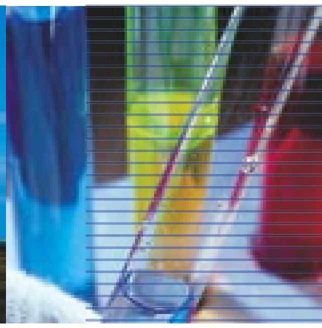
Economic Review

1 - 2005



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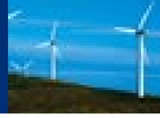

The global and european economic context

1. For much of 2004, the world economy was driven by strong dynamics, supported mainly by the sustained expansion of activity in the United States and the emerging Asian economies, where China is steadily securing a more prominent place, and by a noteworthy if still hesitant recovery on the part of the Japanese economy. In the euro area, too, the recovery was taking root, although it remained heavily dependent on external demand.

2. The main forces driving global economic growth – which, at around 5 p.c., reached its highest level in three decades – were the continuing expansionary policy mix in many parts of the world, the on-going improvement in the financial position and profitability of firms – which, combined with favourable financing conditions, stimulated their investment activity – and a revival in private spending, encouraged partly by wealth effects and brighter labour market prospects. At the same time, a strong expansion of international trade flows occurred, a sign of the current acceleration in the process of economic globalisation.

3. However, it gradually became clear that this rapid expansion of the world economy also harboured the seeds of various imbalances which were likely to reduce its vigour.

4. One of the most striking factors in this respect, has undoubtedly been the continuing rise in the prices of crude oil and other commodities. Since the growth of world demand for oil clearly exceeded expectations, while there were doubts about the oil producing countries' ability to adjust their production capacity, oil prices long remained subject to strong upward pressure, which was further reinforced by concerns regarding the stability of supplies owing to the geopolitical tensions in the Middle East and tight commercial oil stocks in the industrialised countries.

5. Although in US dollar terms oil prices reached an all-time high in October 2004 – at over 50 dollars for a barrel of Brent crude – and on average were 33 p.c. higher than in 2003, the macroeconomic impact of this shock bears no comparison with that of the oil crises which occurred in the 1970s. In real terms, i.e. taking account of the rise in the general price level since then, current oil prices are barely half as high as they were at the end of the 1970s. Moreover, in the industrialised countries, the oil-intensiveness of production has been almost halved since then. And finally, monetary policy proves to be far more effective now in anchoring inflation expectations, thus considerably reducing the risk of a run-away price-wage spiral. Nonetheless, the increase in oil prices has put a damper on household purchasing power and corporate profitability wordwide, and has impaired confidence in the sustained growth of activity.

6. Another source of increased concern was the persistence and even worsening of the external imbalances in the global economy, the most notable instance being the United States, where the current account deficit has now risen to 5.7 p.c. of GDP. Growing doubts about the ease of financing that deficit, particularly via the accumulation of dollar reserves by foreign central banks, caused the dollar to fall further on the international currency markets, particularly against the euro. Taking the year as a whole, the weighted effective exchange rate of the dollar averaged around 7.3 p.c. lower than the previous year, while the bilateral depreciation against the euro exceeded 9 p.c.

7. Both the size of the global current account imbalances and the way in which they are being financed entail latent risks to international financial stability. It is therefore important that all countries and regions concerned should step up their efforts to bring about a gradual, orderly correction of those imbalances. In order to avoid misalignments and excessive volatility on the currency markets, exchange rate adjustments ought to be spread more evenly, which implies in particular greater exchange rate flexibility on the part of the emerging Asian economies. In the longer run, that would also be in their own interest, as a nominal appreciation of the Asian currencies may help to curb inflationary pressure in these fast-growing countries and give monetary policy more scope for absorbing internal shocks. For the United States, the main challenge consists in redirecting the economy towards a more balanced growth path, which implies inter alia a higher domestic savings ratio. During the year under review, the Federal Reserve had already begun gradually adjusting its monetary policy stance towards a more neutral position on interest rates. However, it is mainly the structurally high budget deficit, which – at 4.4 p.c. of GDP – is by far the most significant domestic counterpart to the US current account deficit, that will need to be brought down. Finally, the primary task facing Europe and Japan is to boost their growth potential through structural reforms, thus helping to reduce the growth differentials in relation to other regions of the world.

8. Preliminary estimates indicate that GDP growth in the euro area came to around 1.8 p.c. last year, against just 0.6 p.c. in 2003 and 0.9 p.c. in 2002. For the first time in several years, the initial growth projections therefore came true. However, this relatively favourable result was primarily due to the fact that the euro area benefited from a stronger than expected expansion of foreign demand, especially in the first half of the year. After having contracted for two years, corporate investment also recovered, bolstered by the improved outlook for sales and profitability, and by historically low interest rates. In contrast, growth dynamics did not feed through to private consumption as expected, or at least the picture varied greatly from one country to another. The lack of noticeable improvement in the labour market situation, combined in some countries with strict wage moderation, generally inhibited the growth of households' real disposable income, while energy price increases and higher indirect taxes also curtailed purchasing power. Moreover, in a number of countries, high or rising budget deficits went hand in hand with a high or rising household savings ratio, which may point to consumers' concerns about the sustainability of the social benefits and replacement incomes provided by the government.

9. Owing to the relative weakness of demand and the continuing under-utilisation of production capacity, combined with generally modest wage rises and essentially cyclical productivity increases, domestic pressures on the price level remained muted. As elsewhere in the world, the surge in energy prices nonetheless rekindled inflation, although its impact was attenuated by the further appreciation of the euro. At the end of the year, HICP inflation in the euro area thus stood at 2.4 p.c., against 2 p.c. a year earlier.

10. The deterioration in budget positions seen since 2001 against the background of the cyclical downturn continued in 2004 despite the firming of economic growth. The average budget deficit in the euro area came to almost 3 p.c. of GDP. This trend is worrying in more than one respect. A growing number of euro area countries currently exhibit an " excessive " budget deficit of more than 3 p.c. of GDP, or are getting close to this upper limit set by the Maastricht Treaty. Indeed, some Member States only managed to avoid exceeding this threshold by making extensive use of one-off measures. More generally, in most of the Member States contending with serious budget imbalances, there were few if any signs that the required structural consolidation of their public finances was progressing.

11. The basic principle underlying the Stability and Growth Pact, namely that a monetary union in which fiscal policy remains a national matter requires a clear and enforceable framework that ensures a reasonable level of budget discipline in each of its members, is as valid as ever. In some respects, the Pact has undeniably played a role : budget deficits have been lower than in the past, and a number of smaller countries have been encouraged to persevere with the consolidation of their public finances. In other cases, however, insufficient use was made of the vigour of the economy during the initial years of EMU to achieve an enduring strengthening of the underlying budget positions. As a result of these divergent budget trends, the effective, joint implementation of the Pact has been put to a severe test. In itself, the European Commission's recent initiative which aims at strengthening economic governance and clarifying the implementation of the Pact is therefore welcome. Certain proposals currently under discussion, such as greater emphasis on the need to pursue budget discipline in good times as well, and to place more focus on the sustainability of public finances in the surveillance of budgetary positions, as well as measures encouraging the timely and reliable reporting of the required government finance statistics, are certainly appropriate. However, others which aim in particular at a more flexible or differential interpretation and application of the rules and procedures, on the basis of country-specific economic or budgetary positions, should be treated with extreme caution. Indeed, complex rules which lack transparency are liable to give rise to endless discussions and may impede a fair, equal treatment of the individual Member States, with the obvious risk of further diluting the political acceptance of a common regulatory framework.

12. A rapid return to budgetary discipline is necessary not only to ensure the smooth functioning of monetary union, but even more so to arm the Member States better against the effects of population ageing and the challenges of global economic integration.

13. As regards that other key pillar of European economic construction, the Lisbon agenda of reforms to promote growth and employment, the actual achievements also often fall short of the ambitions, even though these were widely endorsed. Hitherto, the Lisbon strategy may perhaps have been too broad and fragmented, so that it tended to lack political backing. It would therefore be advisable to concentrate the efforts first on its two core objectives. While the past few years of weak economic growth and increasing budget difficulties may not have been conducive to the energetic implementation of structural reforms, these setbacks certainly do not offer any excuse for watering down the aspirations in this respect, since Europe's lack of economic dynamism is precisely one of the reasons for its relatively weak performance, and global competition is certainly not waning. Successful implementation of the Lisbon strategy also requires stronger political commitment, based on a consensual, coherent and result-oriented approach, with the population being given transparent information on both the targets and the actual achievements. National action programmes in which the Member States set out clear and specific commitments concerning the necessary labour, product and capital market reforms, and greater emphasis on the multilateral benchmarking of national performance, can help to reinforce the involvement and accountability of the policy-makers for implementing the Lisbon strategy.

The economic situation in Belgium

14. After more than two years of lacklustre activity, the cyclical upturn which started in the second half of 2003 gathered momentum during the year under review. On average, GDP growth is estimated to have roughly doubled, from 1.3 p.c. in 2003 to 2.7 p.c. in 2004, supported mainly by the buoyancy of domestic demand. For the second year running, Belgium's GDP growth has thus significantly outstripped the figure for the euro area as a whole.

15. In the past, such a more marked cyclical profile has not been that unusual, generally because the Belgian economy – in view of its open character and specific production structure – tends to be more sensitive to fluctuations in foreign demand. In the current cycle, too, the expansion of foreign demand proved to be a crucial factor driving the upturn, as is evident from the acceleration in export growth from 1.7 p.c. in 2003 to 6 p.c. in 2004. Nonetheless, the persistent weakness of domestic demand in some of Belgium's immediate neighbours and the appreciation of the euro, particularly against the dollar area, did curtail export growth somewhat. As in quite a few other euro area countries, export growth in Belgium has lagged behind the expansion of world trade in recent years, largely because of a geographical structure effect, as the most dynamic regions in the global economy were not among the main markets for Belgian exporters. However, since the start of the century Belgium has also lost around 6.5 p.c. to cost competition in relation to a large group of industrialised countries, in particular against countries outside the euro area as a result of the appreciation of the euro. Finally, in comparison with some neighbouring countries, and especially Germany, the export sector's product mix also seems to have placed Belgium at a disadvantage, in that investment goods and particularly ICT-related products, for which there was strong global demand, are relatively under-represented. Boosted by both exports and domestic demand, the volume growth of imported goods and services has also accelerated. In the past two years, imports have actually grown faster than exports so that, on balance, foreign trade made a slightly negative contribution to real GDP growth of around 0.3 percentage point per year.

16. In contrast, the dynamism of domestic spending and particularly private consumption, which grew by around 2.1 p.c. in volume terms for the second successive year, was all the more remarkable. Not only are these figures significantly higher than those recorded in the rest of the euro area, where consumption growth in both years barely exceeded 1 p.c., they are also well in excess of the rise in households' real disposable income, which has averaged less than 1 p.c. per annum in Belgium over the same period. This rather meagre rise in purchasing power was mainly the reflection of subdued employment growth and modest increases in average wages and salaries. The relatively strong growth of private consumption therefore stemmed from households' lower propensity to save : over the last two years, their savings ratio has fallen by 2.3 percentage points to 14.2 p.c. of disposable income in 2004. As in the past, and in contrast to the opposite trend seen in various other European countries, that fall appears to be associated with the on-going fiscal consolidation and public debt reduction in Belgium, which, combined with the progressive implementation of the tax reforms, are obviously prompting households not only to gear their level of spending to their current disposable income, but also to allow for better income prospects in the future. There are therefore strong indications that the continued consolidation of public finances is producing tangible benefits and is one of the reasons why Belgium is currently outperforming many of its European partner countries in economic terms.

17. An improved outlook for profits and sales and a favourable financial climate, featuring very low interest rates and rising share prices, also created the conditions for firms to step up their capital formation : after two years of contraction, investment growth was estimated at 1.5 p.c. in 2004. Government spending and investment constituted another factor underpinning growth.

18. Since the second half of 2003, employment has also maintained an upward trend : over 2004 as a whole, net job creation is put at around 31,000 jobs, representing a rise of 0.7 p.c. Nonetheless, employment growth still lagged behind the expansion in activity. However, that is not uncommon, since – during an upturn in the cycle – firms first make more intensive, more productive use of their previously under-used labour reserves, and it is only at a later stage that they start recruiting new workers. At the same time, however, the labour supply also continued to expand strongly, driven by both structural factors, such as the increasing participation of women in the labour market, and a cyclical component. On balance, this resulted in a further increase of around 38,000 in the number of persons unemployed. Since mid 2003, the year-on-year increase in unemployment had been falling steadily, but in the last quarter of 2004 it edged back up, bringing the harmonised unemployment rate to about 9 p.c. of the labour force, against 8.5 p.c. at the end of 2003.

19. The wage moderation called for by the December 2002 central agreement for the period 2003-2004 has generally been duly respected. The average real rate of increase in agreed wages was estimated at 0.4 p.c. in 2003 and 1 p.c. in 2004. Taking account of indexation, the nominal increase was 1.8 and 2.4 p.c. respectively, representing 4.3 p.c. over the two years, whereas total hourly labour costs – which also include " wage drift " and social contributions – would have risen by 5.4 p.c. over the same period. Nonetheless, since the entry into force of the law of 1996 on the promotion of employment and the safeguarding of competitiveness, hourly labour costs appear to have increased by more in Belgium than in the three main neighbouring countries and the euro area. In terms of unit labour costs, i.e. if the relative movement in productivity is taken into account, the cumulative difference in relation to the three neighbouring countries came to a good 4 percentage points according to the OECD figures now available.

20. Yet it cannot be alleged that the aim of keeping labour costs under control has been of little avail. As is evident, inter alia, from the fall in the share of wages in total value added, it did give firms more scope for improving their operating results and balance sheet positions, which in turn can encourage investment and job creation and help to ease the upward pressure on selling prices.

21. Indeed, in this last respect it is notable that, in contrast to headline inflation, which – primarily as a result of higher energy prices – rose from 1.5 p.c. in 2003 to 1.9 p.c. in 2004, the underlying trend in inflation, which disregards adjustments to administered prices and changes in the prices of energy and unprocessed food, actually decelerated markedly, from 2 p.c. in 2003 to 1.5 p.c. during the year under review. Apart from the subdued pressure of demand and the gradual pass-through of the euro appreciation, the moderate level of wage cost increases was a contributory factor here.

22. The revival in activity and the generally strong improvement in corporate profits – following an increase of 6 p.c. in 2003, the gross operating surplus of companies is estimated to have risen by around 9 p.c. during the year under review – have undoubtedly contributed to the stock market rally in Belgium in the past two years. In 2004, with stock prices rising by an average of 36.5 p.c., the shares listed on Euronext Brussels performed significantly better than in the euro area, where the average price rise was only 10.5 p.c. However, this surge in Belgian share prices partly reflects some catching up, following the relatively modest performance of the preceding years, as is evident from the price-earnings ratios which were still well below the European average at the beginning of 2004.

23. Encouraged by the improved stock market climate, Belgian individuals proceeded to make net investments in shares once again last year, for the first time since 1998. Nonetheless, they continued to show a marked preference for low-risk, liquid investments. There are also indications that Belgian residents have repatriated substantial amounts of financial assets from abroad, partly under the tax amnesty offered in the form of the " one-off declaration of financial assets ", but perhaps mainly in anticipation of the entry into force of the European savings directive, scheduled for mid 2005. Part of the repatriated funds may also have been used for consumption or investment purposes, thus contributing to the buoyancy of private spending observed of late, although that is difficult to measure.

Monetary policy and financial stability

Monetary policy

24. Throughout the year under review, judging by the risks to price stability as they appear from a detailed analysis of economic and monetary developments in the euro area, the ECB Governing Council considered that the interest rate for the Eurosystem's main refinancing operations, which has stood at the historically low level of 2 p.c. since June 2003, remained appropriate. The Council was of the opinion that the medium-term inflation outlook remained in line with the ECB's definition of price stability, while the low level of interest rates underpinned the recovery in economic activity which started in the second half of 2003. However, as the year progressed, the Governing Council became more vigilant : although the most likely scenario for the future was still an increase in consumer prices of less than 2 p.c. per annum – the upper limit of the definition of price stability –, the upside risks in fact appeared to have increased.

25. These risks emanated from a number of new price shocks which pushed current inflation above the 2 p.c. threshold again from May 2004, falsifying earlier forecasts and causing inflation expectations to increase somewhat, as well as from the very accommodating monetary conditions in the context of an economic recovery phase. However, relatively muted domestic demand pressures, restrained wage developments and the appreciation of the euro provided a counterbalance.

26. The main price shocks confronting the euro area in 2004 were the oil price hike and the increases in indirect taxes and administered prices in various countries. In particular the oil shock, which to some extent could be regarded as permanent in view of the structurally higher demand from emerging economies, was worrying in that it was likely to push up prices and depress economic activity, albeit to a lesser extent than in the 1970s. A central bank cannot prevent higher energy costs from having some adverse effect on the supply side, nor can it alter the fact that the deterioration in the terms of trade depletes the oil-importing countries' real income. Similarly, it cannot prevent higher oil prices from having a direct impact on consumer prices for energy products. In fact, the necessary adjustment to relative prices, on the basis of the energy content of the various goods and services, should be allowed to proceed unhindered. Conversely, monetary policy must see to it that the medium-term inflation expectations remain firmly anchored, so that economic agents do not resort to nominal increases in an attempt to compensate for the real income losses due to the deterioration in the terms of trade, as that would trigger a damaging price-wage spiral. The risk of such second-round effects clearly depends on the economic and social context, as well as on the credibility of the central bank. Hence, the spontaneous weakening of demand caused by the oil shock and the realism prevailing in wage bargaining may be sufficient to contain the pressure on prices. In 2004 the Governing Council considered

the risk of such second-round effects to be fairly low in a climate of wage restraint and under-utilisation of production capacity, and in view of continuing high unemployment, though the Council stressed that it would remain especially vigilant in that regard.

27. In 2004, monetary conditions were particularly accommodating, as is evident from the negative real short-term interest rates and abundant liquidity, while the euro area economy was already picking up. Admittedly, the assessment of monetary developments has been complicated since economic and financial uncertainty is causing economic agents to show a clear preference for liquid assets. Following the setbacks that they have had to absorb on the equity markets, private investors may remain risk-averse for some time yet. However, the renewed acceleration in the growth of the broad monetary aggregate M3, apparent since June 2004, seems to be attributable primarily to the low level of interest rates, and has been associated with a strong surge in lending to households – so that property prices in some countries continued to soar – and with a gradual recovery in lending to non-financial corporations. The monetary analysis therefore indicated a need for vigilance in regard to potential excess spending. Against the background of the modest recovery in activity, however, no immediate response was warranted.

28. Apart from the fact that, as a result of hesitant domestic demand, the economic expansion remained fairly subdued and implied some persistent capacity under-utilisation, the euro's appreciation at the beginning and the end of the year under review also tempered the upside risk to prices. In December 2004 the effective euro exchange rate was 7.2 p.c. above the 2003 average. That was due mainly to the depreciation of the US dollar and of the currencies which are linked to it in varying degrees, while the exchange rate of the euro was more stable against the yen and the other EU currencies, three of which joined the European exchange rate mechanism in 2004. While the euro had been clearly undervalued in 2000 and 2001, that was certainly no longer the case in 2004. In view of the extent to which the euro has already appreciated against the dollar, it is difficult to maintain that the exchange rate still hampers a gradual correction of the United States current account deficit. However, it is important that this adjustment process should take place without excessive volatility or disorderly movements in the exchange rates.

29. Having weighed up all these factors, the ECB Governing Council decided to keep interest rates at their very low level in 2004, thus helping to strengthen the economic recovery without endangering the maintenance of price stability.

Financial stability

30. In 2004, strengthening economic growth created a more favourable climate for maintaining financial stability. Since the recovery had little impact on prices, fears of an increase in long-term interest rates receded during the year. These positive factors contributed to the good performance of the financial markets, as the firming of equity and bond prices was accompanied by lower volatility and a reduction in risk premiums.

31. In that context, Belgian credit institutions saw a substantial improvement in profits. On the expenditure side, provisions for bad debts declined as a result of the improved financial position of borrower companies, while – as in preceding years – the banks continued their efforts to keep control over the growth of their operating expenses. However, the turnaround was most striking where earnings were concerned. Banking proceeds, which had fallen in both 2002 and 2003, increased by almost 5 p.c. in the first nine months of 2004. Interest earnings and income from commission fees and banking services were both up as a result of the expanding volume of activity, though the adjustments made by credit institutions to the pricing of a number of bank products were also a factor. This higher profitability, combined with a solvency ratio which remained well above the average for the other EU countries, is helping to make the Belgian financial sector more resilient to economic fluctuations or market changes.

32. As in many other European countries, real estate prices in Belgium have come under upward pressure in recent years. With annual increases running at 7 to 8 p.c. for existing dwellings, Belgium has an intermediate position in Europe. From a macroeconomic point of view, this development has given little cause for concern so far, as the capital gains made by individuals on their properties were offset by the capital losses incurred in previous years on their equity portfolios. Unlike in some other countries, there were also few signs that Belgian home owners are cashing in on those gains by incurring higher levels of debt against the collateral of their properties.

33. However, as the strong dynamism of property prices was partly generated by the decline in interest rates, it could be reversed if credit terms were to become more expensive again. Since borrowers have recently shown a marked preference for variable rate loans, such an interest rate hike would have an even greater impact on their repayment burden. Any reversal in the trend in interest rates also entails other risks: the associated shifts in investment portfolios could have an impact on exchange rates, for example, while certain categories of market operators which, like hedge funds, rely to a great extent on financial leverage effects, could see their balance sheet position weakened.

34. Controlling those interest rate risks is also extremely important for Belgian banks and insurance companies since they maintain substantial bond portfolios. Most of those securities are currently still recorded at their acquisition cost, but once the international IFRS accounting rules are introduced for the consolidated accounts of credit institutions and insurance companies, not only the bulk of their securities portfolios but also various other asset and liability items, or items currently recorded "off balance sheet", will have to be stated at the fair market price. In the event of an interest rate hike, this change could prompt financial institutions to dispose of part of their securities portfolio, thus exacerbating the downward pressure on financial market prices. The new Basel II accord on solvency requirements for banks – finalised in June 2004 and taking effect on 1 January 2007, except in respect of the most sophisticated option, which is scheduled for introduction on 1 January 2008 – could have similar effects on market liquidity. Since the capital requirements will henceforth need to be tailored more closely to the risks actually incurred by credit institutions, this system could mean that the banks will adapt their balance sheet structure more swiftly to changes in the economic or financial situation. The supervisory authorities need to maintain a particularly vigilant watch for such potential effects on the liquidity of financial markets.

35. This simultaneous introduction of new standards and rules also represents a challenge for the prudential supervision authorities, whose institutional structure was recently modified by the merger of the Banking and Finance Commission and the Insurance Supervision Office on 1 January 2004. During the year under review, the new Banking, Finance and Insurance Commission and the NBB, under the auspices of the Financial Stability Committee, formulated recommendations designed to make the Belgian financial infrastructure more resistant to events which could endanger the continuity of operations. When assessing the stability and structure of the Belgian financial sector in general, those authorities will soon be able to refer to the report on the IMF mission currently in progress under the Financial Sector Assessment Program, which the IMF is gradually conducting in all the member countries.

The challenges of globalisation and population ageing

36. The fact that the Belgian economy has performed relatively well in recent years is certainly encouraging, but there can be no room for complacency in view of the major challenges presented by an ageing population and the increasing pressure of international competition, both in Europe and elsewhere.

37. Recent estimates by the European Commission indicate that the trend growth potential of the Belgian economy – some 2.1 p.c. in 2000-2004 – broadly corresponds to the euro area average (2 p.c.). Moreover, in both cases potential growth has hardly changed since the mid 1990s, in contrast to the United States, for example. For the time being, and all things being equal, there is therefore little to suggest that economic growth in Belgium could be maintained much above that level for any length of time. On the contrary, long-term projections indicate that, in future decades, population ageing and the associated contraction of the available workforce could put downward pressure on potential growth, while the dependency ratio between the non-working population and those at work will actually increase, and the rising pension entitlements and care requirements of an ageing population will absorb considerably more public funds. These foreseeable developments might still be kept under control if more people could be brought into the labour process in time, in the first place by employing the current job seekers and subsequently by getting people to continue working longer.

38. At the same time, the accelerating pace of international economic integration – striking examples are the rapid advance of China and the enlargement of the European Union to include Central Europe – is drastically altering the environment in which the Belgian economy operates. On the one hand, new growth markets are being opened up, offering additional potential outlets for exporting firms, while imports of cheaper products from those countries are freeing up purchasing power for spending on other goods and services. On the other hand, the globalisation of the economy and the associated pressure of competition are forcing all industrialised economies to engage in a process of " creative destruction ", which implies both opportunities and threats. The key factors which will ultimately tip the scales are the dynamism and adaptability of all the economic players concerned, in the first place businesses and their workers. By an appropriate flanking policy of structural reforms, the government and the social partners can nevertheless ease that adjustment process, first by creating a favourable framework for change and secondly by helping to reduce the inevitable economic and social adjustment costs entailed.

39. There is a great deal at stake, namely the preservation of a high standard of living and an efficient welfare system. Belgium undoubtedly has a number of assets for meeting those challenges, such as a well educated, highly productive workforce, a sound financial system and strong roots in a European economic union noted for its stability. Somewhat paradoxically, a number of its present weaknesses, such as the low utilisation of the available labour potential and the size of its public debt, leave room for improvement and hence could be turned to advantage. Despite the efforts that have already been made in past years, there are signs of some reform fatigue and dwindling of the social consensus to achieve further significant progress down the same road. It would therefore be expedient to incorporate what has been achieved and what remains to be done in a clear and coherent long-term strategy, while providing the population with accurate and transparent information on both the extent of the impending challenges and the social choices which must be made in order to cope with them. The key tasks facing Belgium lie in three main areas : (1) establishing sound and sustainable public finances which can absorb the budgetary impact of an ageing population, (2) boosting the economy's growth potential through

innovation and raising productivity, and (3) implementing an active labour market policy aimed at augmenting the quality and quantity of the labour supply and increasing the employment rate.

Maintenance of sound, sustainable public finances

40. 2004 was the fifth successive year in which the general government account ended in surplus or close to balance : following a small surplus of 0.4 p.c. of GDP in 2003, a zero balance was recorded for 2004. The prudent fiscal policy pursued in recent years also permitted a steady reduction in the government debt ratio. At the end of 2004 the figure was down to 95.6 p.c. of GDP, bringing it well below 100 p.c. of GDP for the first time since 1982.

41. These favourable results, placing Belgium in the front rank in Europe, nonetheless conceal a number of developments which call for increased vigilance. In the past two years, one-off measures representing quite substantial amounts – 1.5 p.c. of GDP in 2003 and around 0.7 p.c. in 2004 – were needed to square the budget. In some cases, these measures not only generate an immediate budget income, but also entail additional future expenditure. Furthermore, in recent years the Belgian government has been able to make significant savings on its interest charges, partly as a result of the downward trend in the public debt ratio, but largely because of the reduction in the implicit interest rate on its debt, due to the decline in interest rates on the money and capital market. However, this financial bonus, which should not be considered permanent, was not used to strengthen the budget balance, since its effect was neutralised by a steady fall in the primary budget surplus, down from around 7 p.c. of GDP at the turn of the century to 4.7 p.c. of GDP in 2004. Moreover, only a small part of the latter decline can be attributed to less favourable economic conditions, as the cyclically adjusted primary balance has also fallen sharply, indicating an easing of fiscal policy. Yet in the medium term, a sufficiently large and structurally sound primary surplus is one of the basic requirements for a fiscal policy aimed at sustainable public finances.

42. Continuing debt reduction is indeed of the essence in order to create the scope for absorbing the budgetary cost of an ageing population in the years ahead. In its latest report, the Study Group on Ageing assessed that budgetary impact at around 3.4 percentage points of GDP by 2030; this estimate being based, inter alia, on the assumption that the volume growth of health care expenditure would decline from the budget figure of 4.5 p.c. per annum in 2004-2007 to an average of 2.8 p.c. thereafter, which is around half a percentage point lower than the growth rate recorded in the past decade, and that the employment rate would rise by about 7 percentage points between now and 2030 ; two assumptions whose fulfilment will be no sinecure. On the basis of these projections, the High Council of Finance mapped out the budget course required to cater for these additional ageing costs, which in practice means that structural budget surpluses must be gradually built up, rising to 1.5 p.c. of GDP in 2011. In this way it would also become possible to provide for structural financing of the Ageing Fund, whereas the resources accumulated so far have originated almost exclusively from one-off non-fiscal receipts. Under the new stability programme submitted by the government at the end of 2004, that consolidation strategy is already underpinned by the declared intention to achieve another balanced budget in 2005 and 2006 and to move to a surplus of 0.6 p.c. of GDP by 2008.

43. Nonetheless, attainment of these intermediate targets will demand strict budgetary discipline, in view of the fact that the 2005 budget once again incorporates some non-recurring measures, and some other measures which have already been decided or announced will impose an even greater burden on the government accounts from 2006 onwards. The resources needed to cater

for contingencies, such as the recent overspending of the health care budget or an unexpected increase in interest rates, not to mention funding for further tax cuts or additional expenditure, will therefore either have to be found elsewhere within the tight budgetary margins, or be generated by a higher trend rate of economic growth, to which the government can also contribute.

44. A successful fiscal policy presupposes close coordination between the various levels of government, especially between the federal government and the communities and regions. Hitherto, that coordination has been based primarily on cooperation agreements between the authorities concerned, the latest one – which dates from December 2000 and has several times been updated – being due to expire shortly. It is therefore of the utmost importance that the new round of negotiations setting the budgetary framework for the period 2005-2011 should be brought to a conclusion as quickly as possible, resulting in clear and equitable arrangements regarding the allocation of the required overall budgetary efforts.

Boosting the economy's growth potential

45. In comparison with the United States, the growth profile of Europe – and more particularly Belgium – has long been characterised by a relatively low utilisation of labour. Up to around the mid 1990s, that handicap was largely offset by more substantial productivity gains than in the United States, reflecting an increasingly capital-intensive production process. Since then, however, productivity growth in Europe has slowed down, in contrast to the notable acceleration in productivity seen in the United States. In part, that divergence may be due to the wage moderation and labour market reforms which were implemented in the EU in order to heighten the employment intensity of growth and to curb the substitution of capital for labour. In so far as earlier distortions in European growth dynamics were thereby reversed, this trade-off between employment and productivity growth should be regarded as a temporary adjustment phenomenon which need not have implications for longer term growth potential. However, quite a few analyses suggest that Europe's growing productivity gap is caused by deeper, structural factors. Though there are some notable exceptions, EU Member States generally appear to be far less capable than the United States of pushing back technological frontiers and – mainly owing to of all kinds of market rigidities – are less able to take advantage of the opportunities offered by the application and diffusion of new technologies, particularly in the field of information and communication (ICT).

46. More than in the past, productivity growth will therefore have to come from innovation and enhanced versatility, so that the existing factors of production – capital and labour – can be combined with maximum efficiency and directed to those activities which offer the greatest potential for creating economic wealth in the future, taking into account the increasing competition from new players on the world market.

47. A key challenge facing the industrialised countries therefore lies in concentrating on those economic activities and aspects of the production chain where they can assert a clear comparative advantage. Belgian industry has both strengths and weaknesses in this respect. For instance, it boasts one of the highest productivity levels in the EU: despite the expansion of the service sector, the considerable productivity gains achieved in the past have made it possible for activity growth in industry to keep pace with that in the economy as a whole, and to outstrip the growth rates observed in the large European countries. Although industry in the strict sense has seen its direct share in total value added and employment fall steadily over the past thirty years, to around 17.5 and 14.5 p.c. respectively, this sector continues to play a crucial role in

the Belgian economy. For example, industry accounts for the major part of Belgium's substantial current account surplus with the rest of the world, and is responsible for more than 80 p.c. of firms' expenditure on research and development. Moreover, through spin-offs in engineering, consultancy and data processing, and by increased outsourcing of non-core activities, such as transport, maintenance of production facilities, accounting and wage administration, industry is generating growing numbers of jobs in the market services sector, mainly in the business services branch. In 2000, the number of jobs thus created already totalled over 275,000 or around one-sixth of total employment in the market services sector. With its traditional focus on semi-finished products, which have rather low added value, and the relative under-representation of the ICT sector, Belgian industry nevertheless has to contend with a rather unfavourable starting position in international competition. At the same time, modern information and communication technology is permitting significant productivity gains in the service sector, too, where international competition is also growing rapidly. In order to enhance its future growth potential, Belgium will therefore equally have to rely on the development of new, high added-value services.

48. In view of these growing synergies between the industrial and service sectors, Belgium, perhaps even more than other countries – requires a broad, cross-sectoral strategy encouraging innovative investment and the commercialisation of advanced technology products and services, and offering optimum stimulus for research and development – to which, according to the Lisbon objectives, countries should devote around 3 p.c. of GDP by 2010. Such a strategy of delivering favourable framework conditions entails, inter alia, the establishment of synergies between research entities in the public and private sector, the creation of an attractive working climate for the highly skilled, suitably designed financing channels for venture capital, effective and coherent regulations which do not put unnecessary obstacles in the way of businesses starting up or restructuring or hamper their access to particular markets, moderation of administrative burdens and a tax system which fosters economic activity with minimal distortions. There are a number of successful examples in other countries such as Finland and Ireland which could certainly provide inspiration for policy-makers developing such an innovation strategy. Nonetheless, it is essential to bear in mind that an innovative business climate can only thrive in a society which values and encourages entrepreneurial spirit and initiative, and that is primarily a question of attitude.

49. Undoubtedly, some unexploited growth potential still remains outside the actual market sector, as is evident from the examples of the Netherlands and certain Scandinavian countries. Health care, household services, education and cultural facilities, which all belong to what is called the " social profit " sector, are all highly labour-intensive activities which create genuine added value. In past years, the number of jobs in this sector has already risen considerably, with annual employment growth averaging 2.8 p.c. since the mid 1990s, against less than 1 p.c. in the economy as a whole. Economic, demographic and sociological factors are bound to cause a continuing increase in demand for such personal services in the future. However, that demand often lacks purchasing power, so that such services are heavily dependent on government subsidies, or are even provided by the public sector itself. The further expansion of this sector will therefore largely be conditioned by the extent to which the government can provide adequate funding without jeopardising the sustainability and the quality of public finances. The scope for that will primarily depend on the market sector's competitiveness and growth potential, although the introduction of more efficient management methods and other cost-cutting measures in the social profit sector itself can also make a contribution.

50. A modern and dynamic economy also imposes special demands on the working population in terms of skills and occupational mobility. Close attention to education and vocational training is therefore needed, not only to ensure a smooth integration into the knowledge economy, taking account of everyone's personal capabilities, but also to inculcate the necessary social skills to facilitate adjustment to a changing job content. An efficient education system is vital here. Recent international surveys conducted under the auspices of the OECD show that there

is certainly still scope for improving the effectiveness of secondary education with a view to integrating young people into the labour market, particularly in the French-speaking community, and that both the Flemish and the French communities must make an effort to ensure that the opportunities for acquiring the essential basic skills are offered to a wider group of young people, with particular attention to immigrants. In addition, there is a need for adequate in-service training and retraining facilities. The social partners should therefore ensure that they fulfil the commitments made in this regard at the 2003 Employment Conference.

51. Good quality government intervention is another key factor underpinning growth. In the first place, a credible monetary policy and sound, sustainable public finances are crucial to a stable macroeconomic climate, characterised by low inflation, low risk premiums and low real interest rates, where both enterprises and households are prepared to embark on new ventures and can realise their long-term plans under optimum conditions. In addition, a more efficient government will generally have greater scope for limiting the burden of taxation and social charges ; this is particularly relevant in Belgium, which still has one of the highest tax burdens in Europe. A country's economic performance is also heavily dependent on the quality of public infrastructures and the efficiency of public sector services. In that regard, it is worrying, for instance, that the level of both public investment and public expenditure on research and development in Belgium has been well below the EU average in the past decade. Another particular challenge in this field is to raise efficiency in the network industries by the introduction of appropriate market mechanisms, and to reconcile this with the principles of universal access and the obligation to provide new public utility services.

52. Finally, the recent economic literature has highlighted the link between a country's institutional infrastructure and its general level of productivity. Consistent and transparent decision-making, purposeful government action aimed at high standards, and effective social institutions largely determine the rules of the economic game and therefore also the willingness of the various economic players to take initiatives and risks. Efficient institutions not only foster investment in physical and human capital, they also act as an important " lubricant " for the economy, by facilitating complex operations, encouraging specialisation and flexibility, and reducing economic transaction costs.

An active employment policy

53. An increased growth potential would also offer more opportunities for job creation, certainly if economic growth is sufficiently labour-intensive, which in the first place entails maintaining a balance between relative factor costs and ensuring that the intrinsic characteristics of the labour supply match the demand side requirements. Raising the level of total factor productivity, through greater economic efficiency and autonomous technological progress, should therefore not be seen as a threat to employment, certainly not in the longer term and for the economy as a whole. In the shorter term and at microeconomic level, some adjustment processes are inevitable, however : new technologies demand different skills, more efficient production and management processes require modified working methods, and the development of new products and services necessitates restructuring, both within firms and between the various branches of activity. Owing to the globalisation of the economy, those adjustment processes are moreover becoming increasingly international in character. To maximise the potential of innovation and productivity gains to create economic wealth and hence also jobs, it is therefore vital that those adjustment processes should take place smoothly and at minimum cost.

54. As already indicated, growth and employment potential can only be maintained – let alone increased – if there is a sufficient and suitable labour supply. This is precisely where Belgium, in common with many other European countries, performs poorly : in 2003, of 100 persons of working age, 64 participated in the labour market in Belgium, and 59 of them actually had a job, compared to figures of 70 and just over 64 respectively in the EU-15. That situation may become problematic in view of the gradual ageing of the population in the decades ahead. The population of working age can be expected to fall by over 200,000 units by 2030, and if the present framework conditions, preferences and socio-demographic trends which determine labour market participation remained unchanged, that would reduce the numbers in work by around 300,000. However, in view of the low mobilisation of its labour reserve, Belgium does have the makings of an important lever for enhancing its growth potential and thus counterbalancing the pressure exerted by the ageing of population on the social and financial viability of its welfare model. Yet to make effective use of that opportunity, current trends will need to be drastically reversed, requiring a widespread change of attitude and a broad social consensus.

55 Measures to attract more people into employment should in the first place be geared to mobilising unemployed job-seekers. Long-term unemployment is often due to the inadequate qualifications of job-seekers. Apart from matching education more closely to the future demand for human capital and taking measures to reduce the number of early school leavers, attention should therefore be concentrated on training and guidance, particularly for low-skilled job-seekers. In certain cases, the narrow gap between net pay and social security benefits makes working insufficiently attractive. These unemployment traps can be tempered further by measures such as reductions in personal social security contributions for low wage earners in the form of a " work bonus ", replacing the former tax credit for those people. As the government steps up its efforts to reintegrate the unemployed, it would also make sense for entitlement to unemployment benefits to be subject to more stringent checks on the claimants' actual availability for the labour market.

56. The weak position of ethnic minorities on the Belgian labour market calls for special attention. Their employment rate is around 50 per cent lower than that of the indigenous population, while their unemployment rate is around three times higher. This low level of integration is due in part to inadequate training, where the underlying factors are both sociological and language-related. However, an effective integration policy needs to extend beyond schooling. For example, surveys indicate that, given equal qualifications, a non-European applicant has three times less chance of getting a job than a native European, and that the employment rate of immigrants with a university education is comparable to that of unskilled members of the indigenous population. Thus, the social partners should also play their part by offering ethnic minorities proper opportunities on the labour market.

57. Although the participation of women in the labour market has been on a rising trend for some time, their activity rate is still significantly lower than that of men : in 2003 the difference amounted to some 16 percentage points. So here, too, equal opportunity policies still have a role to play, for instance by creating the conditions which make it easier to reconcile working and private life, one of the requirements being a suitably designed social infrastructure.

58. It is sufficiently well known by now, that the employment rate in Belgium is substantially below the EU average, mainly as a result of the particularly low participation rate of the over 55 age group. While more than four out of ten people over the age of 55 are still working, on average, in the EU-15, the figure for Belgium is only around three out of ten. As regards the average length of working life, OECD data seem to indicate that Belgium even comes bottom : for male workers, the figure was estimated at just 36.6 years in 2000, which is 4.5 years less than the average for the EU-15.

59. The reasons for early retirement or non-participation among the older population groups are many and complex. Consequently there is no simple way of remedying that situation, though an answer is definitely needed in view of the progressive ageing of the population. In recent years a number of measures have already been taken which represent a move in the right direction. To further intensify those efforts, in the autumn of 2004 the government initiated consultation with the social partners, with the aim of presenting new measures in the spring of 2005. These should focus on such aspects as a more age-neutral human resources policy, with particular attention to the working conditions and training opportunities for older people. Also, early withdrawal from the labour market should be curbed, on the one hand by encouraging older workers to continue working longer or to seek a new job on dismissal, and on the other hand by inducing employers to recruit older workers or to keep them in service longer. Recourse to early retirement schemes can also be limited by reducing the – often government-subsidised – financial incentives or by reviewing the rules, which tend to make such schemes an attractive instrument for employers and employees alike.

60. If effective steps are taken to boost both the quantity and the quality of the labour supply, measures to reduce or control labour costs can take full effect, while that would not be the case if the increased demand for less expensive labour were to encounter all kinds of obstacles and shortages.

61. Despite the efforts made regarding wage moderation and the reduction in social contributions, labour costs in Belgium are still relatively high. In the past that has tended to encourage the substitution of capital for labour, which – while boosting apparent labour productivity – has also led to the shedding of low-skilled workers and caused an increase in structural unemployment. Wage cost control is therefore important not only from the point of view of international competition, but equally in order to ensure that economic growth is sufficiently job-intensive. At the same time, sufficient scope ought to be left for differentiation, not only to take account of the specific needs of individual sectors or firms, but also to foster the employment opportunities of certain occupational groups, and especially the low-skilled.

62. In January 2005, following difficult negotiations, the social partners compromised on a draft central agreement for the period 2005-2006. The 4.5 p.c. indicative wage norm proposed for the two years together can be called reasonable, certainly bearing in mind the recommendation that due account should be taken of the specific situation as regards competition and employment in the forthcoming wage negotiations at sectoral and company level. Furthermore, this agreement contains the first steps towards a more flexible organisation of labour and enhancement of the innovative capacity of firms and their workers. Finally, it bodes well that the social partners formally undertook to enter into calm and constructive consultation with the government in the near future on end-of-career issues and the modernisation of social security.

63. Belgium's high labour costs are due not only to direct wage costs but also to a fiscal and parafiscal burden on labour incomes which is substantial in international terms: according to the latest internationally comparable figures from the European Commission, the implicit rate of those levies as a percentage of the total wage bill in 2002 was around 7.2 percentage points higher than the average for the EU-15. Nonetheless, in recent years a series of measures concerning both income taxation and social contributions has brought some reduction in that implicit levy on labour incomes: in 2004 it was 42.6 p.c., which is 1.6 percentage point less than in 2000.

64. However, care should be taken that subsequent measures – both further cuts in taxes or social contributions and wage moderation, which in the first instance also leads to a loss of fiscal and parafiscal revenues – do not jeopardise the planned consolidation of public finances, which means that they must be accompanied by continuing control over expenditure. If the available scope in the budget should prove insufficient for a general lowering of these levies, then selective reductions or shifts in the distribution of the tax burden might be considered. One possibility here, in line with what has already happened in recent years, is to finance social security less out of contributions based on labour and more via other means, though such alternative forms of funding must not be allowed to have an impact on labour costs via other channels.

65. In the past few years, progress has been achieved in almost all the policy areas outlined. Yet, here and there the willingness to reform appears to be stalling. Putting off politically or socially difficult decisions entails considerable risks, however, as Belgium's competitors do not remain idle in the meantime, and the burden of adjustment will only increase if further leeway has to be made up. In an uncertain economic and social climate, the population has a particular need to know that the policy-makers are continuing to look ahead and pave the way, so that future generations, too, can look forward to a thriving economy that is capable of safeguarding a high level of prosperity conducive to social cohesion.

Brussels, 2 February 2005

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Layout: NBB Prepress
Cover: NBB Multimedia

Published in February 2005