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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 third specific monitoring report under the Macroeconomic Imbalance Procedure (MIP) for the Netherlands, reflecting the strengthened monitoring of all Member States with imbalances¹. The Netherlands had been found to have imbalances 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 address those imbalances, which were identified in the 2018 Country Report and which were addressed by the 2018 country-specific recommendations. The cut-off date for this report is 6 November 2018.

Growth momentum remains strong, while the current account increased and passive deleveraging continued in 2017. Real GDP is forecast to grow by 2.8% in 2018, and by 2.4% and 1.8% in 2019 and 2020 respectively, according to the European Commission 2018 Autumn Forecast. Household and public spending are the main growth drivers. Wage growth has remained subdued thus far, but is expected to accelerate in line with the tightening labour market. Higher public sector wages are contributing positively to wage growth and both the government and the Dutch Central Bank (DNB) have called for higher wages. The unemployment rate declined further to 3.7% in September. Nominal house prices have been increasing by roughly 9% year-on-year in the first nine months of 2018. At the same time, nominal mortgage debt increased by only 1.1% over the last four quarters, which is below nominal GDP growth (4.6% over the same period), resulting in a passive deleveraging. The current account balance increased from 8.1% in 2016 to 10.5% of GDP in 2017. A large part of the high current account balance relates to the activity of non-financial corporations (NFC's), including multinational enterprises. Their contribution to the surplus increased from 3.2% of GDP to 5.3%, thereby accounting for roughly half of the surplus in 2017. The government balance also increased from 0% to 1.2%. Household net lending continued its declining trend after peaking in 2014, while remaining positive at 2.3% of GDP. Robust domestic demand growth over the forecast horizon is set to gradually decrease the current account balance to 10.1% in 2018 and further to 9.1% in 2020.

Reduction of mortgage interest deductibility (MID) is being accelerated, but remains generous. Private sector indebtedness in the Netherlands is mainly related to the high gross debt of households, closely intertwined with distortive housing market incentives, such as MID in the personal income taxes. In the past years, successive measures to reduce the pick-up of mortgage debt have been implemented, such as a reduction in maximum loan-to-value ratios and stricter loan-to-income ratios. Since 2013, only annuity mortgages with a maximum maturity of 30 years qualify for MID and in 2014 a gradual reduction of the maximum applicable rate began. The government is speeding up substantially the reduction in MID, lowering the maximum rate by 3 pps. per year from 2020 onwards to 37% in 2023. While this implies a considerable decrease in MID, a rate of 37% would still be a strong subsidy on debt creation. While previously implemented policies to improve the functioning of the rental sector seem to have had a positive impact, the private rental sector remains underdeveloped. Overall, there is scope to further reduce allocative inefficiencies in the housing market.

¹ COM(2016)95 final, 8.3.2016.

The government is implementing a fiscal stimulus. The government is implementing a substantial fiscal stimulus package with a direct impact on domestic demand. This includes, amongst others, increased public spending on social affairs (in particular in child-related benefits), defence, education and infrastructure investment. At the same time, the overall tax burden for households will be lowered, stimulating real disposable income. Overall, this reflects an expansionary fiscal stance, with a worsening of the structural budget balance of 1% of GDP over a period of two years, from 0.7% of GDP in 2017 to -0.3% of GDP in 2019 according to the Commission 2018 Autumn Forecast.

In conclusion, the government is addressing the debt bias for households and supports domestic demand by fiscal policy, but incentives to take on mortgage debt remain and the current account surplus is expected to remain elevated. Although reforms in the rental market have been implemented, allocative inefficiencies remain. External rebalancing is also expected to benefit from domestic-demand driven growth. Finally, measures are still to be announced in the field of occupational pensions, which have an important macroeconomic impact on the compulsory payment wedge and savings-investments balances. Measures in the field of the tax and non-tax wedge on labour have the potential to address both observed imbalances simultaneously, as higher disposable household income may fuel domestic demand and may be used for reducing the pick-up of household debt.

Table 1: Key findings on the implementation of policy reforms²

On track	Wait-and-see	Action wanted
• Implementation of fiscal measures • Faster reduction in mortgage interest deductibility	• Further rental market measures • Support higher wage growth	• Second pillar pension reform process

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 22 November 2017, the European Commission presented, in the context of the Macroeconomic Imbalance Procedure (MIP), its seventh alert mechanism report³ 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 7 March 2018⁴ – examined the nature, origin and severity of macroeconomic imbalances and risks in the Netherlands. In the accompanying Communication⁵, the Commission concluded that "the Netherlands is experiencing macroeconomic imbalances". These imbalances are linked to the high stock of private debt and the large current account surplus, with cross-border relevance. The Commission noted that the current account surplus has increased but is forecast to decline somewhat. The Commission also pointed out that private sector debt relative to GDP had only very gradually decreased in the last years and that driven by an on-going recovery in the housing market, nominal mortgage debt has been increasing again. Finally, the Commission noted that measures announced by the new government such as the fiscal stimulus should help to support aggregate demand.

In April 2018, the Netherlands submitted its Stability Programme⁶ 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 13 July 2018⁹. These recommendations concern (i) investment needs in R&D and innovation, as well as the housing market focusing on the development of the private rental sector, (ii) the labour market, including promoting higher wage growth and the pension system. The 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 initiatives¹⁰ undertaken by the Dutch authorities also in the light of the findings of the monitoring mission.

Outlook and recent developments on imbalances

2.1 Recent economic developments and outlook

The Dutch economy has experienced a continued growth momentum in the first half of 2018. GDP is expected to increase by 2.8% this year, followed by 2.4% in 2019 according to the European Commission 2018 Autumn Forecast. This is 0.2 pps. below the Spring Forecast for both years, reflecting outturn data in the first half of the year and a somewhat weaker external outlook. In 2020, growth is expected to slow to 1.8%, as supply constraints become

³ <https://ec.europa.eu/info/sites/info/files/economy-finance/com-2017-771-en.pdf>

⁴ <https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-netherlands-en.pdf>

⁵ https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-communication_en.pdf

⁶ <https://ec.europa.eu/info/sites/info/files/2018-european-semester-stability-programme-netherlands-en.pdf>

⁷ <https://ec.europa.eu/info/sites/info/files/2018-european-semester-national-reform-programme-netherlands-en.pdf>

⁸ https://ec.europa.eu/info/sites/info/files/file_import/2018-european-semester-country-specific-recommendation-commission-recommendation-netherlands-en.pdf

⁹ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2018:320:FULL&from=E>

¹⁰ Details on the policy measures taken can be found in the overview table in the Annex.

more binding. In this phase of the economic cycle, growth is expected to be mainly driven by domestic demand, with little or no contribution from net exports. Positive labour market developments leading to higher household disposable income and elevated consumer confidence are expected to drive solid private consumption growth. Investments will increase at a somewhat slower pace compared to previous years, in line with the more moderate economic expansion and some decline in business sentiment since the start of 2018. HICP inflation is expected to accelerate to 1.6% in 2018 and 2.5% in 2019 on the back of higher energy prices, upward wage and price pressures due to the positive output gap and an increase in the reduced VAT-tariff. The headline deficit is expected to remain in a stable surplus of around 1% of GDP, supported by tax rich growth. The structural balance is set to deteriorate from 0.7% in 2017 to -0.3% in 2019 as the government is implementing its planned fiscal package, before stabilising at -0.1% in 2020. Headline surpluses and robust nominal GDP growth are driving the debt-to-GDP ratio down from 57% in 2017 to 46.9% in 2020.

2.2. Developments as regards imbalances

The Commission concluded in February 2018 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

Private sector indebtedness remained high at 252% of GDP in 2017. Household debt has been steadily decreasing since the peak of 118% in 2010 to 105% in 2017. This is mainly the result of passive deleveraging, as the growth of nominal mortgage debt has been below the nominal GDP growth. Over the last four quarters (2017Q3-2018Q2), mortgage debt increased by 1.1% which is substantially lower than nominal GDP growth (4.6%). Loan level data by the Dutch Central Bank also show that first time buyers are gradually reducing their loan-to-value ratios, from above 100% to circa 90% in the last quarters. While the number of housing transactions seems to have peaked, house prices continued to increase rapidly over the first nine months of the year at 9% y-o-y in nominal terms. As a result, the share of underwater mortgages declined further to 6% in 2018Q2, down from 27% three years earlier, according to loan level data by the Dutch Central Bank.

Current account surplus

The current account surplus increased to a record high of 10.5% of GDP in 2017, but is set to moderate gradually. This marked increase from 8.1% of GDP in 2016 was mainly driven by a higher primary income balance, reflecting lower net distributed income by non-financial corporations. The trade balance also improved somewhat amid strong global trade developments. From a net lending perspective, all institutional sectors reported an observed surplus. Non-financial corporations made the largest contribution to domestic net lending at 5.3% of GDP, increasing from 3.2% in 2016. This was caused by an increase in profitability, an only limited increase in investments and an increase in net property income as reinvested earnings on foreign direct investments went up. The government budget balance also increased, from 0.0% in 2016 to 1.2% of GDP in 2017 due to buoyant revenue developments in this phase of the economic cycle. Household net lending, after peaking in 2014, continued its declining trend to 2.3% of GDP. Looking forward, the current account balance is set to

moderate gradually. Over the first two quarters of 2018, the current account balance declined slightly compared to the same period in 2017. This was mainly driven by a lower trade balance. From a net lending perspective, the contribution of NFC's and households declined while the government balance increased as some expenditure measures were subject to implementation lags. As the peak in 2017 was also impacted by a high surplus in the second half of the year, a gradual reduction of the current account balance to 10.1% in 2018 is foreseen according to the Commission Autumn Forecast. For 2019 and 2020 strong domestic demand is expected to lead to a further reduction of the savings surplus to 9.5% and 9.1% respectively, on the back of higher wages, a positive outlook on private consumption and expansionary fiscal measures.

3. Progress with policy implementation

This section describes policy measures taken to address the high level of household debt, against the background of the 2018 country-specific recommendation (CSR). This recommendation called for a reduction of the debt bias for households and the remaining distortions in the housing market, in particular by supporting the development of the private rental sector. The 2018 CSRs also called for measures that would support external rebalancing, such as creating conditions to promote higher wage growth and a reform of the second pillar pension system.

3.1 Reduce private debt

Mortgage interest deductibility (MID) is being reduced, but remains generous by European standards. 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 2012, all vintages of CSRs have called for measures to reduce distortions on the housing market and the debt bias for households, in particular by decreasing MID. Dutch authorities have taken measures over the past years 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 tax deductibility of mortgage interest expenditures has been reduced, via both the obligation to take out annuity mortgages in order to qualify for MID and a gradual reduction of the maximum applicable rate. The government is speeding up the reduction of the maximum rate in three steps from 49% in 2019 to 37% in 2023. This acceleration has been incorporated in a legislative proposal which is foreseen to be adopted by the end of the year (Belastingplan 2019). While this implies a considerable decrease in MID, a rate of 37% would still be a strong subsidy on debt creation.

As long as there is not a viable alternative on the rental market, there remains an incentive to take on mortgage debt. The Dutch housing market is characterised by a subsidised large owner-occupied market and a large, subsidised, social housing sector. The private rental market is the only sector not receiving any subsidy and with a share of 13% in 2017 it remains underdeveloped. In official publications the existing policy distortions are acknowledged¹¹ by the government and over the past years, a number of measures aimed at improving the functioning of the rental market have been implemented. These measures

¹¹ Paragraph 3.1.3 National Reform Programme 2018

include the possibility to charge higher rent increases for ‘scheefhuurders’ (middle and high income earners in social housing) and a regulatory change allowing for more short-term rental contracts (Wet Doorstroming Huurmarkt, July 2016). The government is coordinating with stakeholders on how to improve the supply of housing in the unregulated private rental market, including via a better use of the instruments local governments already have.¹² This includes the possibility for municipalities to allow for a certain percentage of dwellings for the private rental segment in their zoning plans, which was introduced in 2017. Although the private rental segment was the fastest growing sector in recent years, the continuing impact of previous measures remains to be seen. At this point, no further concrete measures have been announced.

Overall, while the government is determined to tackle the imbalances linked with household debt with its on-going policy reforms, challenges persist. Areas of progress include the increased speed of the reduction of MID. Policy efforts to improve the functioning of the rental market are timidly showing results, but structural allocative inefficiencies in the housing market persist.

3.2 External rebalancing

A large part of the surplus relates to the activity of non-financial corporations, including multinational enterprises, which may be influenced by tax policy. Previous country reports have pointed to the role of multinational enterprises (MNE's) in explaining the elevated current account surplus, as they contribute substantially to corporate gross savings.¹³ The implementation of measures in the area of corporate income taxation and for example the Anti Tax Avoidance Directive (ATAD) might affect this behaviour in terms of cross-border income flows as well as headquarter location decisions. However, whether this has an effect on the current account, remains to be seen.

Accelerating wage growth may support domestic demand as the labour market tightens. The unemployment rate has declined to 3.9% in August and other indicators of labour market slack have also reduced significantly. Yet until recently, wage increases have been subdued. Over the first three quarters of 2018 contract wages increased by 2% y-o-y. Recent wage agreements point to an increase in contractual wages of just below 2.5%. Both the government and the Dutch Central Bank (DNB) have called for higher private sector wage growth, and trade unions have put forward higher wage demands. According to the Commission 2018 Autumn Forecast, accelerating wage growth is expected as the labour market continues to tighten. Wage agreements have been reached for several government sectors, including central government and education. As a result, public sector wage growth has increased to almost 3% y-o-y in the third quarter of 2018. Overall, in a context of a tightening labour market, high corporate profitability combined with increasing inflation, scope for further wage growth remains. This would help boost private consumption, which as a share of GDP has been on a declining trend for almost two decades.

Fiscal policy, including expenditure on R&D, is contributing positively to domestic demand. Overall the government is pursuing an expansionary fiscal stance. According to the Commission 2018 Autumn Forecast, the structural balance is set to fall from 0.7% in 2017 to

¹² Ministry of the Interior, letter to parliament *Kabinetsreactie rapport 'Samen bouwen aan middenhuur'*, March 2018

¹³ See Country Report 2018 section 4.4 and Country Report 2017 section 4.4.1

-0.3% in 2019, before increasing somewhat to 0.0% in 2020. Public expenditure increases in the area of education, defence and health care. The 2018 CSRs contained a recommendation to increase public and private investment in research, development and innovation, while respecting the Medium Term Objective of -0.5%. The government's fiscal plans include additional expenditure on R&D, increasing to EUR 400 million annually in 2020. Additionally, EUR 50 million is spent on research infrastructure in 2018 and 2019. The incremental step in 2019 has been incorporated in the 2019 budget law. However, despite these additional measures, total government expenditure on R&D as a share of GDP is set to decline slightly over the coming years as its growth is outpaced by nominal GDP growth.¹⁴

Proposals to reform the second pillar pension system are still to be announced. Policy measures that reduce the (tax and non-tax) payment wedge on labour fuel household income and have the potential to both reduce the pick-up of household debt and/or to raise domestic demand. In the Netherlands, non-tax compulsory payments for pensions and health care are relatively large. The government has reaffirmed its intention to reform the second pillar pension system on several occasions. It has requested advice from the Social Economic Council on this reform. As this advice is still pending, no concrete proposals have been made at the time of this report's cut-off date.

14 Vennekens, A & De Jonge, J, (2018), 'Totale investeringen in wetenschap en innovatie, 2016-2022', Rathenau Institute, Den Haag

Annex 1: Overview table of MIP-relevant reforms

MIP objective: Reduce private debt			
Housing market regulation (owner occupied market)			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Sep 2018: The reduction of the maximum MID rate by 3 pps per year to 37% in 2023 agreed by the new government has been incorporated in a legislative proposal (Belastingplan 2019).		- Since 2013 a series of reforms: e.g. only annuity or linear mortgages are eligible for MID. - Maximum loan-to-value ratios are being reduced gradually to 100 by 2018 and Maximum loan-to-income ratios are made stricter.	CSR 1, 2018: [...] Take measures to reduce the debt bias for households and the remaining distortions in the housing market [...]
Housing market regulation (rental market)			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
		In July 2017: An amendment to the Law on Spatial Planning entered into force, allowing municipalities to set aside zones specifically for middle segment rental dwellings, In July 2016: The <i>Wet Doorstroming Huurmarkt</i> entered into force. This law allows for more short-term contracts and more mobility on the rental market. In July 2015: The <i>Woningwet</i> entered into force which aims at a better allocation in the social housing sector, reducing the number of <i>Scheefhuurders</i> in social housing. The law also forces social	CSR 1, 2018: [...] in particular by supporting the development of the private rental sector.

		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 <i>Uitvoeringswet huurprijzen woonruimte</i> 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			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
• Sep 2018: The increase in R&D expenditure emanating from the coalition agreement in 2019 has been incorporated in the budget law.		• In 2018 the first step has been taken in implementing the expansionary fiscal package of the coalition agreement, leading to an expected deterioration in the structural balance from 0.7% of GDP in 2017 to -0.3% of GDP in 2019.	CSR 1, 2018: While respecting the medium-term objective, use fiscal and structural policies to raise public and private investment in research, development and innovation. [...]
Pensions			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Sources of commitment</i>
Sept 2018: The government has reaffirmed its intention to reform the second pillar of the pension system, but		• In 2015: the retirement age for the first pillar of the pension system has been increased to 67 by 2021 and is	CSR 2, 2018: [...] Ensure that the second pillar of the pension system is more transparent, inter-generationally fairer

concrete proposals are still to be outlined.		linked to life expectancy afterwards. Simultaneously the fiscal maximum accrual rates have been lowered, leading to lower pension contributions (the so called <i>Aanscherping Witteveenkader</i>). • In January 2015: a revised financial supervision framework was introduced.	and more resilient to shocks.
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