CONCLUDING STATEMENT

Belgium: Staff Concluding Statement of the 2023 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit or mission to a member country. Missions are undertaken as part of regular consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources, as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to IMF management approval, will be presented to the IMF Executive Board for discussion and decision.

Supported by strong and timely policy response, the Belgium economy showed resilience in withstanding a series of shocks in the past three years. Still, as in most euro area countries, growth is slowing, and core inflation remains high. Furthermore, the pandemic and energy crisis increased already-high public debt and structural fiscal deficits. At the same time, an aging population and the climate transition are putting pressure on public finances while low productivity and labor participation are dampening potential growth. Policies should continue to focus on addressing this confluence of cyclical and structural challenges:

- *Sustained and, ideally, front-loaded fiscal adjustment is needed to ensure the sustainability of Belgium's redistributive and solidary social model, restore buffers to absorb future shocks, reduce debt and associated vulnerabilities, and support disinflation. The consolidation needs to be buttressed by a rationalization and greater efficiency of spending at all levels of government, and supported by reforms, notably in tax policy, pensions, and healthcare.*

- *Labor and product market reforms remain needed to boost productivity and potential growth, which will also help mitigate the impact of fiscal consolidation and the cost of aging. Efforts to advance the climate transition should be accelerated in a coordinated manner among federal entities.*

- *With a rapid shift in financial conditions, the recently-decided macroprudential policy tightening will help preserve financial sector resilience. Strengthening supervision, crisis management and resolution preparedness, the macroprudential framework, and systemic risk assessment will further insulate the economy from macro-financial shocks.*

Economic outlook and risks

Growth is expected to decelerate in 2023-24, and inflation, lower in 2023, will pick up in 2024. Reflecting a weaker external environment and slowing domestic demand, growth is projected at around 1 percent this year and next, down from 3.2 percent in 2022. In the medium-term, it is expected to return to its potential of 1¼ percent. Headline inflation is projected to drop to 2.5 percent in 2023 due to lower energy prices, but will rise again in 2024, likely above 4 percent, mostly due to fading effects from energy price support measures. Core inflation will remain elevated, at 7½ percent in 2023 and 3¾ percent in 2024. Labor markets will remain tight. The external current account is expected to return to a small surplus over the medium term, as external demand and competitiveness gradually recover.

The outlook is subject to considerable uncertainty and risks. Escalating geopolitical tensions, coupled with trade and financial flow disruption could undermine confidence and activity and reignite inflationary pressures. Monetary policy of major central banks may tighten more or for longer than presently expected, weighing on macro-financial conditions. Conversely, an insufficient monetary policy response to renewed price pressures would increase the risk of a wage-price spiral, especially with automatic wage indexation in Belgium. A protracted government formation after June elections would risk delaying the needed fiscal adjustment and reforms, increasing risk premia, and worsening debt dynamics.

Advancing Fiscal Consolidation

Fiscal adjustment is needed to preserve Belgium's social model, lower inflation, reduce debt, and rebuild buffers. Belgium's social contract is characterized by a high level of redistribution and wide-reaching safety nets. The model has been successful in reducing inequality and mitigating the impact of the multiple shocks that afflicted the economy since the pandemic. However, it is generating large structural deficits and rising debt and faces the pressure of an aging population. Ensuring its sustainability requires further reforms. Moreover, a tighter fiscal stance is needed to support disinflation. Also, limited fiscal space is constraining room to address future shocks, and buffers need rebuilding.

The fiscal position has structurally deteriorated since the pandemic and energy crisis. In a scenario where no further adjustment would be made, the fiscal deficit would remain high and continue rising over the medium term, mainly reflecting the impact of permanent social benefit and wage measures taken during COVID, indexation, population aging, and higher interest cost. The overall deficit is expected to reach about 5½ percent of GDP by 2028, well above its pre-pandemic trend. Public debt would exceed 115 percent of GDP. Higher debt and interest rates will increase annual borrowing costs by close to 1 percent of GDP.

Fiscal challenges call for a significant, sustained, and ideally, frontloaded consolidation. The 2024 draft budgetary plan will help lower the general government deficit from 2023, but more structural reductions are required at all levels of government. Compared to a baseline with no policy change, a minimum structural primary adjustment of 0.6 ppts of

GDP in 2024 and 0.8 ppts annually during 2025-30—a cumulative adjustment of 5.7 ppts of GDP—would be needed to more than offset the estimated increase in aging outlays, help achieve a structural balance by 2030, and put public debt solidly on a downward path towards 60 percent of GDP.

The fiscal adjustment should primarily focus on rationalizing spending and increasing efficiency, which lags best performers. Given the high level of taxation, room for mobilizing additional tax revenue appears relatively limited, although tax reforms should proceed. Spending has increased the most compared to pre-pandemic projections on social benefits and the public wage bill, adding about 3 ppts and 0.6 ppts of GDP, respectively, by 2028. Social benefits spending was 5.2 ppts of GDP higher than the average of EU advanced economies in 2021, while social outcomes did not overperform peers', suggesting room for efficiency gains—including by reviewing the automatic-indexation mechanisms. In pursuing the fiscal adjustment, high-return public investment, which is crucial to boost potential growth, should be preserved.

Fiscal reforms are key to sustaining the consolidation efforts:

- *Pensions*. While the pension system was already facing rising costs from aging, the increase in minimum pensions and the pension bonuses decided in 2020 and 2022, respectively, increase the system's projected deficits in 2022-70. The agreement reached in July 2023 aiming to offset these costs is welcome. Yet, aging will continue to put pressure on the system over the medium term, calling for further sustainability reforms, including to foster a rise in the effective retirement age.

- *Healthcare*. Health outcomes are comparatively good but achieved at a relatively high cost. Efficiency gains could help absorb part of the projected increase in spending on health, including long-term care, due to aging. This would require significant reforms that could include more emphasis on preventive care, reforming the organization and role of hospitals, and further promoting generic drugs.

- *Tax policy and administration*. The implementation of the 2022 tax reform blueprint should continue to be pursued to help improve labor force participation and make the tax system fairer. Gradually reducing or eliminating rate differentials in the VAT is desirable, with measures to cushion the impact on low-income households. Capital taxation should be more consistent across income sources, particularly regarding real estate and capital gains. The reform should be at least budget neutral and, ideally, deficit reducing. Efforts to continue strengthening tax administration will help improve tax collection.

Fiscal management would benefit from enhanced coordination among federal entities. Consecutive shocks have also worsened the regions and communities' fiscal positions. However, coordination among federal entities is limited due to the lack of hierarchy among them and the absence of an accountability mechanism for all levels. Going forward, fiscal

adjustment at the region and community levels should be part of a broader consolidation plan, with strict spending limits applied at all levels of government.

Preserving Financial Sector Resilience

The financial sector has been resilient to a series of shocks, but systemic risks are rising. Bank profitability and capital adequacy have been increasing and liquidity buffers are ample. Stress tests show a high degree of financial sector resilience. Yet, vigilance is needed as risks are mounting. First, the real estate cycle has been turning. The correction has been orderly, moderating somewhat-elevated valuations, and widespread use of fixed-rate mortgages, strong household financial positions, and low commercial property vacancies provide comfort. Still, riskier segments of real estate lending may become vulnerable if macro-financial conditions deteriorate or structural factors (e.g., work-from-home) intensify. Second, banks could face risks from a fast-changing interest rate environment. Third, vulnerabilities in corporate debt may emerge, as businesses with weaker profitability face cost pressures, tighter funding conditions, and weaker growth.

Despite the turning financial cycle, the National Bank of Belgium's (NBB) recent macroprudential policy tightening was appropriate. Reflecting the evolution of macro-financial risks, the NBB activated the counter-cyclical capital buffer while recalibrating the sectoral systemic risk buffer (SSyRB) maintained against risks from residential mortgages. The adjustment of capital buffers is anticipated to add €1.6 billion in capital to absorb unexpected losses from a broader deterioration in the macro-financial environment, while also preserving the ability to cushion losses from a steep housing market correction. However, it will not be advisable to lower the SSyRB further until the housing market outlook is clearer. The NBB should remain vigilant to potential unexpected procyclical effects of macroprudential tightening.

Financial sector oversight is well developed, but the financial policy framework could be further strengthened in several areas.

- *Supervision.* There is scope for the NBB to further improve the corporate governance framework of banks and monitor bank internal capital targets. The already-strong collaboration between the NBB and the Financial Services and Markets Authority can be further strengthened through greater information sharing and incorporating consumer protection. The regulatory and supervisory framework for the insurance sector can be enhanced further. Large exposures to real estate and mortgages call for closely monitoring the quantity and quality of mortgage loans and prudent valuation by insurers. Work to enhance climate resiliency would benefit from finalizing the legal framework for public-private partnerships for natural catastrophe risk. The AML/CFT sanction and supervisory framework (including over payment institutions) should also be enhanced.

- *Macroprudential policy.* In the near term, the NBB's ability to independently implement macroprudential policy would be fortified by removing the requirement for formal

government approval of macroprudential measures at least for instruments foreseen in the Capital Requirements Directive and Regulation. Ideally, the NBB should be granted full power to set macroprudential policy, while retaining a consultative role for the Ministry of Finance. The NBB's systemic risk assessment framework for setting macroprudential policy could be strengthened.

- *Crisis management and resolution*. The national resolution handbook should be finalized with attention to tools outside of preferred resolution strategies. Operational readiness of resolution plans and greater internal coordination should be ensured. The emergency liquidity assistance framework can be further strengthened through adjustments to its collateral framework. The draft law that aims to enhance the deposit insurance fund by separating it from the national budget and increasing its target level is welcome.

Fostering Higher and Greener Growth

Continued reforms are needed to improve labor market outcomes. With tight labor markets, attaining higher economic growth will require improvements to productivity, labor participation, and interregional mobility. Continuing labor market, tax, and social benefit reforms are needed to effectively widen the net income gap between non-work and work and promote greater labor participation. Reducing skills mismatches and continuing to increase flexibility in the job market—e.g., building on recent measures regarding flexi-jobs—will also help. Efforts should continue to focus on greater inclusion in employment of foreign-born, lower-skilled, and older workers and individuals with disabilities.

Deeper product-market reforms would help raise productivity. Growth in total factor productivity has declined over the past two decades, bringing productivity levels below neighboring economies. Regulation of the retail sector and most professional occupations stand out as particularly restrictive in comparison to peers. Streamlining regulation and licensing of businesses would also help. Although the liberalization of network industries is generally at par with other euro area countries, further reducing barriers to competition would be beneficial.

Meeting ambitious domestic climate goals will require accelerated and sustained efforts and improved federal-regional coordination. The recent extension of two nuclear reactors' life by 10 years, and investment in additional renewable energy and LNG capacity, will help lower Belgium's carbon footprint and support energy security. Still, emissions from activities not presently included in the EU emissions trading system (ETS) are projected to decline by less than 43 percent under the revised National Energy and Climate Plan in its present version, compared to a target of 47 percent. Greater coordination of federal and regional entities would help accelerate climate policy decisions and execution. The planned EU ETS expansion by 2027 should be complemented by measures at the national level to ensure the desired emissions reductions, including higher carbon taxation, reduction of fossil fuel subsidies, sectoral feebates, and price floors/ceilings to ensure sufficient payback from

investment in low-carbon technologies. Part of revenues from carbon taxation should be employed to protect vulnerable households.

The IMF team would like to thank the Belgium authorities and other stakeholders for candid discussions and productive collaboration. It is especially grateful to the National Bank of Belgium for its hospitality and excellent support.