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THE NETHERLANDS – REVIEW OF PROGRESS ON POLICY MEASURES RELEVANT FOR THE CORRECTION OF MACROECONOMIC IMBALANCES

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Executive summary

This is the second specific monitoring report under the Macroeconomic Imbalance Procedure (MIP) for the Netherlands, reflecting the strengthened monitoring of all Member States with imbalances[1]. The Netherlands had been found to have imbalances already in previous years. The imbalances relate in particular to the level of private debt and the current account surplus. This report reviews the latest developments and policy initiatives to correct those imbalances, which were identified in the 2017 Country Report and which were addressed by the 2017 country-specific recommendations. The cut-off date for this report is 7 November 2017.

Amidst a sharp recovery of house prices, robust GDP growth and strong export demand, passive deleveraging continued, while the current account surplus increased. Real GDP is forecast to grow by 3.2% in 2017, and by 2.7% and 2.5% in 2018 and 2019 respectively, according to the European Commission 2017 autumn forecast. Economic growth is driven predominantly by domestic demand, with all expenditure components contributing. While wage growth has remained subdued, it is forecast to pick up as the labour market tightens and supply constraints become more pronounced. Trade unions are formulating substantially higher wage demands than in previous years. House prices have been increasing by roughly 7.5% year-on-year in the first eight months of 2017, although there are substantial regional differences. Despite the pick-up of housing market activity, passive deleveraging continued as household debt grew by 1.3% on average over the last four quarters in nominal terms, which is much slower than nominal GDP growth (3.5% over the same period). Rebounding primary income on foreign investment and relatively strong export growth is driving the current account up to 9.1% of GDP in 2017. However, for 2018 and 2019 a gradual decline to 8.7 % and 8.4 % is projected on the back of buoyant domestic demand.

The new government announced a substantial speeding-up of the reduction of mortgage interest deductibility. Private sector indebtedness in the Netherlands is mainly related to the high gross debt of households, partly linked to distortive housing market incentives, such as relatively generous mortgage interest deductibility (MID). Since 2012, successive measures to reduce the MID have been implemented, such as a reduction in maximum loan-to-value ratios, stricter loan-to-income ratios and a gradual reduction of and stricter criteria for MID. The new government has announced a substantial speeding-up of the reduction in MID; the maximum rate of MID will be lowered by 3% per year from 2020 onwards to 37% in 2023. The previous government has implemented policies to improve the functioning of the social housing sector. Although the number of high income tenants in social housing (so called 'scheefhuurders') is decreasing gradually, there is scope to further reduce allocative inefficiencies. Social housing corporations, for instance, do not use the potential offered by the law to increase rents for high income earners.

The new coalition agreement 2018-2021 contains a substantial fiscal stimulus with a direct impact on domestic demand. The 2018-2021 coalition agreement was published on 10 October and includes, amongst others, increased public spending on social affairs (in particular in child-related benefits), defence and education. These measures have a direct impact on domestic demand, potentially driving the trade surplus down. On the revenue side,

[1] COM(2016)95 final, 8.3.2016.

a lowering of the personal income taxes is foreseen for 2019, which is only partly financed by an increase in indirect taxation (VAT and energy taxes) and thus lowers the overall tax burden for households. The government calls for a faster wage increases, as wage growth is low in light of general improvements in the macro-economy. While the new government aims at containing health care costs and targets a reform of the second pillar in the pension system, the overall impact on the very high non-tax compulsory payment wedge on income is unclear, given uncertainties in the policies to curb (premium financed) health-care costs and the complexities (including implementation risks) surrounding pension reforms.

In conclusion, the new government has agreed on an important further reduction in MID lowering the debt bias for households, while external rebalancing is expected to benefit from a pick-up of domestic demand-driven growth of real household income and fiscal stimulus measures. Although reforms in the rental market have been implemented, allocative inefficiencies remain. Finally, it is important to preserve the reform momentum in the field of pensions, in light of its macroeconomic impacts on the compulsory payment wedge and savings-investments balances.

Table 1: Key findings on the implementation of policy reforms[2]

On track	Wait-and-see	Action wanted
	• New government's fiscal plans • Faster reduction in mortgage interest deductibility • Rental market reforms (reforms to force social housing corporations to focus on their core task, to reduce the number of 'scheefhuurders', to allow for temporary rental contracts) • Additional R&D investment (EUR 400 mln, announced in the coalition agreement)	• Second pillar pension reform process • Wage formation

[2] The table classifies reforms under review on the basis of their respective adoption and implementation process, uncertainty and their level of detail. "On track" are measures for which the legislative or implementation process has been completed or is progressing well according to the foreseen timeline, and which are expected to be sufficiently effective. "Wait and see" are measures for which the legislative process is on-going, but is still in a relatively early phase, or measures for which there is still uncertainty on the complete implementation and effectiveness. "Action wanted" are measures for which limited or no action has been taken, or measures that have been announced but which are not sufficiently detailed yet to be assessed.

1. Introduction

On 16 November 2016, the European Commission presented, in the context of the Macroeconomic Imbalance Procedure (MIP), its sixth alert mechanism report[3] to underpin the selection of Member States requiring an in-depth investigation into the existence and extent of macroeconomic imbalances. The subsequent in-depth review in the country report – published on 22 February 2017[4] – examined the nature, origin and severity of macroeconomic imbalances and risks in the Netherlands. In the accompanying Communication[5], the Commission concluded that "the Netherlands is experiencing macroeconomic imbalances". These imbalances are related to the high stock of private debt and the large current account surplus, with cross-border relevance. The Commission emphasised that the private sector debt had only very gradually decreased in the last years. Nominal mortgage debt has been increasing, against the background of resuming house price growth. The Commission also noted that domestic demand could profit from measures undertaken in 2016, but emphasised that policy challenges were remaining in the field of pensions and interest rate deductibility of mortgages, with a view to rebalancing incentives to take up mortgage debt.

In April 2017, the Netherlands submitted its Stability Programme[6] and National Reform Programme (NRP)[7], respectively outlining the fiscal targets and the policy measures to improve its economic performance and to unwind imbalances. On the basis of an assessment of these plans, the Commission proposed two country-specific recommendations (CSRs)[8], which were adopted by the Council on 11 July 2017[9]. These recommendations concern (i) domestic demand, including R&D spending and housing market institutions, (ii) the labour market, including wage formation and the pension system. Both recommendations were considered to be MIP-relevant, as they are related to domestic saving and investment patterns and household indebtedness.

The present report assesses the latest key policy initiatives[10] undertaken by the Dutch authorities also in the light of the findings of the monitoring mission and the new coalition agreement 2018-2021, which was published on 11 October of this year. Given the seven month period of a caretaker government, relatively few new measures have been adopted and implemented over the course of this year.

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[3] https://ec.europa.eu/info/sites/info/files/2017-european-semester-alert-mechanism-report_en_0.pdf
[4] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-netherlands-en.pdf
[5] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-reports-comm-en.pdf
[6] https://ec.europa.eu/info/sites/info/files/2017-european-semester-stability-programme-netherlands-en_0.pdf
[7] https://ec.europa.eu/info/sites/info/files/2017-european-semester-national-reform-programme-netherlands-en.pdf
[8] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations_-_netherlands.pdf
[9] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2017:261:FULL&from=GA
[10] Details on the policy measures taken can be found in the overview table in the Annex.

2. Outlook and recent developments on imbalances

2.1 Recent economic developments and outlook

The economic expansion in the Netherlands gained speed and is expected to continue over the next years, fuelled by a policy stimulus. Real GDP is projected to grow by 3.2% in 2017 and to decelerate only gradually to 2.7% in 2018 and 2.5% in 2019, according to the European Commission 2017 autumn forecast. The growth outlook has considerably improved since the last in-depth review, which is explained by better-than-expected outturn data (in particular a very strong second quarter) and the expected impact of the new government's coalition agreement 2018-2021. The new government's fiscal plans include a substantial amount of stimulus measures with a direct impact on domestic demand. While wage growth has remained subdued so far, it is forecast to pick up as the labour market tightens and supply constraints become more pronounced. Trade unions are also formulating substantially higher wage demands than in previous years, while inflation is expected to accelerate in 2019 due to increases in indirect taxation (VAT and energy taxes). The headline deficit is expected to reach 0.7% of GDP in 2017, and to fall to 0.5% in 2018 before rebounding to 0.9% in 2019. As a result of the sustained budget surpluses and relatively high nominal GDP growth, the debt-to-GDP ratio is forecast to decrease from 57.7% of GDP in 2017 to 51.5% in 2019.

2.2. Developments as regards imbalances

The Commission concluded in February 2017 that the Netherlands was experiencing macroeconomic imbalances. The imbalances were related to private sector indebtedness and the current external balance. The following section provides an update of the situation with regard to economic developments related to the imbalances.

Private sector debt

Passive deleveraging continued. While the number of transactions and house prices continue to increase[11], growth of nominal household mortgage debt remains relatively low, at 1.3% over the last four quarters, according to Statistics Netherlands data.[12] This is substantially below the nominal GDP growth, leading to a declining mortgage debt-to-GDP ratio. Increasing house prices have also lowered the number of households with negative net housing equity (so called 'underwater mortgages') substantially. According to loan level data by the Dutch Central Bank, the share of underwater mortgages declined from 22.5% in 2016Q1 to 14.8% in 2017Q1

[11] The price of existing dwellings increased by 7.3% y-o-y in nominal terms in the first 9 months of this year. The number of transactions was 14.5% higher, compared to the same period in 2016.

[12] The relatively low growth of mortgage growth may partly be explained by voluntary repayments on mortgages by households with low loan-to-value ratios, due to interest rate arbitrage on savings. The Dutch central bank estimates that circa EUR 60 bn (close to 10%) of the total outstanding mortgage debt has been repaid voluntary since 2013 (Autumn 2017 financial stability review by the Dutch Central Bank, p. 21. https://www.dnb.nl/binaries/OFS_Najaar17%20WEB_tcm46-363954.pdf)

Current account surplus

The current account surplus edged up recently, but is expected to decline according to the Commission forecast. Although the current account surplus had declined in the past years, recent quarterly data point to an increase to 9.1% of GDP in 2017. This increase is driven by an increase of the trade balance driven by booming net exports in the second quarter of 2017 and a less negative overall balance on primary incomes. Improved profitability of foreign activities has led to a sizable increase in the revenues on foreign direct investment, which is only partly offset by a decline in net portfolio incomes. A breakdown of net lending/borrowing by sector shows that in particular the continued improvement in general government net lending adds to the savings surplus. Households continue to be net savers although to a lesser extent than in previous years. A trade perspective shows how in recent quarters the trade balance in goods edged up, mostly due to an increase in small surpluses with third countries. The trade surplus with the most important European partners was relatively stable, while the trade deficit with China widened after having declined in the period up to the start of this year. Although picking-up only slowly so far, wage growth is expected to increase and to fuel private consumption and net imports. For 2018 and 2019 a gradual decline of the current account surplus is projected on the back of robust growth of domestic demand.

3. Progress with policy implementation

This section describes policy measures taken to address the high level of household debt, against the background of the 2017 country-specific recommendation (CSR). This recommendation called for a reduction of the distortions in the housing market and debt bias for households, in particular by speeding up the decrease in mortgage interest tax deductibility (MID). The 2017 CSRs also called for external rebalancing, in particular through supportive fiscal policy, a second pillar pension reform and higher wage growth.

3.1 Reduce private debt

The new government has announced to significantly speed up the reduction in the MID. The high household indebtedness in the Netherlands can largely be linked to mortgage debt, which is fuelled by policy distortions in the housing market. Since the start of the European Semester, all vintages of CSRs have called for measures to reduce remaining distortions on the housing market and the debt bias for households, in particular by decreasing MID. The previous government had taken a number of measures to reduce household debt and improve the functioning of the housing market. Loan-to-value and loan-to-income requirements have been sharpened and the deductibility of mortgage interest expenditure in the personal income taxes is being reduced gradually. The new government has announced to significantly speed up the reduction in MID: whereas the maximum rate under the previous government was being reduced by ½ pps per year, the speed of reduction is 3% pps per year starting in 2020, until the maximum tariff equals the new base tariff in the personal income taxes (36.93%)[13]. While this is a considerable increase in MID reduction, a rate of 37 % would still be relatively high. A strong subsidy on debt creation therefore remains. The new government has indicated to not alter the current policy with respect to maximum loan-to-value ratios, implying a stable maximum LTV at 100 % from 2018 onwards, although the Dutch Financial Stability Committee has advised to continue the gradual decline in maximum LTV to 90%.

The new government is not stepping up the effort in the rental market. The Dutch housing market is characterised by a very large owner-occupied, a very large social housing sector and a small open rental market. An accessible rental market is key for reducing the debt-take up by households. The previous government has implemented a number of measures aimed at improving the functioning of the rental market. These measures include amongst others the possibility to charge higher rent increases for '*scheefhuurders*' and a regulatory change allowing for more short-term rental contracts (*Wet Doorstroming Huurmarkt,* July 2016*)*. The new government intends to improve the supply of affordable housing in the unregulated middle segment of the rental market via a better use of the instruments local governments already have, but without further specification.[14] While the measures from the previous government lead to a noticeable decline in the number of high income earners in social housing[15], continued policy-effectiveness is not guaranteed. Analysis by Statistics Netherlands revealed that in 2014 more than 50% of tenants with a high income received the maximum rent increase by law. However, in 2015 and 2016 this number

[13] The new government has announced to implement a tax reform in 2019 reducing the number of tax brackets from currently four to two, with a base tariff at 36.93% and top tariff at 49.5%.
[14] Paragraph 2.3 Coalition Agreement 2018-2021.
[15] See Ministry of Interior (2016), Staat van de Woningmarkt 2016

declined to 34% and 24%, showing that social corporations might have little incentive to increase rents, limiting the policy effectiveness.[16]

To conclude, although significant policy action is ongoing aimed at addressing the imbalances associated with household debt, challenges remain. Areas of progress include the announced stepping-up of the reduction of MID, but the legislative process is still in a very early phase. Policy efforts to improve the functioning of the rental market are slowly showing results, but allocative inefficiencies in the rental market persist.

3.2 External rebalancing.

Amid an expected acceleration of wage growth, the new government has announced policies to strengthen domestic demand. The total amount of the fiscal stimulus of the new coalition agreement is 0.6% of GDP in 2018, increasing to 0.9% of GDP in 2019. The government balance is expected to decline by circa ½ percentage point in structural terms in 2018. For 2019 a discretionary package with net tax relief is announced: personal income taxes are lowered, while the lower VAT rate is increased from 6% to 9%. These measures are expected to have a direct impact on domestic demand. The government is set to increase expenditure on, amongst others, education and research, mobility, defence and social affairs, in particular child related benefits. With respect to research, the government announced that by 2020, an extra EUR 400 mln euro will be spent annually on R&D, of which EUR 200 mln for technological institutes. In addition, in 2018 and 2019, the government announced to invest EUR 50 mln in research infrastructure.[17] However, as this amounts to less than 0.1% of GDP, the public R&D intensity may still decline, due to positive growth perspectives.[18] Dutch stakeholders and advising bodies broadly agree on a need for extra R&D investment in the coming years.[19]

The coalition agreement of the new government calls explicitly for wage increases.[20] Wage growth remains subdued in spite of the fast decline of unemployment and general improvements in the macro-economy. However, although the new government recognises that wage growth is slow, a part from a reduction of the tax wedge which is announced for 2019, no further measures affecting wages are taken.

While pension reforms have been announced by the new government, the exact plans have not yet been specified and there remain significant implementation risks. Country Report analysis showed that the compulsory payment wedge is one of the largest in industrialised economies. Notably, the design of the pension system entailed an important increase in compulsory savings in particular in a low interest rate environment, much of which is channelled towards foreign investment. Total pension fund assets have increased from EUR 778.5 bn in 2009 (127% of GDP) to EUR 1378 bn in 2016 (almost 200% of GDP

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[16] See https://www.cbs.nl/nl-nl/nieuws/2016/36/laagste-huurstijging-in-vijf-jaar and https://www.cbs.nl/nl-nl/nieuws/2017/36/laagste-huurstijging-sinds-2010 for 2017.
[17] Coalition Agreement 2018-2021, paragraph 1.3.
[18] Vennekens, A.& Van Steen, J. al, 2017, 'Totale Investeringen in Wetenschap en Innovatie, 2015-2021', Rathenau Institute, Den Haag, April 2017.
[19] Raad voor Wetenschap, Technologie en Innovatie (2016a, 2016b), werkgroep Wetenschap, Onderzoek, Ontwikkeling en Innovatie (2016), Knowledge Coalition (2016)
[20] See Coalition Agreement 2018-2021, section 2.1 The government considers that 'employees are insufficiently profiting from the improving economy' and states that there is scope for higher wage growth.

in 2016). The new government is continuing the second pillar pension reform process, but the new coalition agreement is not specific about legislative measures.

To conclude, although some significant policy action is ongoing, the current account surplus is expected to remain elevated. Based on robust growth of domestic demand and fiscal stimulus, the current account surplus is expected to gradually decline in the coming years.

Annex 1: Overview table of MIP-relevant reforms

MIP objective: Reduce private debt			
Housing market regulation (owner occupied market)			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Oct 2017: The new government agreed on reducing the maximum MID rate by 3 pps per year to 37% in 2023.	.	• Since **2013:** Only annuity or linear mortgages are eligible for MID and the maximum rate is being reduced by 0.5 pps per year, starting from 52% to 38%. • Maximum loan-to-value ratios are being reduced gradually to 100 **by 2018** and Maximum loan-to-income ratios are made stricter.	CSR 1, 2017: […] Take measures to reduce the remaining distortions in the housing market and the debt bias for households, in particular by decreasing mortgage interest tax deductibility.
Housing market regulation (rental market)			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		• **In July 2016**: The *Wet Doorstroming Huurmarkt* entered into force. This law allows for more short-term contracts and more mobility on the rental market. • **In July 2015:** The Woningwet entered into force which aims at a better allocation in the social housing sector, reducing the number of Scheefhuurders (by limiting the number of flats that can be offered freely, without the eligibility criteria, to 10%) in social housing. The law also forces social	CSR 1, 2017: […] Take measures to reduce the remaining distortions in the housing market and the debt bias for households, in particular by decreasing mortgage interest tax deductibility.

		housing corporations to focus on their core task, by imposing a legal or administrative split between social housing and commercial activities. • **In July 2013** the *Uitvoeringswet huurprijzen woonruimte* was amended to allow for means tested rent-increases, to create mobility in the rental market and reduce the number of 'scheefhuurders**'.**	
MIP objective: External rebalancing			
Rebalancing via domestic demand			
Public finances and taxation			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Oct 2017: The new government announced to implement a fiscal package of 0.6% of GDP in 2018, increasing to 0.8% of GDP in 2019. R&D investment will be increased by EUR 400 mln in 2020 (<0.1% of GDP). For 2019 a tax shift from direct to indirect taxation is announced.		• **In 2016** a substantial package of tax-measures (EUR 5 bn, 0.7% of GDP) to lower the tax wedge on labour was implemented.	CSR 1, 2017: While respecting the medium-term objective, use fiscal and structural policies to support potential growth and domestic demand, including investment in research and development. […]
Pensions			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Oct 2017: The government has agreed to reform the second pillar of the pension		• **In 2015:** the retirement age for the first pillar of the pension system has	CSR 2, 2017: […] Based on the broad preparatory process already launched,

system by 2020, but no major new measures have been announced since the publication of the CSR.		been increased to 67 by 2021 and is linked to life expectancy afterwards. Simultaneously the fiscal maximum accrual rates have been lowered, leading to lower pension contributions (the so called *Aanscherping Witteveenkader*). • **In January 2015:** a revised financial supervision framework was introduced.	make the second pillar of the pension system more transparent, inter-generationally fairer and more resilient to shocks. […]