EC4408 Public Finance Mid-Term Assignment

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Introduction

For this assignment we will analyse the Netherlands, who are highly ranked within the Euro area, with low debt levels and high disposable income per capita (Van Toorn 2021). To do so we will discuss their key financial statistics, the forecasts of their future debt, their fiscal response to Covid and the implications of this.

Debt Dynamics

For a state to finance its ventures and budget deficits, it must increase its sovereign debt, which is the debt a state contracts with foreign and domestic creditors (Singh 2018). This debt is only an issue when a debt dynamic is set in motion. Governments will compare their primary budget balance and the differential between their interest and growth rates to ensure the stability of this debt (Palcic 2022). The primary budget balance is related to fiscal policy while the interest on sovereign debt and the economy's growth rate are a macro/monetary policy variable.

If the above factors aren't in balance then a debt dynamic is set in motion. Debt sustainability requires the government be able repay its debt in the future and therefore, the primary budget balance is a key determinant of debt dynamics (Beqiraj et al 2018). If the government is running a deficit, this will be financed by debt. This is not an issue if the economy is growing at a greater rate than the interest on this debt. However, should their long-term interest rates exceed their GDP growth, the literature suggests that the key requirement is that a primary budget surplus be run (Beqiraj et al 2018). Should the government fail to do so, then a debt dynamic is set in motion, increasing their Debt/GDP ratio.

As this ratio continues to increase, financial markets will begin to require higher interest rates on national bonds to offset the increasing levels of default risk. Rising interest rates increase the cost of financing debt and has a spiralling effect, bringing countries close to their debt limit, which is the debt level at which a sovereign borrower losses market access and hence cannot service its debt (Fournier et al 2015).

With monetary financing, 'the funding of state expenditure via the creation of new money' (Ryan-Collins 2017), being prohibited by the ECB, Euro area states must borrow, thus increasing the risk of a debt dynamic being set in motion. Ultimately, unstable government debt dynamics can be stabilised by adjustments in various fiscal instruments (Michel et al 2010) or by providing fiscal stimulus to encourage economic growth.

Key Finance Statistics

As illustrated above, the general government balance (GGB) has a significant effect on a country's debt dynamics. The Netherlands had experienced economic growth above EU averages during the 1990's. Inflation inertia, compounded with pro-cyclical real interest rate effects, induced overheating, leading to overshooting of equilibrium prices (Albers and Langedijk 2004). This is what prompted the Dutch government to target more stable budgets, not going above or below one or minus one percent from 2005 to 2008 (Index 1). In comparison, the Euro area average was running a greater deficit but was still within the limit of -3% prior to 2009.

Given these favourable budgetary figures and their low levels of debt, the Netherlands were initially seen as being well prepared for the economic crisis. However, the global crisis hit everyone and a fall in global demand alongside an adverse wealth shock led to a contraction in the Netherland's economy (Masselink and van den Noord 2009) which was reduced by budget deficits. The introduction of these deficits coincided with the entire Euro area average as they plummeted significantly from 2008, seeing both reach their lowest in 2010, with the Netherlands' deficit being -5.3%.

Their recovery is illustrated by their steady decrease in deficits after 2010 (Index 1) and their relatively stable levels of debt (Index 2). With their Debt/GDP ratio relatively close to or below the Stability and Growth pact limit of 60%, this shows that, excluding the global symmetrical shocks of 2008 and 2020, the Dutch economy is quite stable in comparison to its EU counterparts and has a smaller risk of setting a debt dynamic in motion.

From analysing both their GGB and Debt/GDP ratios, the Netherlands have been neutral in operation from 2005-2020, with no significant spike in either figure outside of significant global events. Their gradual reduction of budget deficits after the 2008 crisis, and running of surpluses prior to Covid illustrates the stability of their economy, which when looked at beyond the structural developments due to crises, is in relatively good shape due to its flexible labour market and limited dependency on foreign capital (Masselink and van den Noord 2009).

Long-Term Interest Rates

Faini (2004) suggested that a deterioration in the cyclically adjusted primary fiscal balance in one Euro country would increase the euro area real long-term interest rate and the spread between domestic and euro area interest rates. Such a deterioration in the fiscal balance is funded by debt financing which increases a country's Debt/GDP ratio. This indicates a positive relationship between a country's long-term interest rate and its Debt/GDP ratio.

When analysing the relationship between these two variables for the Netherlands, there is a relatively significant trend which aligns with the above theory. The Netherlands faced an increasing yield on their bonds from 2006 onwards (Index 3) as financial markets became conscious of a potential crisis. Despite their increase in Debt/GDP between 2008 and 2014, the Netherland's long-term interest rates fell during this period. This was so as, despite their increasing debt levels, the Netherlands were comparatively more stable and less leveraged than its Euro area counterparts (Index 2). With their Debt/GDP ratio peaking at 67.9% in 2014, the Netherlands still had a relatively low level of debt and thus were far safer and less likely to default.

Due to this stability, financial markets were willing to take lower yields on their bonds as investors looked for safety during uncertain times. After these initial few years of severe uncertainty, the Netherland's bond yields consistently fell from 2012 onwards. This was due to their Debt/GDP ratio plateauing and reducing while always being below the Euro area average (Index 2). The other significant reason for this decrease was Mario Draghi's 'whatever it takes' speech in 2012 (Spiegel 2014) which settled financial markets and restored confidence. The consistent decline in yields faced by the Netherlands from 2008 and after Draghi's 2012 speech have reduced the risk of a debt dynamic being set in motion significantly. The differential between interest rates and economic growth is key in assessing fiscal sustainability (Turner and Spinelli 2011) and the Netherlands' low interest rates combined with their economic recovery prior to Covid (Index 4) (Eurostat 2022) ensured that this differential was minimised in the six years following the financial crisis (Index 5), thus minimising their debt dynamics and creating recovery opportunities. This differential would become a positive for them from 2014 (Index 5), ensuring a debt dynamic wouldn't be set in motion and also reducing their Debt/GDP ratio.

Fiscal Stimulus

When the Covid-19 pandemic struck in March 2020, the Netherlands engaged in partial lockdowns to limit the spread of Covid and over the following year entered several lockdowns. The Netherlands adopted budgetary measures to increase the capacity of health systems and provided relief to individuals and sectors that were affected by the virus (European Commission 2020).

The Dutch government decided to implement such measures at the expense of their GGB, accepting a significant deficit of -4.2% for 2020 (European Commission 2021). Such a jump from the 2019 surplus of 1.7% illustrates the drastic and radical nature of the fiscal action taken by the Dutch government. Their fiscal response featured three separate areas of 1. Direct fiscal impulse 2. Tax deferrals and 3. Liquidity guarantees (Anderson et al 2020). All these measures were implemented in order to protect those affected most by the pandemic and to maintain aggregate demand.

Direct fiscal interventions included €20billion to keep people in employment while their employer is temporarily closed or suffers a loss of 20% or more of his/her turnover (Rijksoverheid 2020) and €2.45billion in support for entrepreneurs and the self-employed (IMF 2021). Alongside these direct interventions, the Dutch government granted an estimated €17.2billion in tax and other revenue deferrals (IMF 2021). Companies were allowed to defer tax payments without penalties and calculate provisional taxes based on expected reduced activity (IMF 2021). Such deferrals improved the liquidity of struggling companies and enabled them to survive the initial months of the pandemic, thus protecting aggregate demand.

Further funds were made available by the Dutch government to guarantee the loans of SMEs. Additional funds of €15billion and €1.38billion were distributed to guarantee business loans and bridging loans for SMEs respectively (Anderson et al 2020). In 2020, the direct expenditure alone cost €28billion (European Commission 2021) and this combined with the deferred tax payments resulted in a significant decrease in government revenues while expenditure rose significantly. The Netherlands also estimated that fiscal stimulus would cost an additional €40.9billion in 2021, meaning this general government deficit would continue into the following year.

Debt Trajectory Forecast

In addition to a global public health emergency, the COVID-19 pandemic has introduced a large amount of risk and uncertainty among governments in the European union and all across the world. We have already seen governments dramatically increase public spending at the expense of their general balance and debt levels. It is important to map and predict different scenarios of economic growth to gain a better understanding of the problem and how to mitigate the impacts of the pandemic on debt levels.

Our forecast of debt dynamics in the Netherlands will include predictions for the debt/GDP ratio from the years 2021 to 2024. Different scenarios are used in this forecast to account for varying economic growth. They are as follows: negative growth (-2%); zero growth (0%); low growth (2%); and high growth (5%). By comparing this simple forecast to forecasts from the EU Commission, we should be able to show the changing opinions on debt sustainability at different times throughout the pandemic. Included are our forecast plus the official forecasts from 2020 and 2021 (European Commission, 2021; The Netherlands, 2021). Our forecasts suggest that economic growth is crucial to the medium-term recovery. In the zero and negative growth scenario's, the debt ratio will reach levels not seen since the years after the global financial crisis.

Index 6 compares our forecast to the Debt Sustainability Monitor 2020 baseline scenario. A quick glance at the official forecast would suggest that the baseline scenario is quite pessimistic, the European Commission predict a constant rise of debt levels from 2020-2024 to 68.4%. The debt/GDP ratio exhibits a trajectory similar to our negative growth scenario, surpassing the reference value of 60%. The predicted 2020 figure is higher than the actual value of 54.3%. The predicted rise of the ratio by 11% could be attributed to the large fiscal stimulus policies announced to reduce the short-term shocks to the economy. After 2020, the ratio rises steadily by roughly 2% each year. Three of our scenarios suggest that the debt ratio will be lower than the official forecast. The outlook of debt sustainability at the time of the report in early 2021 does not appear to be good. The Netherlands has a 94% chance of increasing debt over the course of the forecast. Compared to the report of the previous year, the medium-term risk worsened due to the pandemic.

Index 7 includes the forecast included in the 2021 stability programme submitted by the Netherlands. Immediately, we notice a more optimistic prediction of debt sustainability in the Netherlands compared to the previous report. The Netherlands predicts the debt ratio to drop to a manageable 55.3%. This is similar to our high growth scenario, which sees GDP increase by 5% each year. The official forecast sees a rise in the debt ratio for 2 years before decreasing until 2024. Our high economic growth scenario takes 3 years to change its course and report a negative change in the ratio. It is expected in all scenarios that 2021 will see a rise in the ratio which is unsurprising. With significant fiscal expansionary measures in place, they predict a rough year in 2021 with a government balance deficit of -5.9%. As different fiscal stimulus packages are phased out over the years, economic growth will start to pick up and return to sustainable levels. An optimistic outlook for Netherlands would suggest that the debt/GDP ratio will not reach a level of 60% in the coming years if economic growth is positive. The difference from the stability programme report to the Debt Sustainability Monitor would suggest that the economic outlook and assumptions regarding the pandemic vary greatly. In the stability programme report it is assumed that the government balance will improve in 2022 as the virus is more manageable. It is expected for many of the policies to cease by this time and therefore improve the government balance.

Implications of Fiscal Stimulus

When looking at the debt/GDP ratio of all EU countries in 2020, without context one would fear the worst for debt sustainability, due to large rises in all ratios. The Netherlands, for 2021 and beyond will struggle to keep its debt/GDP ratio under the target of 60%, while most of the fiscal expansionary measures are in place. While 2020 has already shown a 6% increase in the debt ratio, 2021 should see more debt added due to the even larger stimulus promised by the government. Unfortunately, the short-term sustainability heavily depends on the epidemiological consequences of the virus, with the development of new variants and overall uncertainty surrounding the severity of different waves of the virus. Another large wave of the virus would mean large sums spent on relief payments and healthcare. If the government can reduce most of the policies introduced by the end of 2022, then they will have passed the peak. Governments and policymakers will need to monitor health and economic developments, identifying crucial fiscal stimulus and unnecessary spending to be phased out.

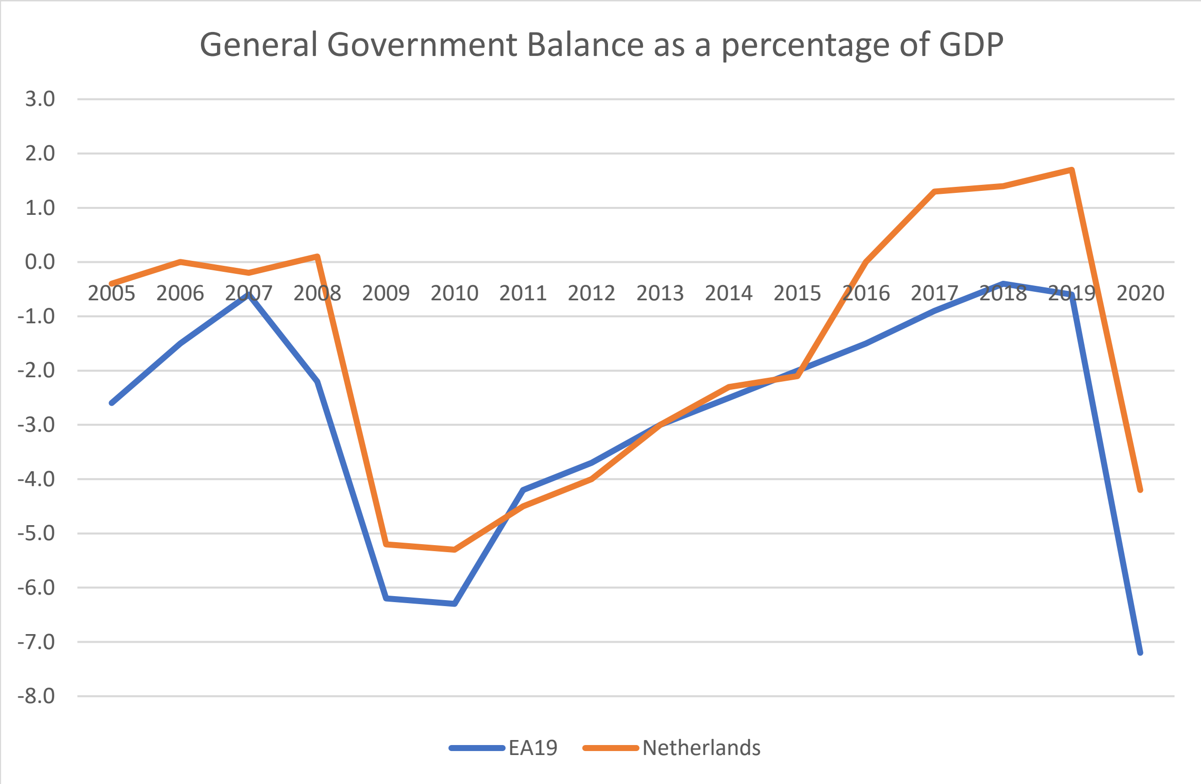
Although the 2008-2009 crisis had a massive impact on debt stability throughout the EU, the response by policymakers was notably quicker for the COVID-19 pandemic. Arguably, this could be down to the instantaneous shock Covid created, spanning all European countries in a matter of months. Everyone was fully aware of the pandemic's magnitude, this led to the ECB acting quickly, to prevent a repeat of many bailouts following the 2008 crisis. Asset purchase programs were announced in March, a month or two after the introduction of the virus, in comparison to a wait of a few years for the same policy to be introduced after 2008 (ECB, 2020).

Conclusion

Debt stability in the Netherlands has taken a hit in the short-term due to unprecedented fiscal stimulus needed to combat the pandemic. Their debt dynamics in the medium-term will be relatively stable though due to their low long-term interest rates. Medium-term debt stability prospects are also positive due to the likely positive economic growth in 2022.

Index

Index 1



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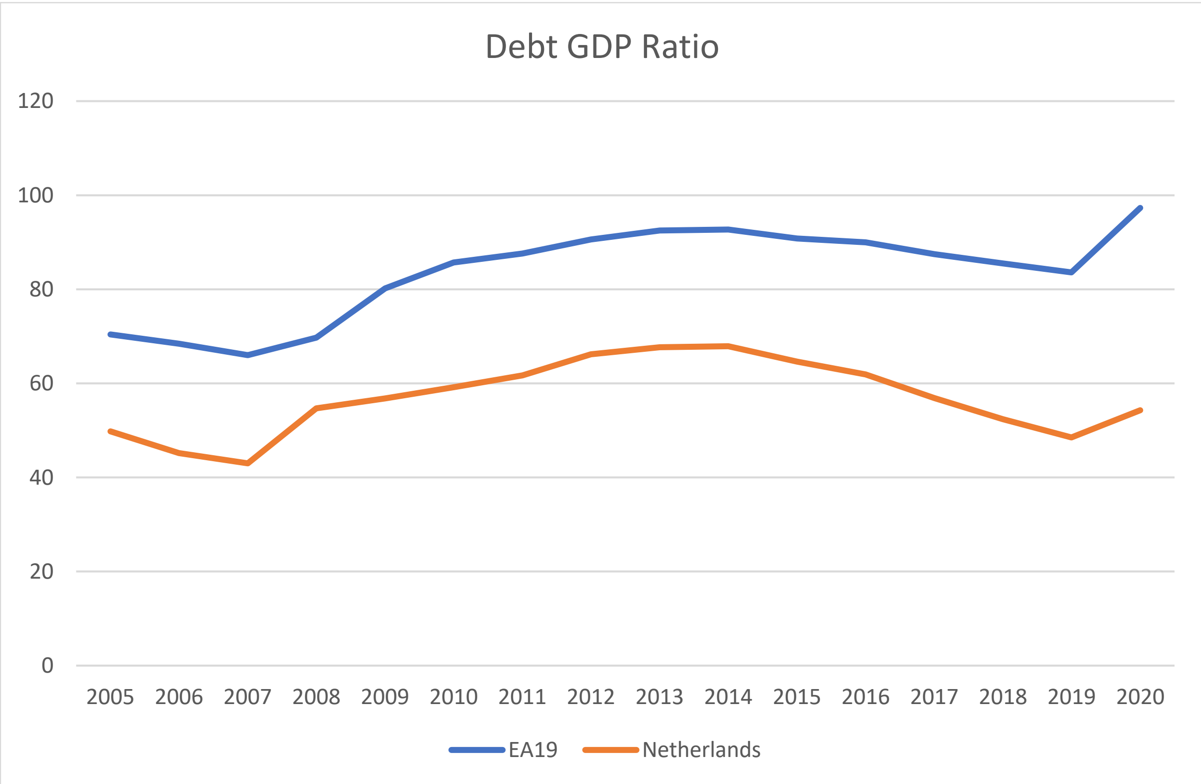

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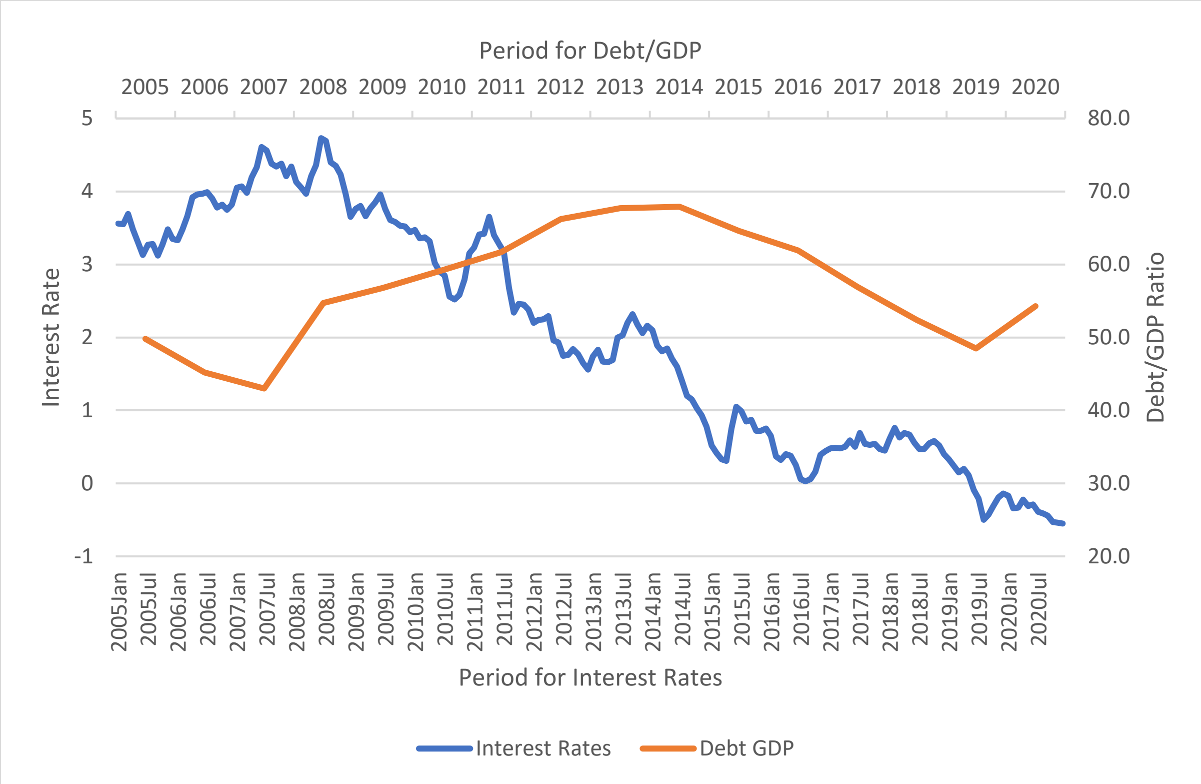

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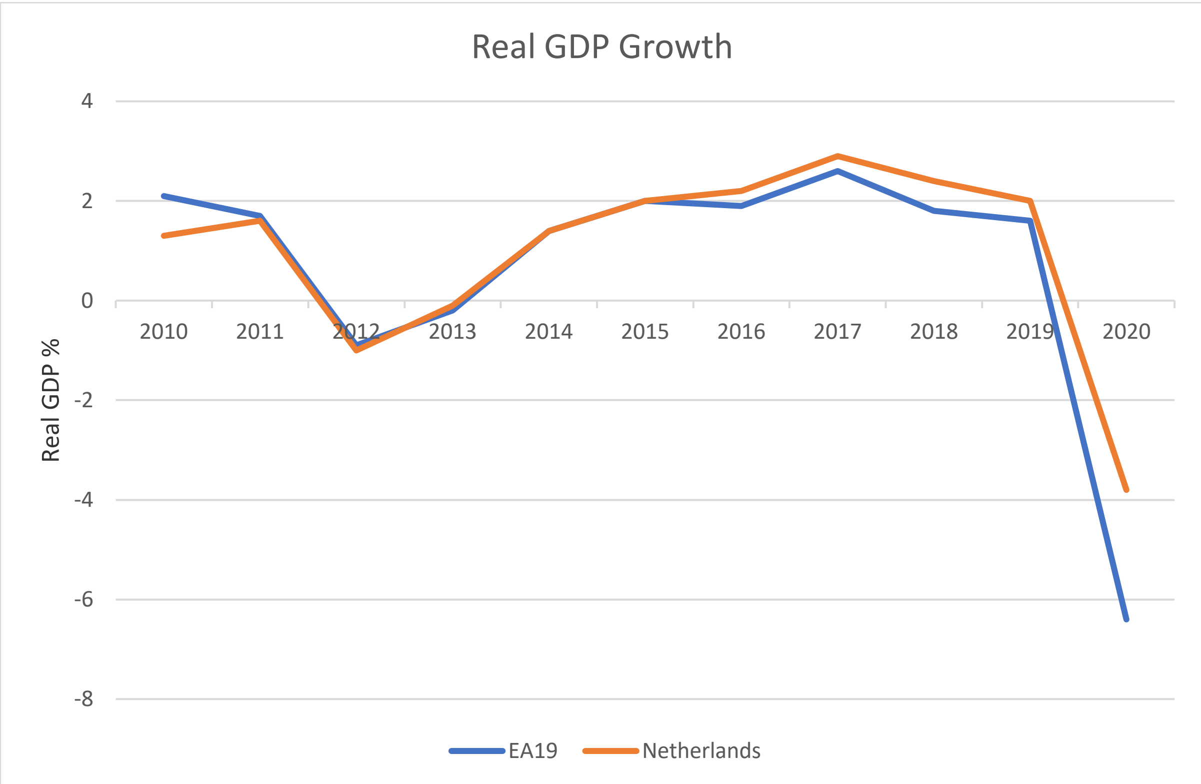

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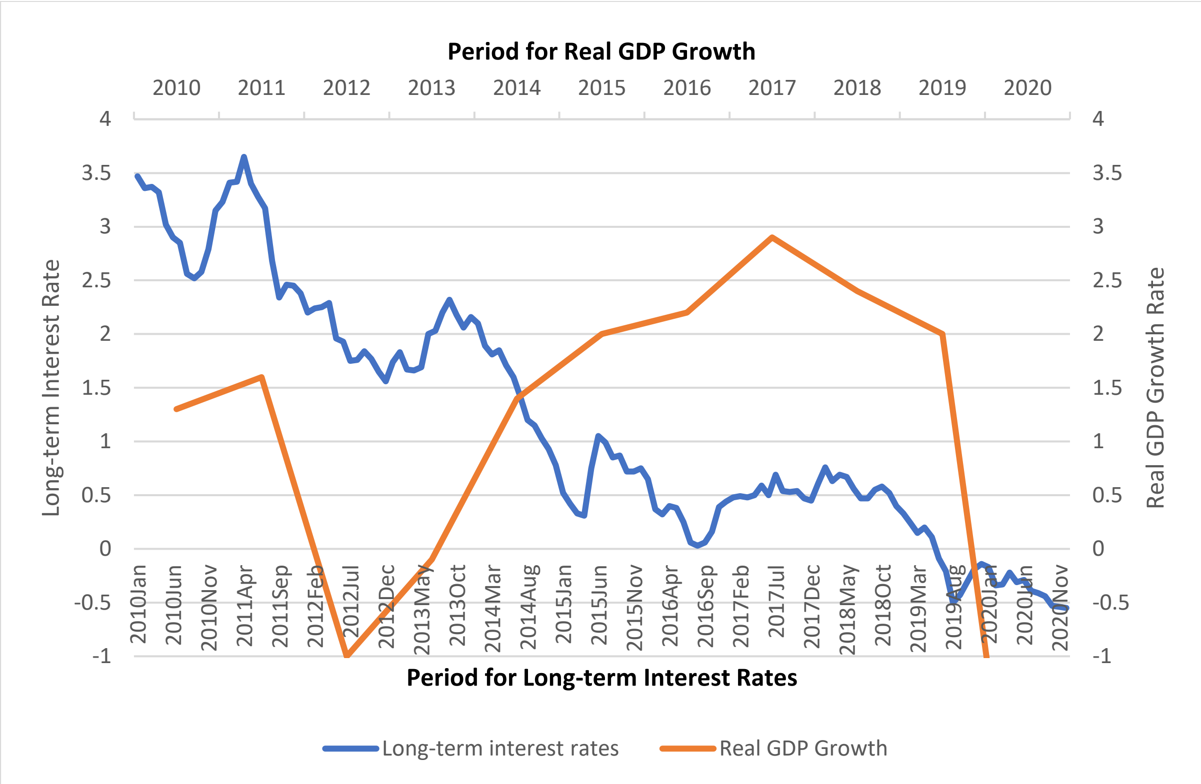

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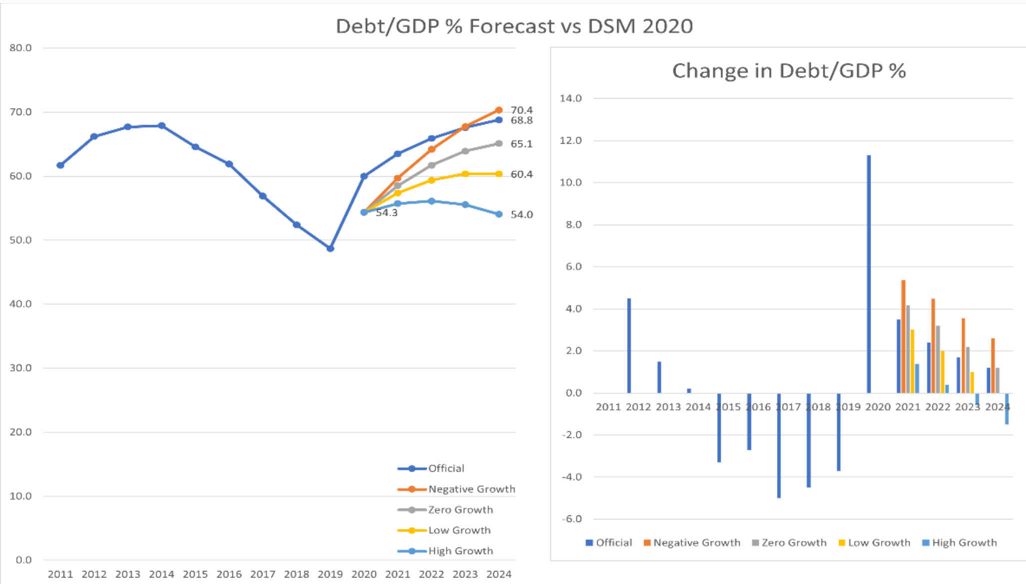

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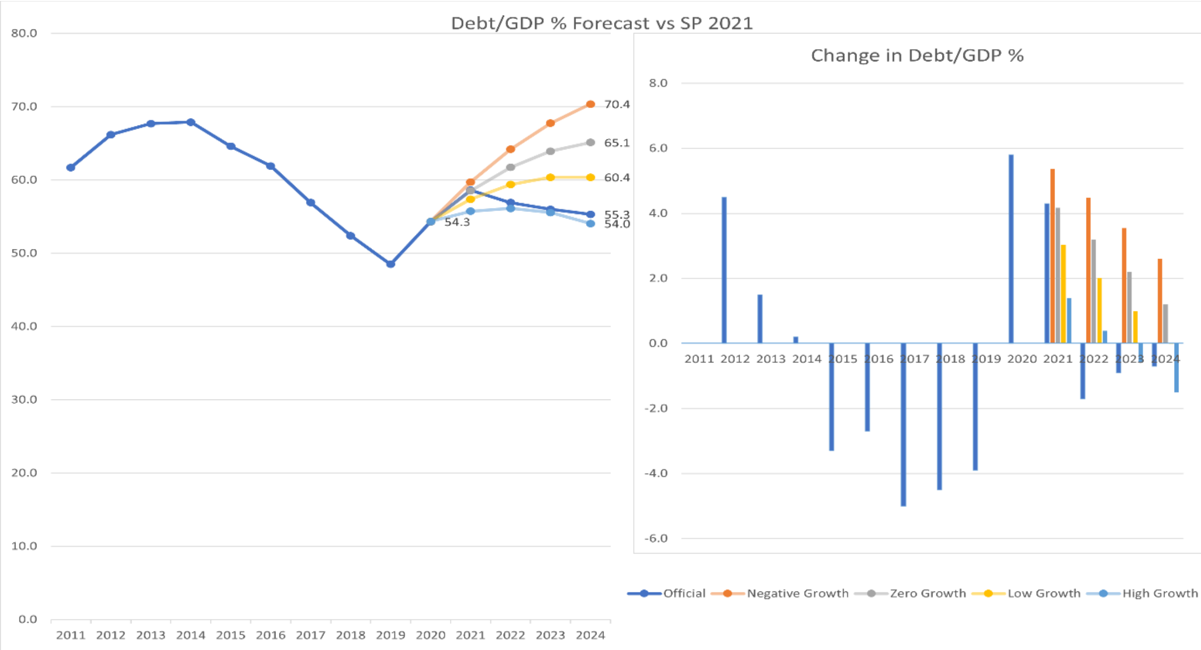
Debt/GDP % Forecast vs SP 2021
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024
70.4
65.1
60.4
55.3
54.3
54.0
Change in Debt/GDP %
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024
Official
Negative Growth
Zero Growth
Low Growth
High Growth

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