CPB Netherlands Bureau for Economic Policy Analysis

Unemployment on the rise | *Budget deficit exceeds 3%*

Central Economic Plan 2013

Chapter 1

(translation)

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1 Summary

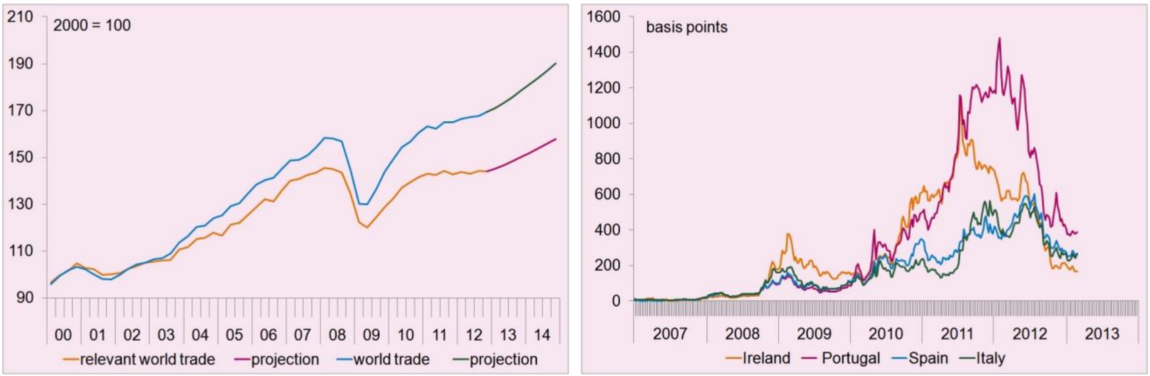
This year and the next, global economic growth will show a fragile recovery. The eurozone's economy is projected to decline this year by ½% and to grow in 2014 by 1%. This trend is also projected for the Dutch economy, the growth of which will be due to export increases. Consumption is under pressure from moderate purchasing power development and declining house prices. Median purchasing power is projected to decline for the fourth consecutive year in 2013, and to rise again in 2014. Unemployment will increase during 2013 by 90,000 people and continue to increase somewhat further in 2014 to 6½% of the labour force. The national deficit is projected to decline to 3.3% of GDP in 2013 with a slight subsequent increase to 3.4% in 2014. The reduction in the deficit between 2012 and 2014 is achieved through sizeable spending cuts and tax increases. The government debt is projected to continue to rise in 2014 up to 75% of GDP, also as a result of the nationalisation of SNS REAAL.

1.1 Summary and introduction

Europe's economy will shrink in 2013 and will show a moderate growth in 2014

The situation on the European financial markets has become considerably less turbulent following the 'whatever it takes' speech by Mario Draghi on 26 July of last year. The introduction of the *Outright Monetary Transactions* (i.e. the possibility, under certain preconditions, of buying unrestricted numbers of government bonds of countries in the eurozone), together with the German Government support for the programme, has reduced fears of a eurozone collapse. There have been substantial drops in insurance premiums for the protection against Italian and Spanish Government defaults (Figure 1.1, right graph), as has the spread in relation to German government bonds. This also applies to the CDS (credit default swap) spreads of banks, for example, in Spain and Italy. Share prices have been rising again and volatility has dropped to pre-crisis levels, while the banks' confidence in each other has also grown to the level of before 2008.

Figure 1.1 Fragile recovery of world trade (left) and a drop in insurance premiums for the national debt in peripheral countries (right)



However, the recovery of the financial markets is only fragile, and there are major downward risks that threaten the relatively calm situation. The political impasse in Italy, following the general elections, may lead to an increase in volatility and uncertainty on financial markets. Moreover, whether there will be sufficient momentum for the set up of a European banking union is uncertain. The impasse between Republicans and Democrats in the United States over reducing the US budget deficit creates 'budgetary hurdles' that could undermine confidence on financial markets.

The restored confidence on European financial markets following July 2012 contrasts the development of the real economy in the eurozone. GDP also declined in the last two quarters of 2012. Preliminary indicators point to a continuation of the economic downturn for the first half of 2013, and to a rather hestitant recovery of the European economy in the second half of this year and from 2014 onwards, in part due to the restrictive budgetary policy. The year-on-year decline in GDP is projected to continue in 2013 with ½%, but with a limited growth in 2014 of 1%.

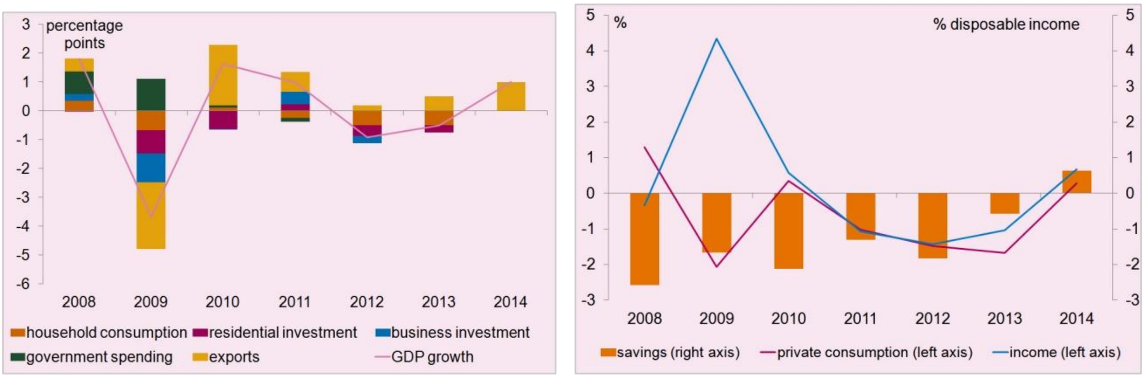
Global GDP is projected to grow by 3¼% in 2013 and by 3¾% in 2014. World trade will also increase gradually during the course of this year and the next (Figure 1.1, left graph). However, the increase in the relevant world trade, with greater weight attached to countries and product groups that are relatively important to the Dutch export trade, is projected to lag far behind. The main reason for this is that Dutch trade is particularly focused on the weak eurozone. Oil prices have been high for some time now, with USD 100 to 120 per barrel, also as a result of – political – risks on the supply side. In addition, the euro's exchange rate, in comparison with the currencies of other trade partners, has risen. High oil prices and increased exchange rates put an additional break on the already weak European economy.

Dutch economy projected to recover slowly, thanks to its exports

The Dutch economy, in line with the projected further decline in the eurozone's economy, will decline over 2013 by a further ½%. This downturn, apart from the recession in the eurozone, is also due to a restrictive budgetary policy, lower pension benefit payments and problems on the housing market. The recession was largely already induced by the economic downturn in the second half of 2012. During the course of 2013, the economy is expected to stabilise and to experience a fragile recovery during the second half of the year, with a projected continuation for 2014, leading to an economic growth of 1% for the Dutch economy.

This economic growth will result from increased exports due to a recovering world trade. Projected national GDP growth of 1% in 2014, thus, will be due to an increase in the Dutch export trade. Lower domestic spending contributed to the contraction in 2012 and will continue to do so in 2013 (see Figure 1.2, left graph).

Figure 1.2 Contribution to GDP growth (left) and decomposition of the growth and decline in consumption (right)



Household consumption is projected to decline in 2013. Lower earnings and benefit payments as well as decreasing house prices are thought to be the main causes of this decline. For 2014, a fragile recovery is foreseen, with a growth of ¼% (Figure 1.2, right graph). Although in that year, the real disposable incomes of families will make a positive contribution, the continuing decline in house prices will slow down consumer spending. Therefore, in 2014, and for the first time since 2002, individual savings will be positive, as households in 2014 will compensate for some of their losses in housing capital by way of increased savings.

Reinhart and Rogoff revisited: more than 4 years later

The previous *Central Economic Plan* (2009) elaborated on the impact of the financial crisis, with reference to the empirical study by Carmen Reinhart and Kenneth Rogoff (2009). This led to the conclusion that financial crises' dynamics and their aftermaths, generally, are similar for upcoming and advanced economies – in duration and severity of a crisis as well as in its impact on production levels, unemployment, real-estate prices, share prices and national debt. For 15 crises that have occurred in the past, the table below provides an overview of the development of the above-mentioned indicators, following such a financial crisis, and compares impacts with experiences in the Netherlands since 2008.

For the Netherlands, data were used on the highest (lowest) point of 2008 to the lowest (highest) point in 2012. The third column shows the difference between the highest en lowest point per indicator, and the last column shows how long it took, starting from the highest point, to reach the lowest. The differences between highest and lowest points for the various indicators as well as the dynamics are relatively comparable with those of the earlier crises, although results for the Netherlands have been somewhat milder across the board. For unemployment, especially, the impact seems to have been substantially less severe for the Netherlands. Fairly soon after a crisis, income per capita and share prices appear to begin to rise again. For unemployment, house prices and national debt, the impact in the Netherlands appears to have remained relatively limited compared to other countries. However, this could be due to the fact that the lowest points, for those indicators, have not yet been reached in the Netherlands. According to current CEP projections, unemployment and national debt will increase further, up to 2014. This causes the total change from highest to lowest point for these indicators to grow to 3.4% and 68%, respectively. Real house prices are also projected to drop even more. In hindsight, therefore, the conclusions by Reinhart and Rogoff, on the basis of *eyeball statistics*, proved to be fairly accurate predictions for the Dutch experience.

Main data on severe financial crises: the Netherlands vs 15 past crises elsewhere

	Total change from highest to lowest point		Time between highest en lowest point (c)	
	15 crises (a, b)	Netherlands (b)	15 crises (a,b)	Netherlands
	%	%	year	year
Income per capita	-9	-6	1.9	1.3
Unemployment (pp)	7	2.6	4.8	>4
Real house prices	-36	-23	6.0	>4
Real share prices	-56	-62	3.4	2
Real national debt	86 (d)	58	3.0	>4

(a) Source: Reinhart and Rogoff, January 2009. The 15 cases (some main data refer to a slightly deviating selection) are: Argentina 2001, Colombia 1998, Philippines 1997, Finland 1991, Hong Kong 1997, Indonesia 1997, Japan 1992, Malaysia 1997, Norway 1899, Norway 1987, Spain 1977, Thailand 1997, United States 1929, South Korea 1997, and Sweden 1991.
(b) For unemployment and national debt: change from lowest to highest point.
(c) For unemployment and national debt: time lapse between lowest and highest point.
(d) Increase over 3 years following the onset of the crisis.

Consumption growth in the Netherlands also lags behind levels in other European countries. Some of the decline over the 2009–2011 period remains unexplained. This might partly be due to a significantly strong decline in consumer confidence since the onset of the Great Recession in 2008. Over the past five years, Dutch consumer confidence has dropped far lower than the European average, and also lower than in most of the EU countries with large financial problems, such as Ireland, Spain and Portugal.

A moderate growth is projected for business investments in 2013, followed by a larger growth next year. The slight increase for 2013 is due to the projected gradual improvement in the economy over the course of the year. As world trade and domestic production are thought to recover in the coming year, investments in 2014 are projected to increase by 2¼%. Given the relatively low usage of production capacity, investments in 2014 are expected to increase particularly through the replacement of outdated capital goods.

The situation on the housing market remains problematic. Real house prices have dropped since 2008 by 23%, but not by as much as in other countries following a financial crisis (see text box). Although house prices have stabilised or even increased in Belgium, Germany and France, they have greatly decreased in many other eurozone countries (and outside the EU, such as in the United Kingdom, United States and Japan). In Ireland (-47%) and Spain (-32%) the decrease was a correction on overproduction during the period up to late 2007. In Greece, the severe economic crisis has caused house prices to drop by around 32%. In Italy, house price decreases have been comparable to those in the Netherlands. Decreasing house prices lead to a negative wealth effect on consumption and to decreasing investments in housing. As was the case last year, also this year, Dutch housing investments are projected to decrease under the influence of a continually dire housing market situation. Because of the slight economic improvement, housing investments for next year are projected to show a small increase.

A moderate recovery is projected for the Dutch export of goods for this year and next year. The main explanation for this recovery would be the moderate growth projected for the European economy, as the main focus of the Dutch export is on Europe. Because of low consumer spending, the growth volume of imported goods lags behind that of the exports. This leads to an increase in surplus on the Balance of Payment of 8¾% of GDP in 2013 and 9% in 2014.

Labour demand declines, unemployment increases

The fragile economic recovery in the second half of 2013 and in 2014 will not have an immediate effect on the labour market. Employment, in labour years, which has a delayed response to production, continuous to decline during both of these years.

Labour supply, meanwhile, will continue to increase although this growth will level off. In 2011 and 2012, labour supply particularly grew because of the increased participation of people over 55 years of age and, to a lesser degree, of young people between the ages of 15 and 24. The increased participation of older people may be explained by the fact that their retirement age has increased, and by a delayed effect of the increased labour participation by women in the past. A relatively small share of the labour supply is expected to withdraw over the course of 2013 and 2014 due to the situation on the labour market, as growing unemployment reduces people's chances of finding a job. Unemployment among young people increased the most, over the past 18 months. Their share in the total group of those unemployed, however, has remained similar to that of 2008.

Table 1.1 Main economic indicators for the Netherlands, 2009–2014

	2009	2010	2011	2012	2013	2014
	annual mutations in %					
International economy						
Relevant world trade	-12.9	11.3	4.0	0.5	2¾	5
Price level imported goods	-8.5	7.3	4.9	2.6	-1¼	¾
Competitor prices	-4.3	7.9	6.3	2.4	-½	¾
Oil prices (Brent. USD per barrel)	61.5	79.5	111.3	111.7	109	109
Euro exchange rate (USD per euro)	1.39	1.33	1.39	1.29	1.31	1.31
Long-term interest rate in the Netherlands (in %)	3.7	3.0	2.9	1.9	2.0	2.3
Volume of spending and foreign trade						
Gross Domestic Product (GDP)	-3.7	1.6	1.0	-0.9	-½	1
Household consumption	-2.1	0.3	-1.0	-1.5	-1½	¼
Government spending	4.9	0.3	-0.6	-0.2	-¼	½
Gross business investments (excluding housing)	-15.7	-5.2	10.2	-2.5	½	2¼
Export of goods (excluding energy)	-9.7	13.5	4.3	2.2	3¼	5
- of which domestically produced	-8.7	9.7	3.8	-0.3	2½	3¾
re-exported	-10.6	17.0	4.7	4.5	4¼	6
Imported goods	-9.4	12.2	4.1	3.4	2	4½
Prices, wages and purchasing power						
Price level exported goods (excluding energy)	-5.5	4.3	1.4	0.6	-¾	¾
Price competition position (a)	3.7	2.3	0.9	1.9	½	¼
Consumer Price Index (CPI)	1.2	1.3	2.3	2.5	2¾	2
Contract wage private sector	2.7	1.0	1.4	1.7	1¾	2
Wage rate private sector	2.2	1.7	2.1	2.2	2¼	2¾
Purchasing power, static, median all households	1.7	-0.5	-1.0	-2.5	-1¼	¾
Labour market						
Labour force (persons)	0.7	-0.3	0.0	1.5	¾	¼
Working population (persons)	0.1	-1.0	0.0	0.6	-¼	¼
Unemployed labour force (in thousand persons)	327	390	389	470	560	575
Unemployed labour force (in %)	3.7	4.5	4.4	5.3	6¼	6½
Private sector (b)						
Production	-5.6	1.1	1.4	-1.8	-½	1¼
Labour productivity	-3.5	2.9	1.0	-1.4	½	1½
Employment in labour years	-2.2	-1.8	0.4	-0.4	-1	-¼
Price gross value added	3.3	2.0	0.3	1.7	0	1¼
Real labour costs	-1.1	-0.3	1.8	0.5	2¼	1½
Labour income share (in %)	80.8	78.7	78.7	80.4	81½	81¼
Public sector						
EMU balance (in % GDP)	-5.6	-5.1	-4.5	-4.0	-3.3	-3.4
EMU debt (in % GDP)	60.8	63.1	65.5	71.4	74.0	75.0
Public financial burden (in % GDP)	38.2	38.8	38.4	38.8	39.9	40.1

(a) Competitor price minus the export price of domestically produced goods.
(b) Businesses excluding health care, mineral extraction and the real estate sector.

On balance and particularly in 2013, unemployment (international definition) will grow rapidly from 5.3% of the labour force in 2012 to 6¼% in 2013 and 6½% in 2014. The decline in employment will decrease in 2014 due to increased production. The growth in labour supply in that year is also projected to level off. This causes the increase in unemployment in 2014 to be relatively limited.

Wages, prices and purchasing power: Light at the end of the tunnel?

Wages are particularly under pressure this year, because of economic contraction and the situation on the labour market. For all sectors, contractual wages will increase less than the inflation rate (by just 1¾%) in 2013, and for 2014 they are expected to increase in the private sector by 2%, which is an increase that equals inflation. Production and labour productivity are projected to increase slightly, although the increase in labour productivity remains moderate, from a historical perspective. Moreover, business profitability this year will be on an average level. A higher real wage development would put pressure on profits and employment.

Rent increases in 2013 – despite recent regulatory adjustments – will continue to exert an upward pressure on inflation, as will the increase in the Dutch VAT rate (BTW) and in the insurance premium tax. The inflation rate will be 2¾%, 1 percentage point of which can be attributed to policy. Next year's inflation of 2% will thus be lower than in 2013, among other things because there is less upward pressure related to policy.

Figure 1.3 Median purchasing power mutation for all households positive again after 4 years

Projected development in purchasing power for 2013 clearly shows that increases in contractual wages lag behind inflation (Figure 1.3). Median static purchasing power in 2013 will decline for all households for the fourth consecutive year, by 1¼%. This decline will be the largest for pensioners, followed by benefit recipients and the employed. For next year, median purchasing power is projected to increase (by ¾%) for the first time since 2009, particularly because real wage levels will have ceased to decline. Those employed will benefit from the increase in the maximum Working Tax Credit of 250 euros. Purchasing power of pensioners appears less positive for next year, as supplementary pensions are expected to be cut further.

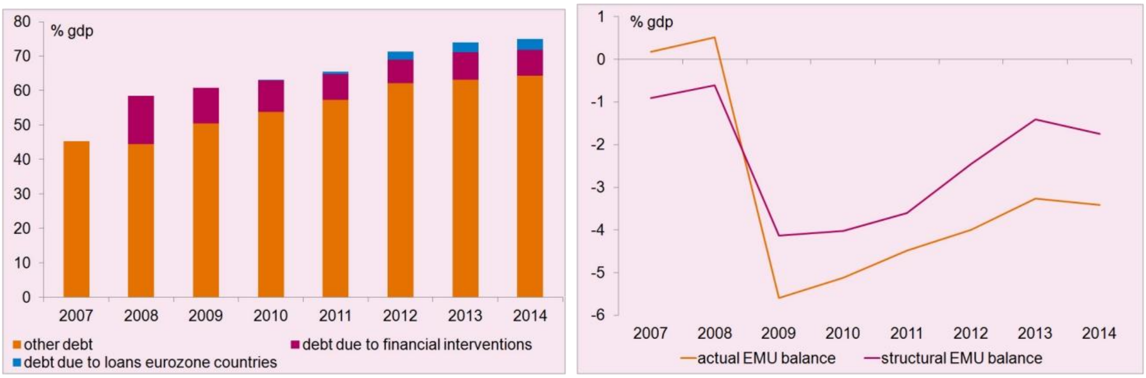
Government finances continue to be an issue

The Dutch national deficit is projected to decrease from 4.0% of GDP in 2012 to 3.3% in 2013, followed by a slight increase in 2014 to 3.4%.[1] The reduction in the deficit between 2012 and 2014, despite a negative economic situation, will be achieved through an accumulation of sizeable spending cuts and tax increases. Public spending in 2014 is projected to remain more or less unchanged, compared to 2012, at around 50% of GDP, while the tax and premium burden will increase from 38.8% to over 40% of GDP.

In 2009, the European Commission started an excessive-deficit procedure against the Netherlands (and 13 other Member States), as it had exceeded the Maastricht cap of 3% of GDP. In 2013, the Netherlands is obliged to reduce its deficit to a level below 3%, in a 'credible and sustainable manner'. On the basis of current projections, this will not be achieved in 2013 or 2014, despite the implementation of stringent, deficit-reducing measures. The Netherlands is not the only eurozone country with problems to bring its national deficit to a level under the cap of 3% of GDP.

Exceptional factors will have a substantial impact on the national budget of 2013. The auctioning of telecom frequencies will deliver a one-time yield of 3.8 billion euros. This amount is being countered by the one-time costs involved in the nationalisation of the Dutch bank SNS REAAL, with a negative impact of 3.5 billion euros on the EMU balance. Crisis-related dividend payments by the Dutch central bank, *De Nederlandsche Bank*, are projected to have a positive impact in 2013 and 2014, as will the one-off resolution levy on banks in 2014.

Figure 1.4 National deficit (left) and the structural and actual EMU balance (right)



The structural national deficit (Figure 1.4, right) will be reduced in 2013, followed by a slight increase in 2014. The national debt (Figure 1.4, left) is projected to increase further, to 75% of GDP in 2014, thus increasingly exceeding the Maastricht standard of 60% of GDP. The national debt increases as a result of the continuing deficit, and of financial transactions. The

[1] This does not include the preliminary package of policy measures of 1 March 2013 (Ministry of Finance, 2013, Response to CPB results, parliamentary letter of 1 March (in Dutch)). On the basis of discussions in the House of Representatives and with social partners, The Dutch Cabinet is expected to present a final supplementary package of measures at the end of April.

nationalisation of the SNS REAAL bank increases the national debt in 2013 by 9 billion euros. In addition, the so-called denominator effect also plays an important role.

Independent economic projections and monitoring of budgetary regulations

In response to the euro crisis, emergency measures were taken by the ECB, banking reform was initiated on a European level, a Macroeconomic Imbalance Procedure was introduced and existing European budgetary regulations were revised. This last response particularly concerns secondary legislation that was adopted in 2011 ('six pack'; a), the agreement on Stability, Coordination and Governance in the Economic and Monetary Union ('fiscal compact'; b), and secondary legislation that was completed in February 2013 ('two pack'; c). This agreement was implemented on 1 January 2013 in 11 eurozone countries, but to date has not been approved in the Dutch Parliament.

Part of the revision of the European budgetary regulations included the obligation to incorporate these regulations into national legislation and procedures, in order to improve compliance. The main obligation is that of laying down in legislation, preferably in the constitution, the aim for budgetary balance, which is part of the Stability Pact and the Fiscal Compact. In addition, Member States are required to appoint an institution that will draft or at least assess independent macroeconomic projections for the budgetary process. Furthermore, Member States must also appoint an independent body to assess whether the budget complies with European numerical budgetary regulation on national deficit, national debt and public spending.

In the Netherlands, these regulations will be incorporated in national law in the Sustainable Public Finances Act (d) currently presented for discussion in the Dutch House of Representatives. This piece of legislation is to ensure that the adoption of a structural budgetary policy takes into account the standard for the medium to long-term objective, as set by EU institutions, for the structural EMU balance (currently with a range of +0.5% to -0.5% of GDP). In addition, the so-called Hof Act states that the independent macroeconomic projections used in the budgetary process are to be made by the CPB Netherlands Bureau for Economic Policy Analysis, and that the Dutch Council of State will monitor whether the draft budget complies with numerical regulations. The Council of State also assesses the reform programme that the government is obliged to submit in case the budget is no longer in compliance with the numerical regulations.

For the CPB Netherlands Bureau for Economic Policy Analysis, the parliamentary approval of the Hof Act is the first legal record of its role over the past decades as producer of the independent economic projections as used in the budgetary process (e). In addition, in each of its Central Economic Plans and Macroeconomic Outlooks, CPB also indicates whether or not the national budget – in view of the presented economic situation together with current government policy assumptions – is compliant with numerical spending regulation (framework assessment) and, when applicable, numerical deficit regulation. CPB intends to continue this practice and supplement it with assessments of other numerical budgetary regulations (e.g. on national debt) as soon as these become operational.

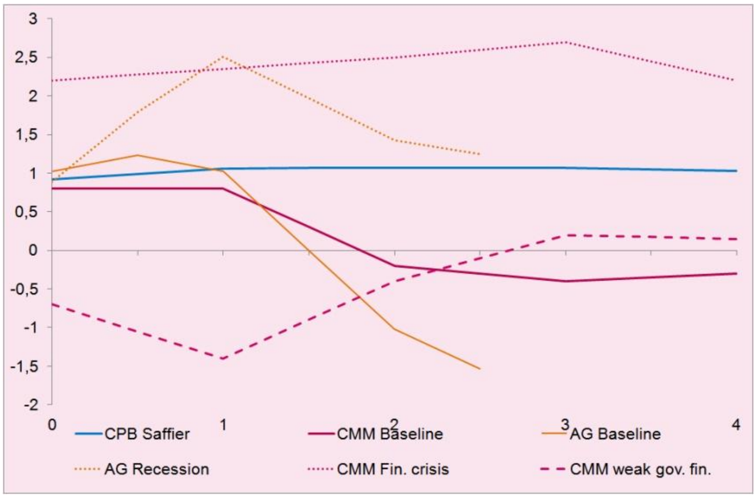
(a) Of the 'six pack' and with regard to this text box particularly relevant is the *EU Directive on requirements for budgetary frameworks of the Member States* (2011/85/EU). In December 2012, the European Comission concluded that progress on the national implementation was 'substantial but oneven'. See also European Commission, 2013, *Interim Progress Report on the implementation of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States*, Occasional Paper 128. There will be European countries in which one and the same institute works on the independent macroeconomic projections and also assesses whether the national budget complies with the numerical budgetary regulations.
(b) The draft agreement (in Dutch) was presented to the Dutch House of Representatives in February 2012.
(c) Of the 'two pack', particularly relevant is the draft directive on monitoring and assessing draft budgetary plans.
(d) Ministry of Finance, 2012, draft regulation on the sustainability of public finance (Hof Act), September (in Dutch).
(e) Also relevant to the independent position of CPB is the regulation by the Dutch Prime Minister, the Minister of General Affairs, on the government regulation for policy-analysis agencies, February 2012 (in Dutch).

1.2 Discussion

The Dutch economy – and that of Europe – again, has not achieved the previously expected level. Currently, even the German economy is being affected by the European stagnation. Evidence that this would also be due to the implemented budgetary policy is mounting. The multiplier shows the impact of the spending cuts on GDP. A multiplier of 1 means that every euro that is cut in the short term also costs one euro in GDP.

Figure 1.5 shows multipliers from two recent studies. The figure shows the effect on GDP in subsequent years if in year 0 government spending is increased by 1% of GDP. Auerbach and Gorodnichenko (2012) show that the multiplier depends on the economic situation[2] and that it is higher in times of recession than under usual economic conditions. During a recession, the multiplier is larger than 1 (the yellow dotted line).

Figure 1. 5 Budget multipliers higher in times of recession[3]



Corsetti *et al*. (2012) made a similar analysis, but with the focus not on the impact of recession but on whether or not a country is dealing with a banking crisis.[4] Results are comparable: a banking crisis also leads to a higher multiplier. However, if a country is in a public finance crisis – which is apparent from a substantial increase in the interest rate on national debt – the multiplier drops sharply and even becomes negative. The solid blue line in Figure 1.5 shows the multiplier for an impulse in material public spending according to the CPB model (Saffier).[5] This line corresponds rather well with the baseline scenarios by Auerbach and Gorodnichenko and Corsetti *et al.* (the figure's solid yellow and purple lines).

[2] Auerbach, A. and Y. Gorodnichenko, 2012. Fiscal Multipliers in Recession and Expansion, NBER Chapters, to be published in: Alesina, A. and Giavazzi, F., Fiscal Policy after the Financial Crisis, University of Chicago Press.
[3] CMM = Corsetti, Meier and Müller (2012), AG = Auerbach and Gorodnichenko (2012). The impulse for material public consumption occurs at time 0. The indicated timeline is in years.
[4] Corsetti, G., A. Meier and G. Müller, 2012. What determines government spending multipliers? *Economic Policy*, vol. 27(72), pages 521–565, October.
[5] Verbruggen, J., H. Kranendonk and B. Smid, 2010. SAFFIER II: 1 model for the Dutch economy, in 2 capacities, for 3 applications, CPB Document 217 (in Dutch). The multiplier for increases in financial burden for the short term, incidentally, is lower than for material public spending, as is indicated by the variants in this document. This causes the average multiplier for a package that includes increased financial burdens also to be lower.

These results are supported by a recent IMF analysis, see Blanchard and Leigh (2013).[6] They show that there is a connection between, on the one side, the projection errors studied by IMF, EC, OECD and EIU (Economic Intelligence Unit) on the GDP growth for several countries and, on the other side, the degree to which these individual countries had implemented spending cuts. The greater the spending cuts, the larger the overestimation of growth. Blanchard and Leigh found a difference for 2010–2011 of between 0.5 and 1, the difference between the high multipliers in times of crisis, such as have been found by Auerbach *et al. a*nd Corsetti *et al.,* and the average multiplier of around 0.5 as it is commonly used.[7] Incidentally, for later years, the difference becomes smaller. The difference is high, particularly, for countries with an interest rate that is close to zero. This prevents a surplus in savings from being solved by lowering interest rates and, therefore, leads to a decrease in GDP (the so-called liquidity trap). The IMF research also indicates that the multiplier for cuts in public spending under current circumstances is higher than 1. The CPB model, thus, appears to overestimate the multiplier in times of public finance crisis (the dotted purple line), and to underestimate it in times of serious recession or banking crisis (the yellow and purple dotted lines). Further research over the coming years could provide additional clarity about the influence of economic circumstances on the level of the multiplier.

Public debate commonly claims that the impact of spending cuts in small, open countries are less significant because of these effects leaking away to other countries. Qualitatively speaking, this reasoning is sound, but, from a quantitative perspective, the small-country effect is not the decisive factor. This has become apparent from various data. To begin with, the multipliers as arrived at in the studies discussed have been estimated on the basis of data on a group of countries, mostly OECD member countries. Within this group, the Netherlands does not fall into the category of small countries, but is of a clear medium size.[8] Results, therefore, are very applicable to the Netherlands. In second place, at CPB's request, the IMF has repeated its analysis of projection errors while taking the difference between small and large countries into account. The small-country effect implies that projection errors are smaller for small countries, as the negative effects of spending cuts leak away to other countries and thus do not translate into lower GDP. However, the IMF has been unable to find empirical evidence for this effect. In third place, the amount of spending that occurs within a country's own borders may be calculated on the basis of input–output tables per country. For the Netherlands this is 74%, for the larger country of Germany it is 82% and for the smaller country of Belgium it is 72%.[9] The small-country effect thus is clearly visible, but even in Belgium most of its consumer spending takes place within its national borders, although these data concern averages over the total consumption. The largest share of last-

[6] Blanchard and Leigh, 2013. Growth forecast errors and fiscal multipliers, IMF Working Paper 13/1. The IMF has a relatively bad score (a difference of more than 1), and the OECD has a relatively good score (0.5).
[7] Idem, p. 19.
[8] For example, Corsetti *et al.* based their research on 17 countries; 8 smaller and 8 larger than the Netherlands. The smaller ones are: Belgium, Denmark, Finland, Ireland, Norway, Austria, Portugal and Sweden. The larger ones: Australia, Canada, France, United Kingdom, Italy, Japan, Spain and the United States. This research approach teaches a more general lesson. Traditionally, macroeconomic models were estimated on national data. However, this would provide insufficiently detailed information, as many of these countries did not experience a major banking crisis in the sample period. These days, therefore, such models are often estimated on the basis of data on multiple countries.
[9] Calculated on the basis of recent IO tables of the WIOD.

earned euros is being spent on imported goods, and therefore spending on national consumption is lower. Precise data on the latter are not available, but estimations indicate that this could be around 10 to 30 percentage points lower.[10] In short, over half of each marginal euro is being spent nationally.

Public debate also assumes that the Netherlands must implement spending cuts quickly, in order to retain the financial market's confidence. This confidence plays a vital role in the economy. Research clearly has shown that a high national debt is bad for economic growth[11] and that multipliers are lower for countries with a high national debt.[12] The increasing national debt in the Netherlands, therefore, is a point of concern. However, financial market confidence is high in the Netherlands, and CDS risk premiums on national debt for Germany and the Netherlands are more or less similar. This has to do with the good reputation of the Netherlands in the field of economic and budgetary policies and especially with the Dutch pension wealth, which provides financial markets with the assurance that the Netherlands will be able to repay its debts. This confidence only would be undermined if the country continues to experience low economic growth and falling house prices.

At the request of the CPB Netherlands Bureau for Economic Policy Analysis, and in addition to the analysis of the errors on GDP projection, the IMF has also analysed those on the national deficit. The question of whether those projection errors have a systemic relation to the magnitude of the implemented national spending cuts was answered positively. The IMF overestimates the effect of one euro in spending cuts on the national deficit in current times, by about 50 euro cents. As the IMF, in its projections, already had taken into account that one euro in spending cuts would reduce the deficit by less than one euro, the effect of additional spending cuts on the current actual deficit will be only marginal. Spending cuts, in the short term, thus, barely have an impact on the deficit, but do have a negative effect on GDP – causing the debt, as a percentage of GDP, to increase.[13] DeLong and Summers (2012), therefore, could be right in their statement that spending cuts, in the current situation of rising unemployment, low interest rates and problems in the banking sector, in the short term, will have little result.[14]

The consequences of the problems on the housing market have not been taken into account in the analysis discussed. Decreasing house prices have large macroeconomic consequences.[15] Therefore, following the Great Recession, unemployment in the Netherlands initially remained within limits, while in Denmark it began to rise immediately. In Denmark, house prices dropped sharply, straight away, but in the Netherlands this process did not really accelerate until during the course of 2012. Around half of the lagging Dutch

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[10] For the calculations, see the CPB Memorandum 203 .
[11] Kumar M.S. and J. Woo, 2010. Public Debt and Growth, IMF Working Paper 10/174.
[12] Nickel C. and A. Tudyka, 2013. Fiscal Stimulus in times of High Debt; Reconsidering Multipliers and Twin Deficits, ECB paper 1513.
[13] Let's assume the debt rate equals 70%, and that 1% of GDP in spending cuts would lower the deficit by 0.5% and GDP by 1%. Then 1% in additional spending cuts would increase the debt rate by 0.2% which is the sum of 70% x 1% = 0.7% because of the lower GDP and -0.5% by the direct impact of the lower deficit.
[14] J. Bradford DeLong and L.H. Summers, 2012. Fiscal Policy in a Depressed Economy.
[15] See Bénetrix, Eichengreen and O'Rourke, 2012. How housings slumps end, Economic Policy pp. 647–692; Mian and Sufi, 2012. What explains high unemployment? The aggregate demand channel, NBER working paper 17830; Case, Quigley and Shiller, 2012. Wealth Effects Revisited: 1975–2012, NBER working paper 18667.

consumption in relation to GDP, since 2008, may be explained by the decreasing house prices.[16] Little is known about the effect of these decreases on the multiplier.

Although economic research will always leave some room for diverging interpretations of results, there is a fair amount of consensus within the international macroeconomic community on the above analysis of the multiplier. This begs the question of why the analysis does not appear to have any consequences for policies implemented in Europe. The broad answer to this question is fivefold.[17]

In the first place, economic science itself has failed. Economists argue that in times of large national deficit policymakers should not immediately begin to cut costs, but rather should implement structural measures that will restore the budgetary balance in the long term. This recommendation defies common sense. Policymakers, therefore, respond by asking the economists the obvious question: If we should not address these problems today, then why would we feel obligated do so tomorrow? Will this tomorrow ever come? Economic research does provide reasonable insight into the level of the multiplier, but there is no satisfactory approach yet for the consequences of this research for the timing of the – in themselves inevitable – adjustments[18]. Currently, there is no clear budgetary policy regulation as there is for monetary policy.

Second, many policymakers still have vivid memories of what went wrong in the 1970s, when for many years growth prognoses were too positive, causing government finances in the 1980s to get out of hand. They fear a repeat of that scenario. However, in those days, wage levels were too high and benefits too generous, and profits were lousy. The Netherlands does not have these types of problems today. In a banking crisis, on average, countries loose between 6% and 10% of their national income over a relatively short time. After a time, however, growth is usually restored to its previous level.[19] The main exception to this rule would be Japan, where, to date, growth levels have remained low, following the banking crisis of 1990. But this fact can be explained by a number of policy mistakes; attempts to balance the national budget were too abrupt and without restoring the banks' own financial situation.[20]

Third, politicians are uncomfortable with campaigning for *fewer* spending cuts. This is an international phenomenon that exists in all established democracies,[21] as voters mostly prefer politicians that would focus on balancing the budget. The most recent Dutch elections

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[16] See the CPB Note, 2013 (in Dutch) on the Dutch housing market – mortgage interest rate, house prices and consumption.
[17] C.N. Teulings, 2012. Why do politicians prefer austerity to long-term structural reform? in: Government designed for new times, A Global Conversation, McKinsey&Company.
[18] See L. Eyraud and A. Weber, The challenge of Debt Reduction during Fiscal Consolidation, IMF Working Paper 13/67, for a first attempt to fill this gap.
[19] See p.140 of the CPB Central Economic Plan 2009 (in Dutch).
[20] Richard Koo, 2008. The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession, New York, Wiley.
[21] See Brender, A. and A. Drazen, 2005. Political budget cycles in new versus established democracies, *Journal of Monetary Economics*, vol. 52(7): 1271–1295; and Brender, A. and A. Drazen, 2008. How Do Budget Deficits and Economic Growth Affect Re-election Prospects? Evidence from a Large Panel of Countries, *American Economic Review* 98(5): 2203–20. They define established democracies as countries that, from 1960 onwards, have scored higher than 0 on an index of democracy characteristics.

also showed that the traditional distinction between left and right, in this respect, has lost much of its meaning.

Fourth, politicians are more likely to implement sizeable spending cuts if there is a commonly shared sense of crisis within society. Recent Dutch experiences confirm this image. In 2006, when the economy still looked fine, the newly installed Balkenende–Bos Cabinet wanted to close only part of the sustainability gap. In the current, difficult circumstances, consecutive cabinets have achieved a sustainability surplus within only a small number of years. Apparently there is some truth to the saying '*Never waste a good crisis*'.

The fifth and final reason why Europe is ignoring the advice of the international economic community is its own disunity. Right at the time when a common macroeconomic policy is badly needed in order to survive this crisis, Europe is deeply divided. A European decision-making structure, needed to design such policy, is lacking. Instead, each Member State is actively trying to ensure it will not have to contribute more than a reasonable share to the solution of the crisis. Thus, decisions continue to be postponed, ultimately resulting in an ever-increasing bill.