CPB Netherlands Bureau for Economic Policy Analysis

Macro Economic Outlook 2014

MEV 2014, translation of chapter 1

1 Summary

The world economy is growing only moderately at present, but for next year a slight recovery is projected. Negative and positive risks will be more balanced than projections earlier this year indicated. There are also signs of some economic recovery for the eurozone, and for next year 1% growth is projected, following a decline of ½% this year. The Dutch economy lags behind these figures, with a decline of 1¼% for this year and a slight growth of ½% in 2014. Spending in all areas will contribute to this turn around. Government spending, investments and exports are all projected to increase in 2014. Although consumption will continue to decline, it will be by less than in previous years. The impact of the package of 6 billion euros in austerity measures on economic growth in 2014 will remain limited to ¼%, due to an additional tax relief this year, as well as the way the tax increase designed for 2014. Unemployment will continue to rise, this year to 7% and in 2014 to 7½%. Median purchasing power is projected to decline, for this year as well as next year, because of policy measures and a decline in real wages. This year, the government deficit will drop to 3.2%, after which it will increase slightly to 3.3% next year. Government debt will increase to 76% of GDP in 2014.

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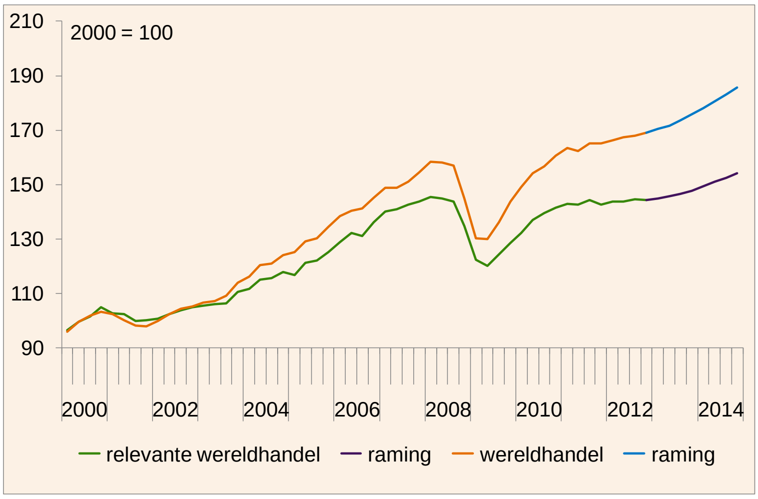
1.1 Summary and introduction

Moderately increasing growth of the global economy, slight recovery in the eurozone

Growth of the global economy is projected to be slightly lower this year than in 2012, but for 2014 it is expected to recover again. Driving force behind this recovery is the economic growth in the United States. For some months now, provisional indicators, such as the OECD's Composite Leading Indicator, are pointing towards increased economic growth, and developments on the labour and housing markets and for private investments are also positive. In Japan, the monetary policy ('Abenomics') that was implemented at the beginning of the year, so far, appears to contribute to a substantial growth in GDP. Early indicators also point to increased growth for Japan, and global GDP growth is projected at 2¾% for 2013 and 3½% for 2014.

Figure 1.1 Volume of international trade



The eurozone's economy is stabilising. Consumer and producer confidence have increased slightly over the past months, and, in the second quarter of 2013, so has the eurozone's GDP. Differences between countries remain large, with positive growth figures in the core countries and continuing recession in those on the periphery. Unemployment levels are high (12.1% in July), but the increase is slowing down. Because of a modest GDP growth in the second half of 2013 and a subsequent acceleration, GDP growth in the eurozone is projected to go from -½% in 2013 to 1% in 2014. Relevant international trade is projected to increase by 1½% in 2013 and 3¾% in 2014.

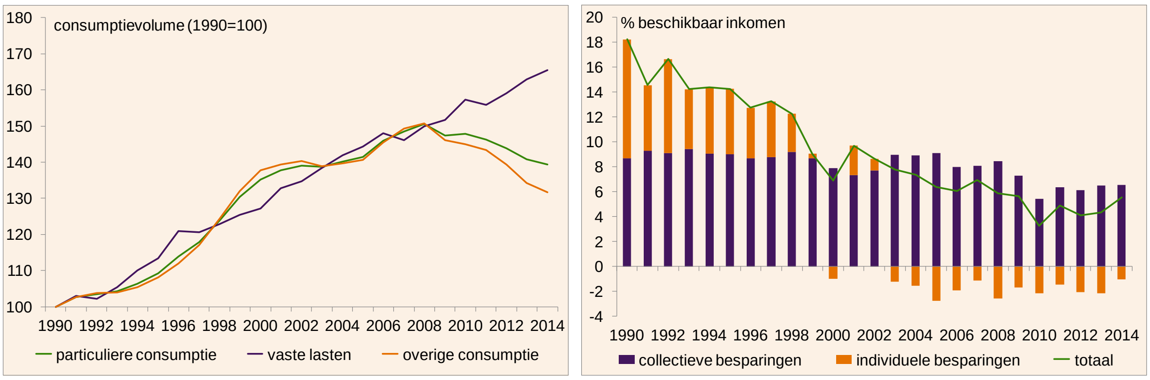
These projections carry the negative risk that transitions towards a less liberal monetary policy in the United States and China may lead to shocks on the financial markets, such as have become apparent over the last months. There is also uncertainty about US budgetary policy as a result of the recurring need to increase their debt ceiling. In Europe, the banking sector remains vulnerable, which leads to real economic consequences related to credit provision. Rising oil prices and negative developments on financial markets in a reaction to the situation in Syria could change the current outlook for the worse. There are also some upward risks: advanced economies could recover at a faster rate than currently expected. This certainly applies to the United States, but also to both the eurozone and Japan.

The Dutch economy lags behind the eurozone

Although the Dutch economy follows the eurozone's economic development, it does lag slightly behind. This year, the Dutch economy is projected to decline by 1¼%, but for next year an economic growth of ½% is expected. After nine quarters, eight of which with negative growth, projections for the second half of 2013 and for 2014 are mildly positive again. All categories of spending are contributing to this turn around. This year, consumption, investments as well as government spending are projected to contribute negatively to GDP development. However, for next year, exports, investments and government spending are projected to increase again. Consumption levels will continue to decline even next year, but at a slower rate than in previous years. Growth in 2014 will be lower than estimated in last June's projections, due to disappointing figures on unemployment and production for the first half of 2013, and because of the impacts of the package of 6 billion euros in austerity measures (see text box). The impact of the package of policy measures on economic growth in 2013 will be -¼%.

Consumption levels have declined since 2008 (Figure 1.2, left) and this decline will persist over the projected period. Disposable household income will decline significantly this year, which will cause a similar decline in consumption levels. The decline in disposable income this year will also have an impact in 2014, causing a slight decline in consumption levels, despite the fact that disposable income levels will see a slight increase next year. Individual savings have been negative since 2003 (Figure 1.2, right). Given the substantial decline in real disposable incomes over the past year, the degree to which people have used (some of) their savings has remained relatively limited. Households are likely to have been reluctant to use some of their savings, as a result of capital losses in privately owned housing and reduced pension entitlements. A large share of the decline in disposable income, therefore, has been addressed through reduced consumption, with households saving particularly on 'other' consumption (Figure 1.2, left). If households would save more (less) than in the current projections, consumption levels will be higher (lower) than currently projected.

Figure 1.2 **Recurring expenses continue to rise, other consumption declines significantly (a) and savings quote shows slight increase**



(a) Consumption volume corrected for the implementation of the Health Insurance Act in 2006.

Table 1.1 Main Economic Indicators, the Netherlands, 2010–2014

	2010	2011	2012	2013	2014
	mutations per year in %				
International economic situation					
Relevant international trade	11.3	4.0	0.7	1½	3¾
Price level importation of goods	8.0	5.1	2.7	-1½	0
Competitor prices	7.9	6.3	4.1	¼	½
Oil price (Brent, in USD per barrel)	79.5	111.3	111.7	105	103
Euro exchange rate (USD per euro)	1.33	1.39	1.28	1.32	1.32
Long-term interest the Netherlands (in %)	3.0	3.0	1.9	1.9	2.4
Volume of spending and international trade					
Gross domestic product (GDP)	1.5	0.9	-1.2	-1¼	½
Household consumption	0.3	-1.1	-1.6	-2¼	-1
Government spending	0.2	-0.6	-0.8	-1¼	½
Gross business investments (excl. housing)	-5.7	12.3	-2.9	-11	1¾
Exportation of goods (excl. energy)	13.4	4.4	1.9	2¾	4¼
of which domestic production	9.5	3.8	0.7	1	3½
Re-exportation	16.9	4.9	3.0	4¼	5
Importation of goods	11.9	4.7	3.6	-¼	4
Prices, wages and purchasing power					
Price level exportation of goods (excl. energy)	4.3	2.1	0.8	-½	½
Competitive pricing position (a)	2.6	-0.2	2.4	½	¾
Consumer price index (CPI)	1.3	2.3	2.5	2¾	2
Contract wages market sector	1.0	1.4	1.6	1½	1½
Wage rate market sector (c)	1.7	1.9	1.7	1¼	3¼
Purchasing power, static, median all households	-0.5	-1.0	-2.5	-1¼	-½
Labour market					
Labour force (persons)	-0.3	0.0	1.5	¾	½
Working population (persons)	-1.0	0.0	0.6	-1	-¼
Unemployed labour force (x thousand persons)	390	389	469	615	685
Unemployed labour force (in %)	4.5	4.4	5.3	7	7½
Market sector (b)					
Production	0.9	1.4	-1.9	-1¾	1
Labour productivity	2.7	1.0	-1.6	-½	1¾
Employment in employment years	-1.7	0.5	-0.2	-1¼	-¾
Price added value	1.9	0.3	1.8	½	1¾
Real labour costs (c)	-0.2	1.6	0.0	¾	1¾
Labour income share (in %) (c)	79.0	79.0	80.5	81¾	81½
Public sector					
EMU balance (in % GDP)	-5.1	-4.3	-4.1	-3.2	-3.3
EMU debt (in % GDP)	63.4	65.7	71.3	75.0	76.3
Collective financial burden (in % GDP)	38.9	38.6	39.0	39.7	40.8

(a) Competitor price minus export price domestically produced goods.
(b) Businesses, excluding health care, mineral mining and real estate.
(c) The wage rates in the market sector, real labour costs as well as the labour income share are calculated to increase for 2014, due to the measure to limit the use of a so-called Stamrecht BV (severance pay insurance fund). Severance payments will be paid directly to the person involved, instead of into such a fund. From a bookkeeping perspective, this translates into a single and incidental wage increase. The economic impact from these payments has been corrected for. Statistics Netherlands is currently studying on how to account for this measure in the National Accounts of 2014. Without this measure, the wage rate in the market sector would have been 2½% in 2014, real labour costs 1% and labour income rate 81%.

The decline in business investments this year will be very large, particularly due to reductions in transport investments. Entrepreneurs, in anticipation of adjustment to the purchase tax on new vehicles (BPM) that came into effect on 1 January 2013, made their transport investments already in 2012. For 2014 a careful recovery is projected for business investments, in relation to slightly improved market possibilities.

The housing market slump will continue, although there does appear to be light at the end of that tunnel. The number of building permits is stabilising, following years of decline, new housing sales are recovering somewhat, and the decrease in the number of transactions appears to be slowing down. In line with these developments, house prices are projected to decline further in the second half of this year, but at a slower pace than before. In addition, house prices are assumed to stabilise next year. Investments in housing are projected to decline by over 8%, similar to last year, but the slightly recovering economy will lead to a small increase in housing investments of 1½% in 2014.

This year as well as in 2014, export growth is projected to remain considerably below the average growth figure of 6% of the past three decades. This year's increase of 2¾% is limited due to the low economic growth in the eurozone and is mostly related to re-export activities. For 2014, export growth is projected to increase to 4¼%, due to the slight recovery of economic growth in the eurozone, reflected by the recovering growth levels in relevant international trade. Export growth is weak, but imports are even expected to decline, this year, due to reduced production levels and strongly declining investments. As a result, the surplus on the current account will surge to a record height of 10% of GDP, both this year and next year.

Inflation (CPI) for this year is projected to come to 2¾%. The rise in value added tax (BTW) of October 2012 has since been fully incorporated in consumer prices. Next year, policy will have a less severe influence and thus inflation is projected to drop to 2%. Both in 2013 and 2014, contract wages in the market sector will increase by 1.5%, more or less equal to wage developments in this year's collective labour agreements. Therefore, contract wages in the market sector are expected to lag behind inflation, both this year and next year, causing real wages to decline in 2014 for the fifth consecutive year.

Further rise in unemployment in 2013 and 2014

During the first half of this year, unemployment increased rapidly – on average, by over 500 newly unemployed people, per day. This rapid increase is caused by a fast growing (net) influx due to lay offs and contract terminations, and because it will remain difficult for new labour market entrants to find employment. The overflowing labour market (few vacancies for many employment seekers) causes the unemployed to experience more difficulties in finding employment. The level of unemployment is higher in these projections than in those of last June. This is caused, in part, by realisations in the second quarter of 2013, in which unemployment increased more strongly than expected. In addition, the policy package of 6 billion euros in austerity measures will lead to a slight increase in unemployment next year.

For this year and the next, the labour market outlook remains bleak. Employment will decline in both years, because of a delayed response to the decrease in production of 2012 and 2013. In particular, because of the decline in employment, unemployment will rise further to an average 7% in 2013 and 7½% in 2014. Labour supply is projected to continue to grow, particularly due to structural growth. For 2014, a turn around in economic labour supply is projected. Because of the substantial rise in unemployment, the low vacancy rate and the declining real wage level, people's search for employment is being discouraged.

Multiannual economic impact of the austerity package of 6 billion euros

The macroeconomic impact of the package of 6 billion euros in austerity measures (a) were calculated using Saffier, CPB's macroeconomic model (b). The calculated impulse provided by the deficit-reducing measures will be less than 1% of GDP (c).

	2014	2015–2017
	% per year, compared to the baseline	
Volume in spending and production		
Gross domestic product	-¼	-¼
Household consumption	-¼	-½
Government spending	-½	0
Business investments	-¼	-½
Exportation of goods and services	0	0
Wages and prices		
Contract wages market sector	0	-¼
Consumption prices	0	0
Labour market		
Employment (employment years)	-¼	-¼
	effect on the end-year level in percentage points, compared to the baseline	
Unemployed labour force	0	½
EMU balance (% GDP)	0.6	0.4
EMU debt (% GDP)	-0.2	-1

Macroeconomic impacts in 2014 will be limited, as GDP growth will finish ¼ percentage point lower. This will mainly be due to less government spending. In the private sector, spending will remain more or less unchanged. This is partly due to the favourable effect of the single reduction in financial burden for employers in 2013. In addition, a substantial part of the package of measures consists of limiting the tax provisions for severance pay insurance. This measure of 2 billion euros barely has an impact on spending (negatively or positively), because it mostly means that future government income from tax revenue will be brought forward. Furthermore, the spending cuts and increases in financial burden in 2014 will have a delayed effect, causing a certain part of the impact to become visible not until in subsequent years. Consumers are assumed to respond to increases in financial burden with a certain delay. Recent years have shown that consumers stop spending a lot sooner when their disposable income is affected (also see Section 1.2 and the text box in Section 2.2). Therefore, there is the negative risk of consumer spending declining in 2014 by more than currently projected.

The EMU balance will improve in 2014 by 0.6 percentage points as a result of the policy package. Because the delayed impact of the measures on the private sector does not begin until in 2014, the impact on the EMU balance will decline after 2014. In 2017, however, the EMU balance is projected to improve again by 0.4% of GDP, and the EMU debt will be lower due to improved EMU balances over the entire period.

(a) See Section 3.3 of this *Macro Economic Outlook*. See also Section 3.2.2. of the *Budget Memorandum*.
(b) CPB, 2010, SAFFIER II: 1 model for the Dutch economy, containing two versions, which can be used in three different ways, CPB Document 217.
(c) The ex-ante impact of the policy package will amount to 5¼ billion euros in 2014. The measure on medications was not included in this calculation, as this windfall had already been incorporated in the projections published before the summer.

Government finances

According to these projections, the government deficit will decline, from 4.1% of GDP in 2012 to 3.2% in 2013 and 3.3% in 2014. These projections include the policy package of 6 billion euros in austerity measures and its delayed macroeconomic impact. Overall, the impact of the policy package on the EMU balance of 2014, including the delayed macroeconomic impact, will be 0.6% of GDP (see text box). All deficit-reducing measures, including this 6 billion euro package, together amount to 12 billion euros. The structural EMU balance will improve from -2.5% of GDP in 2012 to -1.5% in 2013 and -1.4% in 2014.

The government debt is projected to increase in the coming years, from over 71% of GDP in 2012 to over 76% in 2014, further exceeding the debt limit of 60% of GDP set in the Maastricht Treaty. EU regulations require a gradual reduction down to the 60% norm as soon as the Excessive Deficit Procedure now in place for the Netherlands has ended. The government-debt increase is also affected by financial transactions. The takeover of SNS REAAL by the state led to an increase in government debt of 9 billion euros in 2013 (1.5% of GDP). Other financial transactions are projected to only have a limited impact on the government debt of the Netherlands.

Negative outlook for purchasing power

Median static purchasing power is projected to decrease by 1¼% in 2013. Real wage levels will decline by 1¼% due to the fact that the rise in contract wages (with +1½%) lags behind inflation (+2¾%). The decline in purchasing power is the largest for pensioners (-2½%), due to pension cutbacks and no or hardly any indexation of supplementary pensions. In addition, policy in 2013 also has consequences for purchasing power. The further implementation of the Dutch Wage Uniformity Act and the increase in labour deduction both have a positive impact on purchasing power in 2013. Examples of policy measures with negative impacts on purchasing power are the freeze on tax brackets, the increase in the phasing out of labour tax deductions for higher incomes, and the introduction of means tested health care insurance subsidy and child-related budget.

In 2014, median purchasing power will decrease by ½%, and thereby declines for the fifth consecutive year. For the working population, purchasing power in 2014 will remain stable, but for benefit recipients and pensioners it will decline. The decline in purchasing power for pensioners is caused, in part, by the fact that there is hardly any or no indexation of supplementary pension payments, and that sometimes pensions are cut back. Real wages will also decline in 2014; contract wage rises (+1½%) lag behind the inflation level (2%). This decline will be compensated by an increase in labour tax deductions and in general tax deductions, thus ensuring that the median purchasing power of the working population in 2014 will remain the same. Measures with negative impacts on purchasing power are, again, the freeze on tax brackets, a continuation of the income freeze for civil servants[1] and the phasing out of general tax deductions in the second and third tax brackets.

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[1] This measure concerns a limitation to government wage increases by a hold on contract wage development. The Dutch Cabinet has pointed to the option of exchanging a cut down in secondary terms of employment for contract wage increases ('total wage approach'). This type of exchange option, which would depend on negotiations between employers and employees, was not taken into account in the CPB calculations.

1.2 Analysis

Over the last few years (2011–2013), CPB repeatedly has had to make downward adjustments to its previous projections of economic growth. In the same time period, international institutions, such as the OECD and the IMF, also structurally overestimated global economic growth (see also the text box in Section 2.1). Moreover, from a historical perspective, multiannual periods of overestimations or underestimations are by no means unique. Figure 1.3 (left) shows there have been other periods for which projections were too favourable (2001–2003) or unfavourable (1997–2000). The most recent multiannual accuracy analysis has shown that, on average, CPB projections of economic growth were neither overestimated nor underestimated.[2]

Figure 1.3 Projection and realisation of GDP growth[a]

[a] Growth for 2013, based on current *Macro Economic Outlook* projections. The figure on the right compares projections in the Central Economic Plan of the previous year (green bar) with those of the (preliminary) realisation (blue bar). The arrows indicate the subsequent adjustments made to those projections.

What factors have determined the level of adjustment of GDP projections over the last years? The figure on the right provides some insight.[3] It shows not only the projections and realisations, but also the adjustments, had we known the exact level of international trade, decline in house prices and new policies. Policy introduced by the Rutte-Verhagen Cabinet (in 2011) as well as the Budget Agreement (in 2013) both have a limiting effect on consumption, investments, exports, and thus economic growth. The low level of international trade has caused a drop in exports and lower GDP, and lower house prices have led to a decline in household consumption. It goes without saying that we need to make the most accurate projection of international trade and house prices. However, past experience has shown that the uncertainty level of the developments in these variables is large. Projections of policy results are deliberately based on policy proposals and not on new decision-making. These factors, together, may explain around half of the necessary subsequent adjustments to projected GDP growth.

[2] De Jong, J., M. Roscam Abbing and J. Verbruggen, 2010, *Forecasting in times of crisis. CPB forecasts during the great recession* (in Dutch), CPB Document 207.

[3] For the current year of 2013, we have taken current projections and compared these to the initial projections of the CEP 2012. An elaborate explanation of the analysis of the adjustments made in 2011–2013 are presented in the Background document to this Macro Economic Outlook 2014 (‘Accuracy analysis of CPB projections 2011–2013‘ [Trefzekerheid van CPB-ramingen 2011-2013 (in Dutch)].

Not only outside factors, but also the model itself may be a source of error. A model is not a perfect reflection of reality, and this applies especially in times of new economic shocks. Another possible explanation for the adjustments, therefore, could be that the impacts of financial crises have a more long-term effect than the aftermath of a ‘normal’ recession would have. This would be caused be the damage to the capital position of banks and the financial status of businesses and families, with negative consequences for investments and private consumption levels. There are also indications that the impact of loss of capital on private consumption may be larger than currently assumed. An example would be the impact of house prices. Recent research on the United States has indicated that the impact of a decline in house prices on consumption levels is greater than the impact of an increase in house prices.[4] The Saffier model does include such asymmetrical effects for financial wealth, but not for capital assets in the form of houses. This may be partly the reason for consumption lagging behind.

Another additional explanation for the adjustments made to projections is that the multiplier, the impact of policy on economic growth in the first year, is greater during a time of recession that in average times. The economic literature indicates a number of reasons that possibly also apply to the Netherlands.[5] The first reason is the fact that, in uncertain times, households are less inclined to use their private capital to keep their consumption level up to par.[6] In those situations, households are reluctant to use their savings when their income decreases due to an increase in financial burden. A second reason would be the lower lending capacity of banks; in response to a lower income or a lower profit forecast, households as well as businesses are able to borrow less money than they would be in a normal situation and, therefore, they must adjust their level of consumption or investment more severely. A third reason would be that of under-utilisation of the productive capacity, as is apparent from the low rate of capacity utilisation and high unemployment. A reduction in domestic spending in times of economic downturn, because of lower levels of government consumption and a reduction in disposable income, leads to lower production levels and few price adjustments. In times of economic boom, spending cuts lead to less inflation, which in turn causes spending in other areas to increase, both domestic and foreign.

We have underestimated the depth and length of this recession, over the past years. Does this mean that the impacts in the long term also will prove to be negative, or would the positive message rather be that we are overestimating the negative impacts in subsequent years? In the long term, the economy will recover. Long-term growth is determined by structural factors and not by the timing of government spending and taxation. In the meantime, however, a substantial increase in unemployment may also increase unemployment duration.

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[4] Case, K.E., J.M. Quigley and R.J. Shiller, 2013, Wealth Effects Revisited: 1975-2012, NBER Working Paper 18667.

[5] For an overview (in Dutch), see the Background document on frequently asked questions about the budget multiplier (‘*Vraag en antwoord over de Begrotingsmultiplier*’).

[6] The text box in Chapter 2 on adjustments to the consumption projections in 2011–2013 (‘Bijstelling van de consumptieraming in 2011-2013’ (only available in Dutch)) shows that households, in recent years, have been more careful than projections anticipated. In response to the dissapointing level of disposable income and the decrease in house prices, households greatly adjusted their spending patterns. In normal times, a large share of income shocks are absorbed through spending cuts. Over the last few years, however, particularly consumption decreased considerably.

A certain number of people who become unemployed may stay unemployed, also when economic growth recovers. Credit provision may also become subject to such a negative spiral. Because of the low economic growth, banks are unable to sufficiently restore their capital position, and the credit rating of businesses and families continues to be low, causing credit provisions to remain limited, also in the coming years.[7] On the other hand, a faster than projected recovery also cannot be ruled out. The more negative past development, for example, may be attributed to stronger anticipation effects. The impact on economic growth of an increase in financial burden, which will be disappointing in the first year, may be milder in subsequent years. Furthermore, a deep crisis may be the basis of new growth, through *creative destruction*.

The (relative) importance of these factors in the explanation of the overly optimistic projections of the past years is unknown. Since the beginning of the financial crisis, economists have focused, en masse, on these very issues. There has been an exponential increase in the number of publications on theoretical and empirical research into the connection between problems in the financial sector and the real economy, and into the level of multipliers of budgetary policy in various circumstances.[8] CPB faces the sizeable challenge, in the years to come, to discover to which degree the insights from this literature could also be used empirically for the Netherlands, and applied in CPB's own projections, analyses and models.[9]

[7] SER, 2013, The Dutch economy in smoother waters. A macroeconomic outlook (*Nederlandse economie in stabieler vaarwater: Een macro-economische verkenning* (in Dutch)), Report 19 April.
[8] Searching the website of the National Bureau of Economic Research yields 74 NBER working papers published since 1983 with the words 'financial crisis' in the title, 58 of which dated later than September 2008 and 16 from the 24 preceding years.
[9] Commissie Beleidsgerichte toetsing *(Commission on policy-oriented testing*) CPB, 2013, Uit de lengte of uit de breedte (*One way or another* (in Dutch)).

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