherlands and Germany, focusing on German labour market restructuring.

Government finance have hardly improved.

The downward adjustment of the outlook for the Dutch economy also deteriorates the overall picture of government finance. This year, the EMU balance will improve to -4.6% GDP, in particular thanks to the cabinet's measures. According to the current forecast, the budget deficit will also amount to -4.6% during 2013. During subsequent years, the EMU balance will slightly improve; however, without any supplementary measures, the current estimate is that this will result in -3.3 GDP in 2015. This is significantly below the -0.9% that the cabinet counted on when the government programme and multi-party tolerance agreement were concluded. This deterioration in the EMU balance since the calculations of the government programme and multi-party tolerance agreement (figure 1.4, left) is partially the result of lower growth during this cabinet period. However, the deterioration of the EMU balance is major compared with (?) the growth rate adjustment. The main explanation are the lower tax revenues in the current estimate. A key cause of the decrease in income tax is reduced progression in payroll and income tax, as the actual wage increase is lower than in the calculations of the government programme and the multi-party tolerance agreement. VAT is also significantly lower due a drop vis a vis the incidental high level of 2010, lower consumption in the current estimate, and consumption moving to the lower VAT rate due to weaker actual wage rises. The unfavourable development in the housing market leads to significantly lower income from residential transfer tax (also see the text box in Chapter 4).

This means that the deficit will exceed both the cabinet's indicator value (-2.8% GDP) and the -3% limit of the European excessive deficit procedure. The European rules, recently tightened (see text box in Chapter 4), require the deficit to remain under -3% in 2013. If, at the European Commission's discretion, extreme economic conditions occur in EU as a whole or in the economic development of the individual member states, it may decide to grant postponement compliance with the 3% norm. The extent to which this could be the case also depends on EC estimates on 2013 to be published in May. The new recession in the Netherlands and in the Eurozone could be viewed as extreme circumstances by the European Commission. If the Commission should judge that this indeed does constitute extreme conditions, the term for correcting the excessive budget deficit may be extended, as a rule by one year. According to the present insights, the deficit will amount to 4.1% in 2014 without any supplementary measures. For the time being, the Commission refers to the current recession as mild, which would indicate that the recession will not be classed as extreme.[4]

Figure 1.4 EMU balance (left) and EMU debt (right); current estimate compared with estimate at the time of concluding the government programme and multi-party tolerance agreement (Update Economic Outlook 2011-2015)



The deterioration of the EMU balance also affects debt. The estimate at the time of the government programme and multi-party tolerance agreement expected a decrease of government debt from 2013, whereas in the current estimate, government debt increases during the entire cabinet period up to 76% GDP in 2015. This increase is virtually fully attributable to the deteriorated EMU balance. Furthermore, the EFSF loans and the ESM (*European Stability Mechanism*) contribution have a limited debt-increasing effect.

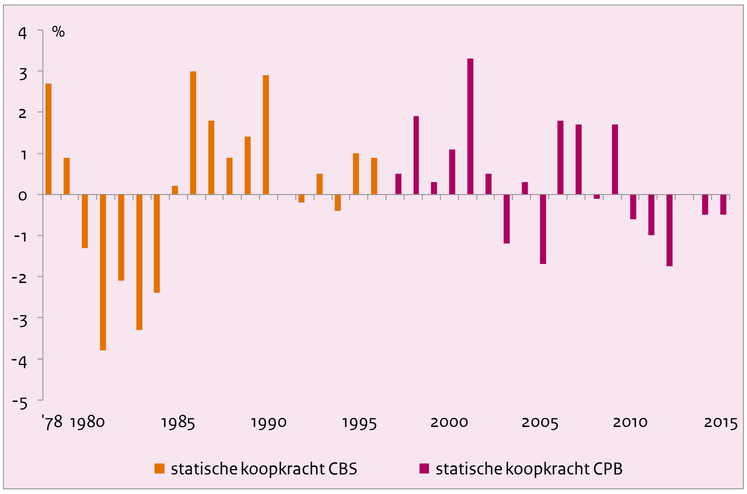
The sustainability gap, the permanent improvement of the budgeting balance required to prevent exploding of government debt in the long-term, is estimated at -2.6% GDP during 2015. Compared with the estimate at the time of the government programme and multi-party tolerance agreement , the robust balance deteriorated by 2.1% GDP. This adjustment is mainly due to taxes lagging behind the GDP during 2011-2015, and to some extent to an increase in government expenditure. The Pension Accord leads to an improvement of the sustainability gap by 0.6 GDP. On balance, the sustainability gap will deteriorate by 1.5% GDP compared with the gap at the time of the government programme and multi-party tolerance agreement.

[4] See European Commission, 2012, EU interim forecast: a mild recession with signs of stabilisation, February.

Gloomy picture of purchasing power

The (static) purchasing power of half the households is decreasing by more than 1¾% during 2012. The deterioration of purchasing power is less than 1¾% for the other half. This is the third consecutive year with a median decline in purchase power. The decline is distributed equally among the labour force, benefit social benefit recipients and pensioners, and is partly due to a decrease in actual wage and higher pension premiums. The supplementary pensions have limited indexation and some are lower. The purchasing power also decreases due to policy measures, such as limitation of the healthcare allowance, limitation of transferability of the general tax credit and the austerity measures regarding a number of child schemes.

Figure 1.5 **Purchasing power (median all households) not set to rise during the years 2010-2015**



This gloomy picture applies more or less to the entire cabinet period. During the period 2011-2015, the median purchasing power, given the current policy and the development of the economy as outlined above, results in an average annual deterioration of ¾%. In the calculations of the government programme and multi-party tolerance agreement, this deterioration was estimated at ¼%. The deterioration is mainly due to a larger decrease in actual wages and pensions which decrease by this ¼ to 1¼% per year. The decrease in purchasing power is smaller for employed persons (½%) than for persons receiving a benefit or pension (1%) because the actual decline in wage is smaller than the actual decline of benefits and pensions. Single earners stand to lose more than other earners. According to this estimate, we will have six consecutive years without any median improvement in purchasing power by 2015 (see figure 1.5). This means that the period without purchasing power would take longer than in the recession of the early 1980's. The cumulative median decline in purchasing power on the period 2010-2015 is far smaller (-4¼%) than during the 1980's (-12¼%).

1.2 Considerations

The Great Recession of 2009 and the 2011 Euro crisis have hit the Dutch economy very hard - harder than many other European countries. In addition to the crisis countries within the Eurozone (Greece, Portugal, Ireland, Spain and Italy), the Netherlands will also be confronted with a shrinking economy.[5] The Netherlands have a tradition of healthy social and economic policies. This policy resulted in high growth rates in the nineties of the previous century, and in low unemployment. The Dutch economy's underperformance therefore now feels like a cold shower. The EMU balance is deeply in the red and the government debt will be running up from 46% to 75% of GDP in seven years' time. Measures to reverse this trend are inevitable. Based on the sustainability gap of 2.6% GDP, the EMU balance must be structurally improved by 17 billion (2015 amounts). With Germany and Finland, the Netherlands are currently paying the lowest interest rate in the Eurozone. The financial markets evidently are confident that the Netherlands will manage to turn the tide. In order to retain that confidence, the Netherlands must now approve a set of credible measures.

What could such a set of measures include? In order to ensure a decline of the GDP percentage, two issues are crucial: a lower deficit and higher growth. A lower deficit will result in a lower increase of the nominator (debt); extra growth will lead to quicker increase of the denominator (the GDP). Furthermore, the extra growth makes it easier to improve the EMU balance, even if it was only for the increase of tax revenue. Conversely, high government debt is bad for growth, as debt is an indicator of higher taxes in future.

Stimulating growth sounds a simple thing; however, in reality, this is no sinecure as it often leads to the burden being shifted between the generations. Raising the state pension age is a typical measure of a two-edged sword: it is good for the budget deficit and promotes growth simultaneously as more people continue to work. This measure is detrimental to the current generation of older employees, as they have to continue working longer. A second example of shifting burdens between generations is limiting the tax deductibility of mortgage rates. This tax deduction freezes up a large slice of the government budget, requiring additional taxation in other items. Additionally, this tax-deductibility drives up the housing prices. Higher prices are good for the current generation of home owners. However, high prices are not good for future generations, requiring them to take out a higher loan to buy a house. A third example is the unemployment benefits and termination benefits for older employees. Such schemes protect the current generation, but make it more difficult for younger generations to get a permanent job, as employers will be hesitant to offer a contract for an indefinite period of time in a situation where high termination benefits apply. As described in Chapter 3.5, permanent contracts have become less popular. The common factor of all three of the above-mentioned measures is that they only appear to disadvantage current generations. The benefits are largely shifted to future generations. In that respect, avoiding structural reforms has the same effect as allowing government debt to run up: the

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[5] The economies of Belgium, Cyprus and Slovenia are also expected to shrink during 2012.

future generations pay the bill. This is why it is understandable for these three subjects to be widely received with objections. The current generation is expected to tighten their belts for the benefit of generations that are mostly not yet old enough to vote. This applies both to reduction of the government debt and for lower housing prices due to limitation of mortgage relief. However, the current generation also benefits from the structural reform. The economy can grow again only by allowing new generations to spread their wings, and this is the only way to ensure that healthcare and pensions will remain affordable to the current generation in the future.
From this point of view, the Netherlands are confronted with the same problems as Italy and Spain. Budget cuts are equally required in these countries in order to regain control of the government budget, where as reforms must be implemented simultaneously in order to ensure economic growth. Both reforms and budget cuts cost current generations money for the benefit of their children. It will take an enormous political effort to carry out both types of measures at the same time. If policy makers have to choose, budget cuts are often chosen over reforms. For example, the Italian prime minister, Mr. Monti, has more trouble reforming the labour market than restoring order in the government budget. The results of reforms are apparently less visible and therefore more difficult to defend.

The consequences of the Great Recession in 2009 remained manageable on a worldwide scale thanks to the intervention of central banks and the governments delaying their budget cuts. This policy was thoroughly evaluated by scientists during the past few years. These evaluations mostly conclude that this worked out well. For example, Auerbach en Gorodnichenko[6] show that spending cuts in times of increasing unemployment during times of increasing unemployment further slows down economic growth, whereas spending cuts in the upward phase of the economy hardly have any negative effects. This advocates refraining from implementing spending cuts suddenly at the moment the economy is in a recession phase, and instead letting automatic stabilisers do their work. Meanwhile, the Great Recession heavily unbalanced the government budgets of most countries, with strongly increasing government debt. This poor start requires reducing the debt share without fully losing the extra value of automatic stabilisation.

[6]Auerbach, A.J. and Y. Gorodnichenko, 2011, Fiscal Multipliers in Recession and Expansion, NBER working paper http://www.nber.org/papers/w17447