

# 1. BELGIUM

## Back on track for a gradual recovery?

### Small, open economy hit by global crisis

The start of the global financial crisis in the second half of 2008 hit Belgium mainly through two channels. First, the fall in world trade had a strong impact on Belgium's small open economy. Second, the financial crisis and the problems in the banking system triggered a tightening of lending conditions and a fall in confidence and in financial wealth, which depressed domestic demand. At the end of 2008, the recession gained momentum, and GDP markedly contracted for two consecutive quarters as a consequence of the strong fall in investment and inventories. In response to the crisis, the government adopted expansionary fiscal measures in line with the EERP, with an estimated budgetary impact of ½% of GDP in both 2009 and 2010. The package included wage subsidies as well as a delay of tax payments for firms, increases in social benefits, a reduction of the VAT rate for residential construction and an acceleration of public investment. Additionally, a series of actions was taken to support the financial sector.

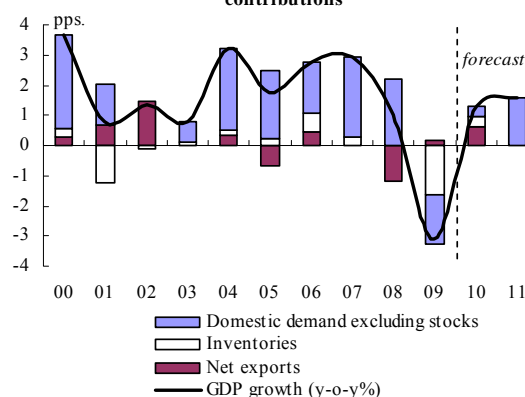
In the second half of 2009, the interplay of the effects of the measures adopted in the framework of the EERP, the recovery of world trade and the improvement in the balance sheets of financial institutions sustained a gradual recovery in economic activity, which translated into a positive GDP growth in quarterly terms of 0.7% and 0.3% in the last two quarters of the year. The main drivers were net trade and inventories, while domestic demand continued to be subdued. This resulted in an annual contraction of 3.1% in 2009 as a whole.

### Gradual recovery ahead

In view of the improved international environment, growth will continue to be supported in 2010 by the positive contribution of net exports and to a lesser extent by the inventory cycle. Domestic demand is foreseen to remain subdued in the first half of the year, as the low capacity utilisation rates will act as a deterrent to new investment, while the labour market, reacting to the crisis with a certain lag, is expected to impact on consumption through negative confidence effects. In the second half of the year, the improvement in the labour market and more generally in internal demand should lead to a gradual recovery which is set to

continue in 2011. In this context, GDP is projected to expand by 1.3% in 2010 and by 1.6% in 2011.

Graph II.1.1: Belgium - GDP growth and contributions



Belgium's relatively better performance in 2009 compared to neighbouring countries and the euro area average stemmed from a smaller contraction of domestic demand, in particular inventories (their initial level was low) and investment. While the inventory cycle is expected to continue to have a positive impact in the first quarters of 2010, investment is expected to remain weak as firms are likely to adopt a prudent approach as a result of the excess of production capacity, difficulties in accessing credit and uncertain demand prospects. In the second half of the year and in 2011, however, a gradual pick-up is projected as global economic conditions continue to improve. In 2009, housing investment declined by less than in the euro area, since there were much more limited excesses in the residential real estate market and due to the temporary reduction of the VAT rate for residential construction. In 2010, housing investment is forecast to continue to contract but at a slower pace, also in view of cooling of housing prices.

Private consumption recorded a negative growth rate in 2009, shrinking by 1.6%, for the first time since 1993. The negative wealth effect from the decline in the value of financial assets and the deterioration of consumer confidence on the back of a worsening labour market situation more than offset the impact of the increase in real disposable income (2.6%) and led to a sizeable increase in the households' saving rate (by 3.5 pps. compared to previous year). Private consumption is projected to

expand again in 2010 even if only at moderate pace. Indeed, higher unemployment, less buoyant wage growth and a pick-up in HICP inflation (to 1.6%) will depress real disposable income. The saving rate is expected to remain at a high level compared to the historical average as negative effects of low confidence will persist. In 2011, a more dynamic development of wages and a stabilisation of unemployment are expected to allow for a stronger growth of consumption.

In 2009, the contraction of external demand triggered large drops in exports, which bottomed out in the second half of the year. In 2010, exports are projected to recover steadily but at a moderate pace as the effects of stimulus measures and inventories adjustments in foreign countries are fading out. They are forecast to pick up more strongly in 2011 in a more favourable international context.

The above scenario is subject to both positive and negative risks. On the positive side, a more vigorous recovery of global demand would boost exports, which would have a significant effect on economic activity as a whole. Negative risks could stem from a worse-than-expected development of domestic demand. Confidence and wealth effects as well as a stronger increase in unemployment could lead to higher precautionary savings and to lower consumption, while a stronger-than-projected tightening of lending conditions would depress investment.

#### The competitive position weakened in recent years and little improvement is expected...

Based on Belgium's export performance in recent years, there are doubts about the country's ability to fully benefit from the rebound in world trade. Over past years, there has been a structural loss of market share for Belgian exports<sup>(69)</sup> for both goods and services. Their disappointing performance can in part be explained by geographical specialisation. Belgian exports are mainly oriented towards other euro area countries, whose import growth has been considerably lower than world trade growth in recent years. Furthermore, the share of fast-growing markets in Belgian export destinations has remained relatively low. Sectoral specialisation also plays a role: Belgian exports show a specialisation in medium-technology goods that are easy to imitate, such as chemicals and steel.

<sup>(69)</sup> As calculated by the growth differential between Belgian export markets and Belgian exports.

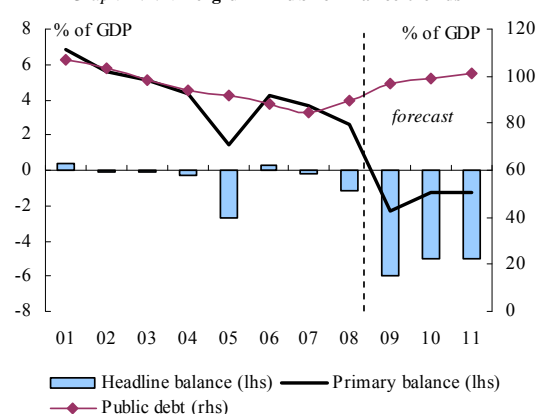
In addition, relatively high wage costs have had a negative impact on Belgium's exports. Since 2005, unit labour costs (ULC) have increased more rapidly than in the euro area, mainly as a result of strong increase in wages.

With an expected fall in ULC in 2010 followed by a moderate increase in 2011, it is expected that the cost competitiveness of Belgium would improve somewhat over the forecast horizon without fully correcting the accumulated losses of the last ten years.

#### ... while labour utilisation is set to remain low,...

In 2009, the impact of the economic downturn on employment has been relatively contained as most employers have resorted to the extended scheme for temporary unemployment, which allows corporations to reduce employees' working time without resorting to dismissals. However, in view of the lagged reaction of employment to changes in economic activity, employment is expected to still contract significantly in 2010 and the unemployment rate is forecast to increase until 2011. Given the characteristics of the Belgian labour market, there is a risk that some of those unemployed become permanently inactive. This would put further downward pressure on labour supply, which is already low as witnessed by the comparatively low employment rate and the high long-term unemployment rate.

Graph II.1.2: Belgium - Public finance trends



#### ... the fiscal deterioration is to be reversed

In 2009, the government general balance deteriorated sharply from a deficit of 1.2% of GDP in 2008 to 6.0% of GDP, triggering the excessive deficit procedure. The budget was strongly affected by the economic downturn. In particular,

the impact of automatic stabilisers (2¼% of GDP) has been larger than might have been expected on the basis of standard elasticities, mainly reflecting a strong fall in corporate taxation. Furthermore, the deficit includes one-offs that increased the deficit by ½% of GDP, in particular reflecting capital transfers to the private sector following two court rulings. Finally, the increase also reflects the impact of the expansionary measures included in the budget for 2009 (½% of GDP) and the fiscal stimulus packages (½% of GDP).

In 2010, the deficit is projected to improve to 5% of GDP, slightly above the official 2010 budget target of 4.8% of GDP as presented by the Belgian authorities. This is mainly due to somewhat less positive tax elasticity assumptions, notably regarding corporate taxes. The projected improvement mainly results from an improved economic environment and the reverse effects of the one-offs in 2009. This improvement is dampened by increased expenditure, resulting from the delayed impact of past policies, population ageing and rising interest expenditure. The gradual phasing out of the stimulus measures is expected to have only a limited positive impact (0.1% of GDP) as the package included several permanent measures, which continue to adversely affect the budget (0.3% of GDP).

Under the no-policy-change assumption, the headline deficit should stabilise at 5% of GDP in 2011, as further expenditure increases are offset by the somewhat more robust economic recovery.

The government gross debt ratio is expected to increase substantially over the forecast period as a result of deficits in excess of nominal GDP growth. In 2011, it is projected to exceed 100%, returning to a level not reached since 2002.

The main challenges for Belgium's public finances are the correction of the excessive deficit, the reduction of the government gross debt ratio and the improvement of the long-term sustainability of public finances. Budgetary consolidation accompanied by structural reforms should address these challenges. This is important given that expenditure is negatively affected by dynamic expenditure trends, coming from past policies, population ageing and rising interest expenditure and in view of the 2012 deadline for the correction of the excessive deficit set by the Council.

Table II.1.1:

**Main features of country forecast - BELGIUM**

	2008			Annual percentage change						
	bn EUR	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	344.7	100.0	2.0	2.0	2.8	2.9	1.0	-3.1	1.3	1.6
Private consumption	179.1	52.0	1.5	1.5	1.8	1.7	1.1	-1.6	0.6	1.4
Public consumption	79.8	23.2	1.7	1.7	1.0	2.6	3.3	1.6	1.3	1.5
Gross fixed capital formation	78.0	22.6	2.3	2.3	2.7	5.9	4.3	-5.0	-1.5	2.1
of which : equipment	34.5	10.0	2.5	2.5	3.7	8.9	5.8	-6.2	-1.2	3.9
Exports (goods and services)	295.6	85.8	4.7	4.7	5.0	4.5	1.5	-10.8	4.3	4.3
Imports (goods and services)	292.7	84.9	4.5	4.5	4.7	4.7	3.1	-11.1	3.6	4.5
GNI (GDP deflator)	347.0	100.7	2.1	2.1	3.0	3.0	0.7	-3.1	1.3	1.6
Contribution to GDP growth :										
Domestic demand			1.7	1.7	1.7	2.7	2.2	-1.6	0.3	1.6
Inventories			0.0	0.0	0.6	0.3	0.0	-1.6	0.4	0.0
Net exports			0.3	0.3	0.5	0.0	-1.2	0.2	0.6	0.0
Employment			0.7	0.7	1.2	1.6	1.9	-0.5	-0.9	0.2
Unemployment rate (a)			8.4	8.4	8.3	7.5	7.0	7.9	8.8	9.0
Compensation of employees/head			2.9	2.9	3.3	3.5	3.0	2.0	1.6	2.1
Unit labour costs whole economy			1.5	1.5	1.7	2.2	3.9	4.7	-0.5	0.8
Real unit labour costs			-0.4	-0.4	-0.5	-0.1	2.0	3.6	-2.1	-1.0
Savings rate of households (b)			-	-	-	16.2	16.6	20.1	19.3	19.1
GDP deflator			1.9	1.9	2.2	2.3	1.8	1.1	1.6	1.8
Harmonised index of consumer prices			1.9	1.9	2.3	1.8	4.5	0.0	1.6	1.6
Terms of trade of goods			-0.4	-0.4	-0.4	0.3	-2.4	2.4	0.5	0.4
Trade balance (c)			3.2	3.2	1.9	1.6	-1.6	-0.3	0.1	0.2
Current account balance (c)			4.6	4.6	3.4	3.7	0.2	2.0	3.0	3.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			4.4	4.4	3.3	3.5	-0.2	1.9	2.7	3.0
General government balance (c)			-2.4	-2.4	0.3	-0.2	-1.2	-6.0	-5.0	-5.0
Cyclically-adjusted budget balance (c)			-2.3	-2.3	-0.4	-1.4	-2.0	-4.5	-3.7	-4.0
Structural budget balance (c)			-	-	-1.3	-1.3	-2.1	-3.9	-3.8	-4.0
General government gross debt (c)			114.9	114.9	88.1	84.2	89.8	96.7	99.0	100.9

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.