N°20 | SEPTEMBER 2013

ECONOTE

Société Générale
Economic studies department

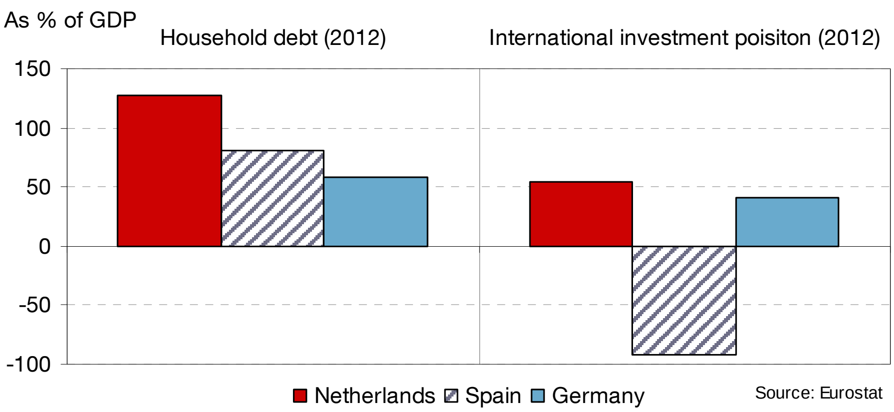
NETHERLANDS: AT THE PERIPHERY OF CORE COUNTRIES

— The Netherlands exhibits several characteristic features of the eurozone's peripheral countries: very high household debt, bursting of the property bubble creating difficulties for two major banks – forcing the government to nationalise them as a matter of urgency – deep recession, difficulties in reducing the public deficit.

— That said, it also shares the strengths of the eurozone's core countries: substantial private savings, foreign accounts showing a comfortable surplus, moderate public debt and the confidence from financial markets enabling it to benefit from very low interest rates.

— All in all, although the country is undoubtedly experiencing a double crisis, property and banking, it appears to be able to deal with it without any external aid. This is because it is not exposed to the third component of the crisis experienced by the eurozone's peripheral countries: the balance of payments crisis (which occurs when a country is no longer able to finance its foreign deficit or renew its existing foreign debt). Indeed, the Netherlands is not dependent on foreign financing: its net foreign asset position (foreign assets minus foreign liabilities) amounts to 54% of GDP, i.e. the third highest ratio of eurozone countries (behind Luxembourg and Belgium and before Germany).

HOUSEHLOD DEBT AND INTERNATIONAL INVESTMENT POSITION



Source: Eurostat

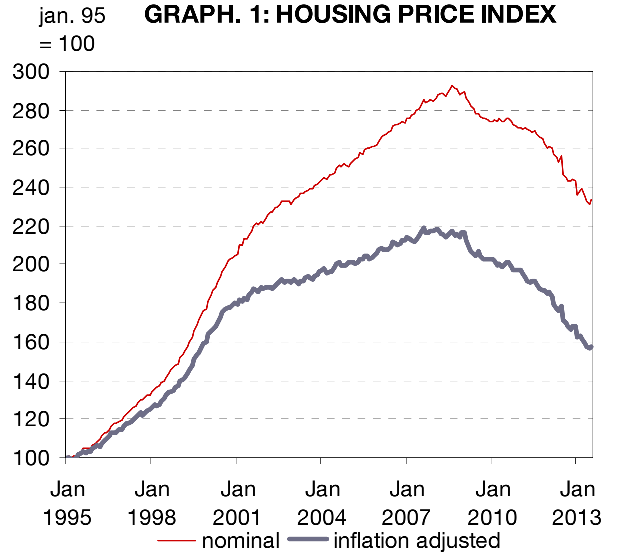
Benoît HEITZ
+33 1 58 98 74 26
benoit.heitz@socgen.com

THE NETHERLANDS EXHIBITS SOME WEAKNESSES SIMILAR TO THOSE OF PERIPHERAL COUNTRIES

A PROPERTY CRISIS AND OVER-INDEBTED HOUSEHOLDS

Housing prices in the Netherlands virtually tripled between the beginning of 1995 and their peak in August 2008, representing an average increase of 8% per year. When adjusted for inflation, the peak was reached a year earlier, with an average annual increase of 6% above inflation (see graph 1). Prices subsequently returned in mid-2013 to their level at end-2002, or even end-1999 when corrected for inflation.

GRAPH. 1: HOUSING PRICE INDEX

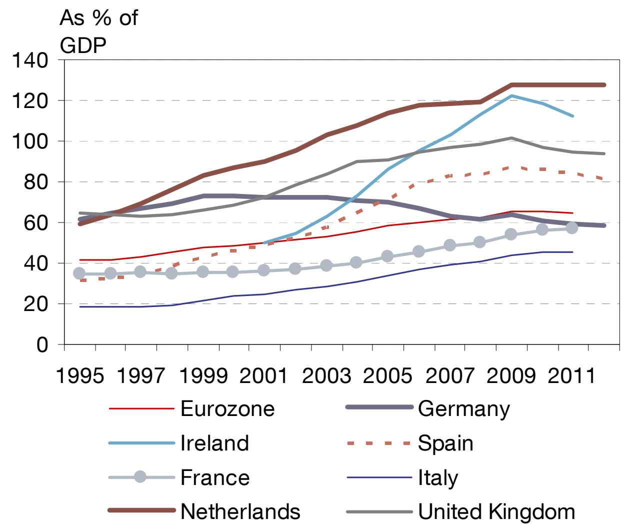


Source: datastream

Mainly in conjunction with this boom in property prices, household debt rose substantially in the period preceding the crisis, reaching record levels. Accordingly, the household debt ratio was significantly higher than that observed in Spain or the United Kingdom, or even Ireland: it amounted to 128% of GDP in 2011, vs. 123% in Ireland and 86% in Spain at the height of their respective property bubble (see graph 2). By comparison, eurozone household debt, taken as a whole, amounts to only 65% of the region's GDP. Dutch household debt consists primarily (more than 95%) of mortgages.

This increase in household debt was helped by specific Dutch tax features. Interest expenses are fully deductible from income in the income tax calculation, as are savings payments into pension funds. Tax optimisation has therefore prompted households firstly, to take on the maximum debt in order to acquire a property asset, typically resorting to a bullet loan[1], and, secondly to build up substantial savings for their retirement in parallel.

GRAPH. 2: HOUSEHOLD DEBT RATIO



Source: Eurostat

In addition to being particularly high when the loan is issued, the ratio of the loan to the value of the purchased asset does not automatically decline over time in the case of a bullet loan, unlike an amortisable loan. As a result, during the life of the loan, this ratio is entirely driven by the trend in property prices: it declines if property prices rise, but if they fall, as is currently the case, it increases.

Therefore, it is now more than a decade of borrowers that are potentially in possession of a property asset whose value is less than the final repayment of their bullet loan. At end-2010, the Netherlands' central bank already estimated that 22% of borrowers faced a mortgage debt that was higher than the value of their property asset.

THE BANKING CRISIS AT WORK

The risk generated by this household debt is borne first and foremost by the banks, with the latter holding nearly 60% of mortgages to households. That said, this debt has also been largely securitised, and increasingly so over time: as a result, more than a third of household property debt is now held by Special Purpose Vehicles (vs. only 5% in 2000) for

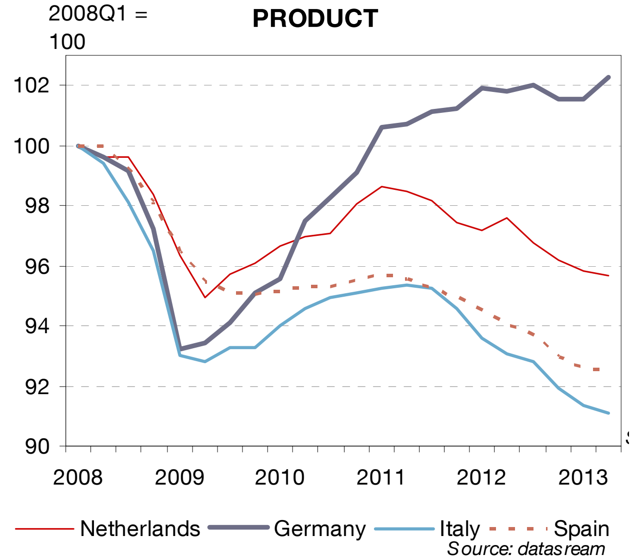
[1] Bullet loans represented 50% of mortgages granted in 2010 vs. 30% in 2000 and only 5% in 1994 according to the Netherlands' central bank. In the case of these loans, only the interest is paid during the life of the loan and the capital is only repaid at maturity, typically over 30 years with a borrowing ratio to the price of the asset of over 100% in order to maximise the tax benefit

securitisation purposes[2], and less than 20% of securitised debt remains in the banks balance sheet.

In addition, the crisis affects not only residential property but also commercial property. In particular, the property crisis was at the origin of the problems encountered by Fortis/ABN Amro, which had to be nationalised in 2008, and SNS Reaal, which was nationalised in turn in 2013. In both cases, loss centres were concentrated particularly within the property-related assets acquired during the record-breaking operation of ABN Amro's purchase/dismantling just before the crisis. In the case of SNS Reaal, the losses realised on the property financing portfolio, alone swallowed up more than the total equity of the SNS Reaal group's banking subsidiary, resulting in a capital ratio (core tier 1) of -2.9% before a capital injection by the government. Therefore it was an undoubtedly bankrupt bank that the government had to nationalise as a matter of urgency.

All in all, in order to rescue two of the country's five main banks, the Dutch government was forced to inject approximately EUR30bn, or 5% of GDP, into these two banks, not taking into account the guarantees that it also had to provide.

GRAPH 3: REAL GROSS DOMESTIC PRODUCT



Source: datasream

THE COUNTRY HAS FAILED TO EMERGE FROM THE RECESSION…

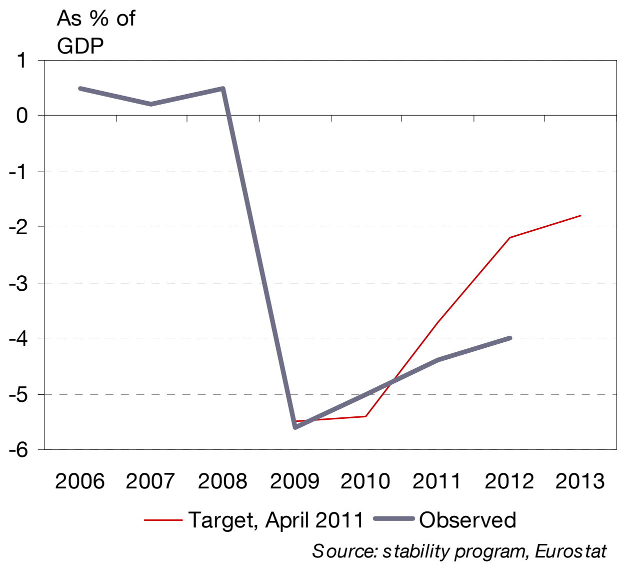
Like in the other eurozone countries, and especially Germany, economic activity has plunged in the Netherlands in 2008-2009, before starting to recover at end-2009.

However, unlike Germany and like the eurozone's peripheral countries, it subsequently experienced a sharp relapse from the beginning of 2011: in two years and a half, the country recorded 8 quarters of contraction in activity. As a result, in Q1-13, real GDP remained more than 4% below its level at the beginning of 2008 (see graph 3). This relapse is due to the sharp decline in household consumption and corporate investment, while foreign trade has helped support activity thanks to resilient exports. Both according to European Commission and Centraal Planbureau forecasts, economic activity is expected to decline again in 2013 and only rebound slightly in 2014.

… OR ADJUST ITS PUBLIC FINANCES…

After the sharp widening of the public deficit with the crisis, the Dutch government forecasted, in its April 2011 stability programme, a deficit reduced to 3.7% of GDP in 2011, vs. 5.4% the previous year, followed by 2.2% of GDP in 2012. In reality, the reduction of the deficit was much more limited: it therefore amounted to 4% of GDP in 2012 (see graph 4). The deficit overshoot compared with the target stems primarily from a much more deteriorated economic situation than expected in its stability programme (growth of +1.0% in 2011 followed by -1.3% in 2012, vs. respectively +1.75% and +1.5% forecast) and the cost of bailout plans for the Dutch financial sector.

GRAPH. 4: PUBLIC SECTOR BALANCE



Source: stability program, Eurostat

… PARTLY BECAUSE THE POLITICAL CONSENSUS HAS CRUMBLED

Another point that the Netherlands shares with the eurozone's peripheral countries lies in the political tensions and instability generated by the crisis. Until the beginning of 2012, there was a relative consensus among the political class regarding the need to implement austerity measures in order to restore the

[2] *In this case, mortgage debt held by the banks is transferred to legally separate entities called "Special Purpose Vehicle" or SPV, which finance themselves by issuing debt securities secured against loan portfolios (these securities are called "Residential Mortgage-Backed Securities" or RMBS)*

public finances, and especially to rapidly reduce the public deficit to below the threshold of 3% of GDP.

However, this consensus was undermined by the public finances' slippage. In the wake of a disagreement on the 2013 budget, which was expected to correct the public finances' slippage, the coalition government, resulting from the elections in June 2010, lost its majority in Parliament in April 2012. There followed a period of political instability which led to early elections in September 2012, and then the formation of a new coalition government, after a compromise was found regarding the extent of the budgetary adjustment.

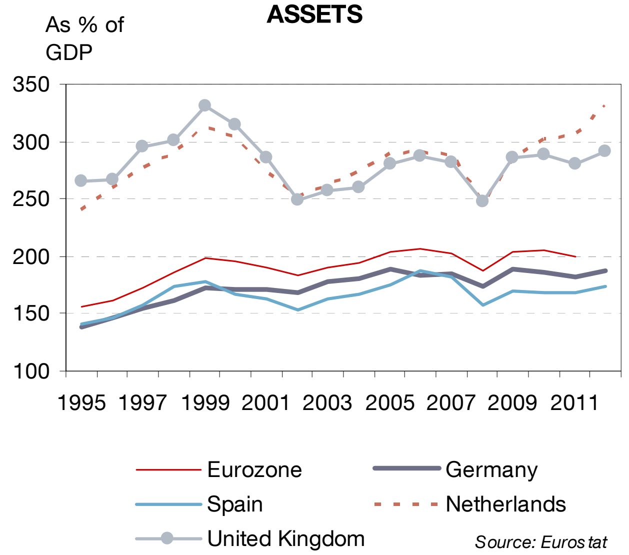
The 2014 budget could constitute a test for the government coalition. The European Commission acknowledged in May 2013 that it would take one more year than initially expected to reduce the public deficit to below the 3% of GDP threshold, i.e. in 2014 rather than 2013. However, at the same time, it pointed out that additional budgetary consolidation measures, amounting to 0.6% of GDP, would be needed in 2014.

HOWEVER, ITS STRENGTHS CLEARLY PLACE IT AMONG THE EUROZONE CORE COUNTRIES

SUBSTANTIAL HOUSEHOLD WEALTH

Given the importance of funded pension schemes and tax incentives, Dutch households stand out because of their substantially higher financial assets than in other European countries (see graph 5).

GRAPH. 5: HOUSEHOLD FINANCIAL ASSETS

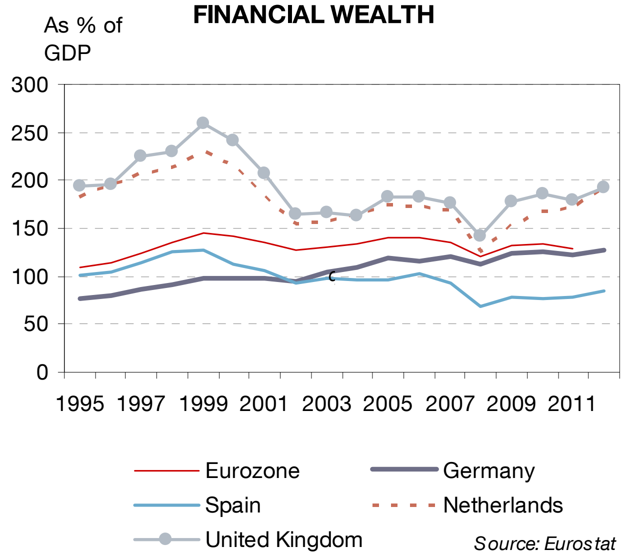


In 2012, their gross financial assets amounted to more than 330% of GDP (vs. a eurozone average of around 200% of GDP), i.e. the highest ratio (with that of the United Kingdom, another country where funded pension schemes have a significant impact) within the major European countries.

In addition to retirement savings, the gross financial assets of Dutch households have been underpinned by another mechanism: although the majority of loans are bullet loans, only a third of total mortgages have been sold without being guaranteed, at least in part, by financial assets. The banks have mainly offered formulas to maximise the tax benefit, by coupling a bullet loan with a blocked savings plan which can only be used to repay the loan. However, according to the Netherlands' central bank, savings built up in this way generally represent a small amount compared with the amount of debt contracted.

In the end, in terms of net financial assets (financial assets minus debt), the position of Dutch households does not appear to be excessively problematic: at around 190% of GDP, it is much more comfortable than that of Irish or Spanish households, and even more comfortable than the eurozone average (see graph 6).

GRAPH. 6: HOUSEHOLD NET FINANCIAL WEALTH



However, it would not be possible to use retirement savings, which represent half of Dutch households' financial assets, to cover mortgage debt in the event of difficulties in reselling, or reselling at a substantial loss, a property asset. The law strictly forbids capital withdrawal from pension funds (except in the case of very small annuities). However, until now, mortgages to households have not experienced particular difficulties, with their default rate remaining low. The government has also taken measures to limit the risk they generate for the financial sector. As a result, since 2011, conditions relating to the use of a bullet loan alone have been tightened: the bullet loan can now represent only half of the value of the property asset vs. the total value previously.

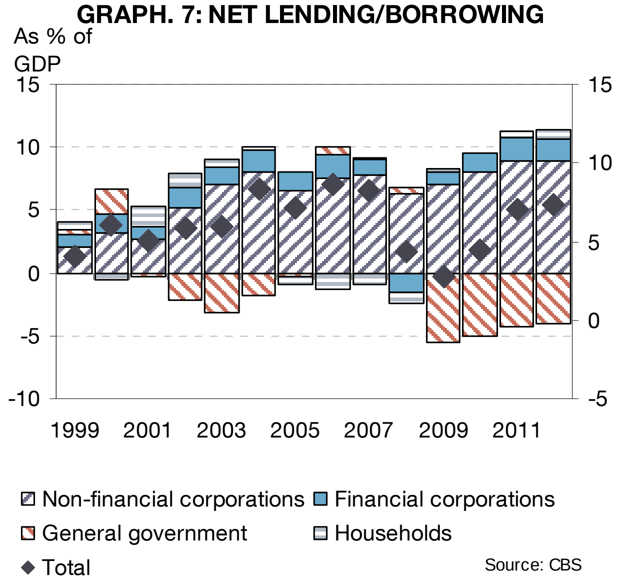
ABUNDANT SAVINGS OF NON-FINANCIAL COMPANIES

More broadly, the country is characterised by abundant national savings: the Dutch economy's net lending, i.e. the surplus of national savings vs. investment, has on average been more than 6% of GDP in the last decade (and was already nearly 5% of GDP in the previous decade).

In particular, non-financial companies net lending is very high: in the last decade, it reached an average of nearly 8% of GDP (see graph 7). They experienced a financing requirement for the last time in 1992.

In addition, the public debt remains relatively limited, measured by eurozone standards, since it amounted to 71% of GDP in 2012. Moreover, it is financed at lower cost: the interest rate differential compared with Germany is small (around 0.4% for 10-year debt in summer 2013) and less than that of France or Austria.

GRAPH. 7: NET LENDING/BORROWING



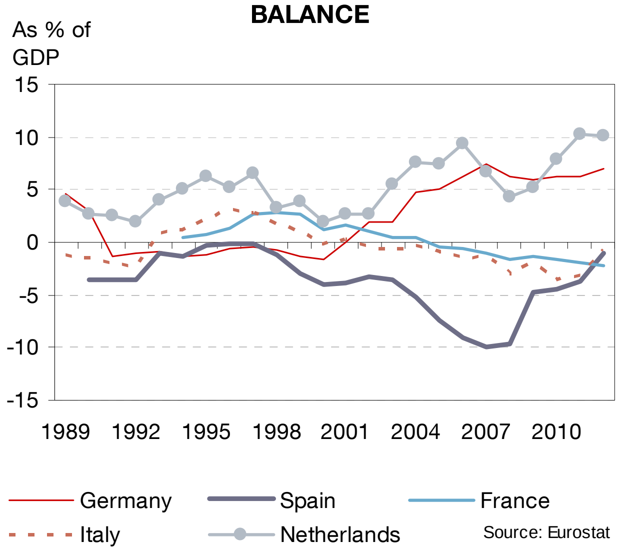
Source: CBS

UNLIKE PERIPHERAL COUNTRIES, FOREIGN ACCOUNTS ARE A SOURCE OF RESILIENCE RATHER THAN FRAGILITY

The counterpart of these abundant savings is that the Netherlands' foreign accounts are a strong factor of resilience, and not fragility as is the case for the eurozone's peripheral countries.

Indeed it has a structural current account surplus (the sum of the trade balance and the balance between revenues received from foreign countries and those paid to foreign countries) that is very substantial (more than 7% of GDP on average over the last ten years), even higher than the figure for Germany (see graph 8). At the other end of the scale, Italy has had a current account deficit since 2000. Spain, especially, has experienced a huge current account deficit, which peaked at 10% of GDP in 2007, before the painful rebalancing process that has taken place since.

GRAPH. 8: CURRENT ACCOUNT BALANCE



Source: Eurostat

As a result of these considerable differences in current account balances, net foreign positions, i.e. the difference in outstandings between the investments of the country's residents abroad and foreigners' investments in the country, are also completely divergent. Accordingly, the Netherlands has a largely positive net foreign position, amounting to 54% of GDP in 2012 vs. "only" 40% for Germany, whereas the figure for Italy is negative at 24% of GDP and, more importantly, the figures for Spain and Ireland are negative at 91% and 108% of GDP respectively.

ALL IN ALL, THE NETHERLANDS HAS SUBSTANTIAL INTERNAL RESOURCES TO OVERCOME THE CRISIS

Like Ireland and Spain, but on a much lesser scale, the Netherlands therefore faces a double crisis, property and banking.

That said, its high national savings and surplus foreign position enables it to rule out the risk of the third crisis experienced by the eurozone's peripheral countries: the balance of payments crisis.

Unlike Spain for example, the Netherlands is not crucially dependent on foreign financing. Consequently, if this financing were to suddenly stop, it would not force the country to resort to external aid. All of which justifies this financing continuing normally.

Therefore, the Netherlands clearly belongs to the eurozone's core countries, despite a number of fragilities that it shares with peripheral countries.

PREVIOUS ISSUES ECONOTE

N°1 – The dollar: the American's currency, their problem?
Benoît HEITZ (31 march 2011)

N°2 – Is Africa about to take off?
Clément GILLET (10 may 2011)

N°3 – United States: State and local governments are dampening the recovery
Clémentine GALLES, Kim MARCH (9 june 2011)

N°4 – China: Internationalization without convertibility of the renminbi
Sopanha SA, Meno MIYAKE (December 2011)

N°5 – Eurozone periphery adjustment: is Latvia an example?
Anna SIENKIEWICZ, Ariel EMIRIAN (January 2012)

N°6 – United Kingdom: Is the spectre of inflation back?
Marc-Antoine COLLARD (February 2012)

N°7 – China: Foreign direct investment outflows— much ado about nothing
Sopanha SA, Meno MIYAKE (May 2012)

N°8 – Turkey: An atypical but dependent monetary policy
Régis GALLAND (July 2012)

N°9 – UK Quantitative Easing: More inflation but not more activity?
Benoît HEITZ (July 2012)

N°10 – Housing market and macroprudential policies: is Canada a success story?
Marc-Antoine COLLARD (August 2012)

N°11 – The Euro Zone: a Unique Crisis
Marie-Hélène DUPRAT (September 2012

N°12 – Germany's export performance: comparative analysis with its European peers
Marc FRISO (December 2012)

N°13 – Financing government's debt: a vehicle for the (dis)integration of the Eurozone?
Léa DAUPHAS, Clémentine GALLÈS (February 2013)

N°14 – China: Housing property prices: Failing to see the forest for the threes
Sopanha SA (April 2013)

N°15 China: The growth debate
Olivier DE BOYSSON, Sopanha SA (April 2013)

N°16 Developed countries: who holds public debt?
Audrey GASTEUIL-ROUGIER (April 2013)

N°17 US energy independence
Marc-Antoine COLLARD (May 2013)

N°18 France: Why has the current account balance deteriorated for more than 20 years?
Benoît HEITZ (June 2013)

N°19 US: Becoming a LNG exporter
Marc-Antoine COLLARD (June 2013)

ECONOMIC STUDIES DEPARTMENT CONTACTS

Olivier Garnier
Group Chief Economist
+33 1 42 14 88 16
olivier.garnier@socgen.com

Olivier de Boysson
Deputy & Emerging Markets Chief Economist
+33 1 42 14 41 46
olivier.de-boysson@socgen.com

Marie-Hélène Duprat
Senior Advisor to the Chief Economist
+33 1 42 14 16 04
marie-helene.duprat@socgen.com

Ariel Emirian
Country Risk Analysis / CIS Countries
+33 1 42 13 08 49
ariel.emirian@socgen.com

Clémentine Gallès
Macro-Financial Studies & United States
+33 1 57 29 57 75
clementine.galles@socgen.com

Benoît Heitz
Global Economic Forecasting & Euro zone and Europe
+33 1 58 98 74 26
benoit.heitz@socgen.com

Constance Boublil
Central & South-eastern Europe
+33 1 42 13 08 29
constance.boublil@socgen.com

Marc-Antoine Collard
Gulf States, Latin America, Commodities
+33 1 57 29 62 28
marc-antoine.collard@socgen.com

Marc Friso
Euro zone, Northern Europe & Sub-Saharan Africa
+33 1 42 14 74 49
marc.friso@socgen.com

Régis Galland
Middle East, North Africa & Central Asia
+33 1 58 98 72 37
regis.galland@socgen.com

Audrey Gasteuil
OECD ex. Euro zone & Macro-Financial Studies
+33 1 57 29 52 26
audrey.gasteuil@socgen.com

Sopanha Sa
Asia
+33 1 58 98 76 31
sopanha.sa@socgen.com

Isabelle Ait El Hocine
Assistant
+33 1 42 14 55 56
isabelle.ait-el-hocine@socgen.com

Valérie Toscas
Assistant
+33 1 42 13 18 88
valerie.toscas@socgen.com

Sigrid Millereux-Beziaud
Information specialist
+33 1 42 14 46 45
sigrid.millereux-beziaud@socgen.com

Société Générale | Risk division
Economic studies department | 75886 PARIS CEDEX 18
http://www.societegenerale.com/en/Our-businesses/economic-studies
Tel: +33 1 42 14 55 56 — Tel: +33 1 42 13 18 88 – Fax: +33 1 42 14 83 29

SOCIETE GENERALE