International environment

1. In the past few years, the world economy had been gripped by successive episodes of financial turbulence and geopolitical tensions which damaged the confidence of businesses, consumers and investors. In the year under review, however, signs of a turn for the better multiplied and strengthened.

2. Once the military conflict in Iraq had been brought to a rapid conclusion and the SARS epidemic in Asia had subsided, the international business and investment climate improved considerably. Throughout the world, share prices recovered from the heavy knocks suffered in the three preceding years, and risk premiums on the corporate bond markets declined. In combination with the historically low interest rates prevailing almost everywhere, these developments facilitated further strengthening of corporate balance sheets and gave businesses a keener appetite for new investment. Oil prices also responded well at first to the resolution of the Iraq crisis, but later in the year they resumed their upward trend, boosted by growing world demand and the restrictions – voluntary or otherwise – on production capacity in a number of oil-producing countries.

3. The American economy once again displayed great resilience so that, together with a number of fast growing Asian countries – including more particularly China, which has now become the third largest economic power in the world – it acted as a vital engine of the international economy. Bolstered by the dynamic demand in the Asian region and the United States and by the improved investment climate, the Japanese economy also unexpectedly staged a recovery, although the structural imbalances and deflationary tendencies afflicting Japan for quite some time have not yet been fully eliminated. In contrast, in the euro area the recovery has been slower and less robust: in the first half of 2003, GDP growth by and large stalled, as a result of declining exports and investments, but the second half of the year saw a gradual revival in activity, encouraged by a significantly improved external environment.

4. In most industrial countries an expansionary macroeconomic policy stance was maintained, which gave a major short-term boost to economic activity. That was particularly true in the United States, where public spending – including defence expenditure – was stepped up sharply, and substantial tax cuts were implemented, while the monetary authorities reduced short-term interest rates to the exceptionally low level of 1 p.c. Elsewhere, too, and more particularly in the euro area, the historically low interest rates were a factor underpinning activity.

5. Although the chances of a continuing and more broadly based recovery for the world economy are now considerably greater than they were a year ago, a number of imbalances and risk factors nonetheless raise concerns about the sustainability of the recovery. Apart from the lingering geopolitical tensions and threat of terrorism, in particular the persistent and unusually large United States current account deficit – which has now grown to around 5 p.c. of GDP – remains a latent factor of uncertainty for the global economy and the international financial system.

6. The United States' external deficit is nothing new, but in the past two years both its underlying causes and the way it has been funded have radically changed. Between 1995 and 2001 the swelling current account deficit was chiefly a reflection of the growing disparity between domestic saving and private investment in the United States, fostered by euphoria over the growth opportunities presented by the "new economy". Against that background, the United States had been able to fund its deficit via a substantial influx of foreign direct and portfolio investment. Demand for dollar assets was actually so strong that the American currency appreciated considerably. Subsequently, however, those developments appeared to be based partly on exaggerated and irrational expectations, so that the financial bubble created by the "new economy" eventually burst, and the inflow of foreign direct investment dried up. However, the external imbalances remained largely uncorrected as the American savings deficit was shifted from the private to the public sector, with a budget position that was almost in balance in 2001 turning into a deficit of around 5 p.c. of GDP in 2003. Furthermore, the public sector also began to play a greater role in financing the current account deficit, as many central banks – especially in Asia – bought US government securities on a large scale. It was precisely these developments that triggered growing concern on the international financial markets about the sustainability of such large balance of payments imbalances, resulting in downward pressure on the dollar, especially against the euro.

7. Such corrections to international exchange rates are an unavoidable and even essential element of the balance of payments adjustment process, certainly insofar as they rectify earlier misalignments. But experience has shown that an orderly absorption of external imbalances also requires adjustments in the real economy. The current US fiscal policy stance has undoubtedly provided a significant stimulus, indirectly encouraging the global economic recovery, but it cannot be sustained over time. The reduction in the budget deficit which is bound to come sooner rather than later, would help to curb domestic dissaving. That might temper American growth somewhat for a while, but at the same time it would alleviate one of the major threats to the growth prospects of the world economy. However, the global balance of payments disequilibria are not a purely American phenomenon, suggesting that stronger growth outside the United States could also help to mitigate them. For Japan and the euro area that should be one more incentive to forge ahead with the structural reforms required to strengthen their growth potential. Conversely, the tendency to resort to protectionism or the artificial maintenance of undervalued exchange rates is bound to be counterproductive. It is therefore important that a number of Asian countries, including China, should pave the way for a move towards greater exchange rate flexibility over time, by implementing reforms to enhance the resilience of their financial sector.

8. In comparison with other regions of the world, activity in the euro area last year was decidedly below par: averaged over the whole year, GDP growth declined further from 0.9 p.c. in 2002 to an estimated 0.5 p.c. in 2003, though there were signs of a revival in activity here, too, in the second half of the year. Yet adjustment to the economic shocks of past years – which were largely universal – has clearly been slower and more faltering in Europe than in the United States, for example. These differences in response may be attributed to both policy and structural factors.

9. For instance, the counter-cyclical relaxation of fiscal policy in the United States was far more radical than in the euro area. Apart from the fact that the American government, in response to the geopolitical developments, substantially stepped up its military and security expenditure, the divergent initial budget positions in the two regions also played a role: in 2000 the American budget showed a substantial surplus of 1.4 p.c. of GDP, while the average member of the euro area was still running a deficit of 0.9 p.c. of GDP, one reason being that many countries had failed to strengthen their structural budget position during the last economic boom.

10. However, a more decisive factor is that the European economy appears to produce a less flexible response to shocks, indicating persistent rigidities hampering more efficient market operation. This was illustrated by the differences in the business sector's response to the latest downturn. In the past two years both the reduction in the large corporate debt position and the improvement in profitability proceeded significantly faster in the United States than in the euro area. And although American firms cut back their investment and labour input more sharply at first, both are now clearly on the road to recovery, supported by substantial productivity increases – which continue to be a structural characteristic of the American economy. In contrast, in the euro area signs of an upturn in investment and employment have so far been limited.

11. Taking the year as a whole, apart from the further reduction in the volume of business investment, it is mainly foreign trade that has put a damper on the expansion of economic activity in the euro area. In the first half of the year, in particular, net exports made a strong negative contribution to growth, owing to the still prevailing weakness of foreign demand and the appreciation of the euro. The euro's steep rise since the beginning of 2002 harmed the price competitiveness of European producers, causing a loss of market shares both at home and abroad, which depressed the volume of exports and boosted imports. However, from the third quarter onwards, the steady strengthening of foreign demand more than outweighed the adverse effects of the sustained appreciation of the euro, thus laying the foundation for an export-led revival of activity in the euro area.

12. After languishing throughout 2002, private consumption did recover to some extent last year and was thus the key component of expenditure buttressing growth in the euro area. Although consumer confidence has shown a slight improvement since the spring, it has remained relatively weak, reflecting the growing uncertainty over the outlook for employment and mounting concern over the sustainability of the pension systems and other welfare provision in the light of rising budget deficits in a number of countries. Private spending was therefore supported mainly by a further rise in real disposable incomes as, despite the subdued economic activity, wages continued to increase fairly sharply while tax cuts in some countries provided an extra boost.

13. Despite the weakness of demand and the appreciation of the euro, inflation in the euro area hardly eased, continuing to hover around 2 p.c. throughout the year. In the first place, that was due to a number of exceptional, temporary factors, such as new oil price rises, food price increases caused by adverse weather, and higher indirect taxes in a number of countries. But also the underlying trend in inflation bore witness to a certain degree of inertia, due partly to the combination of weak productivity gains and stubbornly rising labour costs, plus the fact that the appreciation of the euro was reflected only slowly or incompletely in consumer prices.

14. Given the more robust international environment, the gradual recovery in confidence, favourable financing conditions and a generally moderate inflation outlook, the conditions for sustaining the incipient recovery appear to be present in the euro area as well. Most international institutions are therefore expecting GDP growth to rise to around 1.6 to 1.9 p.c. in 2004, provided that the initial impetus – which at the moment comes mainly from strengthening foreign demand and an accommodating macroeconomic policy stance – is translated in due course into endogenously buoyant domestic spending.

15. The disappointing growth figures and the renewed rise in unemployment highlight once again the need for unceasing efforts to carry out the Lisbon agenda of reforms aimed at turning the European Union into a dynamic and flexible economy. Furthermore, the efficient operation of monetary union imposes specific demands on the macroeconomic policy pursued by the individual Member States. The close links between the national economies within the single market and the safeguarding of the internal stability of the single currency should encourage all policymakers to respect the mutually agreed rules, in particular those relating to the maintenance of durably sound public finances. The difficulties in agreeing on the application of the Stability and Growth

Pact in respect of Germany and France last year show that those rules are not only relevant in bad times, but must equally be geared to creating the necessary budgetary margins in good times, so that later setbacks can be absorbed without significant damage. In addition, more appropriate and forward-looking surveillance procedures should ensure that such a symmetrical approach is indeed effectively implemented. In view of the pressure that the ageing population is likely to place on the budget, a rapid return to structurally balanced public finances becomes all the more essential, even from a purely national viewpoint.

16. Preserving sound foundations for the European internal market and the monetary union will be particularly crucial as the accession of ten new Member States is likely to present the EU with major new challenges, both economic and institutional. It is indeed important for enlargement to take place without jeopardising the main features of the European welfare model. At microeconomic and sectoral level, the integration of those countries will undoubtedly entail some adjustments and shifts, requiring appropriate support, but overall it should result in a win-win situation. As purchasing power in those countries catches up and their markets become more accessible, European firms are set to expand their potential outlets while the continuing dismantling of trade barriers and harmonisation of the regulatory framework will gradually create a level playing field. The past decade has already brought a strong expansion in trading links between the old and new EU Member States. That also applied more particularly to Belgium, where trade with the accession countries has generated a net surplus year after year, averaging around 0.4 p.c. of GDP.

Economic situation in Belgium

1. Since Belgium has a very open economy, domestic economic developments were inevitably affected by those in the rest of the world, a dominant factor being the feeble growth elsewhere in the euro area during the past year. The fact that domestic product declined or at best stagnated in three of Belgium's neighbouring countries, which are also its main trading partners – namely Germany, France and the Netherlands – was an additional handicap. Owing to the great importance of foreign trade for the Belgian economy – and the relatively high import content of Belgian exports must also be taken into account here – the substantial appreciation of the euro in the past two years has also had an unmistakable impact on the level of activity. But it should be remembered that since the introduction of the euro the bulk of Belgium's foreign trade, i.e. trade with the other euro area countries, is no longer impeded in any way by exchange rate variations. While the effective euro exchange rate, weighted by trade between the euro area and non-member countries, has risen by a total of 21 p.c. over the past two years, the appreciation averaged just 5.7 p.c. for the Belgian economy taken on its own, i.e. allowing for its trade with the other euro area countries. Of course, for some businesses and sectors which have to compete mainly with the dollar area, the more expensive euro may still be a major drawback, but on the other hand the appreciation of the euro also has some positive effects on domestic demand via the accompanying improvement in the terms of trade.

2. All in all, it is therefore hardly surprising that Belgium witnessed subdued economic growth for the third consecutive year. Such a protracted period of weak growth has not been seen since the early 1980s. In comparison with the euro area as a whole, however, the Belgian economy stood up rather well, and the growth of activity actually accelerated slightly from 0.7 p.c. in 2001 and 2002 to 1.1 p.c. in 2003. Nevertheless, in the course of the year under review, Belgium and the euro area produced broadly similar growth profiles, with activity remaining more or less flat in the first half year and a marked upturn from the third quarter onwards.

3. In contrast to the previous year, household spending in particular proved to be a significant factor bolstering growth, while the pace of business investment and public spending also accelerated. Since the volume growth of exports, at 1.5 p.c., was considerably outstripped by imports, net exports made a negative contribution to growth for the second consecutive year, totalling around 1.3 percentage points of GDP in 2003. After a marked weakening of exports in the second half of 2002 and early 2003, the revival in activity on Belgium's main markets from the second quarter generated a clear recovery in export volumes, which continued until the end of the year according to the business indicator relating to foreign orders.

4. Following two years of quite mediocre growth, real private consumption expanded by 1.7 p.c. during the year under review, while investment in housing also picked up. This strengthening of private spending in Belgium is all the more remarkable in that it occurred against the background of a very modest rise of 0.7 p.c. in households' real disposable income, primarily reflecting the limited rise in the total wage bill and the decline in property income, though on the other hand it benefited from the tax reforms of recent years. Overall, wavering consumer confidence therefore appears to have had less influence on spending than in preceding years, since, after rising for two successive years, the private savings ratio dropped by 0.8 percentage point in 2003.

5. After a steep fall of 2.7 p.c. in 2002, gross fixed capital formation by businesses showed a 2.2 p.c. expansion in volume terms during the year under review. At least the financial conditions for a recovery in investment were in place, with a marked improvement in operating margins and a less onerous debt position for Belgian firms in comparison with other European countries, as well as generally favourable external financing conditions. Throughout the year, the progress of business investment was rather irregular, however, probably indicating that lingering uncertainty over sales prospects and low capacity utilisation were still inhibiting the propensity to invest.

6. By resorting to flexible working arrangements, which have come into wider use in recent years, firms were able to moderate for some time the impact which the slowdown in activity had on jobs. However, the longer the weakness of economic activity persisted, the more its effects also became apparent on the labour market, prompting a sharp fall in employment from mid 2002 onwards, averaging around 0.4 p.c. in 2003. Taking the year under review as a whole, net job losses totalled 15,000, which was around 2,000 more than the previous year's figure. Since at the same time the labour force expanded sharply, by 31,000 persons, owing to the combined effects of the continuous rise in the population of working age and the increase in the activity rate – partly as a result of the measure obliging older unemployed persons to remain available on the labour market –, this led to an increase of 47,000 in the number of jobless persons, the biggest rise since 1993. Thus, in the space of two years, the harmonised unemployment rate has risen from 6.7 p.c. in 2001 to 8 p.c. in 2003. According to the harmonised European definitions, the employment rate in Belgium fell from 59.9 p.c. of the population of working age in 2002 to 59.5 p.c. in 2003. Although that rate is still around 2.5 percentage points higher than in 1997, the year in which the European employment strategy was launched, it remains significantly below the European average which – according to the latest available data – stood at 64.2 p.c. in 2002, with the gap in relation to the EU growing even wider in the past few years.

7. Following steep increases of 3.9 p.c. in 2001 and 5 p.c. in 2002, the rise in labour costs per hour worked in the private sector slowed to 2.1 p.c. in 2003. Thus, the course of those costs since 1996 has broadly kept in line with that in the three main neighbouring countries and in the euro area as a whole. In that respect, it cannot be said, however, that the trend in labour costs has so far helped to eliminate the jobs deficit in comparison with the European partner countries.

8. Since productivity in Belgium has risen more slowly than in the main neighbouring countries in the past few years, a growth differential of around 4 percentage points persisted at the end of the 1996-2003 period in terms of unit labour costs. However, owing to the cyclical rise in apparent labour productivity, unit labour costs did not increase any further during the year under

review, which helped firms to restore their operating margins. If that trend continues, it is a factor which may help to ensure that the revival in economic activity rapidly leads to the creation of more jobs.

9. The generally moderate rise in labour costs combined with the weak pressure of demand and the appreciation of the euro also helped to keep inflation at a low level in Belgium. In addition, a number of measures in the field of administered prices, such as the abolition or reduction of the television and radio licence fee, exerted temporary downward pressure on consumer prices. As a result, the annual rate of increase in consumer prices was just 1.5 p.c., slightly lower than the year before and 0.6 percentage point below the average for the euro area. However, without the exceptional factors mentioned, both the overall inflation picture and the underlying trend in inflation would have been much closer to those in the euro area.

10. Barring any unexpected shocks, the pace of growth can be expected to quicken in Belgium, too, as the international economy continues to recover. Provided that the country's main export markets expand sufficiently and competitiveness is not further impaired by a continuing appreciation of the euro, net exports are likely to deliver a modest but positive contribution to growth again. The rallying of profit margins, favourable financing conditions and the growing need for replacement investment could further encourage gross fixed capital formation, while private consumption will probably succeed in maintaining its current growth rate, supported by the rise in real incomes, the effects of the personal income tax reform and a gradual improvement in the labour market situation.

Monetary policy and financial stability

1. After five years of the euro, the common monetary policy has certainly been successful. Despite a highly uncertain economic and financial environment and successive price shocks, inflation has been kept in check, inflation expectations remained low and the new currency engendered considerable confidence. Viewed from the medium-term perspective taken by the Eurosystem in conducting its monetary policy, the monetary conditions for durable growth could therefore be maintained. Moreover, the credibility acquired by the European Central Bank (ECB) allowed interest rates to be reduced to a historically low level, so that monetary policy has made its own contribution towards stabilising economic activity over the past three years.

2. Although its monetary policy strategy proved generally apt, the ECB Governing Council did not want to ignore the controversy that it had sometimes caused, particularly in academic and financial circles but also in the macroeconomic dialogue with the European social partners. In May 2003, following an in-depth evaluation, the Governing Council therefore clarified two elements of its strategy which occasionally caused communication problems.

3. Thus, the Council confirmed the quantitative definition of the price stability objective, but at the same time stated that in the medium term it aimed to maintain the increase in consumer prices in the euro area close to the upper limit of 2 p.c. per annum announced in 1998. There were three reasons for spelling this out. First, the Governing Council wished to emphasise its intention to build in an adequate safety margin at all times as a protection against any risks of deflation. In a deflationary situation, there is a danger that monetary policy may become less effective as nominal interest rates cannot be cut below zero, whereas in such circumstances the central bank actually needs to be able to cut the real interest rate further in order to stimulate demand and combat deflationary pressures. In addition, tolerating low but positive inflation figures for the euro area as a whole limits the risk of persistently falling prices in some Member States, which

could have unwelcome consequences if certain prices and incomes display nominal downward rigidity. And finally, the Governing Council wished to take account of potential measurement errors in the index of consumer prices, caused in particular by the difficulty of allowing for the improvement in the quality of some products, so that true price increases may be slightly overstated. The monetary policy objective thus defined is actually in line with the interpretation which financial market participants had apparently already placed upon it.

4. The Governing Council also clarified the nature and scope of the two pillars on which it bases its assessment of the risks to price stability. The monetary analysis – which encompasses far more than a mere comparison of the growth of the broad monetary aggregate M3 against a reference value and also examines, for example, developments in the components and counterparts of broad money, such as lending – serves primarily as a means of assessing medium- to long-term inflationary trends and then comparing them with the short- to medium-term indications coming from economic analysis. To properly reflect this approach, the introductory statement made by the ECB President at the monthly press conferences has been restructured since May 2003. It now starts with the economic analysis, followed by the monetary analysis, and ends by cross-checking the two perspectives to arrive at an overall, coherent assessment of the risks to price stability.

5. In 2003, on the basis of this thorough analysis of all the available information, the Governing Council decided to continue the interest rate reduction process which had already begun. At its meetings on 6 March and 5 June the Council took the view that the persistently gloomy economic climate and the appreciation of the euro minimised the threat of inflation – albeit with no significant risk of deflation – and that the abundance of money, due mainly to a strong preference for liquidity induced by the financial turbulences, was not jeopardising price stability. The two interest rate cuts which the Council therefore decided to make, brought interest rates on the main refinancing operations down to the low level of 2 p.c. No further interest rate adjustments ensued because opposing factors meant there was no fundamental change in the outlook for prices : on the one hand, the burgeoning recovery and a degree of persistence in inflation could well lead to an upward revision in expected inflation; but on the other hand, the appreciation of the euro had a moderating though admittedly delayed effect on prices by reducing import costs and exerting downward pressure on prices in the sectors exposed to international competition.

6. The Eurosystem's monetary policy therefore helped to bolster domestic demand, as the real short-term interest rate had been reduced to zero. Such extremely low interest rates had not been seen in most euro area countries since the 1970s. In June 2003 long-term interest rates also reached a low point, but they have risen slightly since then, driven by the global improvement in growth prospects and deteriorating public finances, although remaining below the level of the preceding three years.

7. The low level of both short- and long-term interest rates has enabled firms to reduce their financial burden, many of them having contracted heavy debts in the late 1990s in order to expand their production capacity or to finance acquisitions. Thus, the reduction in interest charges and measures to save on other operating costs allowed firms to restore their profitability, which was reflected in rising share prices.

8. Thanks to the stock market recovery, financial institutions, and more particularly those which had invested heavily in equities, were able to make good part of the capital losses suffered in preceding years. Thus, in 2003 the insurance institutions were back in profit, while banks enjoyed a boost to their market activities. In the EU, however, where economic growth remained anaemic, the increase from this source of revenue only partly cushioned the stagnation in commission and interest income earned by credit institutions. In Belgium, for example, the banks' gross operating result declined for the third consecutive year, falling by around 2 p.c. during the first three quarters of 2003.

9. Nevertheless, Belgian financial institutions remained sound. Banks managed to maintain their solvency ratio at an average of 13 p.c. of their equity capital, well in excess of the minimum capital adequacy stipulated by the Basle Committee on Banking Supervision. According to the available partial data, insurance companies also managed to maintain their solvency in 2003. Moreover, the financial institutions further refined their internal risk management systems and made greater use of the various risk transfer instruments offered by the financial markets. However, these techniques do entail a cost, and that may weigh on the profitability of financial institutions. For instance, the narrowing of the Belgian banks' interest rate margin in 2003, occurring against the background of interest movements which tended to favour their intermediation activity, might be largely attributable to the transactions which banks arranged to hedge their interest rate positions.

10. This confirms that both the supervisory authorities and the market players themselves have a need for adequate information in order to assess the performance of the financial institutions in the context of the risks which they incur. This guiding principle is an integral part of the forthcoming new Basle capital accord, which provides for an individual approach to the risk profile of each bank and also urges the dissemination of reliable information so that market discipline can play its full role in safeguarding financial stability.

11. Both nationally and internationally, the dialogue with the financial market participants needs to be supported by proper coordination between the respective authorities. To that end, the institutional set-up for the supervision of the Belgian financial sector was recently modified. On 1 January 2004 the Banking and Finance Commission was merged with the Insurance Supervision Office to form the new Banking, Finance and Insurance Commission (BFIC). There will be close cooperation between the Bank and the BFIC, so that the Bank's key functions in the macroprudential supervision of the financial markets can be integrated more effectively into the overall framework of supervision. The Bank has also been given a coordinating role, which it performs primarily via a new Financial Stability Committee set up in 2003 and chaired by the Governor of the Bank. A protocol concluded between the Bank and the BFIC sets out the areas in which the two institutions will pool their resources in order to pursue certain activities jointly.

Challenges for economic policy in Belgium

1. The hesitant and at times stagnating activity of the past few years has inevitably taken its toll in Belgium, too, although its impact has been less acute than in some other European countries. The prudent macroeconomic policy and the efforts made in recent years to safeguard the restored budget balance have undoubtedly contributed to this. That rather favourable starting position must not be put at risk. The fundamental challenges are the same : how to safeguard the achievements of the European welfare state in an increasingly integrated global economy, and in the context of an ageing population? Everywhere there is a growing awareness that a spontaneous economic revival will not be sufficient : what the European economies need more than ever is fundamental reforms in order to enhance their growth potential and resilience.

2. Here and there, signs are emerging of growing willingness to add new momentum to the reform process, even if this means that sometimes difficult adjustments will be needed at first. Some European countries have already made substantial progress with the implementation of the Lisbon programme which, via growth initiatives and structural reforms, aims to make the European Union into a more dynamic and innovation-centred economy with a strong employment potential, while others have recently announced major new plans. It is therefore crucial that Belgium, too, maintains the necessary resolve to complete the reform agenda, which will require vigorous action on many fronts.

Labour market policy

3. The structural weakness that continues to afflict the Belgian labour market remains a major problem. It is therefore commendable that jobs are high on the list of priorities of the government's programme. Moreover, the national Employment Conference launched in the autumn of 2003 has given employers, unions and the federal and regional authorities the opportunity to make a thorough diagnosis of the employment issue, to investigate new angles for policy and to formulate a number of conclusions and policy recommendations. Among the concrete results of that conference there is the clear policy objective of creating an additional 60,000 jobs by 2007, through discretionary measures. Nevertheless, more will be needed to close the still widening employment rate gap compared to the European average, including, in particular, efforts to integrate both job-seekers and persons not economically active into the labour process, e.g. by providing suitable support and guidance plus training opportunities.

4. As a result of ageing, the population of working age will inevitably decline from 2010 onwards. If the current trends in labour market participation continue, that will also mean a substantially slower rise or even a fall in the labour force, with adverse consequences for future growth prospects and the sustainability of the social security system. If the currently under-used labour reserves are not increasingly mobilised, there is not only a clear risk that the limited labour supply will ultimately impede sustained economic growth, but also that the dependency ratio between the active and the non-active population may reach such proportions that it becomes very difficult to fund an adequate level of welfare provision.

5. Measures to avert and remedy structural unemployment, in particular, will consequently need to be supplemented by bringing in non-active persons and by measures to boost the activity rate of the over 55s. Some categories, such as non-European immigrants and young people with low skills, are still in a precarious position on the labour market, which hampers their integration into the regular workforce, and makes them more prone to unemployment than other groups. Nevertheless, in Belgium it is in the over 55 age group that non-participation is most acute, with only about a quarter still at work, compared to an average of 40 p.c. in the European Union. Sometimes, individuals deliberately choose not to participate, but the reason often also lies in the lack of adequate incentives, on both the demand and the supply side, for their lasting inclusion in the labour force. Thus, the existing tax and social legislation still contains a number of "inactivity traps" which often make it insufficiently worthwhile to continue working or to actively look for a job, and which dissuade firms from taking on or retaining certain categories of workers.

6. There is also more potential for job creation in the non-profit sector and household services, where – mostly for financial reasons – there is currently still a great deal of unsatisfied demand, or people tend to resort to undeclared work. The system of service vouchers devised by the government may provide a partial solution here.

7. It is also vital to improve the matching of supply and demand on the labour market. More flexible working arrangements and the development of appropriate social facilities may help to make it easier to combine working life with household duties and leisure, while offering firms the flexibility of adjusting their use of labour in line with fluctuations in their requirements. Measures which encourage the geographical mobility of workers and, more generally, make it easier to change jobs may help to absorb tensions on the labour market and limit the social impact of corporate restructurings, while also fostering the development of innovative activities. Furthermore, some population groups encounter difficulties in finding or keeping a permanent job. People seeking work therefore need appropriate support and follow-up, not only in the search for a suitable job but afterwards as well. Reducing social security contributions is one way of increasing the incentive for employers to take on workers from groups at risk. Finally, proper training, both through the education system and via occupational training programmes,

is essential in order to match the quality of the human capital with the ever higher standards demanded by the knowledge economy, and to maintain the employability and productivity of workers throughout their working lives.

8. Keeping labour costs within bounds remains important for the job-content of growth and to safeguard competitiveness and price stability. The reductions in social security contributions can play a role here, provided they are not used to increase wages, and so long as they are compatible with a fiscal policy stance that ensures the maintenance of sound public finances and the sustainability of the social security system. However, this does not detract from the need to contain wage increases.

9. The economy's production structure, investment expenditure and management quality are equally factors which determine business competitiveness. Nevertheless, in Belgium the cost aspect of competitiveness is firmly in the foreground, one reason being the relatively large weight of sectors which tend to operate as price takers on their markets. In the past, that led to strong pressure encouraging rationalisation, so that increases in labour productivity went hand in hand with staff cost reductions, achieved partly by shedding less productive workers. Without denigrating the need for sustained control over wage costs, greater emphasis on innovative activities in regard to both products and production processes, making it possible to penetrate knowledge-intensive or specialised market segments, could contribute towards relieving that pressure. For example, recent OECD surveys show that Belgium is still performing rather poorly in the production and use of information and communications technology (ICT). Although the share of the ICT sector in total value added generated by firms stood close to the OECD average in 2000, it was markedly lower than in some other European countries and especially the United States, with the gap being particularly pronounced for the industrial ICT sector. Internationally, Belgium also ranks low as regards the share of ICT in total business investment. Efforts to enhance the innovative capacity of the economy will have to be accompanied by the creation of an attractive climate for the employment of highly trained people.

Efficient markets, a business-friendly climate and the development of the knowledge society

10. By improving the allocation of factors of production, structural reforms on the goods and services markets augment economic efficiency and thus enhance the long-term growth potential of the economy as a whole, even though in the short term such reforms may entail adjustment costs. The further opening up to competition of the 'network' industries, the relaxation of provisions which inhibit the creation or expansion of businesses and the reinforcement of competition policy still represent a particular challenge, despite the undeniable progress achieved recently. More generally, a sufficiently strong competitive base needs to be created for both industry and the services sector.

11. Growth potential is also determined by the scale and quality of investments and the efficiency with which capital and labour are used in the production process. That is primarily a matter for the firms themselves, but the government can play a significant role by fostering a business-friendly climate, encouraging funding via venture capital, facilitating business start-ups, minimising the administrative burdens, introducing transparent and stable regulation, and guaranteeing a high quality service. In this regard, the financial sector also has a vital role to perform in ensuring an efficient allocation of the available financial resources. In particular, new and expanding businesses, which are generally dependent mainly on bank lending as a source of finance, must have ready access to the financial institutions.

12. To strengthen the supply side of the economy, it is also important to maintain an efficient public infrastructure and to step up the research and development effort. Belgian public investment has long been below the EU level, while spending on research and development, although slightly higher than the EU average, is still well short of the target of 3 p.c. of GDP set for 2010. That deficit is most acute in the case of government-funded research. The European growth initiative launched last year could provide an important stimulus here. Both the European Commission and the Member States are being encouraged to redirect the existing expenditure, concentrating on investment in the trans-European network infrastructure, innovation, research and development and human capital, and to make maximum use of private sector resources in funding these projects.

13. A dynamic and innovative economy is not possible without a strong enterprise culture. On this point, too, Belgium does not do really stand up to international comparison, as is evident, for instance, from the relatively low percentage of entrepreneurs in the population, and the low start-up ratio. Apart from the structural and institutional factors already discussed, socio-cultural factors play a decisive role in this respect. Entrepreneurship is primarily a question of mentality, requiring not just expertise, but also initiative, ambition and willingness to take risks. Widespread promotion of the enterprise culture in society, both via education and training and through various information channels and the media, could help to develop those attitudes, e.g. by providing training which offers practical experience, by encouraging creativity and innovation, by highlighting the social and financial benefits of successful enterprise and relieving the stigma of failure, and more generally by cultivating a positive attitude towards entrepreneurs.

Sustainable public finances conducive to growth

14. In comparison with other European countries, Belgium coped well with the effects on public finances of the prolonged weakness of economic activity. While the average budget deficit in the euro area grew from 0.9 p.c. of GDP in 2000 to an estimated 2.8 p.c. in 2003, the Belgian government budget ended in balance or with a small surplus for the fourth year in a row, last year the surplus being around 0.2 p.c. of GDP. However, that was only achieved thanks to the exceptional net result of non-recurring operations, such as the take-over of liabilities of the Belgacom pension fund, totalling some 1.5 p.c. of GDP. Accordingly, the government debt ratio fell by 5.4 percentage points in 2003 to reach 100.7 p.c. of GDP.

15. Although last year's budget outcome once again benefited from the downward trend in the interest burden on the public debt, the effect of that was more than offset by both cyclical factors such as higher unemployment expenditure and the shortfall in fiscal and parafiscal revenue, and structural factors such as reductions in fiscal charges and above-average growth in other primary expenditure, which came to around 2.8 p.c. at constant prices in 2003, against an average of 2.1 p.c. over the past ten years. This structural easing of fiscal policy is also evident from the movement in the primary budget surplus adjusted for cyclical effects and non-recurring factors; in 2003 that figure was estimated to have fallen by more than 1 p.c. of GDP.

16. In the present circumstances, there is no objection to a purely cyclical deterioration in the budget balance via the operation of the automatic stabilisers. Moreover, it is perfectly compatible with the Stability and Growth Pact, provided that during a subsequent cyclical upswing the same automatic stabilisers can operate to the full in the opposite direction. As economic growth gains momentum, it is therefore important to revert to the more ambitious consolidation targets outlined earlier, generating the structural surpluses needed to bring about a sufficiently rapid reduction in the public debt and to provide greater scope for coping with the expected financial repercussions of the ageing population.

17. Even though the budget targets were downgraded in the coalition agreement and the new stability programme, the aim now being to restore a surplus of 0.3 p.c. of GDP by 2007, strict budget discipline will still be required : assuming that revenues follow a normal pattern with no new measures, primary expenditure growth would need to be kept almost 1 percentage point below GDP growth. That will not be easy, remembering that in the past ten years – despite a determined effort at consolidation – growth of primary expenditure has slightly outpaced that of GDP. Furthermore, fiscal developments must be closely monitored and adjustments made where necessary, because in the case of a number of recent measures – corporation tax reform, regularisation of evaded taxes via a one-off declaration of financial assets, tighter fraud control – the exact impact on the budget is not known in advance.

18. In addition, the government programme states that expenditure on health care can increase by 4.5 p.c. per annum at constant prices over the next four years, which is faster than in the past, since the average rise has been around 3 p.c. per annum over the past decade. In the longer term, such strong expansion cannot be maintained without jeopardising the essential consolidation of public finances, especially as the course now adopted is liable to increase still further the overall cost of the ageing population. Additional efforts must therefore be made as soon as possible to control costs and upgrade efficiency in the health care sector.

19. The quality of government intervention is an increasingly decisive factor in competition, as an efficient government goes hand in hand with good economic performance. It is therefore important to seek ways of activating the powerful levers available to the government, within the budget limits, to stimulate the growth potential of the economy : public investment in infrastructure, encouragement for research and development, taxes and social security contributions which are more conducive to employment and investment and, more generally, an unremitting effort to enhance the quality and efficiency of public sector services.

20. The challenges facing the policymakers are therefore considerable. Further budget consolidation and debt reduction remain essential to create sufficient scope in time to safeguard the prosperity and social protection of the population as ageing progresses. The first requirement for achieving that consolidation is to find a prompt substitute for the substantial one-off measures which, in view of the effects of the cyclical downturn, were included in the 2003 and 2004 budgets. In addition, it will be vital to ensure that public finances derive maximum benefit from the expected upturn of the Belgian economy as the international recovery unfolds. But the overriding concern must be to create a firmer structural base for the consolidation of public finances in the coming years, which will only be possible if the growth potential of the economy is durably augmented. None of this can be achieved unless significant progress is made in closing the gap in terms of the employment rate. To that end, there is a greater need than ever for a future-oriented, broad social project, supported by all interest groups in society and all levels of policy-making.

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