February 12, 2018
Approval: 2/20/18

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 17/23-2

2:30p.m., March 29, 2017

2. Kingdom of the Netherlands—Netherlands—2016-Article IV Consultation

Documents: SM/17/53, and Correction 1, and Correction 2, and Supplement 1; SM/17/54, and Correction 1; SM/17/55

Staff: Dorsey, EUR; Khamis, MCM; Bredenkamp, SPR

Length: 48 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	D. Mahlinza (AE)
D. Sembene (AF)	
	V. De la Barra (AG), Temporary
	C. Barron (AP)
	B. Saraiva (BR)
	S. Fan (CC), Temporary
	E. Sanchez Rodriguez (CE), Temporary
	L. Zorn (CO), Temporary
	C. Just (EC)
	S. Badirou-Gafari (FF)
	K. Merk (GR)
	R. Gunaratne (IN)
C. Cottarelli (IT)	
	T. Hiroshima (JA)
	G. Nadali (MD), Temporary
	M. Merhi (MI), Temporary
	R. Doornbosch (NE)
	K. Virolainen (NO)
	D. Vasilyev (RU), Temporary
H. Alogeel (SA)	
	T. Marcelo (ST)
	P. Inderbinen (SZ)
	V. White (UK)
	M. Sobel (US), Temporary

H. Al-Atrash, Acting Secretary
R. Dall'Orto, Summing Up Officer
L. Briamonte, Board Operations Officer
P. Martin, Verbatim Reporting Officer

Also Present
Communications Department: B. Silvestre. European Department: M. Burova, T. Dorsey, M. Gerard, A. Musayev, J. Natal, M. Pradhan. Legal Department: H. Kang, K. Kwak. Monetary and Capital Markets Department: M. Catalan, U. Das, H. Kang, M. Khamis, C. Wilson. Strategy, Policy, and Review Department: H. Bredenkamp, I. Fukunaga, E. Lundback.

2. KINGDOM OF THE NETHERLANDS—NETHERLANDS—2016-ARTICLE IV CONSULTATION

Mr. Doornbosch and Mr. Evers submitted the following statement:

The Dutch authorities thank staff of both the Article IV and FSAP mission teams for the constructive meetings, for staff's appraisals and for the well-written reports and SIPs. This board discussion takes place two weeks after the general elections, and a caretaker government is in place. In line with Dutch political etiquette, the caretaker government will leave politically sensitive issues for the incoming coalition government.

Outlook

The post-crisis recovery of the economy is picking up speed and is projected to hold on to its upward trend. GDP growth was 2.1 percent in 2016, according to Statistics Netherlands (CBS), and is projected to be 2.1 percent in 2017 as well according to the latest projection by the Netherlands Bureau of Policy Analysis (CPB). Domestic spending serves as the main growth engine, supported by increased consumer confidence due to real wage increases and an increase in employment, a continuing upturn in the housing market and private investment, which is back at long-run average level. With (projected) economic growth well above potential in the four-year period 2015-2018, the authorities consider staff's projection of the output gap closing by 2019 plausible. Growth in employment outpaced growth in labor supply in 2015 and 2016, which resulted in a substantial drop in unemployment. It is expected that in 2017 and 2018 the unemployment rate will further decrease. Core inflation is expected to rise to 1.1 percent in 2017, after the low level of 0.6 percent in 2016.

Risks to the outlook stem mainly from external (policy) uncertainties. The Dutch economy is to a relatively large extent affected by global and European economic policies and developments. Therefore, weaker than expected growth in the euro area (for example as a result of economies continuing to struggle with post-crisis legacies), declining support for international economic cooperation and an increased protectionist sentiment in important trading partners may have negative repercussions for Dutch economic growth. However, the authorities agree with staff that these downward risks may very well be balanced by upward risks stemming from an underestimation of domestic demand, related to even faster than expected improvement in labor market conditions and greater than anticipated housing price developments.

External Assessment

The current account surplus can be attributed to fundamental factors. Although expected to narrow, it is likely to remain positive and large. The authorities agree with staff that the current account surplus is expected to decline further in the medium term, as a result of demographic developments (as baby boomers increasingly draw down their pension savings) and domestic energy policy which is expected to turn The Netherlands into a net importer of natural gas. In the near term, the expected stabilization of savings by households will contribute to a further narrowing of the surplus. As stated in the staff report, relatively high savings and foreign investments by multinationals and pension funds will continue to contribute to a large current account surplus in the longer term. The authorities don't see in staff's analyses any indication that the surplus is not in line with market fundamentals.

Fiscal Policy and Public Investment

The authorities disagree with staff's assessment that there is a case for additional, near-term growth enhancing spending or tax reductions. Over the past few years, Dutch budgetary policy was geared towards balancing sustainability and economic stabilization while complying with the rules of the SGP. The Dutch authorities emphasize that, with GDP growth outpacing potential growth, the output gap is closing faster than expected. Given that implementing policy measures tend to take time before returning results, implementing new fiscal measures would have a pro-cyclical effect. Furthermore, the authorities stress that the structural balance is a volatile indicator, and caution against assigning this indicator too much weight in short-term budgetary recommendations. More importantly, the authorities note that the level of public debt, while rapidly declining towards the threshold value of 60 percent of GDP, remains well above the level prior to the crisis. They agree with staff that, given the still highly leveraged status of private balance sheets and the need to strengthen fiscal buffers in the wake of downside risks to the economic outlook, a further reduction of public debt should be a priority. For these reasons, the authorities disagree with staff on the need and the room for additional spending.

Structural Reforms

The Dutch authorities agree with staff that reforms in the tax system aimed at reducing the debt bias and improve efficiency would be welcome. In spite of important labor tax reforms that were already implemented in 2016, the authorities agree that a further diversification of sources of tax revenues is desirable, which could also be aimed at encouraging greater labor force participation. The authorities agree with staff that minimizing the debt bias in the current tax system, which in terms of tax-treatment favors debt over equity, should be part of further future reforms. Indeed, reducing incentives for debt formation at household and corporate levels would significantly strengthen these sectors, and make them more resilient against future shocks. The staff rightly addresses some structural issues related to the housing market. In this regard, the authorities also point to measures taken with regards to the Mortgage Interest Deductibility (MID), which already reduces the debt bias on, and enhances the efficiency of, the housing market.

The Dutch second pillar pension system will need a fundamental overhaul in the direction of personalized contracts combined with collectively shared risks. The authorities agree with the staff assessment that the current pension system, which has come under increasing stress mainly caused by protracted low interest rates, needs a fundamental overhaul to maintain future sustainability, public support and confidence. Greater transparency, to provide more predictability to participants whilst retaining elements of collective risk sharing, should be important elements of this new system. It is up to the next government to decide on these future reforms.

The authorities agree with staff that the rise of flexible work arrangements and temporary contracts raise important policy issues regarding the sustainability of the Dutch safety net. The authorities do not necessarily share staff's assumption that the rise of self-employed and workers in temporary contracts is likely to be a symptom of an overly rigid regulatory regime for workers. They do share staff's concern that this increase may jeopardize the popular support for the Dutch safety net and its sustainability. The big increase in flexible work arrangements has contributed to labor market flexibility in the past years, but the low participation rates in disability insurance and pension schemes may indeed expose the increasingly large group of self-employed to economic vulnerability. Although the majority of the self-employed are self-employed by choice, the authorities share the concern of involuntary self-employment. The authorities are determined to ensure that workers stated employment status accurately reflects actual employment situation. They share the view that the large differences in institutional treatment across different employment statuses should be reduced.

Financial Sector Stability

The large Dutch financial sector has recovered from a double-dip recession and important reforms strengthening financial sector oversight have been implemented. Since the last FSAP, the Dutch financial system has steadily built up resilience to shocks, and banks' capitalization improved significantly. However, the authorities agree with staff that risks to its stability are still on the horizon, in particular stemming from the low interest rate environment, indebtedness of Dutch households and NFC-sector and banks' reliance on wholesale funding. The authorities are encouraged by staff's assessment recognizing the reforms that have been implemented over the past years in the face of these risks, which significantly strengthened the financial sector oversight. Also, the authorities share staff's assessment that despite the high indebtedness of Dutch households and high LTV-ratio's, nonperforming mortgage loans remained very low, proving the financial system's resilience against severe external shocks like a housing-price decline of 20-25 percent.

The Dutch banking sector is resilient to risks and able to withstand severe stress. The FSAP subjected a substantial part of the Dutch banking system to an extreme adverse scenario in which all identified possible risks were included. As was the case with similar exercises executed by domestic and European supervisory authorities, the Dutch banking system showed resilience with all banks staying above the regulatory minima for risk-weighted capital ratios. Also, the exercise showed Dutch banks are able to withstand significant funding withdrawals without having to resort to liquidity assistance. The authorities welcome staff's recommendation to encourage banks to continue to build capital buffers to ensure all banks remain above minimum leverage ratio thresholds in the case of severe adverse events, which is in line with the authorities' aim to bring the leverage ratio of four systemically important banks to at least 4 percent in 2018.

The authorities share staff's analysis that the low-yield environment poses significant challenges for the insurance sector. The staff's analysis rightly points out that tools provided by Solvency II to generate long-term interest rate curves have become of significant relevance for insurers aiming to meet minimum supervisory thresholds in the current low-yield environment. Therefore, the supervisory authorities are closely monitoring the sector and using all supervisory instruments at their disposal to mitigate risks stemming from this situation. Moreover, the authorities agree with staff on the importance of improved recovery and resolution legislation that could be used for an orderly winding down of life insurance companies.

Macroprudential Policies

Institutional arrangements for macroprudential policy setting have been strengthened and new macroprudential instruments have been implemented. The authorities concur with staff's assessment that important improvements to the domestic and European institutional setting for macroprudential policy setting have been made, i.e. by the establishment of the Financial Stability Committee (FSC) and the provision of macroprudential instruments by the CRD IV. They welcome staff's recommendation to strengthen the legal status of the FSC as this would strengthen its effectiveness and accountability. As for staff's recommendation to further tighten macroprudential policies to contain potential risks, the authorities point to the major (tightening) policies that have already been implemented since the last FSAP. DNB imposed systemic capital buffer requirements on five systemically important Dutch banks. Moreover, MID is gradually reduced by 0.5 percent a year and the maximum LTV-ratio allowed for mortgages will be reduced to 100 percent in 2018. The staff's recommendation to further lower the LTV-ratio to 90 percent after 2018 is in line with the FSC-recommendation addressed to the new government.

Microprudential Oversight

The institutional framework for banking supervision was significantly strengthened and supervisory strategy is aimed at mitigating risks stemming from the current low interest-rate environment. The authorities welcome the recognition in the staff reports of the significant and far reaching institutional response to the GFC, including a revised strategic vision, more resources, stronger regulations and a more thorough style of supervision. Faced with remaining risks to banks' profitability in a low-rate environment and possible future regulatory changes, the authorities are encouraged by staff's recommendation to adequately assess and supervise banks' business models and risk management, which is well in line with mid-term supervisory strategies. As for staff's recommendation to encourage a more active role of the Supervisory Board of Dutch banks, the authorities note that in the 2-tier governance framework of Dutch companies, the Supervisory Board needs to be at sufficient distance from day-to-day decision making in order to fulfill its oversight function by focusing on the major issues it should be involved in.

The authorities share staff's assessment that supervision of the insurance sector has strengthened and risks stemming from the Solvency II regime should be closely monitored. As pointed out in the staff report, the Solvency II-position of insurers presents an overly-optimistic picture of the financial position, in particular for life insurers. The authorities therefore welcome staff's recommendation to remain vigilant and closely monitor the risks, using all instruments at their disposal to mitigate them.

The authorities welcome staff's recommendations for the Dutch regime for supervision of CIS, auditors and market-based finance. In particular, the authorities welcome staff's recommendation to broaden the supervisory authority of the AFM with regard to loan-based crowd-funding platforms, as they agree that the fast-moving developments in this small but growing area may pose risks to consumer protection that the supervisor should be able to mitigate.

The supervision of financial market infrastructures has been significantly strengthened and the authorities welcome the recommendations for further improvements. As the Netherlands is home to a central counterparty which is systemic for European markets, the authorities support the recommendation to augment the devoted supervisory resources to its oversight. Moreover, the authorities support the recommendation that recovery planning for FMIs within a set resolution regime would further strengthen the FMI supervisory framework.

Financial Safety Nets

The authorities welcome staff's appraisal that significant progress in recovery and resolution is being made, though also share staff's view that arrangements for managing failing banks remain work in progress. The authorities note that most recommendations on crisis management will have to be addressed at the European level, within the Single Resolution Mechanism. The authorities in particular support staff's recommendations regarding the improvement of the domestic crisis management framework, the operationalization of resolution tools and optimization of the use of DGS funds to the transfer of deposits in both resolution and bankruptcy. The authorities take note of the staff recommendation to make legacy frameworks for managing failing banks complementary to the new SRM framework. They note that the European Bank Recovery and Resolution Directive was already incorporated in Dutch law and that the repeal of provisions in the old framework that may provide legal uncertainty is foreseen in the near future. The way the national framework relates to the SRM has been elaborately described in explanatory memoranda accompanying these new laws in order to maximize transparency.

The Dutch authorities once again thank staff of both the Article IV and FSAP mission teams for the fruitful exchange of views during the meetings and the candid policy recommendations provided in the well written reports. The authorities look forward to continuing this policy dialogue in the context of the next Article IV cycle.

Mr. Tombini and Mr. Lingoist submitted the following statement:

We thank staff for the reports and Mr. Doornbosch and Mr. Evers for their insightful and informative statement. The recovery of the Dutch economy after a double-dip recession has accelerated since 2014, as reforms begin to bear fruit. However, as a highly internationally connected economy, the Netherlands is subject to risks arising from external developments—especially those stemming from uncertainties in the European Union, including Brexit.

The authorities have succeeded in containing expenditure and reducing gross public debt rapidly. The fiscal consolidation laid the groundwork for fostering growth and helped to reinforce buffers to tackle future shocks. Going forward, we acknowledge merit in staff advice for the use of fiscal space to narrow the output gap. However, we are a bit puzzled by an apparent disconnect between the prospects for the closing of the output gap under current policies. The views of staff and the authorities seem to diverge. Could staff comment on these discrepancies?

We welcome the authorities' willingness to address excessive tax incentives to mortgages, one third of which have loan-to-value ratios (LTV) above one hundred percent. Reforms in the real estate sector in order to address supply constraints and to streamline rent regulation, as pointed by staff, could alleviate pressures on the housing market.

There still seems to be room for rebalancing the tax system towards a more efficient distribution of revenues. We share some of staff's views about a possible over reliance on labor taxation in detriment to corporate taxation. Could staff comment on the outcomes of the G20 recommendations on international corporate taxation? Has the Dutch Corporate Income Tax Act been modified, as expected in the last Article IV report?

Persistent current account surpluses, especially after the global financial crisis, have been underpinned by increased household savings and non-financial corporate net savings, which have financed large foreign direct investment (FDI) abroad. In this context, the favorable tax treatment for corporate income, as expressed in the External Sector Report, plays an important role. We would welcome staff's comments on the outcomes of Base Erosion and Profit Shifting (BEPS) proposals and how it is expected to affect multinational companies in the Netherlands.

We commend the authorities for the measures and reforms undertaken in order to strengthen the resilience of the financial system since the last FSAP. While increased capital buffers and deleveraging of the private sector have significantly reduced vulnerabilities, the high level of household debt and challenges stemming from low and negative interest rates may require vigilance and possible enhancement of the macroprudential framework.

In the more problematic insurance sector, assessed by FSAP as vulnerable, we appreciate the authorities' concerns about the lack of resolution legislation in an area particularly exposed to low interest rates and leaned towards search-for-yield strategies. Additionally, we consider that financial regulation should address the dependence on wholesale funding to prevent exposure to possibly stressed global financial conditions. The Risk Assessment Matrix does not point to substantial problems, but we welcome staff's further comments on the DSA's contingent risk scenario, which could greatly impact public debt.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

We thank staff for their concise report and the insightful selected issues papers. We also thank Mr. Doornbosch and Mr. Evers for their informative statement describing recent economic developments and the authorities' reform efforts.

The Dutch economic recovery continues to strengthen, but more efforts are needed to sustain it and address a number of risks. The gradual improvement in household balance sheet and recovery in house prices are positive signs, but continued deleveraging could hold back the pace of the recovery. We concur with staff assessment that the weak foreign demand tilts the risks to the outlook to the downside, while a stronger than estimated domestic could be an upside.

The staff is taking a much firmer view this year that the Netherlands has substantial fiscal space that could be used in a way that is compliant with the Stability and Growth Pact. The staff sees a sizeable tightening of the fiscal stance with a negative output that would continue through 2018. Since there are limited financing risks, and given the debt trajectory, staff calls for growth-enhancing spending or tax cuts in the order of 0.5-1 percent of GDP, which could be in the form of education or R&D or cuts in the labor tax wedge. However, the buff informs us that the authorities disagree with staff's assessment that there is a case for additional, near-term growth enhancing spending or tax reductions and disagree on the need and the room for additional spending at this time. We are encouraged that the authorities agree to the same priorities, should fiscal space materialize, but they remain skeptical about staff's estimates of the output gap given implementation lags for past fiscal stimulus measures. The staff should continue to monitor developments to reassess the pace of closing the output gap and the magnitude of fiscal space. Reducing public debt remains a priority over the medium-to-long term to rebuild fiscal buffers.

In spite of improvements in household balance sheets, households remain highly leveraged compared to peers. The large remaining stock of interest-only mortgages also implies significant rollover risks. We share staff's advice on combining prudential measures (reducing loan-to-value ratios for housing finance and reducing mortgage interest rate deductibility) with measures to deregulate rents, promote a more robust private rental markets and reform of social housing. We look forward to measures to be implemented from the policy options outlined in the authorities working group on sustainable growth.

Overall, the FSAP stress test results are reassuring, as banks have rebuilt buffers, lowered leverage, and are well capitalized. However, more stringent stress tests under an adverse scenario expose risks to the leverage ratio for one significant bank. In addition, low profitability and continued reliance on wholesale funding remain a challenge although the relatively long term structure of wholesale funding mitigates this concern.

We note that the authorities broadly agreed with staff's views on enhancing efficiency and reducing debt bias of tax reforms. They also acknowledged the need to overhaul the second pillar pension system. And there was agreement on the need to address labor market rigidities the implications of the large increase in self-employed that could become exposed to economic vulnerabilities. We see merit in increasing efforts to differentiate between genuine and involuntary self-employment. We look forward to further progress by the new government in addressing these constraints on productivity growth and to improve the resilience of the economy.

Finally, we applaud the efforts and innovative approaches of the Dutch authorities in fostering integration of refugees.

Ms. Barron and Mr. Stewart submitted the following statement:

We thank staff for their reports and Mr. Doornbosch and Mr. Evers for their informative buff statement. We welcome the signs of strengthening momentum in the real economy. The short-term challenge is to ensure that policy settings are not pro-cyclical. As such, we place less emphasis than staff on attempts to fine-tune the fiscal stance. More attention can instead be focused on actions to improve long-run growth and resilience. Here we would focus on efforts to further increase the resilience of the financial sector as well as address a number of structural issues.

We would emphasize the importance of taking a flexible approach to fiscal policy in ensuring that it is responsive to signs of strengthening economic growth. While we agree that the Netherlands has some fiscal space and is well placed to use fiscal policy in a flexible fashion given its strong medium-term framework, the rate at which the output gap is closing suggests that short-term fiscal fine-tuning offers less benefits, and more potential downside risks, than would otherwise be the case. Saying this, addressing some of the Netherland's structural issues through short-term fiscal support could help both increase potential output as well as help reduce the sizeable current account surplus driven by corporates lacking domestic investment opportunities. This fiscal support would, however, have to be modest and short-lived. Consequently, we think the arguments for a slower fiscal consolidation, in the near term, are evenly balanced, and would give the benefit of the doubt to the authorities.

The financial sector appears to be well placed to withstand a number of potential stressors given improved buffers and strengthened oversight. Nevertheless, the FSSA highlights a number of areas where we would agree that further progress is warranted. In particular:

Capital buffers should be further strengthened and we welcome the buff statement's suggestion that authorities are working in this direction. This will help ensure that buffers above regulatory minima are maintained following ongoing discussions around the Basel framework. It will also help ensure that the sector could actively support the economy in the event of a significant downturn, rather than being constrained by leverage considerations.

Further measures to address household sector vulnerabilities are warranted, particularly the continued phasing down of mortgage interest deductibility so as to reach a tax-neutral position.

We encourage regulators and banks to seek to lower effective loan-to-valuation ratios (LTV), but would be interested in staff's views on the advantages and disadvantages of doing this through caps versus increasing the amounts of capital held against higher LTV and interest-only loans (so as to get a more resilience banking system, strengthen banks' ability to actively manage risk/return trade-offs, and send the correct price signals to households)?

These actions would be complemented by strengthening the operational independence of the regulatory bodies. While welcoming the buff's suggestion that the authorities look favorably on efforts to strengthen the legal framework of the FSC, we note that an effective framework ultimately relies on the relevant agencies having a clear shared perspective on meeting their objectives, taking a broad approach to those objectives, and engaging with each other cooperatively.

We fully support staff's suggestions on the importance of undertaking reforms to improve the functioning of both the pension system and the labor market. While we appreciate that garnering community support for such changes is difficult, it is important to address some of the current distortions and make sure that longer-term fiscal risks are addressed. With regards to structural reforms to taxation arrangements, we welcome the fact that the authorities want to shift the burden away from labor towards less distortionary alternatives, and note the potential benefits to growth even if measures are budget neutral. We would suggest that the authorities and staff take a very cautious approach in terms of estimating the potential revenues available from reforms to corporate taxation. Here, we continue to note that the revenue impact and priority accorded to such changes—including actions like an allowance for corporate equity—warrant further examination to strengthen policy recommendations. Furthermore, could staff provide the Board with an update on the authorities' efforts to apply new international standards relating to BEPS?

We appreciate that the mission, report and Board meeting are occurring around a general election and understand the importance of caretaker government arrangements. Can staff provide the Board with any further insights into potential policy directions that might emerge based on likely coalitions?

Mr. Estrella and Mr. Corvalan Mendoza submitted the following statement:

The Kingdom of the Netherlands' growth is recovering and it is projected to return to its potential in 2019. Today's global environment is putting at test this gradual recovery, given the openness of the economy and its strong presence in the global trade market. Economic policies are prudent and have created sufficient buffers to protect the economy from shocks. Important steps were taken in the financial, monetary, and fiscal sectors to shield the economy from external shocks.

We thank staff for the report, the interesting selected issues paper, and the financial system stability assessment. The staff correctly states that in order to maintain the quality of living and sustainability of the Dutch safety net in the long run, some calibration in economic policies will be necessary. The staff assessments offered some policy advices on structural reforms to further unlock constraints on productivity growth. These reforms are linked to improvement in labor market efficiency, optimal taxation, expenditure increases on R&D, and easiness to financing SME projects, to name the most relevant ones. We take positive note of the authorities' willingness to move ahead with these reforms. In this regard, we thank Mr. Doornbosch's and Mr. Evers's buff statement for a clear presentation of the authorities' views on structural reforms.

On fiscal stimulus, we are inclined to support the authorities' view that further reduction of public debt is needed. We welcome the authorities' decisions to preserve long-run sustainability and that they agree that "any fiscal space, should it materialize, could be used for further reduction in labor taxation or spending on R&D and human capital," as mentioned in the buff statement. The country has specific factors that require well calibrated use of its fiscal buffers for the future. These factors are well described on Annex I, such as euro area's failure to address in full the crisis legacies that will put a drag on economic growth in the area, where the Dutch most important trade partners are located, or the erosion of confidence on the European project (e.g. Brexit). We believe that the authorities and the staff agree on the main policy recommendations, but there are some nuances in the speed and size of such stimulus that needs thoughtful calibration.

There is a need to reform the labor market in order to create decent jobs that support the existing safety net. These type of jobs, created by firms that are pursuing innovation and the creation of higher-value added in existing industries, are not easy to find. The quest could become even harder to reach, when there is a rise of self-employed and workers in temporary contracts. We are well aware that labor market changes are probably the most sensitive and complex one to tackle for any government, but under the current situation, might be one of the key reforms that affects the future of the economy. After assessing the staff's proposal on Dutch sustainability safety net (tendency to lower participation rates in disability insurance and pension schemes due to overly rigid regulatory regime for workers) and the authorities' views on this issues, we would like to see more details from staff on how advanced this theme is, in the reform agenda of the new government.

On the financial sector, we are encouraged by the actions taken by the government in order to safeguard the financial stability. In this regard, we welcome the government's swift move in the housing sector to minimize potential risks in the system and to acknowledge phasing out of mortgage interest deductibility (MID) as a priority. We also take positive note of banks' capitalization to safeguard the financial system stability and their effort to strengthen the financial sector oversight significantly.

We especially noticed the microprudential oversight over macroprudential ones. Our main concerns are the supervisors' capacity to monitor bank's business models and risk management frameworks appropriately. The supervisory body must correctly assess the quality of bank's balance sheets and the proper loan classification at all times, to rightly assign prudent provisioning when needed. As we see it, microprudential oversight is a precondition for a reasonable use of macroprudential tools. We welcome more details from the staff on how to tackle the reliance on wholesale funding on banks.

With these comments, we wish the authorities and people of the Kingdom of the Netherlands every success in their future endeavors.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the comprehensive report and Mr. Doornbosch and Mr. Evers for the informative buff statement.

Buoyed by improving economic health of households and rising consumer confidence and investment, growth in Netherlands has been improving steadily despite large scale deleveraging in several sectors of the economy and weak external demand which otherwise continues to constrain the economy's return to full potential. In this milieu, structural reforms such as reducing labor tax wedge and pension reforms are key to boosting labor participation for enhancing TFP and potential growth. Despite robust growth in employment, inflation has remained subdued as wage growth remains below productivity.

Post crisis legacies in the banking industry, weak foreign demand in the euro area, increasing protectionist tendencies and the impact of Brexit on external trade weigh heavily on downside risks to economic outlook. Structural reforms, particularly, in the banking sector aimed at addressing post-crisis legacies could help substantially in mitigating risks to growth.

Debt and GFN face limited risks, and any additional fiscal stimulus on account of changing demographics is expected to be smoothly accommodated over the medium term. We agree with staff that the gradual closure of the output gap in the presence of CA surplus and the authorities' medium term fiscal plan that entails overall tightening of the fiscal stance may not be conducive at this juncture, and some temporary near-term relaxation in growth enhancing spending on education and R&D and easing tax policies to reduce labor tax wedge would be useful for strengthening recovery. The authorities however contend that the envisaged fiscal consolidation plan is necessary to strengthen buffers and to ensure secular reduction in public debt given the highly leveraged nature of private balance sheets which could entail future government interventions in the event of rapid deleveraging. Could staff comment on this divergence in opinion?

Although banks are safe, well capitalized over regulatory norms and stable under stress testing scenarios, the relatively higher business concentration, elevated leverage and low RWA to assets ratio of banks using the IRB approach remains worrisome. We appreciate that the framework for banking supervision and regulation has been significantly strengthened in line with mid-term supervisory strategies with focused assessment of banks business modes and their risk management frameworks in the environment of low interest rate.

However, low interest rates are eroding banks' profitability even as their dependence on wholesale funding expose them to volatile financial conditions. Credit growth, particularly to non-financial corporations has remained tepid despite increasing bank competition and ECB's accommodative stance and is not supportive of recovery. Additionally, tight lending standards and high interest rates have impeded the access of credit to SMEs. On the other hand, skewed tax and regulatory treatment of mortgage and rental markets including moderate LTV ratios appear to have manifested in excessive mortgage indebtedness and overheating of housing prices which necessitates closer monitoring to prevent further accretion to negative equity in mortgage exposures.

The authorities should follow a three-pronged strategy of correcting tax distortions, lowering of LTV ratios in line with FSC recommendation and carry out suitable adjustments of ceilings on DSTI ratios. At the same time, due diligence by the SSM in evaluating business models and risk management frameworks for appropriate classification of loans and provisioning is critical to foster long-term sustainability of the banking system. Banks also need to build sufficient capital buffers to manage shocks and to bring down the leverage ratio of systemically important banks in order to guard against rapid deleveraging of private balance sheets. We welcome the authorities' commitment to encourage banks to build capital buffers. Since insurers also face similar challenges from low interest rates, a close monitoring of the solvency of insurers is equally necessary, and for which a tangible recovery and resolution mechanism is needed to arrange orderly winding. We appreciate that the authorities generally concur with staff observations made in the FSAP.

While structural reforms in tax policies should be carried out with a view to reduce the tax burden on labor and removal of incentives for debt bias, pension policy reforms are needed to instill transparency and to mitigate the effects of unfair transfer of redistribution schemes. We believe that, while labor market segmentation could be reduced by liberalizing standard open employment contracts, increased dependence on self-employment with added safety nets could be more useful to preserve the flexibility of labor market in these uncertain global economic conditions. Moreover, measures taken to enhance public R&D, training and easing regulations for start-ups can deliver significant payoffs.

We wish the authorities success in their future endeavors.

Mr. Omar and Mr. Sumawong submitted the following statement:

We thank staff for a set of well-written reports and Messrs. Doornbosch and Evers for their informative buff statement.

While the recovery of the Dutch economy continues to strengthen, underpinned by domestic demand and exports, growth is expected to moderate over the medium term. Weaker-than-expected growth in major trading partners, increased inward-looking policies, and uncertainties surrounding the post-Brexit decision pose downside risks to the economic outlook. In this regard, we agree that policy priorities should focus on improving the country's resilience to shocks and increasing its long-term growth potential. We broadly agree with staff's appraisal and limit our comments to the following points for emphasis.

Fiscal policy can play an important role in lifting potential growth. While more education and R&D expenditures, which would be crucial for higher potential growth, should be encouraged, it is important that fiscal adjustments appropriately take into account macroeconomic conditions and country specificities to enable the economy to respond effectively to fiscal policy initiatives. In this connection, we note the differing views between staff and the authorities on the effectiveness of additional fiscal stimulus. The staff's comments are welcomed. Given that the Netherlands is still a highly-leveraged economy, we welcome the authorities' recognition that fiscal consolidation continues to be a priority to provide additional buffers for the economy as highlighted in the buff statement.

Building upon progress remains critical to safeguard financial stability. We commend the authorities on the progress made on the implementation of the 2011 FSAP recommendations, in particular on the introduction of maximum loan-to-value (LTV) ratios and reduction of mortgage interest deductibility (MID) as highlighted in the buff statement. While these measures have fostered deleveraging in the housing sector, households remain highly leveraged with a high level of mortgages in negative equity that tend to have higher default rates. We therefore encourage the authorities to build on their success to further address financial vulnerabilities, particularly through accelerating the phasing-out of MID and continuing to reduce the LTV ratio, which is in line with the recent FSAP and Financial Stability Committee's recommendations.

Having built buffers through retained earnings and lower leverage since the crisis, Dutch banks are well capitalized and are in a good position to withstand risks as demonstrated by the FSAP stress tests. However, banks continue to face challenges associated with high leverage, low interest rates, and reliance on wholesale funding. Against this background, it is important for banks to continue to build capital buffers and for the authorities to closely monitor banks' business model and risk management framework. In this regard, we look forward to the implementation of the recent FSAP recommendations, including further enhancing supervisory oversight of loan classification and strengthening internal model validation.

Continued structural reforms are essential to sustain and enhance long-term growth. Despite the implementation of labor tax reform last year, the current tax system still relies heavily on labor income taxation and social contribution. We therefore concur with the authorities and staff that the tax system should be further reformed to enhance fairness and efficiency. In this regard, sources of tax revenues should be diversified towards less distortionary alternatives, including consumption and property, whose contribution to tax collection is one of the lowest among European countries according to staff's assessment. As rightly pointed out in the selected issues paper, the comprehensive tax reform will have positive effects on long-term growth and employment. We note that while the authorities agreed on the need of tax reforms, the decision is left to be made by the future government. Could staff comment on the prospect of these tax reforms in the Netherlands given the result of recent general elections?

On the EBA estimates, we welcome staff's acknowledgement on uncertainties on assessment given Netherland's specificities and staff's explanation in the selected issues paper on the persistent current account surplus in the Netherlands. That said, we also encourage staff to further refine the methodology.

Lastly, we commend the Dutch authorities for hosting and supporting refugees, as well as efforts to expedite their integration into the labor market and society.

Mr. Cottarelli submitted the following statement:

We thank staff for their reports on both the Dutch Article IV consultation and the FSAP, and for the accompanying selected issues papers. We also thank Mr. Doornbosch and Mr. Evers for their informative buff statement.

The Dutch economy is performing well, led by domestic demand. Unemployment is falling, the housing market is recovering, and the financial sector appears resilient, though the insurance industry faces important challenges. The current account surplus remains stronger than might be attributable to structural factors alone; it is expected to decline gradually in the medium term, but remaining high mostly on the back of structural factors. Some fiscal space has been created and, to some extent, could be used to strengthen productivity and potential growth. Structural reforms addressing the duality of the labor market, reducing the bias for debt-financed ownership in the housing market, and fastening and deepening the implementation of macroprudential measures would further enhance the resilience of the economy.

Macroeconomic Developments

Solid economic growth and the closing of the output gap will likely continue over the coming years. Following a double-dip recession, the economic recovery of the last three years has strengthened and is becoming more broad-based. The main driver of growth is domestic demand, on account of improving business and consumer confidence and positive wealth and real income effects. We broadly agree with staff's external sector assessment and take note that the external position is estimated to be stronger—though with uncertainties—than the level consistent with medium-term fundamentals; we also take note that the current account surplus is expected to narrow but remain large over the medium term also reflecting structural factors.

Fiscal Policies

We welcome the authorities' prudent fiscal policies geared towards a further reduction of public debt and consider that, as noted by staff, the Netherlands has some fiscal space that could be used to support growth while—importantly—remaining compliant with the Stability and Growth Pact (SGP). The recently published 2016 budgetary outcome shows a 0.4 percent of GDP surplus, almost a full percentage point stronger than staff's estimate. At the same time, a fiscal impulse should be consistent with the SGP and avoid the risk of pro-cyclicality. In any case, any fiscal stimulus should be aimed at boosting the potential of the economy, for example with measures supporting public R&D spending and shifting taxation away from labour and towards less distortionary alternatives, such VAT or property taxes.

Financial Market Policies

While Dutch banks are well capitalized and appear resilient, additional macroprudential measures for mitigating real estate-related risks could be considered. Household debt remains high with a sizeable share of negative equity mortgages, despite some recovery in the housing market. While the authorities' measures to reduce the debt-bias and changes in macroprudential policy go in the right direction, we see merit in fastening the reduction of the mortgage interest deductibility and in further lowering the loan-to-value ratios to no more than 90 percent by 2028. We support the staff view that supervisors should closely monitor banks' business models and risk management frameworks, as well as the financial impact of the important challenges faced by the insurance sector.

Structural Policies

We share staff's analysis of the labor market and support their recommendation for reducing its duality. The Dutch labor market performs solidly in terms of job creation, especially under flexible and temporary work arrangements which benefit from fiscal and regulatory incentives. The risks of market segmentation are increasing and we note staff's assessment, shared by the authorities, that these trends could threaten the sustainability of the social safety net. We therefore encourage the authorities to tackle the remaining barriers to hiring staff on permanent contracts and to addressing the high increase in self-employed, including by reducing tax distortions favoring self-employment.

We support staff's recommendation and the authorities' intention to reform the second pillar pension system. Although effective in terms of fiscal sustainability and adequacy, the three-pillar pension system has revealed drawbacks in terms of coverage, transparency and flexibility over the life cycle. The past few years have exposed the vulnerabilities of the second pillar, where ad hoc adjustments could entail the risk of an unintended intergenerational transfer at the expense of currently younger generations.

Mr. Hiroshima and Mr. Naruse submitted the following statement:

We welcome that the Netherlands' economy is on a solid recovery path supported by steady increase in consumption against the backdrop of falling unemployment and rising housing prices. However, the challenges remain, including weak credit growth, uncertainties surrounding foreign demand, and low productivity growth. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We take note of the staff's appraisal that the Netherlands face very limited financing risks and the level of the government debt does not raise sizable risks. Thus, fiscal measures addressing long-term structural issues including raising potential output might be taken. On the contrary, we are not sure if the near-term growth enhancing fiscal stimulus using fiscal space is warranted, with output gap closing on the back of clearly tightening labor market. If the Netherlands are facing significant downside risks that might stifle a nascent recovery, enhanced support for the recovery should be needed. We understand, however, staff's view is that the risks are tilted only "slightly toward the downside." In this context, could staff further elaborate the necessity for short-term fiscal stimulus that could entail negative consequences as pointed out by the authorities.

Financial Sector Policy

We take note of the staff's analysis that low interest rates and slow credit growth will weigh on banks' profitability and that banks may search for higher risk assets. In this light, we concur with the staff that supervisors should closely monitor banks' business models and risk management frameworks. While further lending to housing sector might not be promising given the already low mortgage rates, which sectors does the staff think that banks could increase their loans?

The staff suggests that supervisors should take a more active role in assessing loan classification. On the other hand, too much emphasis on asset classification might make banks lend to companies with almost perfectly sound financial conditions, resulting in fiercer competition among banks by cutting interest rates and the further compression of loan margins. We would appreciate if the staff would comment on this perspective.

Structural Reform

We welcome the authorities' efforts to reform the tax system to reduce the tax burden on labor. Also, we see merit in the reform of the pension system focusing on enhancing transparency and ensuring portability. In addition, we agree with the staff that the authorities should boost productivity by implementing comprehensive measures, such as increasing R&D and strengthening the skills of labor forces.

Mr. Virolainen and Mr. Gade submitted the following statement:

We thank staff for a set of comprehensive and interesting reports as well as selected issues papers. We also thank Mr. Doornbosch and Mr. Evers for their informative buff statement. We note that the authorities share staff's assessment on most issues, while representing a more nuanced view on some issues. We also note that the missions took place under the previous government. The staff's recommendations should in principle remain unchanged irrespective of governments. We broadly share staff's assessments and support its recommendations. We associate ourselves with the Gray statement of Mr. Cottarelli, but would like to make the following points for emphasis.

On the cyclical situation and the use of fiscal space, we take note of the gradual recovery underway, in which the labor market is tightening, and real wages have started to pick-up. In addition, capacity utilization in the industry is at a relatively high cyclical level, possibly indicating a rise in investment activity going forward. Although such a development would be in line with a gradual adjustment in the Real Effective Exchange Rate (REER), we would caution against the use of fiscal stimulus, as suggested by staff, given the risk of fiscal policy adding a not-needed pro-cyclical demand stimulus to the ongoing recovery. However, we would support the use of fiscal space to boost the medium-term potential of the economy through facilitating labor market reforms and increased spending on R&D, if deemed needed by the authorities.

On the external sector assessment, we broadly agree with staff's assessment, although it is subject to uncertainties. Importantly, we welcome staff's acknowledgement that factors such as demographics, the build-up of pension assets, and deleveraging, play a structural role in sustaining the current account surplus. As a result of past surpluses, it seems likely that primary income will continue to support a current account surplus for a while. We share staff's view, however, that these factors will likely subside or revert in the medium-term, which is consistent with a gradual narrowing of the current account surplus. We also agree that the role of corporate savings and liquidity management as a result of their tax treatment is less clear.

On the financial risks and financial policies, we share staff's assessment of the housing market. The developments on the housing markets, including rental markets, bears some resemblance to Nordic experiences. We find staff's recommendations with respect to reducing the debt bias by lowering mortgage interest deductibility, as well as lower loan-to-value limits, and introducing prudential debt service-to-income ceilings, particularly attractive and important. While the authorities know the appropriate pace of adjustment best, we see merit in a faster transition given the low level of interest rates and the ongoing cyclical recovery.

Finally, the FSAP stress tests provided some comfort that Dutch banks appear resilient to risks, but we would appreciate staff's additional comments on the dynamics of the risks and challenges facing the banking sector, the need to continue to building capital buffers, and the ability to support lending to small and medium sized enterprises in particular.

Mr. Inderbinen and Ms. Andresen submitted the following statement:

After returning from a double-dip recession, the economic recovery in the Netherlands is gaining speed. Growth in the coming years is expected to remain robust, based on strong demand, further improvements in the labor market and a continuing recovery in the housing sector. Nevertheless, we concur with staff that risks to the outlook are slightly tilted to the downside, owing primarily to uncertainty in external developments as well as to potential effects of a delayed deleveraging of banks, firms and households.

We commend the authorities for achieving a sound fiscal position, and note that further efficiency gains could be achieved through revenue-neutral tax reform. We welcome that fiscal risks are limited and public debt is expected to fall below the threshold value of 60 percent of GDP, in line with the expected pace of debt reduction. In view of the closing output gap and the difficulty of accurately predicting of the business cycle as well as the need to further strengthen fiscal buffers, we share the authorities' doubts about the need for additional fiscal spending. The authorities rightly underline that given implementation lags, any fiscal stimulus at the current juncture could end up being pro-cyclical. Conversely, we see merit in tax reforms that, even if revenue neutral, would improve efficiency and reduce debt bias, as proposed by staff. Rebalancing fiscal revenues toward an increased reliance on VAT and property tax could lead to significant growth and productivity dividends.

While we welcome the strengthening of financial sector oversight, persistent vulnerabilities in the housing sector call for further macroprudential measures. We welcome that most recommendations of the previous FSAP were addressed by the authorities. In particular, the various steps taken to strengthen the macroprudential policy framework are commendable. We also note that nonperforming mortgage loans remain very low. Nevertheless, to ensure financial stability in the longer term, weaknesses such as household indebtedness and the share of mortgages with negative equity call for a further strengthening of macroprudential measures. We thus support staff's recommendation to address the high level of mortgage interest deductibility, further lower loan-to-value ratios, and introduce ceilings on debt-service-to-income caps. In addition, to address the issue of homeowners without adequate financial buffers and to foster the supply side of the rental market, regulations undermining the functioning of the private rental market should be addressed.

We welcome staff's analysis about the drivers of current account surpluses in the selected issues paper. The descriptive statistics show that while there may be common factors, the current account is often dominated by a variety of country-specific factors. In addition, these can change over time, as was the case in the Netherlands and Germany after the Global Financial Crisis, or stay roughly constant, as in the case of Switzerland. Therefore, assessments in this regard should generally seek to account for the complexity of the composition of the current account and incorporate country specific factors that could influence it.

Ms. Horsman, Mr. McGrath and Ms. Zorn submitted the following statement:

The economic recovery has taken hold in the Netherlands, driven by household consumption, net exports, and strong housing market activity. However, ongoing deleveraging in the near term against a broader trend of weak productivity growth and an aging population suggest the need to advance policies that reduce vulnerabilities and increase growth potential. As outlined in the helpful buff statement from Mr. Doornbosch and Mr. Evers, the Dutch authorities are cognizant of these challenges and are prepared to address them. We agree with the thrust of staff's assessment and offer a few comments for emphasis.

Available fiscal space could be tapped to enhance growth prospects. There is room to increase spending or reduce taxes over the next several years, while aiming for some degree of consolidation over the longer term to build buffers against adverse future shocks. We agree with staff's suggestion for directing greater near-term fiscal support towards boosting productivity, either through higher R&D and education spending, or by reducing personal income deductions to encourage employment, while also ensuring compliance with SGP rules. More generally, we welcome the authorities' commitment to prudently reduce the debt ratio over the medium term. We note staff's finding that tax incentives motivate low profit distribution by both foreign and domestic firms, contributing to the diversion of national savings from capital formation and a persistent, sizable CA surplus which is above the level consistent with fundamentals and desirable policy settings. Would staff comment on the costs vs. benefits of adjusting these incentives?

Structural reforms that increase workforce participation and reduce labor market inefficiencies could have substantial positive impacts on long-term growth. The Dutch authorities deserve much credit for their efforts in dealing with the inflow of refugees to Europe, particularly in terms of hastening their economic and social integration. In the face of an aging work force, this cohort could potentially offset demographic trends and help sustain the labor supply and economic output. The staff's analysis suggests that reducing labor income taxes or employees' social benefit contributions could also increase labor supply as well as investment and labor demand, raising potential output. We encourage the authorities to build on the 2016 income tax cut package by reducing unfavorable tax and regulatory treatment of traditional, full-time employment vs. self-employment, and by shifting the tax burden away from labor towards consumption and housing more generally. Such measures could also help support the viability of the social security system by reducing excessive self and temporary employment. To complement these labor force policies, we look forward to the development of concrete proposals to increase innovation and productivity growth based on recent government consultations.

In light of the challenging macrofinancial environment and the magnitude of the Dutch financial system, the authorities should consider further prudential measures to mitigate risks. We take positive note of the significant improvements to financial sector regulation and supervision since the last FSAP. The banking sector has built up capital and liquidity, although we agree with staff that there is scope to enhance resilience by increasing capital buffers further above minimum leverage ratios. More generally, given strong incentives for excessive risk taking in a low yield environment, more active monitoring of funding and investments as well as risk management practices is needed across the banking, insurance and pension sectors. We look forward to pension system reforms that will put it on a more solid footing, while at the same time increasing transparency and preserving retirement security for plan participants.

Additional policy action on housing and mortgage finance would help address household financial vulnerabilities. The authorities deserve credit for changes made to eligibility requirements for mortgage loans and interest deductibility over the past several years. However, we take note of the FSAP's findings of high household indebtedness and a sizable proportion of interest-only mortgages for which a substantial number of borrowers will not have the means to meet payment at maturity. We share staff's view on the need to take early action to address this looming stress point, and to lessen a further build up in vulnerabilities by accelerating the reduction in mortgage interest deductibility and by considering the possibility of tighter caps on mortgage eligibility requirements. Noting the small but rapidly increasing presence of non-bank mortgage providers, we also encourage the authorities to standardize and enforce sound mortgage underwriting standards across all lenders. In parallel, the supply-demand mismatch in the rental market could be addressed through changes to social housing, rent control, and zoning rules. Given risks related to the current outstanding stock of mortgages in the Netherlands, would staff comment on implications for the government through the National Mortgage Guarantee scheme?

Mr. Dajani and Ms. Sanchez Rodriguez submitted the following statement:

We thank staff for the interesting set of reports and Messrs. Doornbosch and Evers for their candid buff statement. We associate ourselves with Mr. Cottarelli's statement and would like to add the following remarks for emphasis:

The Netherlands is successfully shaking off crisis legacies after a double dip recession, with house prices recovering and improving bank and household balance sheets. Important steps have been taken to address financial vulnerabilities in the household sector, namely by reducing loan-to-value ratios and restricting mortgage interest deductibility. We concur with staff that the implementation of such macro-prudential measures should be accelerated, particularly regarding the debt bias in the taxing system, and we also see merit in introducing prudential ceilings on debt service-to-income caps by income category. While we acknowledge the high level of net wealth of households as a mitigating factor, we remain concerned by the high level of household debt to disposable income, and more specifically, by the share of interest-only mortgage. The staff's comments are welcome.

On the external sector, staff once again concludes that the external position is stronger than the level consistent with medium-term fundamentals, but at the same time refrains from devising a clear strategy to correct this imbalance on the grounds that the assessment is very uncertain.

We welcome the analysis included in the issues note on commonalities among European surplus countries. In the case of the Netherlands, the note attributes the evolution of the current account surplus—in a context where foreign demand has been subsiding—to contractionary domestic demand developments, namely increasing profit retention by multinational firms, corporate taxation, household deleveraging, increased mandatory and precautionary savings of households and pro-cyclical fiscal policy. Exploring the influence of each of these channels should be warranted for future Article IV consultations.

Uncertainties over the future of the pension system may have played a role on the increase in precautionary savings of households. Could staff comment? We are encouraged to read in the buff statement that the authorities believe that the system needs a fundamental overhaul that will bring greater transparency and predictability.

On the fiscal side, we note that the Netherlands is one of the few countries in the world that enjoys some fiscal space. Given that there is a small negative output gap, we see merit in using the fiscal space to support growth in the medium term while meeting the requirements of the Stability and Growth Pact. We also see merit in rebalancing the composition of taxes—reducing the labor tax wedge, reforming the capital income taxation and so forth—so as to improve the growth-friendliness of the system and encourage labor market participation.

Finally, we welcome the Financial Sector Stability Analysis and concur with its assessment and main recommendations, particularly with the need to reach at least a tax neutral treatment of mortgages on an accelerated basis, and the need to continue to build capital buffers.

Mr. Mahlinza and Mr. Odonye submitted the following statement:

We thank staff for a concise set of reports and Mr. Doornbosch and Mr. Evers for their informative buff statement. We broadly agree with staff's recommendation that the authorities should continue improving the Kingdom of the Netherlands' resilience to shocks and strengthen long term growth potential.

The Dutch economy recorded a steady recovery over the last three years and is picking momentum with real GDP growth recording 2.1 percent in 2016. Unemployment has continued to decline against increasing employment and a slight growth in real wages, supporting consumption. In 2017, domestic consumption and investment are expected to drive growth, helping the gradual decline in the current account surplus and fostering inclusive activity. The baseline assessment projects moderate growth in the medium term with the negative output gap closing in 2019. In this regard, we encourage the authorities to expedite action towards addressing inefficiencies in the economy, especially in the housing and labor markets, reducing the labor tax wage and reforming pensions.

Sustaining the recovery in the context of deleveraging in multiple sectors of the economy and weak foreign demand will require a tactful approach. In this regard, we would encourage the authorities to use any fiscal space to reduce labor taxation or increase spending in R&D and human capital. Increased spending on R&D or further tax reductions, notably to reduce the tax wedge for workers at the margin of the labor force and preferably in the context of a broader tax reform, are possible high impact areas. In the medium term, reducing public debt should be a priority, particularly in the context of the highly leveraged status of private balance sheets and the need to strengthen fiscal buffers.

Although the ECB has maintained an accommodative monetary policy stance, credit declined further in the Netherlands while banks continued to deleverage, reflecting both market and regulatory pressures. The staff notes that credit to the economy especially credit to non-financial corporations continued to drop in 2016, and contracted by 6 percent (year-over-year) in July. We would welcome staff comments on the risks posed by this phenomenon and whether any change is foreseen anytime soon.

Finally, we agree that further structural reforms, especially regarding tax reforms will promote growth and improve the resilience of the economy. In this regard, the Dutch authorities should increasingly shift the tax burden away from labor to consumption and property. This should focus on removing the regressive aspects in asset taxes and eliminate some of the distortions related to multiple VAT rates. We also note that the authorities broadly agree with staff on the need for addressing labor market rigidities and the need to fundamentally overhaul the second pillar pension system in the direction of the more personalized contracts. We see merit in addressing the low labor force participation levels and maintaining a sustainable pension scheme.

Mr. Sembene and Mr. N’Sonde submitted the following statement:

We commend staff for the set of concise yet insightful papers on the Kingdom of Netherlands. We also thank Mr. Doornsbosch and Mr. Evers for their informative buff statement.

We welcome the continued recovery of the Dutch economy against the background of fast-growing house prices, strengthening private balance sheets, and rising consumption. As a result, growth is firming up, labor market is tightening and real wages are rising and further fueling consumption. Deleveraging by the private sector continues which, coupled with market sentiment and tight regulatory framework, helps contain credit growth. These developments are encouraging. However, we share the view that housing market in some areas should be closely monitored as they seem to move strongly above their long-term equilibrium.

Regarding the external sector, we note the expected continued decline of the current account surplus over the medium term on the back of declining savings from baby boomers and the country's shift to natural gas import. However, the external position should remain strong given Netherlands' savings-investment nexus.

While there remain negative risks to the outlook—including those related to European political tensions and protectionist sentiments—we also see significant upside risks: strength of domestic demand, housing price developments, and Amsterdam's potential new status as a center for European financial institutions.

Looking forward, we agree that strengthening resilience to shocks and enhancing growth potential should be priorities on the authorities' policy agenda. Structural reforms to boost labor participation—including by taking advantage of the changing demographics—and bolster productivity should help improve the economy's potential. The country's economic resilience will be enhanced by tackling further leverage, speeding up the implementation of macro- and micro-prudential measures, and promoting growth-friendly tax reforms. We broadly concur with the thrust of staff recommendations and would like to make the following additional comments for emphasis.

Regarding fiscal policy, we encourage the authorities to lean on the country's limited fiscal and financing risks to put in place fiscal stimulus measures that will boost near-term growth while enhancing growth potential, notably spending in the areas of education, human capital and innovation, as well as reductions in labor tax wedge. The growth and potential gains from such reforms should also help put debt on a declining path over the medium to long term.

On the financial sector, we welcome the agreement between staff and the authorities on the main risks, and on ways to enhance resilience as well as policies to strengthen the pension, banking, and non-bank financial sectors. It is essential to cool off mortgage credit through lowering the scope of mortgage interest deductibility and tighten somewhat credit conditions. On the other hand, we see merit in boosting the supply of private rental units by deregulating other segments of the housing market and scaling back subsidization of social housing in order to curb incentives for acquiring homes without adequate financial buffers. We call on the authorities to require adequate provisioning for banks and to follow suit on the FSAP recommendations, particularly those aiming at increasing banks' capital buffers to back up credit growth without excessive deleveraging in case of shocks; and enhancing the independence of banking supervisors.

Steadfast implementation of structural reforms is essential to elevate the potential of the Dutch economy and put it on a sustainable path to stronger, more resilient growth. Diversifying the sources of tax revenues towards consumption and property taxes, while harmonizing VAT rates will help not only achieve this objective but also realize further efficiency gains. We also encourage the authorities to pursue tax reforms on the basis of distributional equity.

Addressing the shrinking labor force through appropriate labor market reforms is critical. We urge the authorities to accelerate the reforms aimed at raising productivity in small and medium-sized enterprises (SMEs) notably through public investment in R&D, facilitating the creation of businesses, and promoting training. Moreover, apart from humanitarian considerations, welcoming refugees and bolstering their integration will benefit the Dutch economy by raising the labor force, increasing productivity while containing risks of dragging down wages. We commend the authorities for their bold actions on this front.

Mr. Merk and Mr. Lieber submitted the following statement:

We thank Messrs. Doornbosch and Evers for their clear buff statement and staff for a comprehensive set of reports. We associate ourselves with the statement by Mr. Cottarelli and would like to make the following comments.

The Netherlands has continued its solid recovery path despite an ongoing deleveraging process in the private sector. Household debt is on a downward trend, the unemployment rate has declined and risks to public finances remain contained thanks to the authorities' prudent policies. At the same time, potential output growth—estimated by staff at a constant rate of 1.6 percent over the medium turn—remains somewhat subdued. In line with staff's recommendations, priority should be given to timely addressing structural bottlenecks, including in the labor market, and raising productivity, while remaining vigilant with regard to vulnerabilities from still high household indebtedness, including through tightening macroprudential regulations where needed.

We welcome the Netherlands' comfortable fiscal position, complemented by a downward trending public debt ratio. While taking note of staff's arguments in favor of additional spending within the rules of the

Stability and Growth Pact, we see merit in the authorities' arguments highlighting uncertainties regarding the size and closure speed of the output gap and the potential pro-cyclicality of fiscal stimulus measures. In this context, we note that the fiscal stance for 2017 is already expected to be slightly expansionary by both the European Commission's Winter Forecast (looking at the change of the cyclically-adjusted and structural budget balances) as well as staff's projection for the change in the structural primary balance. In any case, we agree with staff that some consolidation in the longer run would further enhance the economy's resilience, not least against potential growth and contingent liability shocks.

We concur with staff's structural reform suggestions, particularly in the areas of taxation, pensions and labor market rigidities. The authorities should consider reducing the debt bias of the tax system, including through limiting the deductibility of interest from corporate taxes as for mortgages. Moreover, timely addressing the weaknesses of the defined benefit second pillar of the pension system appears warranted, aiming to restore transparency and predictability for participants and retirees. With regard to the labor market, we agree with staff that a more harmonized approach towards different groups (permanent contracts, temporary contracts, self-employment) would be welcome in order to preserve flexibility while at the same time strengthening social protection for self-employed. Moreover, we support staff's recommendations concerning possible ways to raise labor productivity, including an increase in public R&D.

While we take positive note of increased capital buffers in the banking system, pockets of vulnerability remain with a view to still highly leveraged households. As indicated by the Financial System Stability Assessment, banks appear resilient to risks, but face challenges from profitability pressures and continued reliance on wholesale funding. Furthermore, we see merit in staff's recommendation to accelerate the implementation of macroprudential measures in order to facilitate household deleveraging.

The staff's comments would be welcome on specific measures that could help to raise investment going forward.

Moreover, we would appreciate if staff could elaborate on real wage and labor productivity growth developments over the last decade. The relevant information provided in the staff report appears somewhat unclear, as, at one point, it is mentioned that "employees' compensation has increased less than labor productivity over the last eight years" (paragraph 3), while, at a later point, staff also notes that labor productivity "has virtually ground to a halt in the Netherlands over the last decade" (paragraph 30).

Mr. de Villeroché submitted the following statement:

We thank staff for an interesting set of reports and Messrs. Doornbosh and Evers for their informative buff statement regarding the reforms underway. The Netherlands' economy confirms its robust recovery in terms of growth, employment and fiscal trajectory as well as the strengthening of the resilience of its banking sector. At the same time, the Dutch current account surplus remains very large, at 8.9 percent in 2016, and could reflect structural factors as well as possible distortions. Besides, the duality of the labor market and developments in the housing market as well as challenges faced by the insurance industry call for close monitoring. Against this backdrop, we broadly share the thrust of staff's appraisal, welcome the authorities' efforts to improve tax and pension systems and encourage them to pursue these structural reforms. We particularly would like to encourage them to make use of the available fiscal space to boost domestic demand and potential growth.

We associate ourselves with the statement of Mr. Cottarelli and would like to make some additional points.

Macroeconomic Situation

We share staff assessment that the recovery is more broad-based and that risks are essentially external. In particular, we take note that the composition of growth is on a more balanced track with investment and private consumption contributing more and more. At the same time, being very open, the Dutch economy remains highly dependent on the developments in key commercial partners. Owing to the strong exposure to the United Kingdom, staff assessment of the impact of Brexit on the Dutch economy would be welcome.

We welcome the selected issue on the current account surplus and concur with staff that the external position is stronger than the level consistent with medium-term fundamentals. As analyzed by staff, this reflects subdued demand developments and retained earnings by non-financial corporations. Despite a recent pickup, real wages have increased less than labor productivity over the last 8 years. Moreover, the strong incentives and obligations for households to save in pension schemes and invest in housing have contributed to a highly-leveraged economy and potentially to an inefficient allocation of capital. With a longer-term perspective, the disinvestments of pension funds linked with massive retirements and the shift to being a net natural gas importer might help the Netherlands achieve a more balanced current account. However, although we expect a reduction of the surplus over the medium term, the projections show that it will remain very high, at 7.1 percent in 2022. We take note that staff estimates the norm in a range of 5 to 7 percent of GDP but we remain unconvinced that such a level would be consistent with medium-term fundamentals and desirable policy settings. Such an external position could partly reflect structural factors but also possible distortions. We would appreciate if staff could adopt an integrated approach by assessing the spillover effects of this external position on other euro area countries and provide policy recommendations in order to address the possible distortions, for instance concerning the evolution of real wages. We also welcome staff's intention to deepen their understanding of firms' motives behind trending net savings in future studies.

Fiscal Policy

We fully support staff recommendations on the use of the available fiscal space. In particular, we observe that the fiscal balance should turn positive as of 2017 and public debt should reach the European criteria (60.1 percent of GDP according to the IMF and 59.7 percent according to the CPB). Against the backdrop of very limited financing needs, as recommended by staff, we encourage the authorities to make use of the available fiscal space to support domestic demand and long-term growth, within the limits of the Stability and Growth Package. Growth enhancing measures could encompass education or public R&D expenditures as well as further tax reductions. Such measures would also help bring down the current account surplus and the rebalancing within the euro area. We would like to have staff's assessment of the impact of an overhaul of the Dutch tax system, notably to deter households' indebtedness, as it was discussed during the elections and supported by a majority of parties.

Housing and Financial Sectors

We welcome the strengthening of the financial sector oversight and encourage the authorities to pursue additional reforms to ensure the sector's robustness. The main risks for the banking sector lay in the high level of indebtedness of households and non-financial corporate. Against this background, we support staff's recommendation to correct the housing market distortions by measures tackling both demand and supply. In particular, we agree on the need to accelerate the phasing-out of mortgage interest deductibility (MID) and going further regarding macro-prudential measures, notably lowering the Loan-To-Value ratio. At the same time, such measures should be accompanied by a more flexible provision of housing, to own or to rent, in order to improve market efficiency.

The impact of low interest rates on the insurance industry and pension funds is also an important question and close monitoring is critical.

Structural Reforms

We concur with staff that structural reforms should aim at enhancing the labor market and pension system. Concerning the labor market, while the unemployment rate is very low, its increasing duality could threaten the social cohesion. Against this backdrop, greater harmonization of the employment frameworks should be pursued, notably by reducing tax bias towards self-employment. Moreover, we welcome the authorities' commitment to address the weaknesses of the Dutch pension system as well as staff's advice. In particular, we concur that the pension reforms should focus on increasing transparency and predictability and ensuring portability across funds and sectors also in order to achieve greater labor market's flexibility.

Mr. Sobel and Ms. Svenstrup submitted the following statement:

Economic management in the Netherlands has long been sound and prudent, for which the authorities merit great praise. The economy is now in the midst of a gradual economic recovery. But despite recent improvements, the Dutch economy is only expected to reach potential in 2019, amid prospects for dampened long term growth. Further, very large external surpluses heighten the economy's exposure to external shocks. We concur with staff's assessment that the authorities should do more immediately to support the near-term recovery, while also taking steps to reduce financial sector vulnerabilities and address structural barriers to medium-term growth. We especially agree with staff's assessment that the Netherlands has "substantial" fiscal space to pursue additional easing to boost domestic demand, which would help address its sizable external surplus.

As we broadly agree with staff's coverage of structural and financial sector issues—and we welcome the FSSA in particular—we will confine our comments to external and fiscal issues.

External: An assessment of the staff paper's treatment of the external sector must begin with the reality that the Dutch current account surplus is enormous, at roughly 9 percent of GDP. Against this background, staff's work must be viewed as mixed, and we do not believe that the analysis met the test set forth by the Managing Director at the end of the recent G-20 Ministerial, where she stated: “I reaffirmed the IMF’s readiness to contribute to enhancing global understanding and cooperation in line with our mandate, including through vigorous exchange rate surveillance and analysis of global imbalances.”

On the plus side, we highly welcomed the selected issues paper on the drivers of large surpluses in “S3” countries. Kudos! Indeed, we would like to see more of such work.

But the selected issues paper read as if it were a stand-alone document, and its findings seemingly were not well-integrated into the Article IV paper nor well-linked to the current macroeconomic situation and actionable policy recommendations. The “Key Issues” page lists five focal points for the consultations, none of which directly dealt with the external sector. While the current account surplus is mentioned in the external assessment, it is neglected in the “Policy Discussions” and the “Staff Appraisal.” The wording around the current account surplus in the “External Assessment” also seemingly treats it passively, as derivative in large measure of oil prices, demographics, and multinational enterprise activity. There is no mention of the asymmetric impact of large European surpluses on euro area deficit countries and global imbalances.

The United States is a strong supporter of the ESR/EBA process. On the assessment described on page 4, after noting that the large gap between the actual current account surplus and norm, staff seemingly explain it away, referencing corporate savings and activities, for example. Ditto on page 27, which characterizes the gap as “particularly uncertain.” More generally, our chair remains confused by the treatment of saving issues in the EBA model. It is our understanding that the variables in the EBA model were chosen to reflect the drivers of saving and investment decisions. The existence of a pension or provident scheme in a country has been used to justify the upward revision of the current account norm in a number of recent Article IV reports (e.g., Malaysia, Israel, and now the Netherlands). Does such an upward revision imply that “forced” saving through a pension plan cannot be offset by a reduction in saving through other means which would leave gross household saving unchanged? Would high saving show up in P* or the demographic variables, or perhaps both pointing to the possibility of double counting? How does the adjustment for favorable tax treatment for multinationals work, and does that bias upward corporate saving and the current account norm? Do such ad hoc adjustments violate the multilateral consistency of the EBA model—if the Netherlands current account norm is revised upward where is the offset? In future ESRs, we call on staff to provide the unadjusted current account norm from the EBA model and describe with full transparency and detail the specific adjustments made.

Fiscal: The authorities' fiscal policies are commendably prudent, as reflected in modest and restrained debt and deficit levels. We strongly praise staff for the clarity of their statement on page 5: "The Netherlands has substantial fiscal space." Given the output gap, sound fiscal position, and the excessively large current account surplus, we also strongly agree with staff's assessment that the Dutch authorities can take advantage of considerable fiscal space to boost domestic demand and support the recovery.

Notwithstanding the availability of considerable fiscal space, though, one cannot help but notice that staff believe that the use of such space should be limited in order to be compliant with the SGP (page 6), and further that spending should not over-perform relative to the MTO. However, we understand that the EC allows flexibilities relative to the MTO, including for countries implementing structural reforms and investments, and in fact, has encouraged countries, including the Netherlands, to utilize all available flexibility under the rules in 2017. Could staff discuss how their analysis takes into account this guidance?

Finally, in assessing fiscal positions, let alone fiscal space, our chair wishes to harken back to a theme we have often raised, both generally and in specific contexts (e.g., Finland). The staff paper does not mention that the Netherlands' net debt is around 30 percent of GDP. At times, staff suggest that general government debt should be used for cross-country comparability's sake, or that the "gross" number is preferable due to old age spending needs or the government's assets being difficult to value. To echo the questions our chair raised in the Finland Article IV, why does staff not mention the Dutch net debt position? Is net debt a relevant concept from an economic standpoint for the broader fiscal space debate? Should the comfortable net debt position in the Netherlands from an economic standpoint provide more leeway and scope for flexibility under the SGP?

Mr. Alogeel and Mr. Rouai submitted the following statement:

We thank staff for a well-written set of reports, including the FSSA, and Mr. Doornbosch and Mr. Evers for their informative buff statement. The Dutch economy continues to perform relatively well, with solid growth and reduced unemployment, underpinned by improved bank and household balance sheets. Over the medium-term, however, growth prospects will be affected by the ongoing deleveraging process and developments in major trading partners, in view of the Netherlands' openness and relatively large share of exports to the United Kingdom. Since we broadly share staff appraisal and policy recommendations, we would limit our remarks to a few issues.

We take note of the divergence of views between staff and the authorities on fiscal policy, in particular with regard to fiscal space and staff recommendation for near-term additional growth-enhancing spending or tax reductions. This divergence is further compounded by the need to comply with the requirements of the Stability and Growth Pact (SGP). We do not consider that it is helpful at this stage to take side on this issue with either staff or the authorities because what matters at the end is the traction of Fund advice. Viewed from this angle, we welcome the authorities' readiness to use any fiscal space, should it materialize, to further reduce labor taxation or increase spending on R&D and human capital and we encourage staff and the authorities to continue their dialogue on this issue in the context of next year Article IV consultation. In any event, we welcome the agreement between staff and the authorities on the need to reduce public debt over the medium-term to levels well below 60 percent of GDP and comply with the SGP rules.

We note the recent acceleration in house prices in an environment of continuously elevated household sector indebtedness. We support staff recommendations to tighten the macro-prudential toolkit to reduce vulnerabilities, in particular, through promotion of the rental housing sector and further reduction of the maximum loan-to-value ratio for mortgage loans.

We are comforted by the results of FSAP stress tests, which show that banks are well capitalized and resilient to liquidity risks. We note, however, that banks face challenges associated with low profitability and continued reliance on wholesale funding. We encourage the authorities to pay due consideration to the FSAP recommendations, in particular with regard to the importance of strengthening the operational independence of the supervisors, De Nederlandsche Bank (DNB) and Authority for the Financial Markets (AFM). Could staff clarify why these supervisors are not allowed to issue technical regulations? We also support staff recommendations with regard to the insurance sector, which continues to face important challenges and represents a global stability risk in view of the existence of a globally systemic important insurer.

Finally, the Netherlands will benefit from the implementation of staff recommendations in the area of structural reforms to improve the resilience of the economy. In this regard, footnote 6 refers to the potential negative impact on productivity growth of the rise of flexible employment. In view of the current interest within the Fund to investigate the reason behind the decline in productivity growth, further research by staff on the case of the Netherlands could have been helpful. The staff's elaborations on this issue would be helpful.

With these remarks, we wish the authorities further success.

Mr. Field and Miss Chen submitted the following statement:

We thank staff for an extensive set of reports and Mr. Doornbosch and Mr. Evers for their informative buff statement. We welcome the continued recovery of the Dutch economy and the signs that it is gathering speed. This should give the authorities space to concentrate on longer-term measures designed to support growth and the resilience of the economy, including reforms to the tax and pension systems. Although household balance sheets are improving, the high level of indebtedness remains a source of vulnerability for the Dutch economy. We agree with the thrust of the staff appraisal and broadly associate ourselves with the comments of Mr. Cottarelli's statement. Reflecting that, we only have a few additional comments.

We welcome staff's assessment that the Netherlands has fiscal space, however, we would have expected a fuller discussion of how staff came to this judgement. On the related question of whether fiscal space should be used to support the recovery, we have some sympathy with the authorities' concern that a stimulus at this point could be pro-cyclical given estimates suggest the output gap has nearly closed and the lags associated with fiscal policy changes. Are there circumstances in which staff would recommend the use of fiscal space whilst an economy is at potential and, if so, what are they?

We recognize that without an independent monetary policy, fiscal policy may have a role to play in managing macroeconomic conditions, and we note staff's finding that a stimulus would support a reduction in the currency account surplus, however, we do not think that the report adequately explains the motivation for staff's advice. Can staff expand on the objectives for their proposed fiscal stimulus, including stating clearly whether reducing external imbalances is the objective. Finally, we note that the advice is for a stimulus in the short-run followed by further consolidation thereafter. Given tax cuts are easier to implement than tax rises (and vice versa for changes to spending or entitlements) we wonder about the practicalities and efficiency of using fiscal fine-turning in the way that is proposed. Again, staff comments would be welcome.

We read with interest the selected issues paper describing drivers behind persistent and large current account surpluses in Germany, the Netherlands and Switzerland (the S3) and, in particular, its conclusion that before the global financial crisis (GFC) S3 surpluses mainly reflected competitiveness gains in Germany and unsustainable demand in deficit countries, and that subsequently subdued demand in the S3 has been the main factor. This chair believes that the Fund is best placed to perform such cross-country comparisons, which are a core part of its mandate, and we would strongly encourage staff to do more cross-country work, including on firms' and households' saving behavior as proposed in the paper.

Finally, we welcome the FSAP and the resilience of the Dutch banks under the stress test exercise. We agree with the thrust of the FSAP recommendations, in particular that banks should continue to build capital buffers towards higher capital leverage ratios. This is particularly important given the risks associated with highly indebted households, identified in the Article IV report, which are likely to persist for some time. We agree that further household deleveraging should be a priority and support the use of macroprudential tools to promote this. However, could staff elaborate whether further reduction in LTV limit would cause problems for households looking to remortgage in future, given significant number of interest only mortgages (where the LTV at origination have not changed over time)?

Mr. Mojarrad and Mr. Nadali submitted the following statement:

Following a double-dip recession, the Netherlands economy has experienced three consecutive years of gradual recovery. In 2016, against still sluggish external demand, growth accelerated on a broad base, inflation remained subdued, and there was a further rapid decline in unemployment. The fiscal deficit continued to narrow, the large current account surplus further widened, and public debt dropped closer to the SGP threshold and remained the lowest among European peers. The banking system continued to build capital buffers and appeared resilient to risks. Progress was also made with structural reforms, including through the implementation of a labor income tax reduction package. While risks to the outlook are slightly tilted to the downside, the authorities are encouraged to proceed with sound policies to enhance the economy's growth potential and boost its resilience. We concur with the thrust of staff appraisal and policy recommendations.

Substantial fiscal space on the one hand, and continued negative output gap on the other, argue for near-term fiscal easing. This could also help reduce the sizeable current account surplus and bring it more in line with fundamentals. We see merit in further cuts to the labor tax wedge as well as increased spending on human capital and public research and development, and note that these could be accommodated within the SGP rules. The difference in measurement of structural balance between staff and the European Commission highlights the uncertainties surrounding the estimation of the output gap. Could staff comment on the authorities' assertion, as indicated by Messrs. Doornbosch and Evers in their helpful statement, that the structural balance is a volatile indicator and should not be assigned too much weight in short-term budgetary recommendations? Fiscal consolidation over the longer-term, however, remains appropriate to rebuild buffers for looming demographic pressures and potential future fiscal support for the financial sector.

The large and globally-interconnected banking system is well capitalized and liquid. FSAP stress tests have confirmed that all banks would maintain capital ratios above the minimum regulatory requirements and would be able to withstand significant funding withdrawals under severe adverse shocks. However, high leverage, low profitability associated with the low interest rate environment, and continued reliance on wholesale funding present challenges and warrant vigilance. Continued strengthening of capital buffers bodes well for supporting credit growth. We endorse close monitoring of banks' business models and risk management frameworks as well as of insurers' financial conditions, and look forward to the early enactment of a new legislation on the recovery and resolution of insurers. Given the highly-leveraged household sector, consideration should be given to accelerated tightening of macroprudential measures, including faster phasing-down of mortgage interest deductibility and further lowering the maximum loan-to-value ratios. This should be combined with deregulation of the housing market to help boost the supply of private rental units and meet increased housing demand.

Structural reforms to overhaul the tax system, reform pension plans, and address labor market rigidities are essential to enhance the economy's resilience to shocks, raise productivity, and bolster growth. Tax reforms should aim to reduce the debt bias, eliminate VAT distortions, and shift the tax burden from labor towards consumption and property. We agree that a viable, fair, and predictable pension system that ensures greater portability when changing jobs and preserves financial security at retirement could be achieved by combining individual accounts with collective risk sharing. Increased flexibility in the regular labor market and greater harmonization among regular, temporary, and self-employed workers could go a long way in improving the functioning of the labor market as well as in ensuring the sustainability of the safety net and pension schemes. We welcome fast-tracking the integration of refugees into the society and labor market, and appreciate staff comments on how this might ease pressure of a shrinking labor force.

Ms. Erbenova, Mr. Just and Mr. Varga submitted the following statement:

We thank staff for the broad set of papers and Messrs. Doornbosch and Evers for their comprehensive buff statement. The Dutch economy is growing for the third year in a row on the tailwind of higher global growth, increased consumer confidence and higher employment. Despite this good performance, we agree with the overall objective of the authorities to increase the resilience as well as the buffers of the economy to create the fiscal room for policy maneuvers should downside risks materialize. We associate ourselves with the statement by Mr. Cottarelli.

We agree with staff's assessment that the Netherlands has a limited fiscal space, which should be used cautiously, in line with the Stability and Growth Pact and only for fostering potential output. We welcome the overall prudent fiscal stance of the authorities, which thus far has resulted in a rapid reduction of public debt. We hope that the incoming government will continue on this course, but will also give some consideration to staff's tax reform proposals with a view to decrease the tax wedge, which would help overcome the duality of the labor market and avoid potentially longer-term negative effects for social security, as well as address some of the negative aspects of flexible work arrangements without undermining their clear benefits.

The structural problems in the Netherlands are well known and have been extensively discussed. It is important to find a political consensus needed for implementing necessary reforms. The residential tenancies regulation could help address the unsatisfied demand for housing rentals and reduce the incentives for households to contract mortgage debts. The very rigid labor market regulations should be eased to boost formal and open-ended employment and avoid reinforcing the already high number of part-term contracts and self-employment.

We appreciate staff's analysis of some of the common drivers to Europe's largest current account surpluses—in the Netherlands, Germany, and Switzerland, the so-called "Surplus 3" countries. We welcome the attempt to identify the common and idiosyncratic drivers of those current account surpluses. This comparative analysis is also instrumental for better understanding the situation of a particular economy and we would see value in adding in future analyses the behavior by firms and households. In addition, we would appreciate similar analyses in the future to recognize the positive aspects of the export component of those surpluses in terms technology transfer, FDI, as well as job creation and economic growth for countries which are part of the various supply chains.

We commend the authorities for significantly strengthening financial sector oversight. The banking sector is well-capitalized and banks appear resilient to various stress scenarios. We largely agree with staff's recommendations concerning micro- and macro-prudential policies, bank business models and wholesale-funding or improving the quality of regulatory capital. While we agree with staff's longstanding recommendation on the measures to decrease banks' vulnerabilities from household indebtedness and mortgages, we think that the authorities' plan is too gradual, especially on the phasing out the mortgage interest deductibility. We would also be interested in staff's views whether (and to what extent) insurance products are used as assets to back mortgages or assess borrowers' creditworthiness and whether the increased vulnerability of insurance products could increase the relative riskiness of mortgages. We note with some concern weaknesses in data quality across Dutch significant institutions supervised by the ECB, which may also undermine the work of the Single Resolution Board as its plans need to be based on accurate and readily available data. We fully share staff's views on the need to enhance the oversight of the EuroCCP, as well as its stress testing and recovery planning. We would be interested whether more detailed discussions took place with the authorities on the possible implications of the Brexit for those banks with significant asset exposure to banks in the United Kingdom but also related to CCPs? We appreciate staff's observation that the creation of the SSM has significantly strengthened banking supervision in the Netherlands. The points on streamlining the decision-making procedures are instructive but would more appropriately be addressed within the context of the euro area surveillance or in a regional FSAP exercise.

Mr. Mozhin and Mr. Vasilyev submitted the following statement:

We thank staff for a set of well-written papers and Mr. Doornbosch and Mr. Evers for their informative buff statement.

With improvements in domestic demand, growth in the Netherlands achieved 2.1 percent in 2016 and is expected to remain at the same level in 2017. Recovering housing prices, improvements in balance sheets, and some recent increase in real wages support consumption. As negative output gap is steadily closing, growth is expected to converge to 1.6 percent by 2019. The staff notes that slow TFP growth, population aging, and low investments contribute to a reduction in potential growth.

According to the staff assessment in the External Sector Report, the current account surplus is stronger than the level consistent with medium-term fundamentals by 2-4 percent of GDP. The current account surplus has reached 8.9 percent of GDP in 2016. We welcome the selected issues paper on Europe's largest current account surpluses. We note from this paper, that before the global financial crisis, in 1999-2007, the Netherlands' external position benefited from a positive external demand shock, whereas Germany and Switzerland benefited from competitiveness gains. What can explain the persistence of the current account surplus in the Netherlands in 1999-2007? Should competition with other economies not have reduced positive gains to the Netherlands from a positive external demand shock? We note the conclusion in the ESR that non-financial corporate savings explain the bulk of the current account surplus. As Mr. Tombini and Mr. Lingoist, we are also interested in the effects that the BEPS proposals may have on multinational companies, as well as on the current account surplus in the Netherlands.

The staff have noted that the Netherlands have significant fiscal space, as the public debt-to-GDP ratio is expected to decrease below 60 percent of GDP in 2018 and only severe tail events may undermine debt sustainability. We see a rationale in the staff recommendation to use some fiscal space to invest in education and R&D in order to increase potential growth. At the same time, we agree with the Dutch authorities that the implementation of fiscal policy measures takes time and this additional spending may become inflationary, as the output gap is almost closed.

On the reforms of the tax system, we support the staff recommendation to remove the debt bias. However, a straightforward recommendation would be to remove interest rates deductibility and not to introduce a similar deduction for equity finance.

Despite the ECB's stimulating monetary policy and negative interest rates, banks in the Netherlands continue to deleverage. According to survey data cited in paragraph 4 of the report, credit conditions for SMEs remain tight. In addition, banks continue to charge high interest rates to risky borrowers. Could staff comment on the effects that negative interest rates are having on Dutch banks?

Although Dutch households remain highly indebted, mortgage defaults are relatively low and the financial system stability assessment confirms that Dutch banks are fairly resilient. However, we note from the FSSA that leverage in the banking sector is high and the ratio between risk-weighted assets and total assets is low, especially in cases when banks use internal ratings-based models. We support the staff recommendation to continue to build capital buffers in the banking sector.

Mr. Sun and Mr. Fan submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Doornbosch and Evers for the informative buff statement. It is good to note that the Dutch economy has being picking up from the double-dip recession, although challenges remain in some areas. We broadly agree with the thrust of staff's appraisal and limit our comments to the following for emphasis.

It is encouraging that the economy is projected to grow above 2 percent in 2016 and 2017 and the recovery is broad-based. At the same time, the economic outlook faces some uncertainties such as weaker-than-expected growth in the euro area and the Brexit process. Uncertainties could be two-fold. On the one hand, domestic demand and employment improvements could be stronger than the projections. On the other hand, growth could be weaker if trade protectionism had a negative impact on the economy. In Table 1, the CPI is projected to jump from 0.1 percent in 2016 to 0.9 percent in 2017. Although this change is largely in line with the broad recovery trend in the euro area, it is somewhat large in scale. Could staff explain what supports this projection?

On fiscal policy, there seems to be a need for both the authorities and staff to further assess how much the fiscal space is and on what to spend. Both sides agree that there is a small output gap that can be closed soon. The staff suggests to use the existing fiscal space to support the recovery such as on public R&D or education. While the authorities believe that there is limited room for additional spending, as implementing new fiscal measures would have a pro-cyclical effect and the public debt remains above the pre-crisis level. We encourage more deliberation on this issue, and believe that further tax cuts to reduce the tax wedge for workers at the margin of the labor force could be useful, and that further reduction of public debt is desirable.

On structural reform, we appreciate staff's analysis on the current tax system and their tax reform options in the selected issues paper to redistribute the tax burden from labor income to value-added tax or property tax. We agree with staff that the tax reform should be growth-friendly and budget-neutral, and the debt bias should be minimized. Reforms on corporate tax could neutralize the corporates' excessive incentives on saving their profits and might be helpful to reduce the current account surplus. We take note of the financial stress in the second pillar of the pension system due to protracted low interest rates, and encourage the authorities to overhaul the system. We agree with the authorities that the reform should aim to make the pension system more transparent, predictable, and sustainable. To address labor market rigidity, we concur with staff that more flexibility on regulations and contracts, and raising productivity by promoting R&D are important. We also agree that greater harmonization is needed across the three main categories of workers. Since the rapid increase of self-employment in the labor force is not unique for the Netherlands, a comprehensive study on this issue in the near future might be useful for other Fund members to share lessons and experiences.

We appreciate staff's comprehensive analysis in the FSSA report. It is encouraging to see that the banks are resilient in the stress tests, and the macroprudential and microprudential oversight have improved. The insurance companies face vulnerabilities, especially due to the low interest rate environment, longevity, and competition. Given the insurance sector's importance in the economy, we encourage the authorities to take strong measures to mitigate the risks in the insurance sector and to cut the transmission channels to other sectors, if any. Also, with total financial assets eight times of its GDP and the high openness, the country could be significantly influenced by other financial centers like Frankfurt, Paris, as well as London. Therefore, supervisors are encouraged to closely monitor the financial conditions to ensure financial stability.

The representative from the ECB submitted the following statement:

We would like to thank Mr Doornbosch and Mr Evers for their clear buff statement and staff for their informative report. We associate ourselves with the statement by Mr Cottarelli. As we are in broad agreement with the staff assessment, we would just briefly elaborate on a number of aspects.

We share the staff assessment that economic growth in the Netherlands is strengthening and activity is expected to continue expanding at robust rates in the medium term. On the external sector, we concur with the staff view that the current account surplus is likely to remain high over the medium term, predominantly reflecting structural factors. Like staff we also consider that the growth outlook is subject to slight downside risks, stemming mainly from the external environment. On the financial sector, we agree with staff that Dutch banks are well capitalized. Nonetheless in view of vulnerabilities stemming from housing markets and high household indebtedness, we share the view that additional macroprudential measures for mitigating real estate-related risks could be considered, in particular an acceleration of the implementation of measures.

We broadly share the macroeconomic assessment and outlook presented by staff, in particular that economic growth is solid and that the closing of output gap likely to continue over the coming years. The economic recovery in the Netherlands has strengthened driven mainly by domestic demand and is becoming more broad-based. We expect economic activity to continue expanding at robust rates in the medium term. There are a number of tailwinds which should support private consumption growth going forward, in particular strong disposable income developments, improved household purchasing power and positive wealth and confidence effects. Economic slack is expected to shrink and the output gap to close over the next 2-3 years. In this context, HICP inflation is expected to gradually pick up over the coming years, amidst stronger wage growth, supported by the strengthening of energy prices and the depreciation of the euro.

Regarding the current account, we concur with IMF staff that, owing mainly to structural factors, the strong surplus is likely to remain over the medium term, despite strengthening domestic demand and restrictions on natural gas extraction. We consider structural and institutional factors as the predominant contributors to the large current account surplus: namely, the country’s status as an international financial center, the high savings and foreign investments of Dutch-based multinationals and pension funds, demographic trends, integration into global value chains, as well as the structural shift towards intangible (ICT) investment. This implies that a large current account surplus would likely be maintained in the medium term. Nevertheless, from a saving-investment perspective, there seems to be room for policies to boost private investment and public spending on R&D.

Notwithstanding the factors supporting consumption growth, we share the view of overall slight downside risks to the Dutch economy stemming mainly from the external environment (Brexit, geopolitical tensions, emerging markets). For instance, lower-than-expected growth in its main trading partners and/or an escalation of geopolitical tensions could have substantial repercussions on the growth prospects of the Dutch economy.

On fiscal policy, we agree with staff that the use fiscal space should be in compliance with the obligations under the SGP. In this regard, the upper end of the order of magnitude proposed by staff for an additional fiscal stimulus (0.5-1.0 percent of GDP) seems rather large and uncertain in terms of effectiveness. Any fiscal measures would have to be well designed, given questions about the effectiveness of rather large temporary stimulus measures to close a relatively small and anyways declining output gap. Thus, we agree with the broader fiscal policy recommendations outlined by staff, such as future tax reforms to minimize the debt bias and to enhance the efficiency of the tax system. Such measures would also help creating additional fiscal space to boost productive spending and decrease labor taxation over the medium term in a manner consistent with the SGP. More generally, the government should aim to recreate adequate fiscal buffers by reverting to the MTO and to maintain the record of past compliance with the expenditure rule.

On structural policies, we concur with staff's assessment that key priorities are addressing dualities in the labor market, household indebtedness and framework conditions for R&D. We note staff's assessment that the increasing importance of flexible work arrangements, reflecting dualities in the Dutch labor market, could threaten the sustainability of the social safety net and expose a significant part of the self-employed to economic vulnerability. This suggests policies targeted at reducing the very strict employment protection of permanent workers with the aim to alleviate the duality in the labor market by increasing its overall flexibility and improving its functioning. Labor market participation could be promoted further, particularly at the intensive margin and among the low-skilled, elderly and immigrant population. On housing, given that vulnerabilities stem from the high household indebtedness, we agree with staff's recommendation for accelerating the speed of reduction of the mortgage interest deductibility. The current speed of reduction of existing distortive incentives seems to be too slow to significantly influence household behavior. In terms of other structural policy areas, the framework conditions for investments in research and innovation should be improved in order to strengthen the long-term growth potential of the economy. We concur with the staff (and the authorities) view that pension reforms should continue to be pursued to maintain sustainability and improve transparency.

On the financial sector, we agree with staff that Dutch banks are well capitalized and that in view of vulnerabilities stemming most notably from housing market developments additional macroprudential measures could be considered, in particular an acceleration of the implementation of measures. Funding profiles vary greatly across individual credit institutions. In this regard, we would note that the significant share of wholesale funding of total liabilities mentioned by staff is not observed among Dutch significant institutions. In view of high, albeit declining, household debt and the relatively large share of households in negative equity, we share staff's view that macro-prudential mitigation measures can be considered. In particular, we consider that the recommendation of the Dutch Financial Stability Committee to additionally reduce the LTV limit to 90 percent in the 10-year period after 2018 should be adopted. On policy recommendations, we note staff's views with regard to the need to reduce the share of borrowers which fully rely on Interest Only (IO) facilities and the FSAP recommendation to "enforce an industry-wide approach to informing IO mortgagors of estimated repayment shortfalls." On this point, we would mention that a coordinated approach is being actually undertaken at micro level by the supervisor in charge of the largest SIs, which represent the vast majority of the mortgage market in the Netherlands. The recommendation could be actually further strengthened emphasizing the potential for synergies between micro and macro interventions. Further, we would note that common recommendations together with a detailed and harmonized plan of approach were about to be finalized during the consultation period and that the top 4 SIs received the same recommendation in January this year.

Mr. Doornbosch made the following statement:

I would like to provide some background on the election results of March, as these will determine the context of today's Article IV consultation.

The Netherlands has a tradition of coalition government since no political party has a large enough majority in parliament. This means that a new coalition has to be formed based on the outcome of the negotiations.

The previous coalition of the Liberal Party and the Social Democratic Party completed its full term, but at a significant political cost in this election. The combined loss was almost 25 percent, of which 80 percent of the loss was for the Social Democratic Party. At the same time, The Freedom Party of

Geert Wilders, which is perceived in the Netherlands as the right wing populist party, gained only 3 percent. The big winners are the Progressive Left with 12 percent, and the Christian Democratic Party with 4 percent. The remaining seats, roughly 6 percent, were distributed amongst two new parties and the 50-Plus Party.

There are several ways to look at these results. For sure, the ruling government lost and the opposition won. Another way would be to say that parties that favor international cooperation and multilateralism won more than parties with more nationalistic and inward-looking policy.

Nevertheless, the Netherlands is no exception to other countries in which there is a debate on the merits of multilateral cooperation and economic integration. Parties that favor strict immigration policies have gained a solid majority in the parliament.

Given that the Netherlands has a system of full proportional representation, the election threshold is low and 13 parties in total have been elected in parliament, of which at least 4 are needed for a majority government.

In the week after the elections, an appointee explored all possible coalitions and she concluded that the four-party coalition led by the Liberal Party of the current prime minister should first try to reach an agreement on a government program. These parties started their negotiations today.

It is difficult to predict what the result will be, but since these four parties have their election manifesto being assessed by the Netherlands Bureau for Economic Analysis, it is possible to see where the differences and similarities are.

All four parties have the intention to use some fiscal space in the coming four years, leading to a small surplus in the end in 2021 and a debt of about 54 percent. They all want to ensure a more equitable treatment between self-employed and regular employees. They want more transparency and individual choice in the second pillar pension system, and they want no fundamental changes to the health care system, with some additional investments in long-term care. Finally, they would all commit to the objectives of the Paris climate agreement.

At the same time, there are still huge differences in the targeted emissions level and the way they want to pursue their goals. There are differences on what is deemed to be a desirable income distribution, on immigration policies, and several other issues. I am not saying that it is easy to solve and form a government. On average, the time needed to form a new government is around 70 to 80 days. There is absolutely no reason to believe it will be faster. Hopefully, we will have a new government before summer.

Mr. Cottarelli made the following statement:

We broadly agree with the staff's views on the macroeconomic outlook, the external assessment, the structural assessment, and most policy recommendations. I particularly welcome the fact that the economic recovery in the Netherlands is strengthening and becoming more broadly based. It is expected to consolidate further on the back of increasing domestic demand. Such a rebalancing of the drivers of growth will contribute to shielding the Dutch economy from potential negative external shocks, and contribute to reduce the current account surplus, which remains stronger than might be attributable to structural factors alone, even though it is expected to decrease gradually.

Still, as in the rest of the euro area, Dutch potential output growth remains rather low at about 1.5 percent, underlining the need to tackle the main supply-side structural bottlenecks.

In this respect, I share the staff's labor market diagnosis, including on the increased risk of market segmentation and duality due to the predominant recourse to flexible and temporary work arrangements, which reflects also fiscal and regulatory incentives. We therefore see the need to harmonize contracts across the main categories of workers, and to tackle the remaining barriers to hiring staff on a permanent basis.

On macroeconomic policies, we believe the traditional sound and prudent approach of the Dutch authorities has to be praised, and we particularly welcome the steady downward trend in the public-debt-to-GDP ratio.

In this context, we consider that the Netherlands has some fiscal space that should be used in a way that is consistent with the Stability and Growth Pact (SGP), while avoiding the risk of procyclicality. In particular, the use of fiscal space should be aimed at boosting the potential of the Dutch economy, thereby reinforcing the structural reform efforts, for example, with measures supporting public R&D spending and shifting taxation away from labor and toward less distortionary alternatives such as a VAT or property taxes. On the fiscal side, we see particular merit in the recommendations to reduce the debt bias of the taxation system.

On the financial system, we welcome the results of the Financial Sector Assessment Program (FSAP), according to which the financial system appears sound and resilient, although the insurance sector is facing important challenges that need to be monitored closely. We invite the authorities to build on the progress achieved in recent years, and further strengthen the resilience of the system. In particular, we believe that additional macroprudential measures are warranted in order to reduce the real estate related risks and the vulnerabilities associated with the high household indebtedness.

Mr. Merk made the following statement:

We associate ourselves with the gray statement of Mr. Cottarelli. We have issued a detailed gray statement, and I would like to make two comments for emphasis and offer some comments on the selected issues paper.

The Netherlands has continued its solid recovery path despite an ongoing deleveraging process in the private sector, thanks to the authorities' prudent policies. In line with the staff's recommendation, priority should be given to addressing structural bottlenecks in a timely manner, including in the labor market, and raising productivity. We welcome the Netherlands' comfortable fiscal position, complemented by a downward trending public debt ratio. While taking note of the staff's arguments in favor of additional spending within the rules of SGP, we see merit in the authorities' arguments highlighting uncertainties regarding the size and speed of the closing of the output gap and the potential procyclicality of fiscal stimulus measures. We agree with the staff that some consolidation in the longer run would further enhance the economy's resilience.

On the selected issues paper, we are surprised to see a country-specific discussion of the German current account surplus in the context of the Fund's surveillance of the Netherlands, not the least because there is no possibility for us to comment as usual in bilateral surveillance documents.

On substance, the assessment of the drivers of the German current account surplus seem one-sided. For example, the competitiveness of the German economy is analyzed only in terms of price and unit labor costs. In particular, important competition based on quality is not taken into account. The further increase in the current account surplus after the Global Financial Crisis is attributed to so-called domestic demand shocks in an undifferentiated way, without mentioning the dynamic development of domestic demand in Germany, particularly as it concerns household consumption. Nor does the staff appropriately consider structural factors of the German current account surplus, such as demographics. In fact, the development of all domestic demand components highlighted by the staff—for example, fiscal consolidation, decreasing the ratio of investment to GDP, and in particular, non-financial corporates' increasing propensity to save—are longer-term trends, according to the staff, which is why the description of negative demand shocks seems not to be appropriate.

Moreover, the role of the exchange rate depreciation as a result of the European Central Bank's (ECB) monetary policy is not adequately reflected. The same holds true for commodity price developments. It should be clear that this work by the staff cannot be a solid basis for the upcoming Article IV consultation with Germany.

Finally, we echo Ms. Erbenova that the staff should recognize the positive aspects of the export component of surpluses in terms of technology transfer, FDI, as well as job creation and economic growth for countries that are part of the various supply chains. Dismantling well-established, market-driven trade structures will decrease the wealth of everyone.

Mr. Inderbinen made the following statement:

The Netherlands, like other countries, has shown an impressive return from the double-dip recession, not only due to an improvement in external conditions, but also due to a strengthening of domestic economy. The authorities' policy efforts, such as advancing macroprudential measures, have been key in achieving this.

Another important factor for this achievement has been the authorities' prudent approach to fiscal policy. Since the crisis, the overall balance has strengthened. Public debt has stabilized. Nevertheless, a number of factors call for continued vigilance. The uncertainty in external conditions is high, as the staff describes in the risk assessment matrix. In addition, slower-than-anticipated deleveraging of the public sector remains a risk for public finances.

Finally, we should keep in mind that timing the business cycle is a difficult endeavor. The staff describes that the Dutch output gap is closing, but it is inherently hard to predict when exactly it would actually be closed.

Given the natural implementation of fiscal policy, there is significant risk that any expansion will become procyclical. This would undermine the authorities' efforts—and also the staff's recommendations—to aim for a debt consolidation over the near and medium term. Based on these considerations, we voice our support for the authorities' view that there is currently no case for fiscal expansion.

Finally, on the selected issues papers, we welcome the analysis of country-specific factors that determine the current account in different countries. We believe it is important that the assessment should generally seek to account for the complexity of the composition of the current account and also incorporate country-specific factors that could influence it.

Mr. Virolainen made the following statement:

Two fundamental issues have been raised in the gray statements, and also touched upon in the discussion today: the use of fiscal space and the current account surplus. We associated ourselves with the gray issued by Mr. Cottarelli, but I would like to add some additional remarks on these topics.

On the use of fiscal space, we agree that fiscal space exists according to the staff's assessment framework, and that there is in principle flexibility to use it, while also adhering to the rules of the European SGP. However, our main concern is whether it is wise to use it in the current state of the economic cycle. We believe there are reasons to exercise restraint as fiscal policy should be countercyclical and not procyclical. We note that the recently circulated Fiscal Monitor also outlines this fundamental principle.

We also note that the question of net versus gross debt was raised in the gray statements. In this regard, the situation in the Netherlands, with fairly sizable second-pillar pension funds, is somewhat similar to that of Finland. However, as outlined in the staff's written responses to technical questions, we should be careful not to focus on financial assets that are not available to finance general government debt service, as this can lead to misperceptions of the risks related to public debt.

On the current account surplus, we broadly agree with the staff, which has assessed the level in accordance with the agreed methodology. It is important to have clarity on the role of structural factors and their medium- to long-term effects on the current account balance, which can be large. It would be useful to widen the discussion on other policy options that could influence the savings-investment balance beyond April's fiscal stimulus.

Mr. Badirou-Gafari made the following statement:

We associate ourselves with Mr. Cottarelli and would like to support the comments he made in the Board. I will limit my intervention to two questions on the external position and the fiscal stance.

On the external position, we appreciate the staff's efforts to tackle this important and complex question, and the selected issues paper provides useful information in this regard. Having said this, we agree the analysis could be strengthened in three directions. First, we remain unconvinced about the high level of the norm. We understand that the fact that the Netherlands is being considered as a financial center contributes significantly to this high norm. But we would appreciate if the staff could elaborate on the economic rationale. Why should a financial center have such a high current account surplus?

The gap between the surplus and the norm remains important. As the staff rightly noted, corporate savings are a key determinant of the Dutch current account surplus. We therefore strongly encourage the staff to examine further the drivers of corporate savings. In any case, it seems the gap between the norm and the current account surplus reflects at least partly structural factors, but it could also reflect some persistent distortions. This could be assessed more systematically.

Therefore, we see a case for elaborating clearer policy recommendations. Like Mr. Sobel, we find this to be missing in the Article IV report itself. Besides, such recommendation could take into account the spillovers to the euro area of such an important surplus.

Turning to the fiscal stance, we all agree that the Netherlands has some fiscal space. I was a bit astonished to see that there were many Directors who were wondering whether it should be used. We all support the recommendation that is made in the multilateral context, that countries with fiscal space should use it. In the case of the Netherlands, it is a bit more difficult to argue that it should not be used given the fact that even if the output gap is closing, there is still an output gap. Obviously, the stimulus should be designed consistently with SGP rules, and also limit the risk of procyclicality, but it seems difficult to argue that it should not be used at all.

Then the question can be, what use should be made of this fiscal space. We support the recommendation by the staff. We believe that at the current juncture, namely low potential growth and output gap, there is a case to use the fiscal space within the framework of the SGP to support domestic demand and short-term growth, and also to boost potential growth.

The measures flagged by the staff, education, R&D, and tax reduction seem adequate in this regard. Besides, this would also help bring the current account surplus down.

Mr. Sobel made the following statement:

I have little to add to our gray statement and comments on fiscal space and the excessive current account surplus. The staff’s answers to the questions we raised in our gray statement have left me a bit perplexed, though.

Regarding our question on net debt, we recognize there are different categories of financial assets held by governments, and that those are not equally liquid. But from the perspective of a sovereign’s balance sheet, where the government’s net debt position is highly germane to economic agents’ perception of the sovereign’s sustainability and fiscal space; and from the perspective of the deficit, the government should be able to sell securities it holds fairly easily, and even other assets which would reduce its debt burden. Additionally, the government is often earning a return on its assets, which would reduce the net interest service burden.

Moreover, we note that the Fund has recognized the usefulness of looking at net debt when discussing a country’s debt sustainability. The 2013 staff guidance note for public Debt Sustainability Analysis (DSA) in market-access countries states the DSA should be based on gross debt but the concept of net debt could be applied to the complementary measure to reflect factors that could mitigate risks associated with high levels of gross debt.

Furthermore, a December 2016 IMF working paper found that net debt rather than gross debt was a more appropriate indicator for evaluating the effect of indebtedness on sovereign spreads in emerging markets. Many Article IV country papers use net debt. I refer to the United States, the United Kingdom, and Canada. It is high time that this institution develops a transparent and holistic view on net debt. Furthermore, regardless of one’s view on the matter, not considering or mentioning a country’s net debt in Article IV reports strike us as negligent, and this was a point that even a former Fiscal Affairs Department Director agreed with in the Finnish Article IV discussion.

We asked a question in our gray statement, but basically the staff said the use of fiscal space should be limited to be compliant with the SGP, and that spending should not overperform relative to the medium-term objective. But we understand the European Commission allows flexibility relative to the MTO, including for countries implementing structural reforms and investment, and in fact has encouraged countries such as the Netherlands to utilize all available flexibility under the rules. Our French colleague was raising a similar point. If the staff could clarify that issue, it might help us non-Europeans understand a bit better.

On the current account and external assessment, I agree in general with the thrust of Mr. Badirou-Gafari’s remarks. The United States is a strong supporter of the External Balance Assessment (EBA) and External Sector Review (ESR) process.

Regarding our questions on staff’s ad hoc adjustments to the EBA current account norm, the current account regression model estimates the current account as a function of consumption, savings proxies such as income per capita, demographics, expected income, etcetera. It does not include measures of actual savings such as pension funds, to the best of our comprehension.

The demographic variables in the EBA model should be seen as drivers of the need to save for retirement. In the case of the Netherlands, the demographic variables raise the current account norm by 1.9 percentage points in 2015, more than any other country in the ESR database except Germany and Italy.

If the demographics variable fully captures the need for old-age savings, then there should be no need to bump up the current account norm. But if the variable does capture the need for old-age saving, and then adds pension funds on top of that, it seems that there would be double counting. Furthermore, in that scenario, it would seem that the model is by implication skewed toward or biased toward validating excess saving. This is a general issue. It has arisen not only in the Netherlands and elsewhere, but recently Israel and Malaysia. It is not just a European issue. We call on the staff to provide a clear explanation of these issues, if not today, then in the context of the ESR.

Since I have taken the floor, I would like to ask a question I proposed in several other European country cases. Since the Single Supervisory Mechanism (SSM) is the supervisor of European banks, could the staff clarify both with respect to the Dutch Article IV and the FSAP, when the staff refer to the authorities, is the staff referring to the Dutch authorities or the SSM? Perhaps it is both, but then can the staff tell us which is which, and what are its interactions with each, so we could have better understanding about how the European supervisory prudential framework is working?

The staff representative from the European Department (Mr. Dorsey), in response to questions and comments from Executive Directors, made the following statement:[1]

We tried to answer as many of the technical questions in our written responses, but I want to cover a few others and react to some of the interventions.

There were several questions relating to the policies in the new government, both in general and with respect to specific policies such as taxes and social safety net programs. Mr. Doornbosch indicated that there is not yet a new government, and history suggests that it will be quite some time until there is one in place. I do not believe we can say anything beyond what Directors have already heard in terms of the policies of the new government. We know the stated policies of the parties, but we are not even sure which parties will form the government. The process of coalition negotiations is just beginning.

On Brexit, there is a specific question on the implications of Brexit for banks and central counterparties that we answered, but also a more general question on the implications for the Dutch economy as a whole.

On the more general question, this did come up in the Article IV consultation, but the bottom line is much the same as the more specific financial sector implications. Without knowing the nature of successor relations between the United Kingdom and the rest of the EU, it is difficult to say anything concrete.

On fiscal policy, several gray statements noted the divergence between the views of the staff and the authorities on the appropriate fiscal stance and the amount of fiscal space. Both in the staff report and the authorities' buff

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[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

statement, we have tried to be open about this, and I can confirm this again now. However, let me note that the disagreements are largely technical rather than ideological. The magnitudes of the divergence in the next few years are relatively small, and both the staff and the authorities agree there are large margins of error associated with any estimates of the output gap and the structural fiscal balance, including our own estimates. Both the staff and the authorities agree on the desirability of further debt reduction in the medium and long term to rebuild fiscal buffers. This is a regular topic in our discussions, particularly with the Central Planning Bureau, which documented the difficulties with such measures.

The staff's view is that a modest additional fiscal impulse would be appropriate so long as the output gap remains negative. The authorities view the economy as closer to potential, and believe there is a risk that the staff's advice could be procyclical. However, given the prolonged nature of the downturn, its double-dip nature, and the fact that previous pursuits have withered, we are somewhat more supportive of modest fiscal expansion than the authorities.

The structural balance is attractive in principle as a measure of the fiscal stance, but we do not yet have sufficiently reliable econometric methods of estimating this unobservable variable to have full confidence in it. The question is finding an alternative. Avoiding the structural balance entirely is not an option because the medium-term objective to the SGP is based on this measure as estimated by the European Commission. Using the headline balance as an anchor would be a particularly unsatisfactory alternative as it would be highly procyclical.

In this context, we do not blindly follow our calculations of the structural balance or the output gap. In our assessment and advice, we also look at unemployment rates, capacity utilization measures, and other factors. I am sure the authorities do the same in their assessments.

On other fiscal topics, as to whether there are any circumstances under which the staff would recommend using fiscal space in an economy that is at potential, we are making the case for higher spending on R&D and human capital because we believe these are sensible expenditures and there would be a case for these even if the economy was at potential.

In terms of spillovers, one can imagine a large economy at or above potential, tightly integrated with much smaller countries for which it is the dominant trade partner that are well below potential. However, this is not a particularly strong argument in the case of the Netherlands. The top-six import sources and therefore the presumed beneficiaries from the Netherlands are, in order, Germany, Belgium, Luxembourg, China, the United States, and the United Kingdom. All of these are growing at or near potential and all but Belgium and Luxembourg are much larger economies.

Similarly, on labor market friendly tax cuts, we do not see this as a cyclical fine-tuning measure being set, or a desirable permanent change in tax policy that could be adopted in the context of a modest stimulus. Reversing the stimulus when the economy reached potential could be done through other policies, for example the reduction in mortgage interest deductibility we are advocating in any event, or an increase in consumption taxes.

On another topic, we are not exactly sure what is being referred to in the question on European Commission guidance on fiscal policy, but we note that the recent general proposal from the commission was not adopted by the Council of Ministers, and that the specific Dutch policy objectives have been endorsed.

On net versus gross debt, we would note that while net debt is much smaller than gross debt, the difference is not accounted for by liquid assets for the most part. They are quite small. Instead, the assets are dominated by items such as accounts receivable, equity investment, fund shares, and loans.

On the financial center argument for the current account, we do not see this as the central reason for the current account surplus in the ESR analysis. We would put considerably more emphasis on deleveraging of both households and banks, and we see these as the main drivers.

The staff representative from the Monetary and Capital Markets Department (Ms. Khamis), in response to questions and comments from Executive Directors, made the following statement:

To clarify our reference to the authorities in our report, when we say authorities, we are referring to the Dutch authorities, the national authorities in our reports. In our interactions and in other reports, in all areas that refer to either banking supervision, banking sector stability, stress testing, and safety nets, our counterparts are both the national authorities, the national competent authority designated by the ECB, and also the ECB counterpart.

Our work on financial stability stress testing and banking supervision included interaction with the ECB supervision, and also with the The Dutch

Bank (DNB) at the national competent authority. In our recommendations and our technical notes in areas where we recommend action, we refer to action that is under the purview of the ECB and SSM, whereas action required by the national authorities under the purview would refer to the Dutch authorities, or the DNB.

Mr. Doornbosch made the following concluding statement:

I thank the teams of both the Article IV and the FSAP assessment for the useful discussions we have had, and the well-written reports. I thank Directors for the insightful remarks in the gray statements, which I will certainly share with the authorities in the Hague. The topics that Directors raised were not only well chosen but also of great relevance for the coming years in the Netherlands. Some of these issues will likely end up on the negotiating table of the new coalition.

I will make a few remarks on the issues that were raised. It was hardly a surprise that Directors had mixed views on the use of fiscal space. I am pleased to have this debate, because before we debated whether there was any space at all. Now because the economy is gathering speed, we debate whether it is advisable to use it, and how.

What is most striking is that the dialogue that we have is always about discretionary measures that are incompatible with the more rules-based nature of our fiscal policy in our general budget debates. The objective of a rules-based or discretionary fiscal policy is the same: Using fiscal policy for economic stabilization. However, in the Netherlands, it is the belief of subsequent governments that discretionary policy would in our context always turn out to be symmetric. In difficult times, political parties in the Netherlands would have no problem deciding on additional stimulus measures. In the good times, it is easy to find a reason not to consolidate. For that reason, we have adopted rules that prevent this from happening. At the same time, because of the time it takes to prepare, decide, and execute measures, the economic cycle will always have turned and the measures might end up being procyclical. That is another reason why we favor a rules-based system.

Governments tend to restrict themselves to trend-based fiscal policy that gives as much room as possible to automatic stabilization. However, to do this, fiscal space is needed, and that has not been the case in the last years because the fiscal space is needed to have this automatic stabilizer work and because the impact of a shock on a small, open economy can be quite large.

To illustrate this point, from 2008 to 2009, the budget went from a small surplus to a deficit of more than 5 percent.

As for the surplus on the current account, I understand the interest in this as the surplus has been persistent and relatively large since the 1970s. We share the analysis that the surplus can to a large extent be explained by structural factors, the relatively high economic savings and international investments of our pension funds and multinational companies, but we do not see them point directly to a market or policy failure. Employers and employees determine the scope of the second-pillar pension system, and decisions on earnings and investments are made in private boardrooms.

Although the question can be asked, and certainly should be asked, whether we are over-saving, being stingy might well be part of our genetic makeup. The expression “going Dutch” is probably no coincidence.

But the increase in bilateral trade imbalances, especially in the case of the Netherlands with the euro area, is a cause for concern and analysis. At the same time, it is difficult to come up with a firm conclusion. Wages in the Netherlands are not set by the government. They are the outcome of negotiations between employers and employees. The market for goods, services, capital between the Netherlands and other euro area countries is open and non-discriminatory, so it is hard to find the right policies that should or could address this, if there is anything that that is not in line with market fundamentals. That being said, monitoring the developments in the external sector is at the heart of the Fund’s mandate, and like Mr. Sobel and Mr. Field, we would encourage the staff to continue to deepen its knowledge on these issues.

On financial stability, we are a encouraged by the conclusion of the FSAP. The financial sector has recovered after the crisis. It is resilient to the identified risks, and the supervisory framework is significantly strengthened. We are glad to see that all banks stayed above the threshold for risk-weighted capital. We agree that resilience should always be further improved, and that is why we are encouraged by the recommendation to further increase the leverage ratios of our banks.

I would like conclude by once again thanking Mr. Dorsey, Ms. Khamis, and their teams for their hard work. I understand the FSAP team had to weather a blizzard in D.C. to start the assessment, and along the way they sat in over 150 meetings and did thousands of pages of self-assessment. Truly something to commend them for.

We thank both teams for their excellent cooperation and we are looking forward to the consultations next year to see how the economic program of the new government will be assessed.

The Acting Chair (Mr. Furusawa) noted that The Netherlands is an Article VIII member and no decision was proposed.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They welcomed the continued recovery of the Dutch economy despite the ongoing deleveraging process in the private sector. Directors noted, however, that risks to the outlook are slightly tilted to the downside and challenges remain, particularly due to uncertainties related to external developments and low productivity growth. Against this backdrop, they concurred that the priority should be to ensure steady and sustainable growth through policies that focus on decreasing leverage, boosting potential output, and safeguarding financial stability.

Many Directors supported staff's recommendation to use existing fiscal space to support the recovery in the short term, particularly through additional growth-enhancing spending in public R&D and education or through further reducing the tax wedge for workers at the margin of the labor force; the need to comply with the requirements of the Stability and Growth Pact when using the fiscal space was noted. A number of Directors, however, expressed concern that further fiscal stimulus could become procyclical in the near term. More generally, Directors agreed that, in the medium run, aiming for some fiscal consolidation would help rebuild buffers in a still highly-leveraged economy.

Directors underscored the importance of lessening the financial vulnerability of still highly leveraged households. They encouraged the authorities to build on the important steps taken in the last few years and accelerate the implementation of real-estate-specific macroprudential measures. In addition, Directors noted that the efficiency and flexibility of the housing market could be improved by removing existing subsidies in the social and owner-occupied sectors—thereby promoting the development of the private rental market—and by easing existing regulations that prevent construction from meeting housing demand.

Directors commended the authorities for improving the oversight of the financial sector, and recommended continued vigilance. They agreed that the banking sector is well capitalized and resilient to risks, but faces challenges associated with high leverage, low interest rates, and continued reliance on wholesale funding. Against this backdrop, Directors saw scope for banks to further increase their capital buffers. They also encouraged the authorities to closely monitor banks’ business models and risk management frameworks. Directors considered that insurers’ financial conditions should also be closely monitored and Pillar 2 measures should be applied if required.

Directors welcomed the labor tax reduction package introduced in 2016, but stressed that a more fundamental overhaul of the tax system is needed. In particular, they noted that future tax reforms should aim to further improve efficiency, reduce the debt bias, and shift the tax burden from labor toward consumption and property.

Directors noted that the increase of flexible work arrangements calls for addressing potential rigidities in the formal employment sector, while ensuring the sustainability of the safety net. In particular, they underscored the need to better harmonize labor protection as well as social benefits and taxation frameworks across various categories of workers. Directors also commended the authorities’ efforts to integrate refugees into society and the labor market.

Directors welcomed the principles underpinning the government’s pension reform proposals, which are focused on enhancing transparency and ensuring portability, while preserving financial security at retirement.

It is expected that the next Article IV consultation with the Netherlands will be held on the standard 12-month cycle.

APPROVAL: February 20, 2018

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Growth

1. ***In Table 1, the CPI is projected to jump from 0.1 percent in 2016 to 0.9 percent in 2017. Although this change is largely in line with the broad recovery trend in the euro area, it is somewhat large in scale. Could staff explain what supports this projection?***

- The expected increase in the CPI is consistent with strong economic developments, where the output gap is rapidly closing and unemployment decreasing at a fast pace against the backdrop of strong domestic demand. As noted, the inflation forecast is also in line with improving prospects in the euro Area, which can be expected to strongly impact small open economies such as the Netherlands, as well as stronger energy prices.

International Tax

2. ***Could staff comment on the outcomes of the G20 recommendations on international corporate taxation? Has the Dutch Corporate Income Tax Act been modified, as expected in the last Article IV report? The favorable tax treatment for corporate income, as expressed in the External Sector Report, plays an important role. We welcome staff's comments on the outcomes of Base Erosion and Profit Shifting (BEPS) proposals and how it is expected to affect multinational companies in the Netherlands. Could staff provide the Board with an update on the authorities' efforts to apply new international standards relating to BEPS?***

- On 22 December 2015, the Dutch Parliament formally approved the "Dutch State Secretary for Finance's draft law that proposed to modify the Corporate Income Tax Act 1969 (CITA 1969) to include supplementary transfer pricing documentation requirements in line with the three-tiered approach of Action 13 of the OECD BEPS project. There were no material changes to what had been proposed under the draft law and the rules contained in the regulation are almost identical to the templates provided in the OECD report on BEPS Action 13. Under the new legislation, the Country-by-Country (CbC) report, the master file and local file requirements will be applicable for fiscal years starting on or after January 1, 2016. Moreover, on September 20, 2016, the Dutch Ministry of Finance issued its tax budget proposals for fiscal year 2017 and beyond that contains proposed legislation to further align the Dutch innovation box with the BEPS Action 5 recommendations.

- International taxation will be a major topic for the next Article IV consultation in the Netherlands, which will be investigated with FAD's assistance according to current plans.

3. ***We note staff's finding that tax incentives motivate low profit distribution by both foreign and domestic firms, contributing to the diversion of national savings from capital formation and a persistent, sizable CA surplus which is above the level consistent with fundamentals and desirable policy settings. Would staff comment on the costs vs. benefits of adjusting these incentives?***

- This is a complex issue that would require further studies. One of the main issues is that it is difficult to estimate the part of FDI that is due to tax incentives as opposed to the natural extension of global value chains as has been observed for other advanced economies. Also, low profit distribution was motivated by deleveraging needs in the Netherlands and may have happened anyway after the 2001 recession, irrespective of the tax regime.

4. ***The Risk Assessment Matrix does not point to substantial problems, but we welcome staff's further comments on the DSA's contingent risk scenario, which could greatly impact public debt.***

- As part of the DSA, the contingent risk scenario provides for an immediate expenditure shock typically arising from the need to bail out a financial institution, calibrated at about 10 percent of the banking sector's private sector loan portfolio, i.e. about 15.3 percent of GDP, and accompanied by reduced real growth rates (by 1 standard deviation), lower inflation (by 0.25 percent per percentage point of lower growth) and higher interest rates (by 25 basis point per percentage point of deterioration in the primary balance). Applied to the insurance sector, a shock of such magnitude would correspond to losses of up to 20 percent of total assets, or 26 percent if it were to be restricted to the life insurance business. Moreover, financial difficulties affecting the insurance sector are to be understood and dealt with in actuarial terms, thus reducing the likelihood of sudden disruptions as may typically affect the banking sector.

5. ***Why does staff not mention the Dutch net debt position? Is net debt a relevant concept from an economic standpoint for the broader fiscal space debate? Should the comfortable net debt position in the Netherlands from an economic standpoint provide more leeway and scope for flexibility under the SGP.***

- The net debt of the general government stood at EUR 203 billion in 2015 (30 percent of GDP) and is estimated at EUR 206.5bn in 2016 (29.6 percent of GDP). Following the EUROSTAT definition, it is calculated by deducting financial assets held in debt instruments from the gross debt concept. Dutch government assets mostly consist in debt securities and shares (about 40 percent of the total), loans (about 26 percent) and other accounts receivable (19 percent). Without going into further details, these assets are not generally available to finance debt service as if they were government deposits at the central bank.

Pension Reform

6. ***Uncertainties over the future of the pension system may have played a role on the increase in precautionary savings of households. Could staff comment?***

- The deterioration of the financial situation of the second-pillar pension system in the latter years, with some funds forced to proceed to benefit de-indexation or even curtailments to restore their solvency ratios, has prompted some widespread concern among participants that they may not get the full pensions they had been hitherto expecting. In turn, this may have held back consumption and triggered an increase in precautionary savings by households.

External Sector

7. ***Does such an upward revision imply that "forced" saving through a pension plan cannot be offset by a reduction in saving through other means which would leave gross household saving unchanged? Would high saving show up in P* or the demographic variables, or perhaps both pointing to the possibility of double counting? How does the adjustment for favorable tax treatment for multinationals work, and does that bias upward corporate saving and the current account norm? Do such ad hoc adjustments violate the multilateral consistency of the EBA model—if the Netherlands current account norm is revised upward where is the offset?***

- The concerns as stated are valid. However, they reflect some confusion as regards i) the ESR page results and ii) the workings of the EBA methodology.

i. it is important to state from the outset that the norm was almost exactly the same with respect to last year (5.9 percent compared to 5.7 percent). The difference is much smaller than the EBA model typical standard error of estimate and less than a third of the increase in cyclically adjusted current account between 2015 and 2016.

ii. In the EBA model, neither the presence of multinational, nor the existence of pension providers affects the estimation of the current account norm as these variables are not included as potential drivers of savings and investment decision in the model.

Therefore, staff typically argues for additional prudence when interpreting EBA gaps in cases when these factors could arguably have played an important role. The "pure" unadjusted EBA current account norm is provided as part of the regular reporting package; it is 5.9 percent for the Netherlands. The staff's judgment as regards the importance of pensions/multinational boils down to assess the uncertainty surrounding the estimate. The unadjusted norm is 5.9 percent, leading to a EBA gap of 3 percent. The staff assesses that the gap could be distorted in both directions by the non-inclusion of pensions/multinational and puts the uncertainty range to 2–4 percent, a rather conservative estimate given the large uncertainties surrounding the estimation of the EBA gap.

- The possibility for households to reduce their aggregate savings appears limited given the importance of mandatory contribution to the second-pillar pension system, with premiums typically representing 15 to 20 percent of the gross wage. However, net dissaving did take place due to strong housing investment and mortgage indebtedness in the years leading up to the crisis—with limited effects on the overall current account surplus, which magnitude mainly reflects the corporate sector's savings-investment position.

8. ***What can explain the persistence of the current account surplus in the Netherlands in 1999–2007? Should competition with other economies not have reduced positive gains to the Netherlands from a positive external demand shock?***

- The identification strategy highlights that the persistent increase in the Dutch current account surplus was driven essentially by foreign demand of high value added goods. These goods are typically less sensitive to price competition, as the simultaneous increase in the trade balance surplus and the REER shows. The trade balance with the rest of Europe—the typical destination for high value added goods—has been positive and increasing over this period. However, the trade balance with the rest of the world, in markets where pricing power is lower, has been increasingly negative, and the Dutch exporters have gradually lost market shares.

Financial Sector

9. ***While further lending to housing sector might not be promising given the already low mortgage rates, which sectors does the staff think that banks could increase their loans?***

- The FSAP did not opine on alternative business models or asset classes for the banks to invest in. However, our discussions with banks indicated that bank management and boards are actively exploring opportunities and strategies to manage their profitability over the longer term. On the cost side, Dutch banks are seeking to manage their cost to income ratio as closely as possible through accessing lower cost sources of funding. In addition, banks are looking to manage their other costs by embracing technology to help customer acquisition. For example, several of the Dutch D-SIBs were part of the R3 blockchain project which aims to leverage FinTech and some of the Dutch banks are among world leaders in terms of digitization. On the asset side, banks saw scope to leverage their competencies in project and object finance (secured financing on equipment acquisition), particularly in oil and gas, commodities and commercial real estate.

10. ***The FSAP stress tests provided some comfort that Dutch banks appear resilient to risks, but we would appreciate staff's additional comments on the dynamics of the risks and challenges facing the banking sector, the need to continue to building capital buffers, and the ability to support lending to small and medium sized enterprises in particular.***

- We recommended that that Dutch banks continue to build buffers to ensure all banks remain above minimum leverage ratio thresholds in the case of severe adverse events. This would support credit growth and help mitigate the risk of significant deleveraging being needed in the case of adverse shocks. Sectoral analysis conducted by staff suggests that lending to small- and medium-sized enterprises (SMEs) may be held back by the protracted debt overhang and insufficient collateral for some categories of firms. Although debt-to-equity and profitability ratios appear to have improved in the aggregate non-financial corporate sector, firm-level data reveals that a non-negligible proportion of small businesses still operate with relatively low interest cover ratios, exposing them to financial vulnerabilities. Moreover, while residential house prices have been generally recovering, commercial real estate, used by many firms as collateral, has remained depressed across the country. Overall, in a situation where credit standards are likely to remain tight on account of continuing bank deleveraging, lending growth to SMEs is expected to pick up gradually, trailing the repair of private sector balance sheets and the recovery of real estate prices.

11. ***According to survey data cited in paragraph 4 of the report, credit conditions for SMEs remain tight. In addition, banks continue to charge high interest rates to risky borrowers. Could staff comment on the effects that negative interest rates are having on Dutch banks?***

- As noted in the FSSA, low interest rates and slow credit growth are expected to weigh on financial sector profitability. Net interest income (NII) of Dutch banks has been relatively resilient to falling interest rates. This is largely related to the dominance of fixed rate mortgages on the asset side. If low interest rates continue for a prolonged period of time, the full impact on mortgage rates will materialize with time, further compressing net interest margins.

- As regards negative interest rates, on the funding side, banks are paying low but positive interest rates on deposits; and they are reluctant to reduce rates further (or venture into negative territory) over concerns of destabilizing the deposit base. On the asset side, the largest banks hold 16–18 percent of their assets in the form of cash instruments (6–7 percent) and debt securities (10–11 percent). Most of the cash instruments, and a significant fraction of debt securities would likely have been earning zero or negative returns in recent months as yields up to the 2-year benchmark were negative—negatively contributing to bank profitability. It should be noted, however, that the rise in 10-year government bond yields—in both Germany and the Netherlands—over the last 6 months (50+ basis points) have partially (but only partially) mitigated these concerns, to the extent that government bond yields are used as benchmark to (re-) price future loans.

12. ***The staff notes that credit to the economy especially credit to non-financial corporations continued to drop in 2016, and contracted by 6 percent (year-over-year) in July. We would welcome staff comments on the risks posed by this phenomenon and whether any change is foreseen anytime soon.***

- In February 2017, credit growth to the private sector was still negative at -1.9 percent year-on-year, driven by protracted contraction in the non-financial corporate sector at -3.6 percent while lending growth to the household sector was broadly flat. These developments reflect a situation of ongoing deleveraging in the banking sector and balance sheet repair in the non-financial sector. While most of the associated risks to economic growth already materialized in the wake of the global financial crisis, such weak credit developments have arguably been holding back the economic recovery up until the recent period, and point to some ongoing financial difficulties in some segments of the non-financial corporate sector. Looking forward, staff expects credits conditions to improve in line with the strengthening of borrowers' creditworthiness, starting with the household sector against the backdrop of rising house prices, while lending growth to small and medium sized enterprises would only pick up gradually in line with the weak and uneven recovery of commercial real estate prices.

13. ***We would be interested whether more detailed discussions took place with the authorities on the possible implications of the Brexit for those banks with significant asset exposure to banks in the United Kingdom but also related to CCPs?***

- The mission did not have detailed discussions with the authorities on the possible implications of Brexit for Dutch CCPs. At the time of the missions, the debate over whether cross-border EU/UK CCPs will be recognised post-Brexit had not begun. In terms of what the implications might be for Dutch CCPs, we would presume that

EuroCCP will need to be recognised under the new U.K. regime once it has been developed as it clears a significant proportion of the U.K. equities market. However, as it will be a new regime, we would expect that there will be transition arrangements that should minimise disruption. If the U.K. entities were no longer allowed to clear through EuroCCP, they would either need to clear through a non-U.K. related party or become clients of another clearing member.

- At the time of the FSAP there was significant uncertainty about the form which Brexit would take and the implications for the U.K. and Dutch financial systems. The effects on the Dutch economy were limited thus far, and banks did not generally have Brexit in their risk registers, (the direct exposures of Dutch banks to the United Kingdom are limited, less than 5 percent for all banks). Banks were more concerned about the low income environment placing pressure on profits and potential changes in capital adequacy rules as immediate threats.

14. ***We encourage regulators and banks to seek to lower effective loan-to-valuation ratios (LTV), but would be interested in staff's views on the advantages and disadvantages of doing this through caps versus increasing the amounts of capital held against higher LTV and interest-only loans (so as to get a more resilience banking system, strengthen banks' ability to actively manage risk/return trade-offs, and send the correct price signals to households)?***

- Tighter sectoral capital requirements imposed on banks' balance sheets are less distortionary than other direct measures since they work through the pricing mechanism (see Staff Guidance Note on Macroprudential Policy[2]). However, they may be less effective in moderating excessive household leverage than demand-side tools (e.g., limits on LTV and LTI ratios). The latter may be more successful in moderating household leverage and enhancing household resilience against future house price and income shocks. Generally, the literature finds that higher capital requirements on particular groups of mortgage loans failed to limit the household leverage during the pre-crisis period, for example, in countries like Bulgaria, Croatia, Estonia, and Ukraine. The Staff Guidance Note suggests that combining different macroprudential instruments can help lessen these shortcomings and enable policymakers to use several transmission channels at the same time, thereby promoting effectiveness of policy responses. Furthermore, the FSAP stressed the importance of sound underwriting as part of the overall strategy in order to address a build-up of risks in household loans.

- There are a number of reasons why higher capital requirements may be less effective than limits on LTV ratios. First, when banks hold capital well above the regulatory

[2] http://www.imf.org/external/np/pp/eng/2014/110614.pdf

minimum (as is the case in the Netherlands), lenders may choose not to make any change in credit supply/conditions in response to increases in risk weights. Second, when lenders compete intensely for market share, they may internalize the costs of higher capital requirements rather than imposing higher lending rates. This often happens during housing booms when policymakers need the tool to be most effective. Third, sectoral capital requirements aim at increasing the domestic banks' lending rates. This could result in a migration of lending activities to domestic nonbanks. LTV limits are less subject to such a leakage, because borrowers' eligibility criteria could be applied to all products that are offered by any financial institution within a country (as is the case in the Netherlands).

15. ***Could staff elaborate whether further reduction in LTV limit would cause problems for households looking to remortgage in future, given significant number of interest only mortgages (where the LTV at origination have not changed over time)?***

- The staff recommends a gradual reduction of the LTV limit. A gradual approach will help mitigate potential negative impacts on borrowers by allowing behavioral changes over time. The pace of this reduction could be accelerated if the current house price recovery persists and is across the board. For interest-only (IO) mortgage holders, this measure should be accompanied with other measures to (i) raise awareness among IO policy holders regarding their ability to repay the loan at maturity; and (ii) undertake early remedial actions, including by encouraging banks to convert these loans to annuity or linear mortgages.

16. ***The staff suggests that supervisors should take a more active role in assessing loan classification. On the other hand, too much emphasis on asset classification might make banks lend to companies with almost perfectly sound financial conditions, resulting in fiercer competition among banks by cutting interest rates and the further compression of loan margins. We would appreciate if the staff would comment on this perspective.***

- Accurate loan classification is fundamental to effectively managing credit risk by assigning a credit grade based on the ability of the obligor to service the debt as well as a recognition of collateral. In balancing risks, we see less downside in the banks paying significant attention to sound credit risk management given that it tends to be the biggest risk facing a banks' balance sheet and capital adequacy.

17. ***While we acknowledge the high level of net wealth of households as a mitigating factor, we remain concerned by the high level of household debt to disposable income, and more specifically, by the share of interest-only mortgage. The staff's comments are welcome.***

- As we have noted in the FSSA, households in the Netherlands have significant positive net worth in aggregate. However, staff are concerned about household indebtedness from two aspects. While the default rates on mortgages have been low, including during the global financial crisis, a large proportion of young household mortgages are underwater. A future house price or income shock could put mortgages with higher LTV and LTI ratios under further stress and may lead to higher credit losses. Second, staff are concerned with the procyclicality of house price shocks, which as indicated by our analysis, can be exacerbated by high LTV ratios, contributing to further declines in output and employment in crisis conditions. The staff proposes a holistic approach to address the household indebtedness problem by accelerating the phasing-out of mortgage interest deductibility (MID) and lowering the LTV limits. Structural reforms in the private rental market are also needed.

18. ***We encourage the authorities to pay due consideration to the FSAP recommendations, in particular with regard to the importance of strengthening the operational independence of the supervisors, De Nederlandsche Bank (DNB) and Authority for the Financial Markets (AFM). Could staff clarify why these supervisors are not allowed to issue technical regulations?***

- The financial supervisors (DNB and AFM) do not have broad authority to make legally binding instruments (rule-making authority). The supervisors have the authority to issue measures such as supporting guidelines and interpretations of rules, and only have authority to make legally binding instruments where a specific statute explicitly grants them that power. Where the power exists, it usually addresses very technical aspects of regulation, and the Minister of Finance may revoke the regulation if, in the Minister's opinion, it contravenes a law, treaty or binding decision of an international organization, or imposes an unreasonable burden on financial markets. All other rule-making authority belongs to the legislature or the Ministry of Finance. This is a more significant issue in the pensions and securities sectors than in the banking and insurance sectors in which greater rule-making takes place at the European level.

19. ***We welcome more details from the staff on how to tackle the reliance on wholesale funding on banks.***

- The reliance by banks on wholesale funding is an indirect consequence of households' high level of savings in pension assets (pillar 2), which reduces households' savings in bank deposits. To finance household mortgage lending and other lending, banks' turn to the wholesale market for financing. The challenge for Dutch banks is to manage the risks related to this dependence on wholesale funding.

- Liquidity stress tests undertaken in the FSAP indicate that banks could handle significant funding withdrawals, thanks to the relatively long-term structure of wholesale funding. Banks' efforts to extend the maturity of wholesale funding since the crisis have therefore reduced roll-over risks. However, about a third of total liabilities is still short-term. Dutch banks also currently adhere to the Liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), despite the latter not yet being legally in force. The European Commission submitted a legislative proposal on the NSFR to the European Parliament and the council with some adjustments from the Basel rule, which will be applied two years after the date of entry into force of the proposed Regulation (most likely in 2019). The NSFR encourages banks to manage maturity mismatch and to avoid overreliance on short-term wholesale funding. The LCR is designed to encourage banks to build short term resilience to funding shocks and other disruptions to funding markets—including wholesale markets. The intention is to ensure banks are able to withstand short term funding shocks over a 30-day period. The LCR is calibrated to encourage banks to rely more on stable sources of funding such as sticky retail deposits as opposed to short-term wholesale funding. By enforcing the LCR and NSFR, supervisors are able to monitor banks' liquidity profile, identify emerging issues at an early juncture and encourage more stable (including longer term) funding.

20. ***We would also be interested in staff's views whether (and to what extent) insurance products are used as assets to back mortgages or assess borrowers' creditworthiness and whether the increased vulnerability of insurance products could increase the relative riskiness of mortgages.***

- While the FSAP could not perform due diligence of loan files, we were comfortable that banks are assessing credits based on repayment capacity without regard for insurance. As regards interest-only mortgages, data provided by the authorities indicated that the share of non-amortizing mortgages backed by insurance accounts is about 12 percent. The staff encouraged the authorities to adopt a standardized approach to informing interest only mortgage holders about the risk of potential shortfalls in their savings products and to take early remedial measures, e.g., switch their loans to repayment mortgages, prepay the loans voluntarily, or accumulate financial assets.

21. ***Given risks related to the current outstanding stock of mortgages in the Netherlands, would staff comment on implications for the government through the National Mortgage Guarantee scheme?***

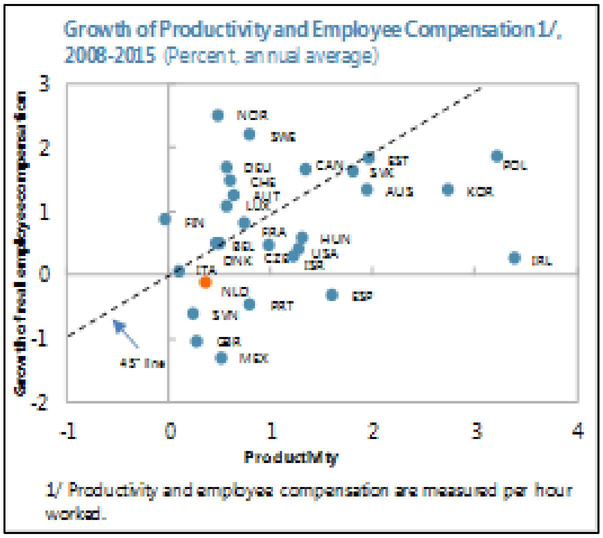
- The National Mortgage Guarantee Fund (NHG) is a voluntary mortgage insurance scheme. The scheme is operated by a private institution, WEW, and is fully funded by mortgage borrowers' premium (an upfront payment of 1 percent of a mortgage). It is currently well capitalized, and it is guaranteed by the government which could present contingent fiscal liabilities. The system was robust through the crisis as shown by its assets under management increasing rather than declining, and it holds a large volume of short-term liquid assets (e.g., cash and government bonds) to cover loss claims. As house price recovery continues, the number of claims has been falling in recent years. The authorities conducted stress tests under severe scenarios, which indicated that it would take around a 30 percent decline in house prices and 15 percent increase in unemployment rate to require the government's guarantee to be called. Finally, the NHG reduced the guarantee limit and raised its premium in 2014 in order to shift towards more risk-based pricing and lower contingent liabilities.

Structural Reforms

22. ***We would appreciate if staff could elaborate on real wage and labor productivity growth developments over the last decade. The relevant information provided in the staff report appears somewhat unclear, as, at one point, it is mentioned that "employees' compensation has increased less than labor productivity over the last eight years" (paragraph 3), while, at a later point, staff also notes that labor productivity "has virtually ground to a halt in the Netherlands over the last decade" (paragraph 30).***

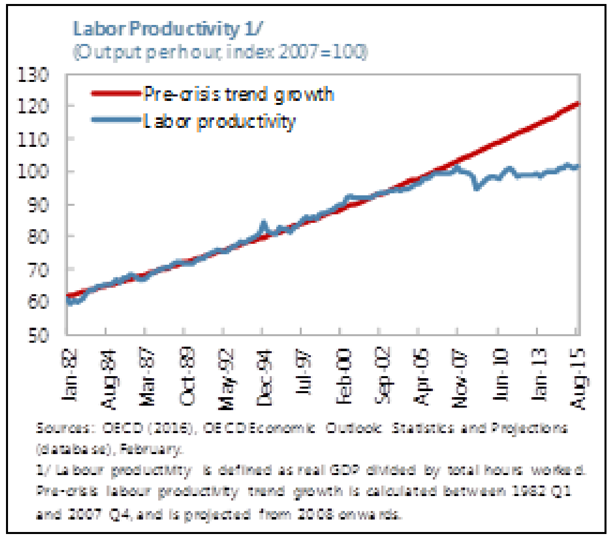
- The two statements are not contradictory. The new Keynesian Phillips Curve postulates that inflationary pressures arise when real compensation grows faster than labor productivity, for given inflation expectations. In other words, inflation is driven by real marginal costs (real compensation/labor productivity) as firms try to stabilize markups over the medium run.

- In the Netherlands, it seems that real compensation has risen less than labor productivity, which itself has quasi-stagnated. The two graphs below show that while labor productivity has increased by about 0.2 per year between 2008–2015 (about 0 percent btw 2005–2015), real employee compensations have declined by 0.1 per year.



Growth of Productivity and Employee Compensation 1/, 2008-2015 (Percent, annual average)

1/ Productivity and employee compensation are measured per hour worked.



Labor Productivity 1/ (Output per hour, index 2007=100)

Sources: OECD (2016), OECD Economic Outlook: Statistics and Projections (database), February.
1/ Labour productivity is defined as real GDP divided by total hours worked. Pre-crisis labour productivity trend growth is calculated between 1982 Q1 and 2007 Q4, and is projected from 2008 onwards.

23. ***In view of the current interest within the Fund to investigate the reason behind the decline in productivity growth, further research by staff on the case of the Netherlands could have been helpful. The staff's elaborations on this issue would be helpful.***

- We agree that further research on the question of the impact of flexible employment on productivity would be helpful, but was beyond the scope of this consultation. The report simply speculates that, on the one hand, the rise of self-employment could lead to an increase in productivity as the productive capacity of individuals may be unleashed when they are incentivized to explore innovative production ways and new markets. On the other hand, as mentioned in footnote 6, the rise of flexible form of employment arrangements, to the extent that they represent more precarious form of employment, could lead to lower productivity growth as firms' incentives to provide lifelong training may be lower for this category of employees.

24. ***The staff's comments would be welcome on specific measures that could help to raise investment going forward.***

- Investment typically responds positively to measures that increase the future expected return on capital. Improving labor productivity by encouraging measures that increase public R&D, incentivize private R&D, streamline procedures for starting businesses, promote lifelong training of the labor force are all steps in the right direction. At the same time, measures that favor increased participation in the labor force, such as e.g., alleviating the tax burden for workers at the margin of the labor force, speeding up the access of migrants to the labor market, including by measures to improve their language and professional skills, would also increase the marginal product of capital and therefore stimulate investment in the Netherlands.