



European
Commission

ISSN 1725-3187

EUROPEAN ECONOMY

Economic Papers 465 | October 2012

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balance and net international
investment position

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Economic and
Financial Affairs

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KC-AI-12-465-EN-N
ISBN 978-92-79-22986-2
doi: 10.2765/27352

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The Dutch current account balance and net international investment position

By Windy Vandevyvere

THE DUTCH CURRENT ACCOUNT BALANCE AND NET INTERNATIONAL INVESTMENT POSITION

Windy Vandevyvere¹

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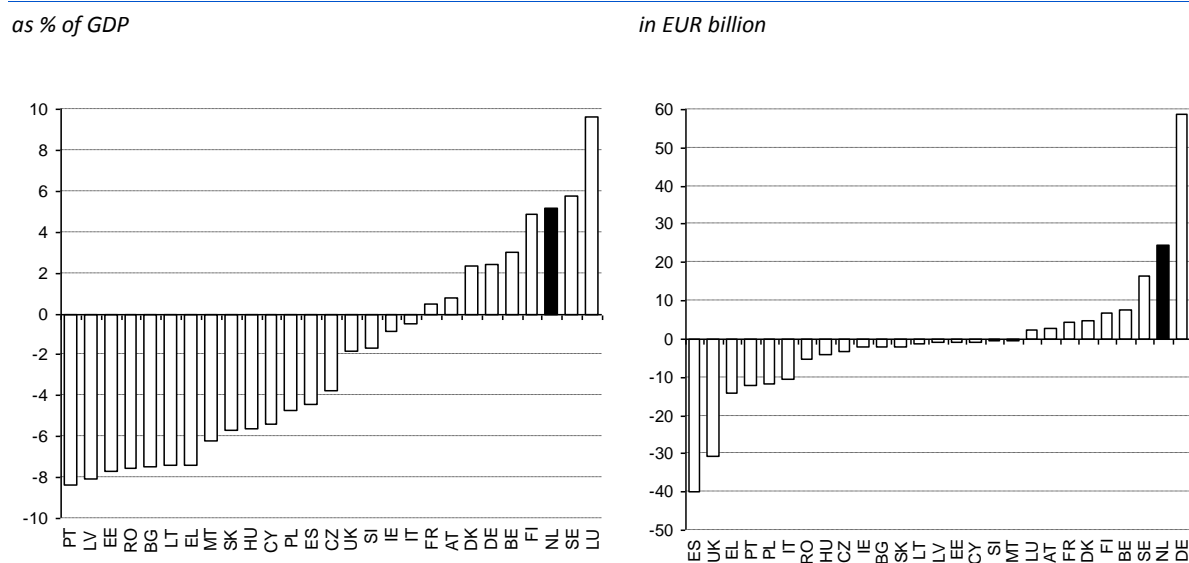
References

¹ This paper was written by Windy Vandevyvere under the guidance of Ronald Albers. Contributions from Davide Balestra, Julien Genet and Andreas Zenthöfer are gratefully acknowledged. A special thanks is due to Mary McCarthy, Johan Baras and Elena Reitano for helpful comments. Suggestions from experts who participated in the country workshop on the Dutch current account, organized by unit F3 of the Directorate-General for Economic and Financial Affairs in Brussels on the 15th of December 2011, are also gratefully acknowledged.

1. Introduction

In the last decade, the current account² of the euro area has, on average, been close to balance. However, on an individual country basis, large differences have prevailed. Measured in terms of 15-year averages, current account positions range from deficits of around 8% of GDP to surpluses of almost 10% of GDP (Chart 1). Recently, Member States with large and persistent current account deficits have been in the spotlight, whereas so far surplus countries have drawn less attention. The Netherlands, whose current account has been persistently in surplus for over three decades and which currently has one of the highest current account surpluses as a percentage of GDP in the euro area, is such an example.

Chart 1: Current account balance by EU member state (1995-2010 average)



Source: Eurostat

The aim of this paper is to shed light on the driving forces behind the Dutch current account surplus from various angles, in order to assess the likelihood of its persistence in the future, but also to detect fundamental strengths and/or vulnerabilities of the economy and to identify policy measures if any are called for. The paper also looks into the mirror image of the current account and the capital account, the financial account, in order to signal a potential accumulation of macro-financial vulnerabilities.

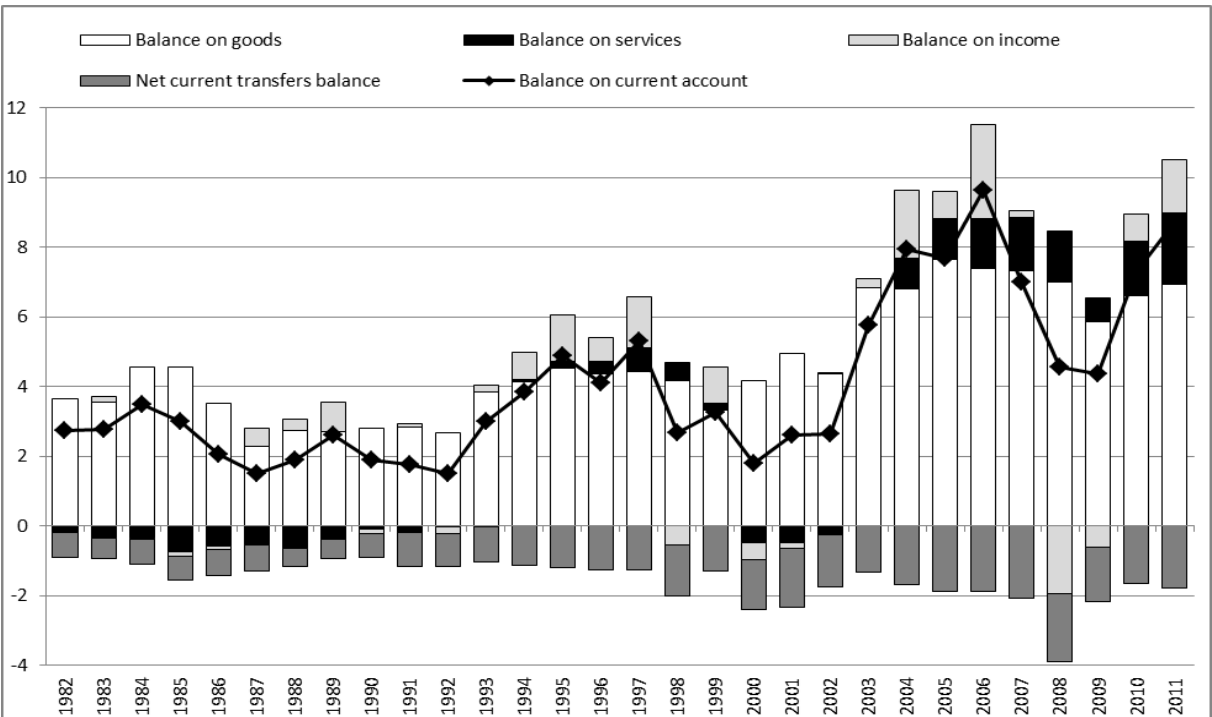
Section 2 sets the stage by summarizing the main characteristics of the Dutch current account, focusing on foreign trade, and looking into the composition of Dutch exports and their competitiveness. Section 3 zooms in on the sectoral savings balances in order to examine to what extent savings and investment decisions of households, firms and the government have been driving the current account surplus. Section 4 looks into the financial account, describing the financial transactions mirroring the current account surpluses. Section 5 then examines the returns on the current account surpluses generated, relating the current account flows to changes in the Dutch net international investment position. Section 6 concludes and adds a few pointers to possible policy implications.

² Together with the capital account and the financial account, the current account makes up the balance of payments, i.e. a statistical statement that summarizes transactions between residents and non-residents of a country during a period. The current account consists of the goods and services account, the primary income account and the secondary income account.

2. The current account balance and an assessment of competitiveness

The Netherlands is one of the most open economies in the euro area. Its trade openness (measured as the sum of imports and exports relative to GDP) increased steadily from 74% of GDP in 1980 to 161% in 2008 (compared to the euro area average of 89% recorded in that year). The shares of both gross exports and imports in GDP have been increasing at a rather similar pace in the last few decades, with the former rising from 37.3% in 1980 to 84.1% in 2008 and the latter from 37% in 1980 to 76.8% in 2008. Due to the recent global economic and financial crisis, however, trade openness declined in 2009 for the first time in almost thirty years. Nevertheless, the Dutch current account balance remained in firm structural surplus. It averaged around 5% of GDP during the 1990s and increased to some 6% of GDP during the 2000s, reaching a record surplus of 9.3% of GDP in 2006. Thereafter it declined but it has been subject to an upswing in the wake of the financial crisis. In 2010, in line with growing trade volumes, the Dutch current account balance increased to EUR 41 billion (7.1% of GDP) and in 2011 a surplus of EUR 55 billion or 9.2% of GDP was recorded.

Chart 2: Breakdown of the Dutch current account balance in main standard components (% of GDP)³



Source: De Nederlandsche Bank

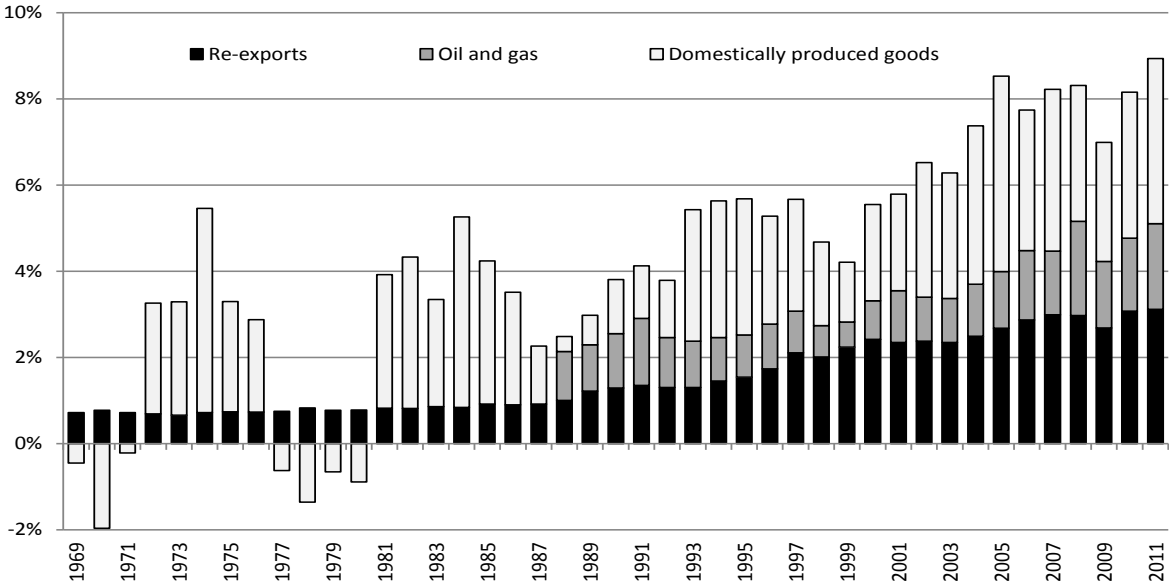
The current account surplus of the Netherlands averaged around 7% of GDP over the past decade, largely owing to the **balance on goods** (which, in value terms, accounts for about four-fifths of the total balance, see Chart 2). The trade surplus of natural gas averages around 1% of GDP, although this is only the lower bound of the overall effect of natural gas provisions. Because parts of natural gas production are domestically consumed, imports are lower than they would have been without the domestic gas reserves. The overall effect can be approximated with reference to the value added of natural gas production, which has been around 2.5% of GDP in recent years. This

³ Including Special Financial Institutions from 1999 on.

suggests that the structural trade surplus would be around 2.5 percentage-points lower when natural gas reserves are depleted, which is expected to happen in around 30 to 40 years.

Apart from a small structural component stemming from the country's resources of natural gas, the positive goods balance increasingly reflects the so-called re-exports, goods which have been imported and leave the country again after no -or virtually no- further processing with relatively low added value⁴; re-exports now account for roughly one half of the Dutch goods balance. As shown in chart 3, the growth of exports of domestically produced goods lagged seriously behind the growth of re-exports (4.2% and 9.2% respectively over the period 1986 – 2006). The spectacular growth of re-exports has been mainly due to a combination of the on-going globalisation and the rise of 'global production chains'. The specific geographical location of the Netherlands (with the port of Rotterdam being the effective trade gateway to Germany) and a competitive transport sector accentuate this development (CPB, 2007).

Chart 3: Trade balance of domestically-produced goods and re-exports (% of GDP)



Source: Statistics Netherlands (CBS)

The **balance on services** had been negative for a few years before turning positive in 2004. The growth in net exports of services reflects in particular the contribution of the non-financial corporate sector (see section 3.2), notably in transportation services (mainly air and sea transportation), but also royalties and license fees, charged by parent companies to their foreign affiliates in exchange for intermediate services, and notably other business services (including "miscellaneous services" between related resident and not-resident enterprises that cannot be specifically classified as services elsewhere⁵). On balance, the share of services in total exports has remained relatively stable (around 23% in 1980 against 24% in 2010, which is slightly above the corresponding euro-area average of 20%).

The **balance on income** covers two types of transactions: compensation of employees paid to non-resident workers or received from non-resident employers, and investment income accrued on external financial assets and liabilities, i.e. income on direct and portfolio investment (such as dividends, repatriated profits, etc.). About

⁴ According to the definition, to count as re-exports the goods in question also have to be owned by a Dutch resident at some point and subsequently by a foreign based person or company. If there is no transfer of ownership at any stage, the goods are deemed to be in transit. Goods are counted as domestically-produced exports if they undergo some processing. Other important re-exporting countries include Singapore, Belgium and Germany.

⁵ Although on net these services do not weigh extremely heavily, they accounted for about 14% of total exports and 15% of total imports in 2010 (CBS: Statistics Netherlands, StatLine: International trade – Imports and exports of services by country).

three quarters of the total balance on income originates in direct investment (see also sections 3.2 and 5). Finally, the **net current transfers balance**, which has been negative throughout the observed period, mainly comprises transfers to the European Union budget.

The merchandise trade balance traditionally has been the main driving factor behind the large current account surplus, and the relative importance of exports of goods has even increased considerably over the last decade. It is therefore key to examine the trade balance, in order to get a grip on the persistent character of the current account surplus. The next section (2.1) focuses on the balance of trade whereas the following ones (2.2. and 2.3) provide an assessment of Dutch competitiveness through examining market shares and relative competitiveness (or real effective exchange rate) indicators.

2.1 PRODUCT AND MARKET COMPOSITION OF DUTCH EXPORTS

The share of overall Dutch imports and exports of goods in world trade has remained relatively stable over the past few decades and even slightly increased from 3.2% in 2000 to 3.4% in 2010 for imports, and from 3.6% in 2000 to 3.8% in 2010 for exports.

Table 1: Composition of gross exports from the Netherlands (2005 – 2010 average; % of total)

| | |
|--|-------------|
| Food | 11.6 |
| of which: Meat | 2.4 |
| Dairy | 1.6 |
| Vegetables and fruit | 3.2 |
| Coffee, thee, cacao, spices etc. | 1.0 |
| Beverages and tobacco | 1.8 |
| Raw materials, inedible, except fuels | 5.2 |
| Mineral fuels, lubricants and related materials | 13.3 |
| of which: Mining and quarrying | 0.3 |
| Oil and natural gas | 9.5 |
| Animal and vegetable oils, lubricants and related products | 0.8 |
| Chemical products | 17.8 |
| of which: Organic chemicals | 4.5 |
| Medicinal and pharmaceutical products | 4.3 |
| Manufactures of textile, wood, paper, rubber, metals, etc. | 9.5 |
| Machinery and equipment | 30.2 |
| of which: Office machinery and automatic data-processing machines | 8.6 |
| Telecommunications and sound-recording and reproducing apparatus and equipment | 5.0 |
| Electrical machinery, apparatus and appliances, n.e.s., and electrical parts thereof | 5.0 |
| Road vehicles (including air-cushion vehicles) | 3.5 |
| Other | 9.7 |
| of which: Clothing and footwear | 1.9 |
| Total | 100 |

Source: Statistics Netherlands (CBS)

A breakdown of gross goods exports by category (Table 1) indicates that exports are concentrated in a few categories notably "machinery and transport equipment" (30.2%), "chemicals and related products" (17.8%), and "crude materials" (13.3%). The high share of crude materials (largely food and oil and gas) can be explained by the fact that the Netherlands is both a producer and an exporter of gas (see above), an importer of crude oil and an exporter of refined oil products (concentrated in the port of Rotterdam). The large share of agricultural produce in merchandise exports reflects the fact that the Netherlands is one of the most substantial exporters of agricultural products worldwide.

Unsurprisingly, the total share of exported goods going to the EU is relatively high, reaching 80% in 2010 (of which, in value terms, almost 60% went to the rest of the euro area, notably Germany 24.3%, Belgium 11.1%,

the United Kingdom 8%, France 8.7% and Italy 5%). The gross trade balance of the Netherlands is significantly positive and increasing with respect to the rest of the EU (16% of GDP), while it is negative with respect to non-EU countries (-10% of GDP), mainly China (Table 2). This is a pattern broadly observed also in other relatively affluent open economies among the countries in the euro area, although there are notable differences depending on the areas of specialisation of these economies. Although the largest share of total Dutch imports comes from the EU (61.8%, of which some 40% in value terms, originated from other euro area countries in 2010) most re-exported goods originate in the USA and Asia, in particular China, and are primarily oriented towards the rest of the EU⁶, which illustrates the role of the Netherlands as a major transit country for global trade and supply chains.

Table 2: Gross trade balance vis-à-vis main trading partners, 2000-2010 average

| Largest bilateral trade surpluses | | | Largest bilateral trade deficits | | |
|-----------------------------------|-------------|-------------|----------------------------------|-------------|-------------|
| | billion EUR | as % of GDP | | billion EUR | as % of GDP |
| Germany | 21.2 | 4.1 | China | -15.0 | -2.9 |
| France | 13.3 | 2.6 | USA | -8.0 | -1.6 |
| Italy | 9.4 | 1.8 | Japan | -5.1 | -1.0 |
| United Kingdom | 9.3 | 1.8 | Malaysia | -3.8 | -0.7 |
| Belgium | 7.0 | 1.4 | Russia | -3.7 | -0.7 |
| Spain | 5.1 | 1.0 | Brazil | -2.8 | -0.5 |

Source: Statistics Netherlands (CBS)

Apart from the product and geographical structure, the relatively stable performance of Dutch exports may also be largely explained by competitiveness once composition effects are accounted for. In Section 2.2, a so-called constant market share analysis, a breakdown regularly used to understand the relative importance of composition and competitiveness effects, is carried out. To complement the analysis, section 2.3 focuses on some other often used competitiveness indicators, in particular relative cost and price indicators (which are conceptually equivalent to some measure of real effective exchange rates (REERs)).

2.2 CONSTANT MARKET SHARE ANALYSIS

The constant market share analysis (or shift-share analysis) -hereafter CMSA- is often used to identify the components of a country's export growth (or market share) that can be attributed to world trade growth, changes in the (product and market) composition of its exports, and other factors i.e. competitiveness. As stated by Magee (1975), even if a country maintains its share of every product in every geographical destination, it can still experience an increase in its aggregate market share if it exports to individual markets that grow more rapidly than the world average and/or if it exports products for which demand is growing more rapidly than average. A positive shift-share effect thus results if specialization takes place in particular products or markets that are growing strongly. Differences between this hypothetical (composition-based) change and the actual change in the aggregate export market share (or export growth) are then attributed to a 'residual' competitiveness effect.

⁶ The markets for domestically-produced exports and re-exports are broadly the same.

We applied the technique to evaluate the Dutch export performance during the period 2000 – 2010⁷. According to our results, Dutch exports showed a cumulative increase in total market share over the period 2000-2010 of 25%, which is higher than the potential, given growth of world trade of 10% over the same period⁸. This can be attributed mainly to the positive effect of competitiveness (16%) and the product composition of Dutch exports (5%), namely the specialization in products facing rather favourable demand conditions, notably in 'Pharmaceutics', as well as in 'Basic metal industries'. By contrast, the negative market effect (-6%) tells us that export performance was hampered by a relatively low weight in Dutch exports of the most rapidly growing geographical markets, notably China. This is partially offset by the rising specialisation of Dutch exports in the EU27. It thus seems that competitiveness has played a more prominent role in the explanation of the export growth performance than the product composition and geographic structure of Dutch exports. As the competitiveness effect is the crux of the analysis, it is informative to identify which sectors and geographical markets are responsible for this result. First, looking only at the product dimension, the positive contribution came mainly from the high-tech sector 'Pharmaceutical products' (+36 for a total effect of 100), and to a lesser extent the medium-tech sector 'Chemicals, rubber and plastic products' (+13). Conversely, some loss in competitiveness can be observed in the case of low-tech sectors ('Textiles, wearing apparel and leather industry': -16) and 'Paper and paper products, printing and publishing': -13). Second, from the geographical market perspective, the Netherlands' gains in competitiveness can be largely attributed to the euro area (for +115 out of a total of 100), and also, but to lesser extent, to the other EU27 countries (+12).

Although a useful tool of analysis (as it allows the isolation of the effects of foreign demand to reflect changes mainly in competitiveness), the CMSA also has several shortcomings, which should be kept in mind when interpreting the results⁹. First, the positive value for the competitiveness effect means that the Dutch exports have grown faster than would have been the case if the Netherlands had maintained its market share among its trading partners. Although this can be interpreted as representing an improvement of the Dutch position vis-à-vis its trade partners – i.e. a *de facto* gain in market share that cannot be explained either by the geographical structure or the product composition of exports – it is not possible to completely disentangle the influence of destinations and products, so the result has to be interpreted with caution.

Moreover, and more importantly in view of the Netherlands, the data used refer only to gross traded flows as these are commonly reported in standard statistical sources. They do not distinguish domestically produced exports from re-exports (see above). Ideally, we would have applied the CMSA to domestically produced exports only. Unfortunately, for many counterpart countries, data on re-exports broken down into product composition and destination are not available, so, the magnitude of the re-export effect on export market growth cannot be determined accurately, nor can the magnitude of the domestically produced export on export performance be determined. The picture on Dutch market shares would be considerably less rosy had only domestically-produced exports been considered. As Chart 4 shows, in contrast to the increase in the relative

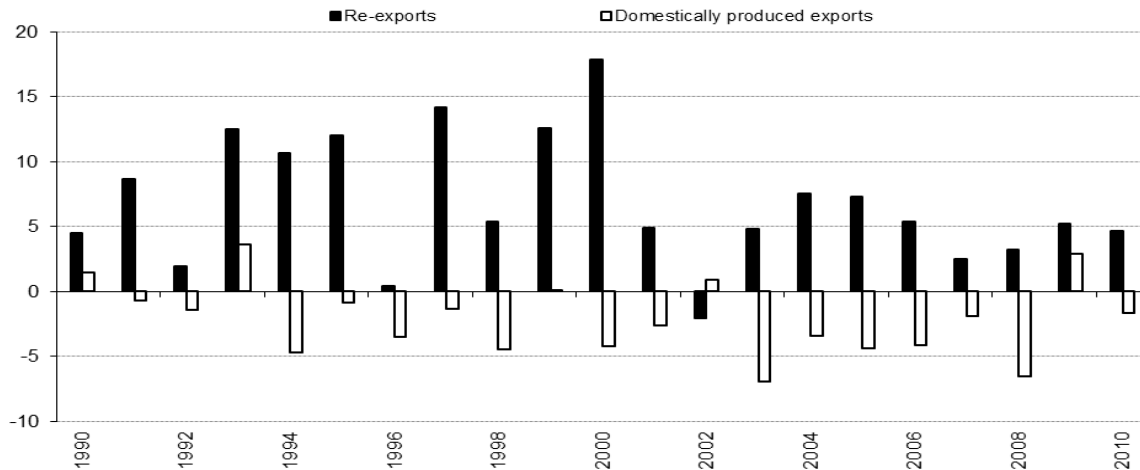
⁷ We used data on bilateral merchandise trade between countries and self-designed country groups or regions in value terms from 1993 on from the United Nations Commodity Trade Statistics. Exports are in USD value, hence developments in market shares are mechanically influenced by changes in the dollar exchange rate.

⁸ This corresponds to an annual nominal export growth, net of the growth of world trade, of 1.3 percentage-points; competitiveness gains contributed 1.4 pts, product composition 0.3 pts and a loss of -0.4 pts was due to market composition effects.

⁹ The residual aspect of the competitiveness is obviously a major weakness. A further problem is that a change in the calculation sequence of product and market composition modifies the values and signs of these effects due to path dependency.

export performance¹⁰ of re-exports, that of domestically-produced exports of manufactures has been decreasing in the last few decades¹¹.

Chart 4: Relative export performance of domestically-produced merchandise exports and of re-exports to growth in relevant world trade



Source: The Netherlands Bureau for Economic Policy Analysis (CPB) – MEF 2012

An important explanatory factor for the relative underperformance of Dutch domestically produced exports can be found in the very different product mix of domestically-produced exports versus that of re-exports. Domestically-produced exports are dominated by agricultural products, foodstuffs, chemical products, rubber and plastics, machinery and transport equipment. By contrast, computers and electronic equipment account for nearly half of the re-exports and re-exports account for around two thirds of the total exports of machinery and transport equipment. Since global demand for agricultural products and foodstuffs tends to grow less rapidly than the world markets for electronic equipment and telecommunications, the percentage share of Dutch domestically-produced exports in world trade is falling.

Second, and even more importantly, many of the Dutch exports markets are saturated, especially for some products, such as foodstuffs; increasing profits can only come from an increase in market share, not from growing demand. Venturing into new markets is necessary if global export market shares are to be maintained. But doing so means investing in market entry, something other exporting countries have already done.

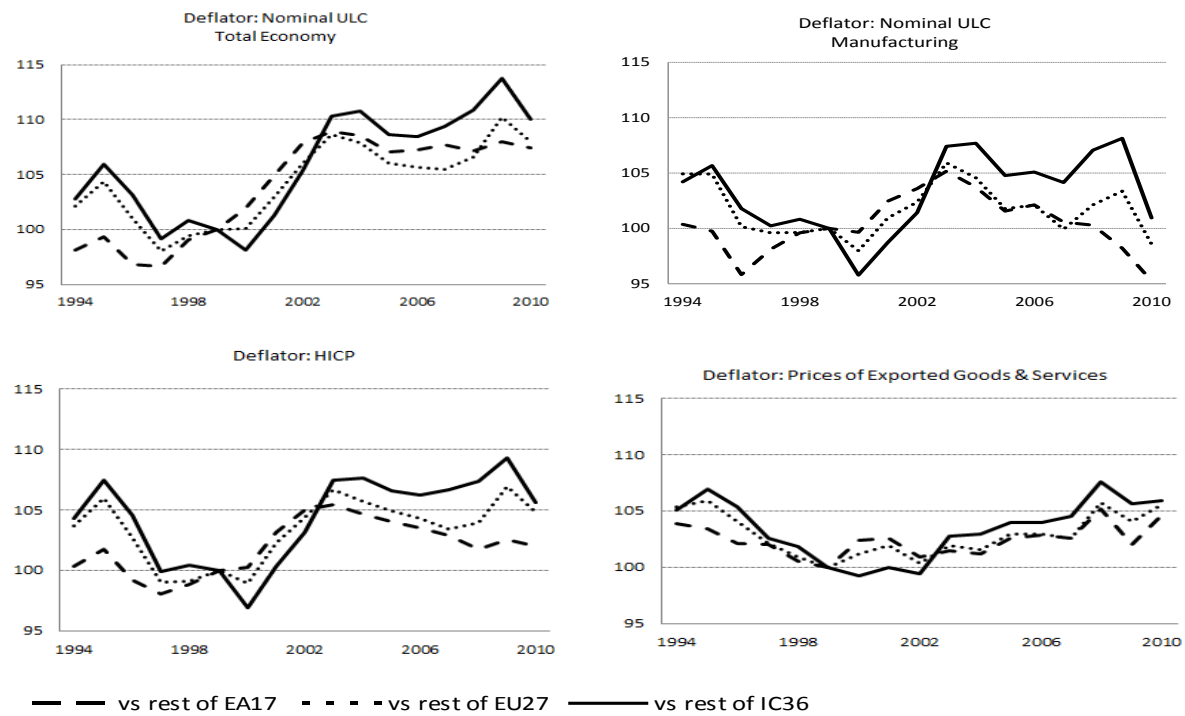
¹⁰ Market performance correlates the volume trend of domestically-produced exports to that of domestically-produced exports in other countries or to export market growth for Dutch manufactures (CPB, 2007).

¹¹ However this in turn is an overly somber presentation of the situation because Dutch domestically-produced exports data, calculated by the CPB, are corrected for re-export trends while the export market growth for Dutch manufacturers is not (because data on re-exports are lacking for many countries) so the loss/gain of market share of domestically-produced exports/re-exports is overestimated.

2.3 PRICE, COST AND OTHER COMPETITIVENESS INDICATORS

Although relative price and costs trends cannot be directly translated into absolute judgements on the level of competitiveness, developments in cost and price competitiveness can be assessed by standard indicators. Chart 5 shows a wide range of relative price indicators based on various price and cost measures, such as consumer prices, export prices and unit labour costs (which are conceptually equivalent to measures of REERs).

Chart 5: Real Cost and Price Competitiveness Indicators (1999 = 100)



Source: Commission services

Across all different measures used to calculate competitiveness indicators, the registered loss in competitiveness is stronger against IC36¹² than against the EU and euro area countries. This appears to be associated with significant gains in price and cost competitiveness in the US, Japan, and to a lesser extent, the UK compared to relatively unfavourable trends in price and cost competitiveness in many euro countries. Developments in the EU and euro-area trade and competitiveness over the last decade were at all events markedly shaped by globalisation trends. The increased number of cost-competitive emerging market economies as major exporters has raised the degree of competition. Moreover, the buoyancy of trade flows among emerging markets further contributed to gross export market share losses of advanced economies.

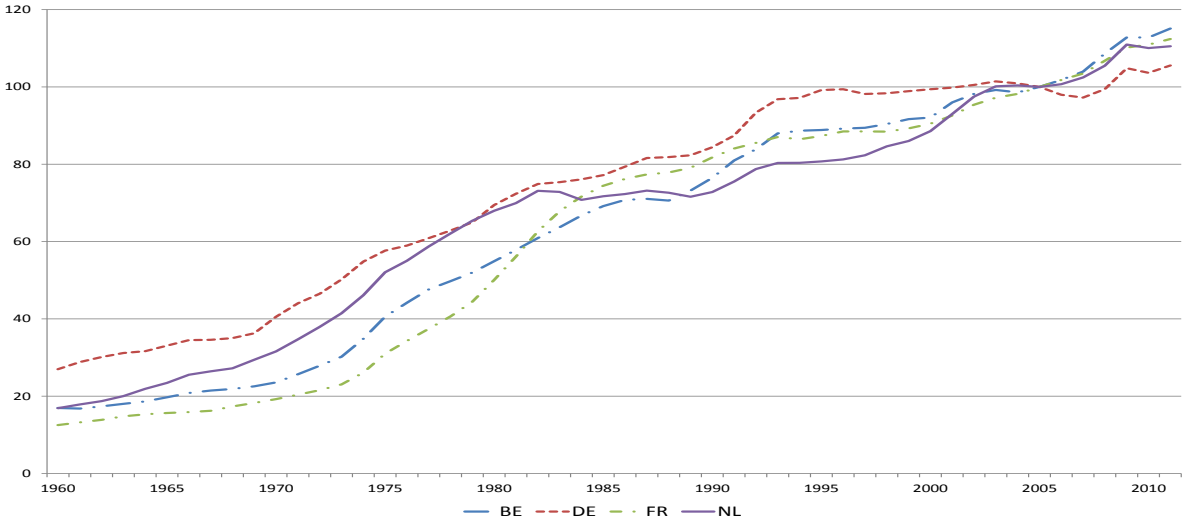
The indicator based on the export prices deflator points to smaller losses in price competitiveness (an appreciation by 7% vis-à-vis IC36 over the period 2000-2010) compared to the indicators based on unit labour costs in the total economy (which increased by 12% vis-à-vis IC36 over the same period). This suggests, on the one hand, that productivity gains have been important in preserving external competitiveness and, on the other hand, that firms offset relative price movements by decreasing their profit margins instead of instantly passing them on in the export prices (i.e. pricing-to-market strategy). This may be one of the reasons why the (limited) loss of competitiveness has not yet translated in a decrease in the trade surplus.

¹² The group of 36 industrial countries consists of the 27 EU Member States plus the United States, Canada, Japan, Switzerland, Norway, Australia, New Zealand, Mexico, and Turkey.

The cost competitiveness indicator deflated by nominal unit labour costs in the *manufacturing sector* shows competitiveness gains in this sector relative to other euro area and EU27, whereas the cost indicator deflated by unit labour costs for the *total economy* indicates that the economy has lost competitiveness. This shows that the manufacturing sector (which faces stronger international competition) has managed to keep unit labour costs at an internationally competitive level, whereas unit labour costs in the rest of the economy have put pressure on the competitiveness of other (non-manufacturing) sectors.

Overall, most cost and price competitiveness indicators appreciated from 1997 to 2002, pointing to decreasing competitiveness, and have stabilised since then. The higher price and cost increases during several years are partly explainable by the fact that in 1999 the Netherlands had a very strong competitive position relative to the other IC36 following years of wage moderation. As shown in Chart 6, unit labour costs increased steadily in the Netherlands and at a faster pace than in its main counterparts until 1981; during the period 1980 to 1999 unit labour costs rose only by around 26% in the Netherlands vs. 67% in Belgium, 42% in Germany and 78% in France.

Chart 6: Nominal unit labour costs, total economy 1960 – 2011 (national currency, 2005 = 100)

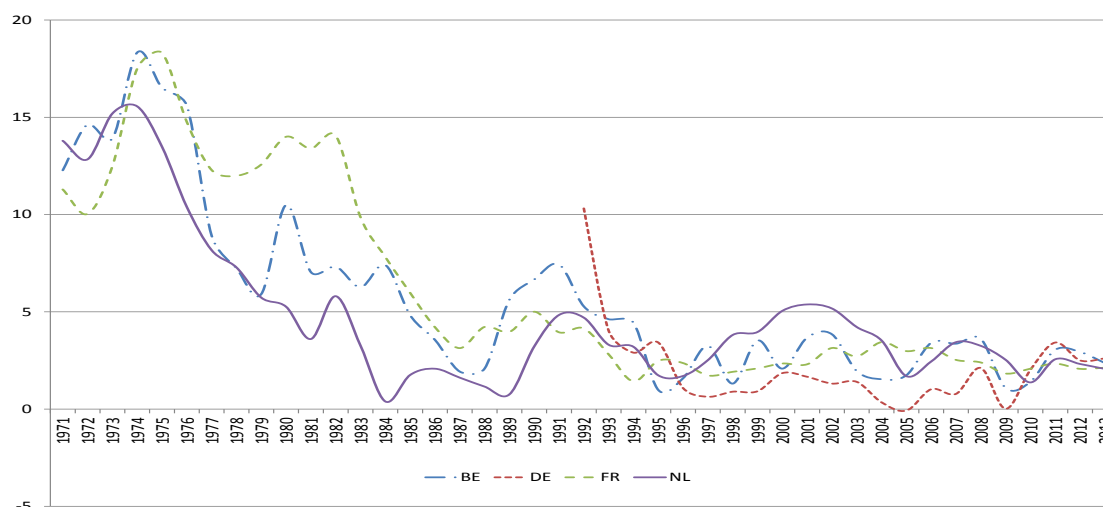


Source: Ameco

In contrast, looking at the period 2000 to 2010, unit labour costs rose by around 24% in the Netherlands, which is somewhat above the 22.5 % increases in France and Belgium, but markedly above the 4% increase in Germany over the same period. This widening gap vis-à-vis Germany is particularly important given the fact that Germany is the main trading partner of the Netherlands.

Observed differences in unit labour costs appear to have resulted mainly from differential trends in compensation of employees rather than from differences in productivity. Since it is difficult to increase productivity through the implementation of new policy measures, at least in the short run, policy makers tend to plea for wage moderation when competitiveness needs to be improved. They have done so during the 1980s and, to a lesser extent, at the beginning of the 1990s (Chart 7).

Chart 7: Nominal compensation per employee, total economy (annual percentage change)



Source: Ameco

The Netherlands embarked on a wage moderation strategy in the early 1980s, following the Wassenaar agreement, reached in 1982 between employers' organizations and trade unions. The agreement implied restrained wage growth in return for the adoption of policies to combat unemployment and inflation, such as reductions in working hours and the expansion of part-time employment. It has been associated with the end of the wage-price spiral of the 1970s, greatly reducing unemployment and producing strong growth in output and employment (CBS, 2007). However, while wage moderation may have favourable effects on employment in tradable sectors, it may well result in some downward pressure on real disposable income, which is the main driver behind private consumption. Given this dampening impact on domestic demand, wage moderation alone may not be a promising long-term strategy, all the more so if sectoral specialisation and possibly adverse effects, such as induced innovation, are taken into account. This has given rise to a longstanding debate, triggered by Kleinknecht (1994) on whether or not wage moderation in the Netherlands has had long-term negative consequences for total factor productivity growth. Arguably, however, even if the impact of wage moderation on productivity or innovation was not damaging, one may still surmise that the induced skewness in the sectoral distribution of income (with a higher profit share falling to enterprises) may have brought about dynamic inefficiencies in terms of the returns on profits generated (see section 5.1 below).

From the mid-1990s on, the growth of nominal compensation per employee in the Netherlands has been relatively high compared to its main trading partners; over the period 2000 - 2010, nominal compensation per employee rose by 42% in the Netherlands compared to 33% in France and Belgium and only 15% in Germany. However, on the whole labour cost dynamics do not appear to have been causing very strong losses in Dutch external competitiveness when measured over a longer period given the preceding period of relative wage moderation since the early 1980s. Other factors may thus have played a role in explaining the relatively stable performance of Dutch exports in spite of the deterioration of the REER vis-à-vis a group of 36 industrialised countries.

Among such non-price competitiveness developments that can affect total export growth, the quality of the infrastructure, the level of education and the tax and regulatory environment, are all influential factors. Apart from these, also geographical conditions and trade frictions, i.e. how accessible the country is to international competition, and at the same time, how accessible foreign markets are for domestic producers and exporters, can play a crucial role. Regarding the latter, the Netherlands has made significant foreign investment in key

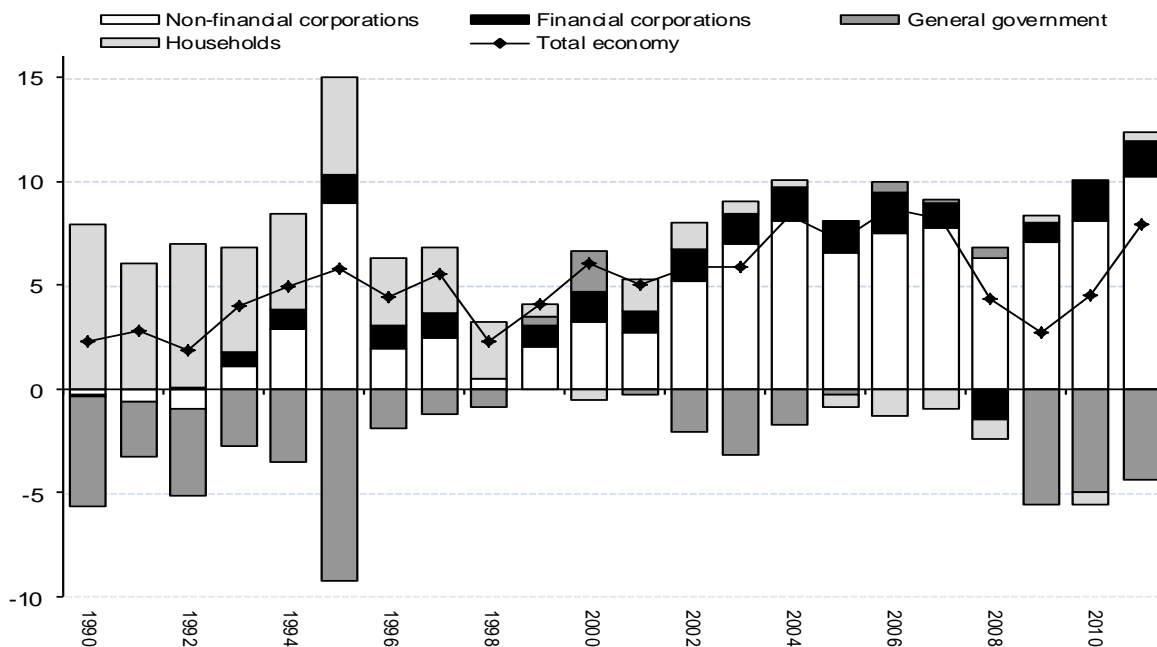
destinations and shifted production facilities abroad. Depending on the purpose of the engagement in FDI and the stage of the investment, this can lead to higher or lower exports. Losses or gains in export market share may therefore not necessarily be due to developments in price competitiveness, but rather to different strategies of internationalising production. Using FDI destination countries as export bases would lower home production and thus Dutch exports. The opposite holds if unfinished products are imported back and exported after only minor processing (Di Mauro et al., 2008).

The medium to long-term outlook for the Dutch trade balance is highly uncertain. On the one hand the geographical location, close to other core EU economies, and historically strong and credible institutions should help support the competitive position the country currently enjoys on many fronts. This would however need to be supported by policies conducive to the areas of innovation and education. Indeed, underneath the apparent healthy trade surplus some worrying trends are visible. These concern mainly the specialisation pattern of the Dutch economy and a trend loss in market share for domestically produced goods. The measured losses in external competitiveness also warrant close attention, even though they reflect deterioration from an overall strong starting position. In the longer run the depletion of natural gas reserves would ultimately contribute to reduced exports. As regards the more immediate outlook, clouded prospects for domestic demand, which is held back by balance sheet adjustments, militate against a sharp near-term reduction in the trade surplus.

3. Sectoral contribution to the current account balance

This chapter offers an alternative view on the economy-wide external balance from the perspective of savings-investment decisions of the main institutional sectors as the ultimate determinants of the current account balance. In national account terms, a current account surplus implies an excess of savings over investment aggregated across institutional sectors. The chapter attempts to shed more light on the specific causes of the noticeable shifts in sector balances witnessed over the last few decades, also with a view to identify vulnerabilities and possible imbalances which may have emerged. The most striking development in the sectoral breakdown of the Dutch current account (as illustrated in Chart 8) is the switch from a significant savings surplus emanating from households towards a savings surplus of non-financial corporations from approximately 1999 onwards. One important explanatory factor for this shift is the increase in financial leverage of households, largely reflecting trends in housing and mortgage markets. This arguably increased the vulnerability of Dutch households to financial shocks operating through balance sheet channels.

Chart 8 – Sectoral breakdown of the current account 1990 - 2011



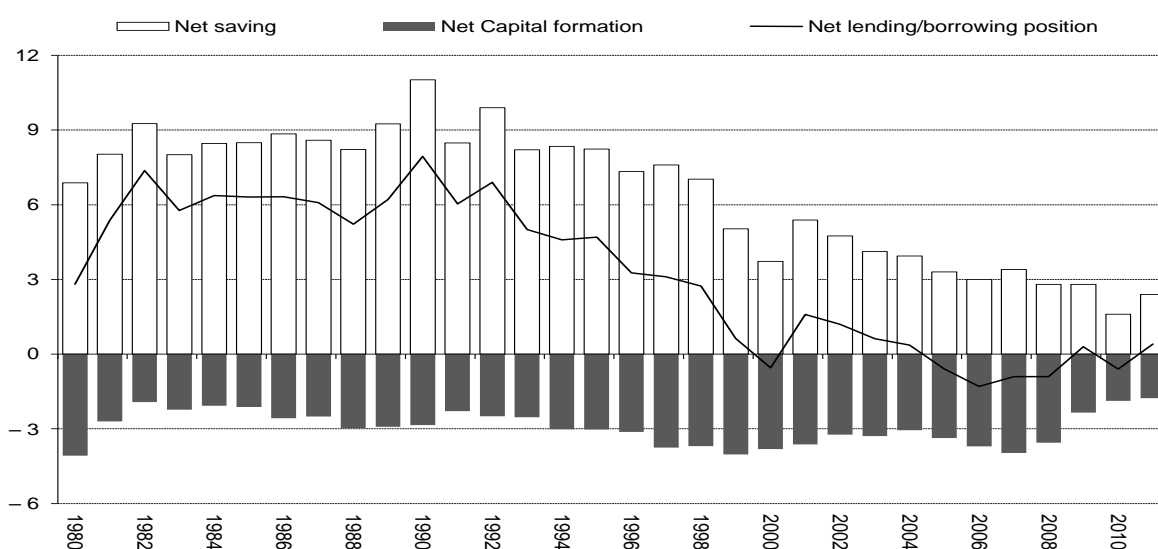
Source: Eurostat

The emergence of a persistent savings surplus in the non-financial corporate sector no doubt owes much to the increasing importance of globalisation and monetary integration in shaping the dynamics of corporate balance sheet adjustments. A host of other factors also partly account for the observed pattern, but to an extent the underlying dynamics remain a riddle. Moreover, although providing financial buffers that are useful to weather the recent economic headwinds, substantial corporate savings may not be entirely benign. Looking forward, dynamics initiated in the wake of the crisis, such as changes in risk attitudes, the on-going deleveraging in the banking sector, the adoption of more careful funding strategies by non-financial corporations, and, finally, a risk of a persistent downward shift in the economy's growth path, may all reinforce accumulation of substantial corporate savings (Ruscher and Wolff, 2012).

3.1 HOUSEHOLDS

For decades Dutch households have recorded a sizeable saving surplus. This was mainly due to significant occupational pension savings, which are, although managed by pension funds, part of households' savings in the current account. However, even if the mandatory second pillar occupational pension contributions and the third pillar contributions¹³ are taken into account, total savings of Dutch households have been below the euro area average since 2002. In 2010 households gross savings rates were 10.9 % in the Netherlands vs. 17 % in Germany, 13.9 % for the euro area and 12 % for EU27¹⁴. From 2005 onwards, households' savings shifted from a surplus to a trend deficit (allowing for cyclical influences). Therefore, the often heard reasoning that the national savings surplus is due to the high households' pension savings, may have held until the mid-1990s but no longer applies. The household net lending position turned into a borrowing position in the most recent years.

Chart 9 – Net lending position of the Dutch households 1980 - 2011 (in percentage of GDP)



Source: Statistics Netherlands (CBS)

To a significant extent the disappearance of the savings surplus of Dutch households appears to be linked to financial leveraging. A factor often mentioned to explain the downward trend in the net lending position of households is the decline in real interest rates to historically low levels. One part of the explanation may be that, discouraged by the low interest rates, households depleted their savings in favour of investment and consumption. Another much more important reason behind the fact that the saving surplus of households dwindled since the start of the current millennium relates to the housing market, as discussed in Vandevyvere and Zenthöfer (2012). On closer inspection it appears that the shift in the Dutch households' net lending position is mainly related to investment in housing, reflected in the high household investment rate, which in 2009 was the highest of all European countries (11.5 % vs. 8.9 % for the euro area and 8.2 % for the EU27). In line with this, housing wealth has increased significantly in the past decades, from 31 % of total household wealth in 1993 to 39 % in 2010.

¹³ The Netherlands has a long-standing funded second pension pillar (dating back to the 1950s), on top of a public first pillar for every Dutch citizen of 65 years or older organized as a PAYG system. The second pillar, the supplementary pension, which is also mandatory, and in which in principle every employee has to participate, is the most important part of the system. The importance of the second pension pillar is much higher in the Netherlands than in other countries. This has translated into the creation of huge pension funds, the assets of which constitute an ever-larger part of total accumulated savings in the country; they have grown from approximately 70% of GDP in 1990 to 136% of GDP in 2010. The third pension pillar, which is relatively modest in size, consists of additional private savings, for instance, through tax-preferred pension accounts.

¹⁴ Eurostat: Annual national accounts.

The very strong growth in housing investment in part reflects supply constraints and higher income expectations: apart from the expected rise in the value of their assets, which have had an upward effect on house prices, households also expected higher income owing to the growing participation rate of women in the labour market. Also, and even more importantly, the investment in housing can be linked to a rapid trend in financial innovations giving households much easier access to credit. Moreover, households were encouraged to take up mortgage debt through tax-incentives (the tax deductibility of mortgage interest payments), so that household leverage - measured as household debt relative to disposable income - against housing wealth progressively increased, essentially as a result of the growing volume of mortgage loans. This has been accompanied by a very strong growth mortgages: housing loans accounted for 27 % of bank assets in 2009, up from 17 % in 1997, and well above the corresponding number for the EU (15 %). The downward trend in interest rates coinciding with a phase of heightened globalisation and EU market integration boosted by monetary union supported the trend towards higher household financial leverage. Within the euro area, the Netherlands now has the highest gross household debt related to housing¹⁵ in terms of GDP: outstanding residential mortgage debt almost doubled from EUR 357 billion in 2003 to EUR 640 billion - corrected for securitization (DNB, 2012a) - in 2010 (and an estimated EUR 652 billion in 2011), or 109% of GDP¹⁶. The country has the highest households' interest payments as well (10 % of gross disposable income vs. 4 % for the euro area).

In recent years, limitations on interest rate deductibility rules and a progressive tightening of banks' mortgage lending standards did reduce the incentives to leverage up against housing wealth but the overhang of a high gross housing mortgage debt of households remains. With risks emanating from the financial crisis, the risks to households with high debt servicing costs have also increased considerably. This in turn has increased the vulnerability of Dutch banks because of funding gaps¹⁷ and concurrent mismatches and refinancing risks. The use of wholesale funding (securitized borrowing) in increasingly encumbered markets to finance long-term liabilities (to provide the mortgages) is one of the reasons mortgage borrowing costs increased rather steeply in the Netherlands in the wake of the crisis. The balance not only of banks but also of pension funds and insurance companies badly suffered from the fallout of the global financial crisis. The associated losses will have to be absorbed and arguably, given the extension of leverage, this has made the Dutch financial sector vulnerable on several counts, despite the overall solid creditor status of the country. Lastly, also the government is exposed to substantial risks stemming from high mortgage debt because of the national mortgage guarantee scheme that runs to more than 20% of GDP.

Even though forced liquidations so far have remained rare, in terms of policy challenges some rebalancing seems necessary to reduce risks. This can partly take the form of capping loan-to-value ratios and introducing a mandatory amortisation percentage for mortgages; in fact, steps in this direction have already been taken. But quite likely more radical measures will be needed, notably the progressive phasing out of interest rate deductibility for mortgages and the need to let households fund a larger part of house mortgages from own savings, which could also improve the funding of domestic banks. Also, premiums for mortgage guarantees under the national scheme could be increased to market based levels (to at least 2% from the current 0.7%). Lastly, 'interest only mortgages', where the debtor only pays interest during the term of the mortgage with a balloon payment of capital at the end of the contract, should be abolished.

¹⁵ Gross mortgage debt, as a percentage of total household debt, is 85%. In contrast to mortgage debt and to other countries, outstanding consumer credit is negligible in the Netherlands.

¹⁶ Compared to a ratio of 40 % of GDP in 2007 for the euro area as a whole. Mortgage debt as a share of disposable income increased from 56 % in 1990 to 233 % in 2011, according to MEV (2012) and from 151% in 2000 to 250% in 2010, according to Eurostat, one of the highest shares recorded of any advanced economy and the highest in the euro area, which had an average ratio of 99% in 2010.

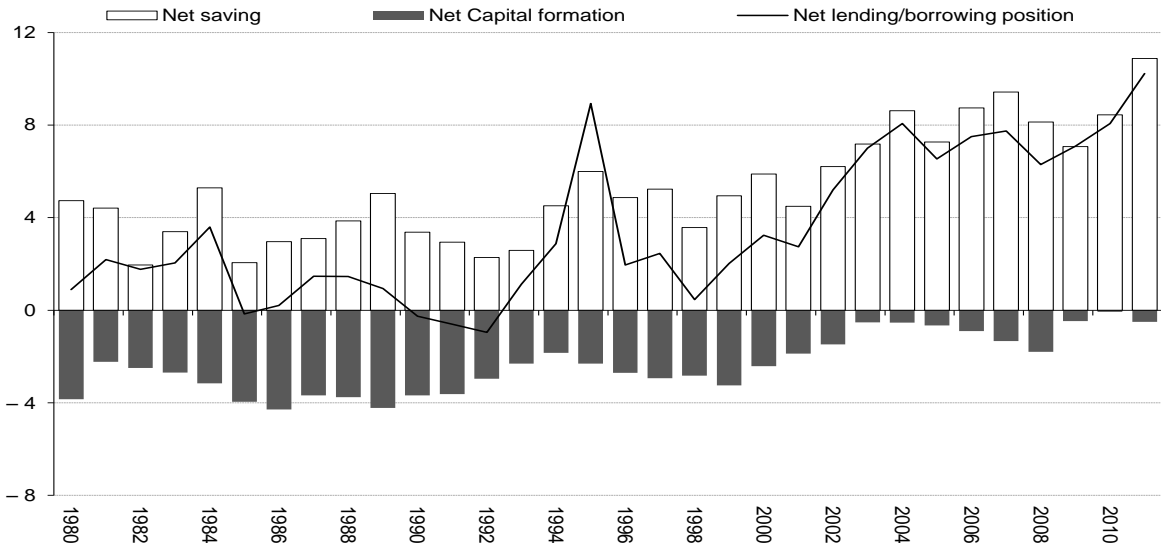
¹⁷ This is the difference between savings deposits with banks and loans to households and enterprises. The total Dutch banks' funding gap amounts to some EUR 480 billion (or approximately 79% of GDP), larger than elsewhere in Europe, despite the national savings surplus.

3.2 NON-FINANCIAL CORPORATIONS

The Dutch non-financial corporate sector¹⁸ has changed its status from net borrower to a very significant net lender to the rest of the economy. Corporate net lending has been around 8% of GDP on average over the last decade (Chart 10). The emergence of such a large and persistent savings surplus in the non-financial corporate sector raises the issue to what extent this can be seen as a benign development and to what extent it may signify the emergence of an underlying potential imbalance and associated risks that may be worth considering at the policy level.

The excess of gross corporate saving over fixed investment amplified between 1998 and 2004, mirroring a roughly equivalent rise in gross saving and fall in gross fixed capital formation starting around the turn of the century. This turnaround pattern, by which firms have moved from their traditional position of borrowing funds to running financial surpluses - lending on to other sectors of the economy- has been observed in many industrial countries since the early 2000s and suggests that at least some non-country specific explanatory factors are at play, such as the bursting of the dot-com bubble in 2000-2001 which left Dutch corporations with significantly deteriorated balance sheets. At the time, substantial write-downs on foreign investments had an adverse effect on the real economy. In the aftermath of the bursting bubble, affected nonfinancial corporations made the decision to use profits to repay debt (or to acquire financial assets, i.e. equities, including higher (net) direct investment abroad, and cash), rather than to finance new (domestic) capital investments or to distribute them to shareholders through dividends. However, the very explicit trend in the behaviour of corporations is most likely not only driven by the bursting of the equity market bubble in the early 2000s, but by a range of complex and interrelated factors which differed across companies and sectors and partly were specific to the Netherlands.

Chart 10 – Net lending position of the non-financial corporations 1980 – 2011 (in percentage of GDP)



Source: Statistics Netherlands (CBS)

Corporate savings are likely to have been driven mainly by increasing profit shares, possibly related to lower tax and interest payments (as nominal interest rates have fallen with inflation), but especially to higher profits

¹⁸ We disregard financial corporations, since they have only been registering positive and increasing excess-saving positions since the early 1990s (except in 2008, when it was negative), related to structural factors that are specific to the financial sector. Apart from banks, insurers and pension funds, the financial sector in the Netherlands comprises a relatively large category of ‘other financial institutions’ such as ‘special financial institutions’ (SFIs - see below) and investment firms. Unlike banks, insurers and pension funds, these other financial institutions do not finance themselves through deposits or premiums but mainly by issuing equities and bonds and taking up long-term bank loans.

received from foreign operations (through intra-firm dividends, interest payments or royalties that are repatriated by the subsidiary to the parent company as well as retained earnings reinvested at the foreign location). This trend appears to have been sparked by the increased internationalisation of the corporate sector since the 1990s, and the favourable tax treatment of repatriated foreign income in the Netherlands (cf. *infra*). Traditionally, the Dutch participation exemption on cross-border intra-firm dividend payments has been a major attractor of companies to the Netherlands. This exemption implies that when transnational companies repatriate affiliate income, or in other words, pay themselves dividends from abroad, the tax treatment of this income is not subject to domestic taxation¹⁹. This has made (and makes) the Netherlands very attractive as an investment base for regional expansion, with many firms setting up their European headquarters. This repatriation behaviour probably accentuates the way the operations of multinational companies are reflected in the macro-economic statistics.

Moreover, distributed dividends to the shareholders did not rise in line with profits, especially in Dutch multinational enterprises (i.e. enterprises that are situated in the Netherlands and whose decision-making is in Dutch hands, but also have groups abroad). Arguably, tax optimising incentives (lower tax tariffs on realised capital gains than on distributed income) partly account for this behaviour. Another factor likely at play here is the Dutch tradition of using stock-dividends, i.e. a preference for dividend payment made in the form of additional shares, rather than as a cash pay-out²⁰.

A persistent tradition of relative wage moderation has also contributed to boosting corporate savings. This has allowed the profit share of income to hold up at the macro level. However, the impact of this factor should not be exaggerated. Although the wage share in GDP in the Netherlands has been falling over the past few decades, particularly in the 1980s following the landmark 1982 agreement between employers and trade unions on wage moderation, and (less so) in the 1990s, from the 2000s onwards it developed broadly in line with the euro area average. Hence, changes in the economy-wide wage share of income cannot explain the relatively high net corporate lending. For a part, higher cash holdings could also be due to the fact that some companies have large unfunded pension liabilities.

Finally, a factor which appears to have played a role is persistent sluggish domestic capital formation by non-financial corporates. Net capital formation of Dutch corporations fell from 4.2% of GDP in 1989 to 0.9% of GDP in 2010. Abstracting from the cyclical impact of the global crisis, the trend fall in the investment ratio over such a long period seems to have occurred also across other euro-area countries, possibly related to capital-saving biases in new technologies. To some extent, this may reflect a declining trend in the relative price of investment goods, stemming from ICT innovations, so that firms have to invest less in nominal terms to achieve a given real investment rate. However, this is unlikely to have been an overriding factor.

The mirror image of weak domestic investment in the presence of high aggregate corporate profitability has been the increase in outward foreign direct investment (FDI) since 2000. Cause and effect are difficult to separate here as potentially perceived good investment opportunities abroad may also have driven the apparent weakness in corporate investment in the Netherlands. Rather than investing at home, part of the available funds have been used to purchase either existing capital equipment abroad and/or acquire financial stakes in foreign companies. This, in turn, could be partly linked to technological innovations that have increased the possibilities of conducting foreign investment, regulations allowing free movement of capital in the EU and the elimination of

¹⁹ Although this system is applied in most EU countries, with the exception of Greece, Ireland, Spain and the United Kingdom, the extent to which income is fully or partially exempted varies across countries and is affected by the provisions of bilateral tax treaties.

²⁰ This may be partly traced back to tax distortions before the 2001 tax reform, when distributed corporate equity was taxed twice, once at the corporate level and again at the households' progressive personal income tax rate on pay-out.

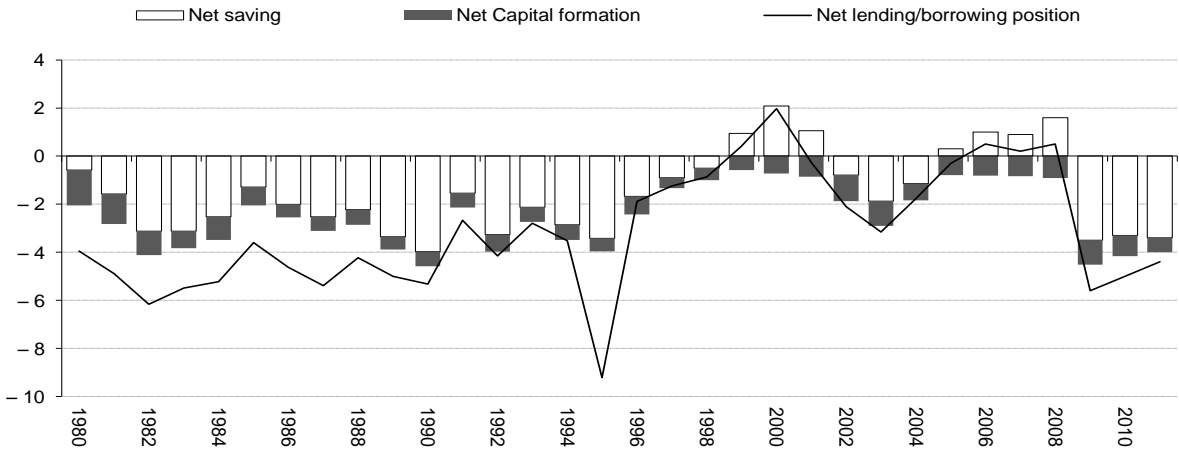
the exchange rate risk (within the euro area) since the introduction of the euro in 1999, which arguably triggered (un-hedged) cross-border capital flows within the euro area. As FDI outflows have increased, investment earnings in the form of profit remittances (the profits on investment that are repatriated to the country of origin) have also grown substantially and clearly affected the balance of payments²¹ (see Chart 1). At the same time, FDI inflows multiplied (see section 4) and the significance of FDI as a channel of capital inflows and outflows is massive; it could be even larger than official data on remittances of profits reflect (see also section 5.1).

On balance, the strong net lending position of Dutch non-financial corporates remains a bit of a puzzle, despite the several factors identified that can account for part of the tendencies observed. It is beyond the scope of this paper to fully resolve this riddle. Future inquiries arguably could zoom in more on complex linkages between financial flows, exposures and operations and the flows of profit and investment registered in the official external accounts. One may argue that the comfortable net lending position of the non-financial corporate sector is a positive factor, underpinning the strength and credibility of Dutch businesses and even adding to the strong and credible financial standing of the country. However, by the same token it may be interpreted as an underutilisation of domestic resources and hence as a sign of an imbalance or even vulnerability. The profitability, marginal efficiency, and risk profile of home versus foreign investments will be points to watch. Relatively recent history provides sufficient examples of large financial investments abroad going sour, with a severe backlash on the real economy in the Netherlands through the balance of payments channel. This in itself should be reason to take heed.

3.3 GOVERNMENT

The decline in the budget deficit of the government since the early 1990s only accounts for a limited part of the changes in the current account surplus. The general government deficit was significantly reduced in the run up to the introduction of the euro - even posting a general government surplus in 1999 and 2000 (Chart 11). Also since the introduction of the euro general government deficits have been relatively modest, and fiscal consolidation was important for the dynamics of the 2004 – 2008 period. Global trade boomed during this period and the Netherlands benefitted strongly from world demand and significantly expanded its exports. This trade-driven cycle found its counterpart in the net lending of the government, rather than in the net lending position of corporations, which slightly improved during this period.

Chart 11 – Net lending position of the Dutch government 1980 - 2011 (in percentage of GDP)



Source: Statistics Netherlands (CBS)

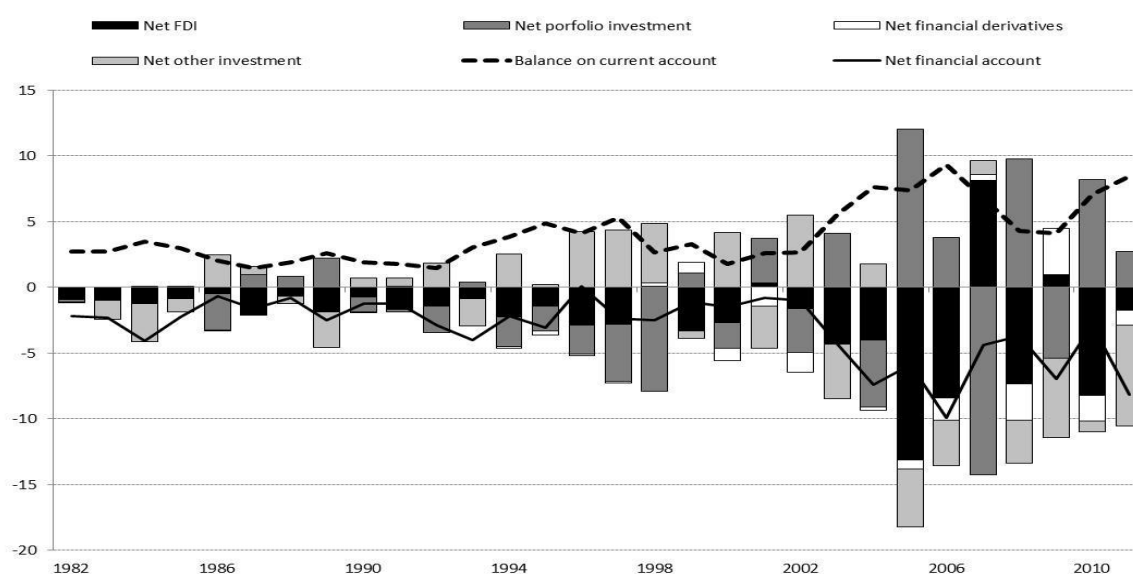
²¹ Indeed, the net balance of payments impact of outward FDI results from subtracting the FDI outflow from all the positive flows associated with the outflow, mainly repatriated profits, dividends and interest (on the income account), and net receipts of royalties and license payments (on the services account).

4. The financial account balance

One reason why the current account balance is economically important is that it reflects a country's net borrowing needs. A country with a savings surplus builds up international assets (or runs down debt), whereas a country with an external deficit runs down reserve assets or builds up foreign debt. Hence the gap between saving and investment is mirrored by the transactions that finance them, i.e. by borrowing or lending, by in- and outflows of capital, which can be read from the 'mirror image' of the current account balance: the capital and financial account balances.

The balance on the financial account is given by the sum of net foreign direct investment (FDI²²), net portfolio investment, divided into equity (shares, stocks, participation shares) and debt instruments (bonds and notes, money market instruments), net flows in other investment (mainly net cross-border bank loans), net financial derivatives, plus changes in official reserve assets. The relative importance of the positions by main asset categories is presented in Chart 12²³.

Chart 12: A breakdown of the financial account in functional categories of investment 1982 – 2011 (in percentage of GDP)²⁴



Source: De Nederlandsche Bank (DNB)

While the Dutch *net* capital flows are sizeable, they are dwarfed by the cross-border holdings of *gross* external assets and liabilities, which currently represent 455% and 427% of GDP, respectively. The value of these gross holdings has increased substantially since the mid-1990s, a pattern of financial globalization that is observed across most countries, particularly in the industrialized world (Lane and Milesi-Ferretti, 2006), but also in the Netherlands, due to its role as a financial intermediation centre.

²² Financial flows are classified as direct investment when a foreign investor possesses at least 10% of the total equity capital or voting rights or the equivalent thereof. Therefore, portfolio investment data and FDI data are closely related. FDI can be categorized into three components: equity capital (for example, mergers and acquisitions), reinvested earnings (i.e. undistributed profits imputed to the direct investor) and intra-company loans. What is important is that the investor acquires a permanent interest in the company and can exert a substantial influence in the companies' management board.

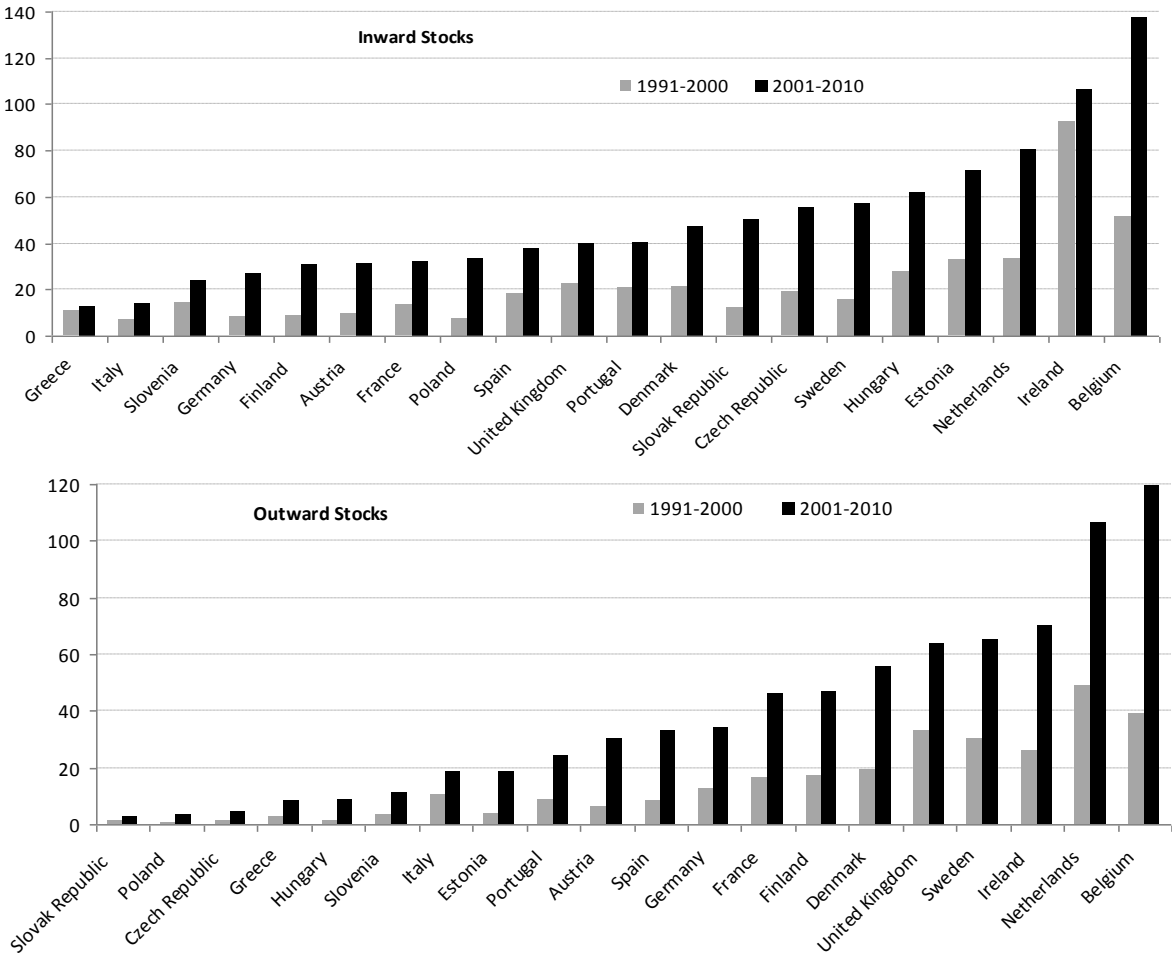
²³ The various components of the financial account should always be analysed together in order to get a complete understanding of movements over time, as significant reductions in a category are often compensated by increases in another (as a result of portfolio shifts).

²⁴ Excluding Special Financial Institutions (see below).

One of the main observations that arise from Chart 12 is that the Netherlands is a structural net direct investor abroad, as the net foreign direct investment balance was mainly negative in past years. Towards the end of the 1990s, multinationals substantially increased their FDI abroad through takeovers to increase market shares. Only in 2007 did the Netherlands record a positive net FDI balance, which can be explained by the take-over of ABN-AMRO by a consortium of Spanish, British and Belgian banks. Due to the subsequent nationalisation in 2008, the total net FDI turned negative once again. The Netherlands is also important in terms of inward FDI, seemingly because it is considered as providing an attractive investment base for multinational companies²⁵, not only because of its favourable strategic geographical position, but also because of its legal framework and economic stability, or for the favourable tax system.

Both inward and outward FDI flows have risen substantially and both inward and outward stocks of FDI are among the highest worldwide (Chart 13). In absolute terms, the Netherlands ranks fifth as receiver of FDI after the United States, the United Kingdom, France and Canada. In terms of the ratio to GDP, the Netherlands ranks fifth in terms of inward as well as outward FDI stocks, after Luxemburg²⁶, Switzerland, Belgium and Ireland.

Chart 13 – FDI positions in OECD countries, 1990s and 2000s – Inward and outward stocks (% GDP)



Source: OECD - Dataset: FDI flows by partner country.

²⁵ In the Netherlands, an initial FDI investment allows multinational companies to take on significant corporate debt with reduced transaction costs, leading to large gross foreign asset and liabilities positions.

²⁶ However, the high FDI in % of GDP observed in recent years is due to the creation of Arcelor Mittal Group.

FDI positions are even higher when Special Financial Institutions (or SFIs) are included; these account for no less than three quarters of total FDI from the Netherlands, especially during recent years. An SFI is a subsidiary - sometimes little more than a letterbox or an anonymous office - of a foreign parent company that receives or borrows funds from abroad and transfers them to the parent or to other group companies, often to reduce global tax exposure²⁷.

The fiscal attractiveness of the Netherlands results from several factors. One of these is the so-called 'participation exemption' that exempts business profits (dividends as well as capital gains) from subsidiary companies abroad from corporate income tax levied in the Netherlands (see also section 3.2). A second reason is the large Dutch Double Taxation Treaty (DTT) network that substantially reduces withholding taxes on dividends, interests and royalty payments between Treaty countries and the Netherlands. A third reason is the "advance tax ruling" system whereby, contrary to many other countries, the Netherlands offer the possibility to discuss tax positions in advance with the Dutch tax authorities. These discussions can be formalized in agreements binding both the taxpayer and the tax authorities. Fourth, there is a special regime for group financing companies offering very low tax rates on interest received from loans to subsidiaries, while interest payments can be deducted at the tax rate abroad.

At the end of 2009 the Netherlands numbered some 11500 SFIs. Possibly this growing number of special financial institutions and the on-going globalisation and financial integration can explain part of the increased volatility and magnitude of the financial flows from 2004 onwards, as shown in Chart 12. SFIs external assets and liabilities are extensive, entailing a ballooning effect on the *gross* balance of payments data. The aggregate balance sheet of all SFIs was over EUR 2300 billion (in 2009), almost half of the total Dutch external claims (EUR 4700 billion, more than nine times GDP)²⁸. The SFIs external assets and liabilities have also been changing in terms of the composition of holdings and liabilities. SFIs are particularly active in the field of direct investment (participating interests and intercompany financing)²⁹. More than four-fifths of their assets (EUR 1900 billion at the end of 2009) are in external investments. On the liabilities side of the 'national SFI balance sheet' the share of investments is smaller. Over one quarter of obligations is in the form of securities issued (DNB 2010; Mellens et al., 2007). Since SFIs do little else than channel funds (they are generally set up with foreign capital only, which is usually also invested abroad), their external claims and obligations nearly cancel each other out. This is why they are of little significance to the *net* external asset position of the Netherlands and to the measured flow of the current account balance. However, because of the fact that the net external position represents a relatively minor difference between very high gross levels of assets and liabilities, it should be kept in mind that net external asset positions are subject to major fluctuations and that it is thus not excluded that part of the operations may show up in the sectoral savings surplus of the corporate sector.

Portfolio investment likewise expanded since the end of the 1990s. Apart from high private investments associated with the open nature of the Dutch economy, savings channelled through the mandatory second pillar occupational pension scheme also contribute to this. Pension funds, responsible for the management of the mandatory pension contributions, hold significant assets, and invest a huge portion hereof abroad (see also Chart 16). In contrast to direct and equity investment, foreign investment in Dutch sovereign bonds is generally higher

²⁷ Some profits do not derive from physical goods, but from, for example, royalties on intellectual property, which makes it easier to shift them to a tax haven. From the bilateral balance of payment of SFI's one can see that Germany, the UK and the US are the countries where the SFIs hold most of their assets; most liabilities are held in the UK. Furthermore, on the liabilities side, offshore centers such the Netherlands Antilles and the Cayman Islands figure relatively prominently (DNB, 2003).

²⁸ Because the amount that SFIs transfer is so huge they are not included in the 'overall' balance of payments statistics. However, since 2003 they are registered on a separate sheet.

²⁹ The fact that inter-company transfers often reflect shifting profits between countries (notably in multinational companies) should be duly taken into account when interpreting data on FDI returns.

than Dutch investment in foreign sovereign bonds. This mainly reflects the attractiveness of Dutch sovereign bonds, which are generally considered a 'safe haven', whilst generating slightly higher returns than, for example, their German Bunds.

Overall, the financial account shows a skewed picture, with the increased volatility and magnitude of financial flows posing potential stability risks, also in view of the mismatches that sit on the nation's balance sheets. As regards the medium to long term outlook, one may expect the excess savings to be reduced somewhat as Dutch pension funds repatriate assets to finance higher pension pay-outs.

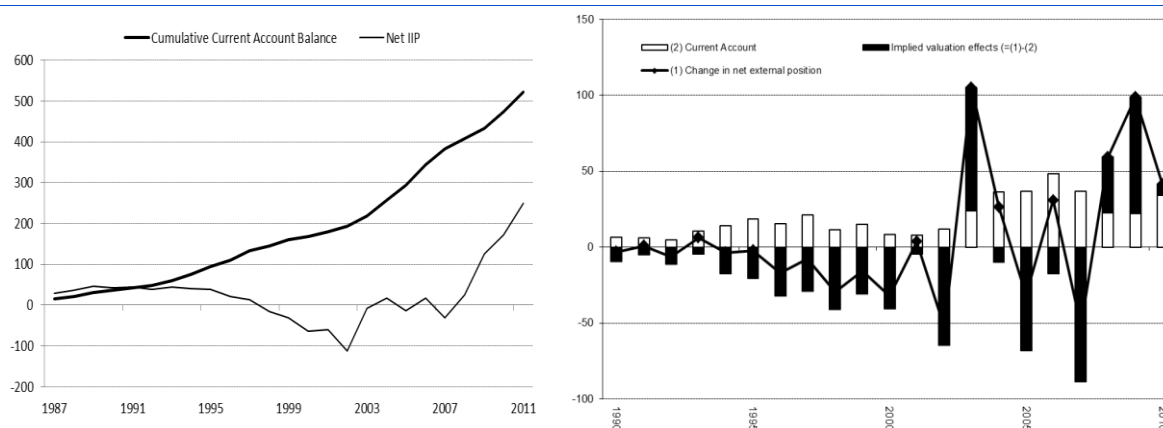
5. The net international investment position

5.1 THE DUTCH BLACK HOLE

Whereas the balance of payments captures cross-border capital in- and outflows between residents and non-residents, the 'net international investment position' (net IIP hereafter) captures the corresponding stocks of external assets and liabilities of a country vis-à-vis the rest of the world³⁰. The transaction based flows of financial assets and liabilities between one year and the next recorded in the balance of payments typically do not correspond to the change in the stocks between those dates due to valuation effects. Apart from the recorded volume of transactions in the current account, a change in the net IIP also includes capital gains (or losses) due to revaluations of cross-border external assets and liabilities or to exchange rate fluctuations occurring during the year. Since these valuation changes do not concern transactions, they are not recorded, nor observable in the flow statistics of the balance of payments. The changes in the outstanding amounts also include other adjustments (e.g. sectoral reclassifications, shifts between financial instruments or exceptional events).

Depending on their size, fluctuations in asset prices in either direction may often have a significant impact on the outstanding amount of a country's stocks of external assets and liabilities³¹. Chart 14 shows that the external assets and liabilities position of the Netherlands has been subject to persistent significant negative valuation effects which have contributed to dampening the effect of the current account surpluses on the net IIP. As such, even a persistent savings surplus seems to be no guarantee for the build-up of a solid net IIP. The difference between the cumulated current account surpluses and the change in the net IIP of the Netherlands between 1987 and 2006 was dubbed the Dutch 'black hole' (Kusters, 1998), in which surpluses mysteriously seemed to disappear.

Chart 14: The Dutch black hole (left) and decomposition of changes in the net external position of the Netherlands (right), in billions of euro



Source: De Nederlandsche Bank (DNB); Commission services.

³⁰ The net IIP is calculated as the sum of all foreign claims minus all foreign liabilities (the difference between foreign assets owned by a country's residents and a country's assets owned by foreigners). It reveals the net debtor/creditor position of a country towards the rest of the world; it is an indicator of the long-run saving-investment balance of an economy, referring to its net borrowing needs or net wealth position.

³¹ While valuation effects are not new, two factors at play in recent years have contributed to making them both more volatile and more important. First, the relative importance of direct investment and portfolio equity investment in international portfolios had increased, and these instruments have on average higher and more volatile returns than debt instruments (Lane and Milesi-Ferretti, 2005). In these high risk categories the return usually comes in the shape of capital gains or losses, and adjustments in the book value of FDI, which do not result into cross-border cash flows and are therefore outside the scope of the balance of payments (but affect the net IIP through valuation changes), while in the low risk categories (debt instruments, loans, interbank positions), the yield comes in the form of interest income, which is recorded on the income account of the balance of payments, just like dividends, reinvested earnings and repatriated profits, but these all carry relatively minor weight. Second, the size of gross external portfolios has grown dramatically. As a result, a given differential in rates of return across assets and liabilities now has a much larger effect on the dynamics of the net position.

Over decades, the Dutch net savings surplus initially did translate into the building up of a positive IIP, although its size appeared to be moderate. In 1998, according to the IIP statistics, the country became a net debtor despite a history of persistent current account surpluses; in 2002 the net IIP reached a low of minus EUR 113 billion (24.4% of GDP). The net external position only turned positive again in 2004 and 2006 by a mere EUR 2 billion (less than 1% of GDP). In recent years, sharp swings in asset valuation in response to the economic and financial crisis in 2008-2010 have clouded longer-standing trends: paradoxically, the Dutch net IIP markedly improved during these crisis years; a similar pattern is discernible in year 2003, when the dot-com bubble burst (Chart 14 right). However, these measured gains in the net external position should be interpreted with caution; the intrinsic dynamics of the net external position depends on the *difference* between the rates of return on external assets and liabilities. In this sense, one could say that the gains in net IIP did not as much stem from positive returns on investment, but rather from relatively smaller 'Dutch losses' on foreign assets than losses on Dutch liabilities mainly 'absorbed' outside of the Netherlands by foreign investors. Consequently, the positive price effect in 2008 might have stemmed from the fact that the Dutch stock market (AEX) performed worse than the average of global indices. Another possible factor at work is that Dutch assets abroad are less marked to market than foreign assets in the Netherlands.

Overall, according to the official statistics as they stand, the Netherlands has had a poor track record in terms of building up a solid net financial asset position, despite generating persistent and large current account surpluses. This can be explained by economic as well as statistical factors.

The steady appreciation of the guilder and, subsequently, the euro constitutes part of the explanation³². Another economic cause lies in the fact that foreign direct investors in the Netherlands have outperformed Dutch direct investors abroad, causing foreign holdings in the Netherlands to rise more sharply in value (Boonstra, 2008). Also, Dutch foreign assets have tended to be largely in debt and FDI whereas Dutch liabilities vis-à-vis foreigners have been more heavily directed towards portfolio equities (with higher returns). According to Boonstra (2009), this 'composition effect' played an important role for the Netherlands, as foreign investors had built up portfolios in Dutch equities before Dutch investors started to invest in foreign equities on a large scale. According to the *portfolio balance hypothesis* (Markowitz, 1952 and Tobin, 1958) the on-going unfavourable differential in the rates of return is due to the investors' behaviour, who optimise portfolios by holding a mixture of higher-risk, higher-return assets and lower-risk, lower-return assets; countries with persistent current account deficits tend to earn more on foreign assets than they pay on their foreign liabilities, while the opposite is true for net savers. Also, Mellens et al. (2007) suggest that the relatively small yields of Dutch investors could be explained by the relatively large role played by Dutch pension funds in portfolio investment abroad (see also 5.2). Since these are subject to strict supervisory conditions, such investments have a lower risk (and yield) profile than most of the foreign investors have in the Netherlands. Finally, apart from price and exchange rate effects, one of the other main economic factors that influence the net external position of the Netherlands are write-offs on paid goodwill (reflecting lower than expected future profits of the company that has been taken over), leading to a lower value of direct investment.

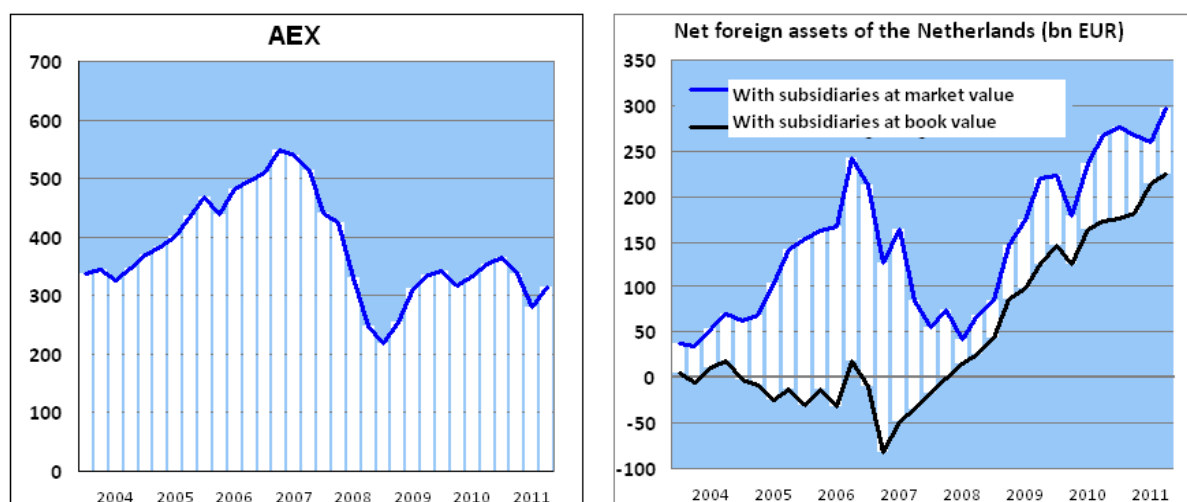
In addition, statistical factors related to the way in which holdings are valued play a role. Although the balance of payments best practice guidelines³³ recommend the recording of assets and liabilities at market value as often

³² Exchange rate movements have a direct effect on the value of cross border holdings. If, for example, the euro appreciates vis-à-vis the dollar, Dutch holdings in dollar denominated assets in the United States will decrease in value in terms of euro (the domestic currency), and vice versa, a euro depreciation will result in gains. On the other hand, such an appreciation may also translate in a decrease in value of its foreign liabilities when denominated in foreign currency. So, the currency composition of external assets and liabilities plays an important role. Boonstra (2008) estimates a negative exchange rate effect on the rates of return on Dutch foreign assets of 0.42% per year in the period 1987-2005, while Lane and Milesi-Ferretti (2004) estimate it at -0.38%.

³³ Balance of Payments and International Investments Position Manual.

as possible, most countries value them at 'book value' in view of practical difficulties associated with determining a market price. However, when the acquired assets are sold and the associated market value is revealed, potential accounting-related book profits or losses may arise. Since foreign participations in Dutch stock-market-listed companies are recorded at book value, whereas the stocks that foreign investors hold in Dutch parent companies are rated against market value (the value recorded at the end of the year), an increase in stock prices will lead to an increase of foreign liabilities, whereas the book value of foreign participations does not change, even if their market value increases, and, by consequence, the net external position is underestimated³⁴. Chart 15 illustrates that these underestimations can be very significant. In the period 2004-2011, the difference was often higher than EUR 100 billion, sometimes twice this amount. At the end of 2011, the Netherlands was more than EUR 70 billion richer according to the market-value figures of both outgoing and incoming participations that De Nederlandsche Bank (2012b) has estimated, in addition to the usual figures. Stock market conditions played an important role in this respect: the more optimistic the investors, the greater the price effect, i.e. the greater the gap between market and book value. Statistical discrepancies may thus lead to substantial and systematic divergences between changes in the net external asset position as measured by IIP and the (cumulated) flows between one year and the next recorded in the balance of payments.

Chart 15: AEX index and distortion of net external assets, 2004 - 2011



Source: De Nederlandsche Bank (DNB)

A second source of statistical errors and omissions concerns the phenomenon of 'capital evaporation', due to misreporting or underreporting of income. Specifically, foreign affiliates of parents (typically a multinational corporation) may have reinvested their earnings without either reporting these earnings as a payment of foreign investment income to the parent or reporting the investment as new FDI by the parent. In other words, the earnings reported by a foreign affiliate do not reflect the true financial contributions made by the affiliate to the parent. Through transfer pricing and other mechanisms, profits and earnings can be shifted among the parent and the affiliates almost at will, in response to tax or regulatory incentives; because market-based benchmarks for determining arms-length prices are often lacking, transactions (and the recording in the balance of payment) may be distorted. In that case, the significance of FDI as a channel of capital in- and outflow would be even larger than official data on remittances of profits seem to reflect.

³⁴ A similar story holds for the valuation of immaterial assets (e.g. human capital, market accessibility of the company in question, brand value, etc.).

Finally, as the net IIP is estimated on the basis of sample survey, sampling errors may play a role. Corrections therein or a change in the sample employed can equally have an impact on the recorded external wealth of a particular country.

Taking into consideration all of the above, the impact of statistical errors and omissions should not be underestimated, as these can contribute to a significant misrepresentation of the factual net external wealth position. A fair degree of caution thus seems warranted when interpreting the available figures. Although, theoretically, statistical omissions should level out over time, given that they should apply to both assets and liabilities, in practice, international divergences in statistical recording with respect to revaluations of assets and liabilities still exist. Moreover, since the size of financial flows has grown dramatically and amounts to several times the level of the Dutch GDP, even a relatively small statistical omission can have a considerable impact on the recorded net IIP.

5.2 NET EXTERNAL POSITION BY SECTOR

The fact that, contrary to expectations, the Dutch net IIP hardly improved for most of the past twenty years, as could have been expected on the basis of the accumulated current account surpluses may, as seen above, be explained by a combination of statistical and economic factors. This matters for, among other things, the challenge of addressing the financial implications of population ageing. Given the gap between the current account and foreign wealth changes one might question whether saving for the future through a policy that aims at a high degree of institutionalised pension savings and/or budget surpluses, in order to generate current account surpluses and a positive net IIP, is an appropriate policy strategy.

Pension funds and insurance corporations have by far the largest positive net external assets position³⁵, followed by investment companies and 'other financial institutions'³⁶ (Chart 16). The large amount of pension assets reflects the very sizeable mandatory second-pillar pension savings in the Netherlands, which are managed by pension funds. The largest pension fund, the *Stichting Pensioenfondsen ABP* ('National Civil Pension Fund' for government and education employees) is amongst the largest in the world, with total assets of EUR 261 billion as of end March 2012³⁷. In 2010, the net external assets of these three sectors combined showed an increase, mainly as a result of revaluations, to EUR 838 billion, or 142% of GDP³⁸.

The external asset position of pension funds and insurances deteriorated in 2008 and 2009, caused by the fact that pension funds shifted a substantial proportion of their investments abroad to (domestic) investment funds, but also due to the losses they suffered as a result of a strong decline in equity prices (mainly stocks) and market interest rates, as illustrated in the drop, at the end of 2008 and 2011, in their coverage ratios³⁹ below the statutory minimum of 105% and in some cases even below 100%, compared with 144% at the end of 2007.

³⁵ The data on pension funds were included into the 'other/households' category until 2002; from 2003 on they are registered apart in a 'pension funds and insurances' category, explaining the break in continuity between 2002 and 2003.

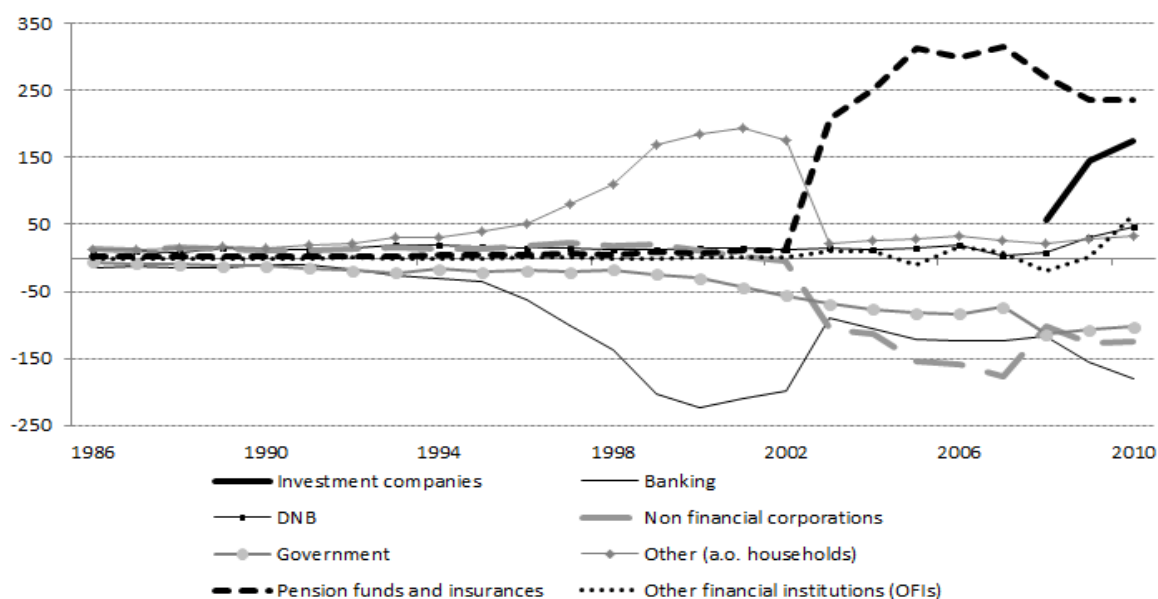
³⁶ Including a.o. investment funds, financial holding companies, special purpose vehicles (SPVs) and special financial institutions (SFIs).

³⁷ Website ABP.

³⁸ De Nederlandsche bank; own calculations.

³⁹ The Financial Assessment Framework, which is part of the new Pension Act for the 2nd pillar, sets out the requirements for the financial position of a pension fund, which is largely reflected by the coverage ratio (i.e. the relationship between the fund's assets and the pension fund liabilities). In addition a pension fund must hold enough financial buffers (equity) to be able to cope with setbacks, such as interest rate

Chart 16: Sectoral contribution to the Dutch external net lending/borrowing (as percentage of GDP)



Source: De Nederlandsche Bank (DNB)

Other institutional sectors, such as the Dutch government, non-financial corporations and the Dutch banking system, all have a net external liability position. In 2008, negative valuation effects implied a strong decline in foreign obligations of non-financial corporations, due to the fact that the large majority of stocks issued by these corporations are quoted on the stock exchange, whilst on the asset side they mainly hold non-quoted stocks.

It may be clear from chart 16 that, beyond the associated wealth effects in the net IIP, important valuation effects and swings also raise the risk of sharp deteriorations in balance sheets in some sectors of the economy, as large and sudden valuation shifts can work their way through the real economy in the form of large-scale portfolio shifts, flight-to-quality, and write-downs on large foreign investments. The larger the ratio of assets or - especially- liabilities to GDP, the more vulnerable a country is to abrupt changes in financial market conditions and to adverse wealth and balance sheet shocks.

developments, increasing life expectancy and financial markets turmoil. The pension fund's investment results as well as the liabilities are valued at market price.

6. Conclusion

The Netherlands is almost a textbook-case of an open economy that is highly integrated in the world economy in terms of both trade and financial flows. The trade balance, in particular for goods, by far accounts for the largest part of the persistent and substantial Dutch current account surplus. Apart from a structural component stemming from natural gas, the positive goods balance has increasingly mirrored the contribution of so-called re-exports (goods which leave the country again after some added value from processing). The positive trade balance reflects the increasing links of the Dutch economy into global production chains and the benefits from locational factors, but also a competitive edge from adding even a small percentage of value added to the large flows of goods channelled through the Dutch territory. By contrast, relative market shares for domestically produced exports, originating notably in industries such as foodstuffs and chemicals, have developed less favourably, pointing to a possible challenge with respect to the competitiveness of domestically produced exports. Even so, the overall competitive position of the Netherlands underpinning the trade surplus appears to have remained quite strong. Moderate losses in competitiveness of domestically-produced goods and services, which partly reflect sectoral specialisation patterns, have broadly been offset by the dynamism of re-exports.

One may be tempted to tentatively conclude that the high and persistent current account surplus of the Netherlands does not seem to reflect a major problem of the Dutch economy itself and that no significant policy interventions are called for especially since arguably the current account of a country should not be considered a policy variable to be targeted directly. However, on closer inspection a less benign interpretation may be warranted.

From a birds-eye's view one could say that over the past few decades sectoral financing and leverage strategies that were prompted by institutional settings and incentives in a globalising world led to the quite distinct pattern of financial flows and balance sheet positions underlying the persistent Dutch current account surplus. A key issue that stands out is the shift that has taken place from households to non-financial corporations as main contributors to the surplus. This shift to a large extent reflects the pivotal role played by the housing market in shaping the households' balance sheet. At the same time, profits received from foreign affiliates have spurred non-financial corporation's savings. Owing to its geographical location, historical ties and a traditionally strong competitive position and sound and credible institutional setting, the Netherlands has become a hub for international trade and capital flows, allowing non-financial corporations (mostly multinationals) to channel FDI and "route" income flows, via entities in the Netherlands, between a company in one country and subsidiaries or affiliates in other countries.

These financing patterns arguably served the Dutch economy well for a long time but also exposed it to vulnerabilities which have come to the fore in the wake of the global crisis. Dutch household savings primarily end up with pension funds and insurance vehicles, which channel these savings largely abroad. At the same time Dutch households piled up substantial residential mortgage debt. In turn, the high mortgage levels on bank balance sheets resulted in deposit funding gaps so that Dutch banks are relatively dependent on foreign market funding, causing problems in the current distressed markets. Non-financial corporations hold huge financial buffers yet do face difficult choices on how to invest them. Given the high savings generated by the non-financial corporate sector, good corporate governance to ensure an appropriate balance between home and foreign investment and to support strategies to maximise returns while appropriately allowing for risks is an important challenge. In the current financial turmoil, this task arguably has become as difficult as ever before. However, the fact that inter-company transfers often reflect shifting profits between countries should be duly taken into account when interpreting data on FDI returns.

The Netherlands thus appears to be stuck in a self-reinforcing spiral in which a combination of multiple factors has been at play: it has been to a large extent financing itself from abroad in an original, yet risky way. The structural mismatches (in terms of maturities, exposures etc.) of Dutch assets and liabilities and concurrent funding problems have made the Dutch economy volatile and dependent on the whims of international capital markets. This raises the risk of sharp deteriorations in balance sheets in some sectors of the economy, through large-scale portfolio shifts, flight-to-quality, and write-downs on large foreign investments. The ensuing negative feedback loops from the current account to the real economy are also posing a severe challenge to government accounts, notably to corporate tax revenues. Against this backdrop, a fundamental reflection on the optimal investment strategies of the proceeds of the accumulated surpluses as regards savings-investment patterns and the balance between home and foreign investment may be called for. Moreover, fairly sluggish productivity increases in the most recent period and the low value added of re-exports imply that policies should remain focused on fostering innovation and competitiveness. Profitable segments of the economy with a strong competitive edge can still help to underpin domestic purchasing power, but with the Netherlands going through what is likely to be a prolonged spell of balance sheet adjustments in the wake of the global crisis, economic dynamics is likely to be sluggish in years to come. Finally, in addition to an overhaul of the institutional setting of pension funds, strong measures to address a far-reaching reform of the housing market are already long overdue. These not only concern capping loan-to-value ratios and introducing a mandatory amortisation percentage for mortgages, but also a phasing-out of the mortgage interest rate deductibility scheme.

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Publications Office

ISBN 978-92-79-22986-2



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