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Highlights in this issue:

- **At the start of the crisis the Dutch economy seemed to remain relatively untouched by the overseas problems**
- **Typical Dutch strengths now have turned out to be vulnerabilities in the wake of the crisis**
- **Structurally, the Netherlands is in relatively good shape.**

The Global Financial Crisis and its effects on the Netherlands

*By Maarten Masselink and Paul van den Noord**

Summary[1,2]

With very low unemployment, a large and stable current account surplus, low government debt and a budget in surplus, the Dutch economy was assessed initially to be relatively well prepared to weather the financial and economic crisis. This view was reinforced when the Dutch economy seemed to remain relatively untouched by the overseas problems at the start of the crisis. Economic growth in 2007 remained robust at 3½%, which was above the euro area average of 2¾%. In 2008, however, the negative effects of the financial crisis became more apparent and economic growth came to a grinding halt in the second quarter. And for 2009, GDP growth is expected to come out at -4½%, even below the euro area average of -4% (Commission Services, 2009). This large contraction was not only driven by the strong fall in world trade, but more surprisingly also by negative developments of domestic demand associated with an adverse wealth shock. Specifically, typical Dutch strengths, like its funded pension system and its strong position in world trade, now turned out to be vulnerabilities in the wake of the crisis and have negatively impacted consumption and investment. However, when looking beyond the crisis at structural developments, the Netherlands is still in a relatively good shape, most importantly because of its flexible labour market and limited dependency on foreign capital.

The unfolding of the crisis and the transmission channels

The first signs of the financial crisis appeared in the summer of 2007 in the American financial system. Financial institutions had invested heavily in very risky assets, like subprime mortgages and related products. Moreover, these investments were primarily financed using short-term debt securities. With rapidly rising default rates in the subprime mortgage market, trust within the banking sector declined sharply and suddenly, leading to considerable problems in the market for interbank loans. The subsequent bankruptcy of Lehman Brothers in September 2008 triggered a further confidence crisis in the financial sector. From then on not just the liquidity,

1 With special thanks to Elena Flores, Barbara Kauffmann and Javier Yaniz Igal for valuable comments and suggestions.

2 This Country Focus draws on an earlier article published in Dutch, see Maarten Masselink and Paul van den Noord (2009), "De crisisgevoeligheid van Nederland", *Economisch Statistische Berichten*, No. 4563S, Dossier 'van subprime tot recessie', pp. 4-9.

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but also the solvency of financial institutions was all of a sudden questioned. As a result, banks had to limit their credit supply and the global economy went into recession.

The global financial crisis affected the Dutch economy through dropping demand, bank balance sheet problems and confidence issues.

Much like with previous financial crises, the current one was preceded by a long period of strong economic growth and very high credit growth (IMF, 2008). Optimism was fed by a certain belief that macroeconomic instability was a thing of the past, thanks to improved stock management by companies, increased stability of macroeconomic policies, greater importance of cyclically insensitive services in the economy, like health care, improved portfolio management and increased financial buffers of companies and households (Elmeskov, 2009). Moreover, the high savings surpluses of China, Japan and oil producing countries led to very low levels of the real interest rate, while the low inflation enabled central banks to implement expansionary monetary policy despite high economic growth. The abundant credit growth in the pre-crisis years also was linked to moral hazard problems as banks were considered to have become too big to fail. Furthermore, accounting rules induced banks to improve their balance sheets by including gains from increasing asset prices. Finally, the lack of transparency of very complicated investment constructions, the high bonuses coupled with low risk for top management of banks and the dubious role of credit rating agencies all led to risky behaviour in the global financial markets.

When the housing bubble in the United States burst, this led to widespread trouble in the banking sector because of the high degree of interconnectivity through investments in (derivatives of) each others' products. A subsequent sharp decrease in the supply and a simultaneous increase in the price of trade credit, combined with a weakening demand, resulted in a considerable decline in production and an unprecedented drop in world trade. All these factors also led to historically low confidence levels, both of producers and consumers.

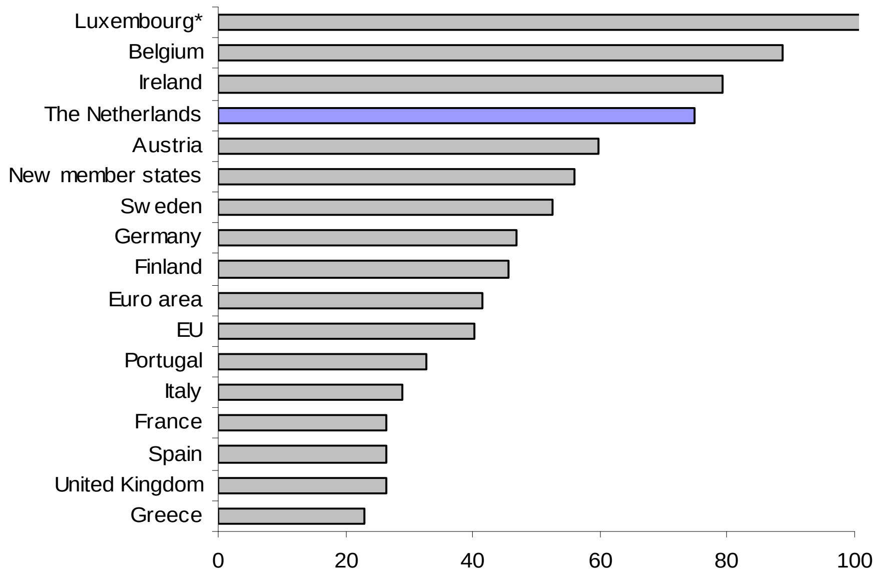
The financial crisis affected the Dutch economy through three channels: plummeting global demand, problems with bank balance sheets, and the decline in producer and consumer confidence. To each of these channels the Dutch economy seems to be relatively vulnerable, compared to other European countries.

World trade

The openness made the Dutch economy vulnerable to the sudden sharp decrease in world trade.

World trade fell by almost 6% quarter-on-quarter in the fourth quarter of 2008, and even by 11% in the first quarter of 2009. Such near collapses are bound to have considerable consequences for export-oriented open economies like the Netherlands.

Figure 1: export of goods and services (% of GDP, 2007)



* Luxembourg stood at 180% and falls outside the scale.

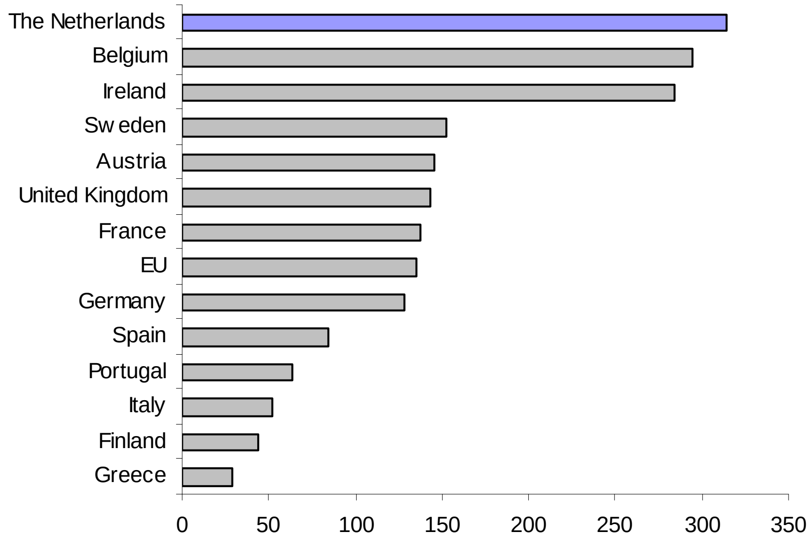
Source: Eurostat

Within Europe, the Netherlands is one of the most open economies (see Figure1). The export of goods and services amounts to about 80% of GDP, which is almost twice the European average. The absolute figures are even more telling: after Germany and France, the Netherlands is the largest exporter in terms of volume. It is therefore not surprising that exports have been an important driver of growth over the past decennia. Given this considerable importance of the external sector for the Dutch economy, it is clear that it will be relatively sensitive to changes in world trade, compared with other European countries. For 2009, exports are expected to decrease by almost 11% (Commission Services, 2009), resulting in a negative contribution to economic growth of over 8%, although the impact of net foreign trade on GDP will be smaller due to the high share of transit trade, which lead to lower imports as well.

Financial sector

The vulnerability of the financial sector to the crisis can be gauged by indicators such as the size and composition of the financial sector, the importance of stock markets and the housing market. Figure 2 shows the consolidated foreign claims of the banking sector at the end of 2007. It shows that at the start of the crisis, no other country within the European Union had a larger foreign claim than the Netherlands in % GDP.

Figure 2: consolidated foreign bank claims (% of GDP, 2007)



Source: BIS

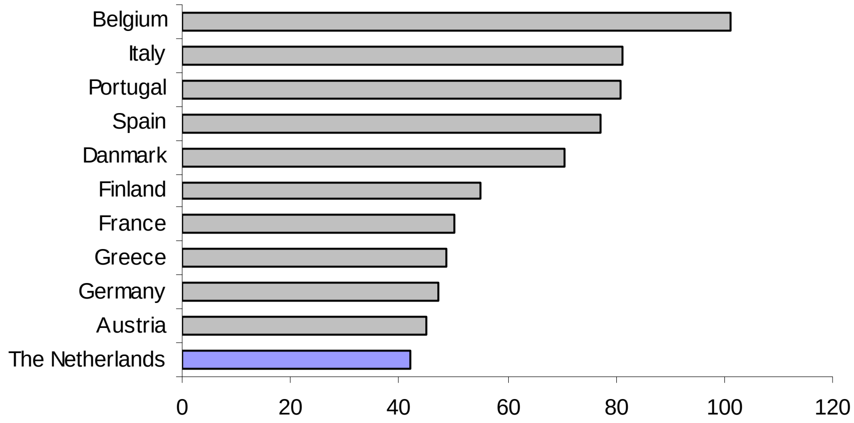
The Dutch financial sector had a relatively large exposure to the American financial markets.

Total foreign claims of Dutch banks amounted to over 300% of GDP. The Dutch financial system therefore depended heavily on external developments. Only the Belgian and Irish banking sectors were in a similar position. The European average was less than half the Dutch figure at 135% of GDP. When looking at the geographical spread of the claims, it is noteworthy that the exposure of Dutch banks to the United States also was the highest in Europe, at 66% of GDP. Belgian and UK banks also had considerable exposure to the American financial markets of around 40% of GDP, whereas the average of European banks had kept limited exposure of less than 30% of GDP. By contrast, the exposure of Dutch banks to hard-hit Eastern European countries was at 11% of GDP just above the European average of 8% of GDP. Mainly Austrian (69% of GDP) and Belgian (25% of GDP) banks had considerable exposure to this region.

Contrary to what the considerable foreign financial exposure would suggest, the value added of the financial sector in the Dutch economy is relatively limited, at 6%, only marginally above the European average of 5½%. The share in the real economy of the Dutch financial sector is therefore not particularly large. Possible negative impacts on the real economy stem mostly from the systemic effects, but these were fortunately mitigated by the government interventions, which prevented bankruptcies that would have led to more significant repercussions for the real economy.

A second important indicator on the impact of problems in the financial sector is the stock market valuation. The financial crisis led to a strong decrease in the stock markets on a global scale. Most European indexes lost about half of their value during the first year of the crisis. The size of the investment in stocks, however, differs strongly. Dutch households only possess a relatively limited amount of stocks, just totalling about 40% of GDP in 2007, which is low in the European context. In Belgium for example, this figure was over 100% of GDP, in Italy over 80% and in both France and Germany around 50% (see Figure 3). However, this excludes the indirect holdings of stocks through occupational pension funds which are very high for the Netherlands. Total assets of these funds reached 130% of GDP in 2007, by far the highest in Europe. This compares with a total wealth of stocks amounting to almost 350% of GDP in 2007 in the Netherlands, which was markedly higher than in other countries. In Belgium, this figure was 250%, in France 230% and in Germany only 190% of GDP.

Figure 3: Households' stock portfolio (% of GDP, 2007)



Source: Eurostat

These pension funds constitute a considerable advantage in view of the ageing population: people are saving now for future pensions. However, the financial crisis had an important negative impact on the pension fund assets, in large part through the stock markets. Over a period of just over a year they lost about EUR 70 billion (twelve percent of GDP) in assets, compared to the record high in 2007. Indirectly, the wealth losses of pension funds are borne by households, through higher premiums or lower pension pay-outs.

Decreases in Dutch household wealth through occupational pension schemes have significant effects on private consumption and therefore also on economic growth. This is evidenced by the private consumption figures of this year. The first three quarters of 2009 all showed negative growth, despite a rise in real disposable income.

The high leverage of the household and corporate sector makes them dependent on credit supply and conditions.

Dutch households are relatively dependent on bank loans. In 2007, total indebtedness of households in the Netherlands amounted to approximately 120% of GDP, whereas in Germany, for example, this figure only reached 64%, in France 49% and In Belgium 47% of GDP. Only Denmark scored higher than the Netherlands at 128% of GDP. Dutch corporations are also relatively dependent on bank loans. In 2007, bank loans to corporations amounted to 83% of GDP, which is much higher than in other European countries. In Germany, France and Belgium this figure is around 60% of GDP. Spain is the outlier in Europe at 115% of GDP. High indebtedness can have a negative effect in two ways. First, it can become more difficult to keep fulfilling debt service obligations if the economic circumstances take a turn for the worse. Second, problems can arise when debt has to be rolled over. Over the past year, Dutch banks have continuously announced further tightening of credit conditions. This undoubtedly complicates the (re)financing of corporations through bank loans. The high dependence of the Netherlands on bank credit makes it relatively vulnerable to changes in the credit conditions.

The financial crisis revealed the overvaluation in the housing market in several European countries. House prices decreased rapidly, in Ireland for example by more than 25% in real terms. In this context, the question arises about the vulnerabilities of the Dutch housing market. A study by the Netherlands Bureau for Economic Policy Analysis (2008) concluded that the overvaluation, which built up in the 1990's, gradually disappeared over the past decade. Since 2000, the development of the housing market has been relatively mild, resulting in a total increase of 28%. However, over the past year, prices have started to come down also in the Netherlands, albeit mildly. At this moment, house prices are about 5% lower than a year ago and a further decrease cannot be ruled out. Downward pressure predominantly stems from increasing unemployment. Uncertainty over future earnings, wealth and expectations on decreasing house prices themselves all have a negative impact on house prices (Van den Noord, 2005).

Confidence

The third channel through which the financial crisis affects demand is via the confidence channel. Dutch consumer confidence followed the European trend until the end of 2008, but showed a stronger decline from the beginning of 2009 onward. Although developments in producer confidence in the Netherlands stayed in line with EU average, the level used to be somewhat more positive than in other European countries in previous years, which implies that the drop was somewhat larger for the Netherlands. The impact of confidence effects on the real economy is not straightforward and it is difficult to determine whether the effects in the Netherlands would be larger than in other countries. A fact is that in any case, both private consumption and investment suffered more in the Netherlands than in other European countries. For 2009, private consumption is expected to decline by 2¾% in the Netherlands, compared to a relatively mild 1% decline for the euro area (Commission Services, 2009). That a part of this decrease can be explained by confidence effects is supported by the fact that, despite some recent positive wealth effects through a rebound in the stock markets and a (tentative) stabilisation of house prices, private consumption still showed a quarter-on-quarter decrease of 0.4% in the third quarter of 2009.

Capacity to recover

The Dutch economy seems to have been highly exposed to the effects of the financial crisis, both in absolute and in relative terms. Some of the main characteristics of the Dutch economy, like the considerable export sector, the internationally oriented financial sector and the vast pension funds caused an increased vulnerability to the financial crisis. The situation after the crisis depends on both the determinants of the recovery and on the capacity of the Dutch economy to recover in structural terms.

A quick recovery in world trade could lead to a quick recovery of Dutch economy in the short-run….

First, the global recovery is a very important factor. A swift rebound in world trade would clearly benefit the Dutch economy. In this respect, the third quarter of 2009 already showed a significant rebound in exports with 2¾% quarter-on-quarter growth. A rebound in the stock market could have a significant positive impact on the Dutch economy. With stock markets at this point in time being about 50% higher than at the start of the year, pension funds have seen a considerable increase in their assets and thus an improvement in their coverage ratios. This could eventually lessen the need for increasing premiums or lower pensions, thereby supporting private consumption.

With respect to the structural aspects related to the recovery capacity of the Dutch economy two factors are of crucial importance: flexibility of the labour market and fiscal space. A highly flexible labour market decreases the chance that rapidly rising unemployment turns into structural unemployment, hindering recovery. An adequate fiscal space has enabled the government to use it as a buffer for bad economic times.

At the start of the crisis, the unemployment rate in the Netherlands was the lowest in Europe at around 3%. Combined with an exceptionally high vacancy rate, which at some point was even higher than the unemployment rate, the labour market was extremely tight. However, it did not lead to excessive wage increases, as labour supply showed a very high degree of flexibility, brought about by the large number of part-time and temporary workers, which were able to quickly adjust supply to new circumstances. A highly flexible labour market ensures a high participation rate and enables a quick adaptation to changing economic situations. On the other hand, the employment protection legislation for fixed contracts is still relatively strict in the Netherlands. Also, over the past years, companies have had difficulties attracting qualified personnel, due to the tight labour market, which could increase the effect of labour hoarding. In the medium- to long-term, however, given the future structural shortage of labour, the labour market should be well equipped to return to lower levels of unemployment.

…supported by a flexible labour market.

Over the years, the general government position has been relatively favourable compared to other European countries. Both the nominal and the cyclically adjusted balance have consistently outperformed the European average. Although this good performance was partially due to increasing gas revenues, it did make it possible for the Dutch government to stimulate the economy by increasing the deficit, be it through the full use of automatic stabilisers, or via discretionary measures. As a result, the government deficit is expected to exceed the 3% of GDP threshold in 2009 and to increase to about 6% of GDP in 2010 (Commission Services, 2009), implying a budgetary easing of almost 7% of GDP in no more than two years. Although this provides a considerable impulse for demand, it also necessitates an important, and painful, budgetary adjustment in the near future. The Council is expected to recommend to the Netherlands to start consolidating in 2011 and to bring the deficit back to below the 3% reference value in 2013, based on a Commission proposal of 11 November.

At the start of the crisis, government debt in the Netherlands was very low. At the end of 2007, the gross government debt level stood at around 45% of GDP, considerably below the European average of 59% of GDP. This relatively good starting position made it possible for the Dutch government to undertake massive operations in order to stabilise financial markets. In total about EUR 90 billion (15% of GDP) was spent on rescue operations. On top of that, the government issued billions of euros in guarantees to the financial sector, which constitute contingent liabilities. At the end of 2009, government debt is expected to be around 60% of GDP and will rise further in the coming years. Debt levels can be brought down to pre-crisis levels by attaining budget surpluses and by recouping (some of) the costs of the financial market interventions.

Besides the budgetary situation, fiscal space is also determined by the current account position. The Dutch current account position has been in large surplus for a number of years. At the start of the crisis, in 2007, a current account surplus of almost 10% of GDP was recorded, among the highest in Europe. Contrary to some other member states, the Netherlands also showed a surplus in the capital balance, limiting the dependency on foreign capital. The current account surplus is currently trending down, but this is mostly cyclical, associated with the collapse in global trade. Over the longer haul the external surplus is likely to persist, owing to the high aggregate savings propensity stemming from the funded occupational pension system.

Conclusion

At the outbreak of the global financial crisis, the Dutch economy was assessed to be relatively well prepared to weather the storm, given its very low unemployment level, large and stable current account surpluses, a low government debt level and, at that time, a budget in surplus. The fact that the Netherlands seemed to remain untouched by the (then) overseas problem, supported this view. Economic growth remained robust and above the euro area average throughout 2007. However, the negative effects of the financial crisis became more apparent in 2008 and economic growth came to a grinding halt in the second quarter. For 2009, GDP growth is expected to show the sharpest contraction ever and to be below the euro area average. In the wake of the crisis, typical Dutch strengths, like the pension system and its strong position in world trade, now have turned out to be vulnerabilities. On the other hand, the capacity of the economy to recover seems to be relatively robust in the Netherlands. It has a highly flexible labour market, a low unemployment and a very high participation rate. Furthermore, the government's budget surpluses of the past years enabled the government to allow the full working of the automatic stabilisers and to implement stimulus measures. Also, the low level of government debt enabled the government to intervene in the financial markets. Furthermore, the considerable current account surplus diminishes the Dutch dependency on foreign capital, making the country less dependent on changes in international capital flows. This does mean, however, that over the coming years a considerable fiscal adjustment will have to be made, not least to address the rising fiscal cost of ageing and the cost of bank rescues, while occupational pension funds will have to recover their losses or adjust contribution and benefit rates. Hence, for all its comparative strengths, tough times are ahead for the Dutch economy.

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