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In-depth review for BELGIUM

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the document

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EXECUTIVE SUMMARY AND CONCLUSIONS

In May 2012, the Commission concluded that Belgium was experiencing macroeconomic imbalances, in particular as regards developments related to external competitiveness and indebtedness. In the Alert Mechanism Report (AMR) published on 28 November 2012, the Commission found it useful, also taking into account the identification of imbalances in May 2012, to examine further the persistence of imbalances or their unwinding. To this end this In-Depth Review (IDR) takes a broad view of the Belgian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **Belgium continues to suffer from export market shares losses.** This is mainly due to declining shares in goods that are only partially offset by export share gains in services. While the current account position remains broadly in balance, the gradual but steady deterioration observed over the past years is a source of concern. As concluded in last year's IDR, Belgium's export performance highlights competitiveness issues. In terms of geographical orientation, Belgium is still predominantly trading with the EU27, although compared to last year the scope has widened. Should this trend be confirmed, a softening of export market share losses may follow. As regards product specialisation, intermediate goods still dominate other types of manufactured exports. However, high-tech exports have been on an increasing trend, which reflects the strengths of the Belgian research and innovation system.
- **The specialisation in cost-sensitive products makes the evolution of unit labour costs a key issue for Belgium's competitiveness.** The trend depicted in last year's IDR, with unit labour costs in Belgium rising faster than in trading partner countries, has been confirmed, driven to a large extent by the wage setting mechanism. Since the publication of the 2012 IDR, the authorities have announced measures to reduce the widening wage gap. However, such a correction will only materialise gradually and additional measures may be needed to close the historic gap entirely, the more as several trading partners have been implementing relevant labour market reforms.
- **Belgium needs to foster total factor productivity as gains to be expected from labour productivity are limited.** For this to happen, it is essential for Belgium to speed up the transition towards a more knowledge-intensive economy, enabling the full exploitation of the strengths of its research system. As business R&D is very concentrated, Belgium needs to broaden its innovation base and fasten the renewal of its economic fabric. However, Belgium's weaknesses in terms of entrepreneurship and firms' dynamics impede this necessary renewal.
- **The high level of public debt still represents an imbalance in view of sustainability concerns.** Since 2008, the public debt has peaked up again to reach around 100% of GDP. This deterioration of public finances is largely due to the effect of the crisis on government revenues, temporary stimulus measures and rescue operations in the financial sector. Recent consolidation efforts have slowed down the increase but the debt ratio is expected to

stabilize only in 2014. The high debt level makes Belgium vulnerable to tensions in financial markets that could result in an upward debt spiral. A large share of Belgian debt is held domestically, which may reduce external vulnerabilities but reinforces risks for spill-overs between the public sector, the banking sector and the real economy. Contingent liabilities to the financial sector for around 15% of GDP constitute an additional risk. Moreover, the remaining fiscal space to address the debt burden is very limited, while the fiscal sustainability risk is high in the medium to long-term due to the budgetary impact of ageing in Belgium.

- **The indebtedness level of non-financial corporations, which is high in terms of non-consolidated debt, does not point to emerging risks given the still reasonable consolidated level.** As pointed out in last year's IDR, the high divergence between both levels is explained by the high degree of intra-group loans, which have been fostered by advantageous tax regimes. Although abolishing this tax policy would result in a reduction of such loans, it would not constitute a macro-economic risk. Household indebtedness is mostly mortgage related. As this IDR argues, however, a possible downward correction of housing prices would only have limited effects on consumption, on the construction sector and on the financial sector.

The IDR also discusses the policy challenges stemming from these developments and what could be avenues worth exploring in terms of policy actions.

- **In order to improve external competitiveness, the Belgian economy would benefit from a reform of the wage bargaining system, a reduction of the tax burden on labour, and measures to improve total factor productivity.** The 'wage norm', adopted during a phase of high productivity growth, would benefit from a modernisation. Some examples that could be considered include the incorporation of productivity growth differentials in the wage norm, the application of ex-post corrections, as well as all-in agreements. This would help align wage developments more closely with productivity dynamics, allow more wage diversification between sectors and push back structural labour mismatches. With regard to automatic wage indexation, allowing a more flexible application would help the very open Belgian economy to absorb external shocks more smoothly. Competitiveness would also be enhanced by a further shift in the tax burden from labour to other sources of revenue and a continued effort to improve the functioning of networking industries. A further stimulation of investment in R&D and ICT would increase the technological content of products as well as total factor productivity. While the orientations taken by research and innovation policies in recent years are appropriate, efforts need to be reinforced. In particular, further development of the support to clusters and better conditions for the growth of innovative firms, as well as the further development of entrepreneurial education and culture, are required.
- **Concerning the challenge linked to the high public indebtedness, the economy as a whole would benefit from a continued implementation of measures aiming at a consolidation of public finances in a sustainable way, putting the public debt on a firm downward path, in line with the**

commitments under the Stability and Growth Pact. Also the implicit debt associated with an ageing population may be addressed by curbing age-related expenditure in order to prevent new increases of the debt levels. Decreasing debt levels would also provide the authorities with more latitude to implement a fiscal policy aimed at improving the competitiveness of the country, as well as to face unexpected developments in other economic sectors such as financial markets.

1. INTRODUCTION

On 28 November 2012, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No 1176/2011, these country-specific 'in-depth reviews' (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of follow-up it will recommend to the Council.

This is the second IDR for Belgium. The previous IDR was published on May 30 2012 on the basis of which the Commission concluded that Belgium was experiencing macroeconomic imbalances, in particular as regards developments related to external competitiveness and indebtedness. Overall, in the AMR the Commission found it useful, also taking into account the identification of imbalances in May, to examine further the persistence of imbalances or their unwinding.¹ To this end this IDR takes a broad view of the Belgian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 of this in-depth review looks more in detail into these developments covering both the external and internal dimensions. Section 3 focuses on the role of services in the current account balance, innovation in Belgium and the evolution of the housing market. Section 4 discusses policy considerations.

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

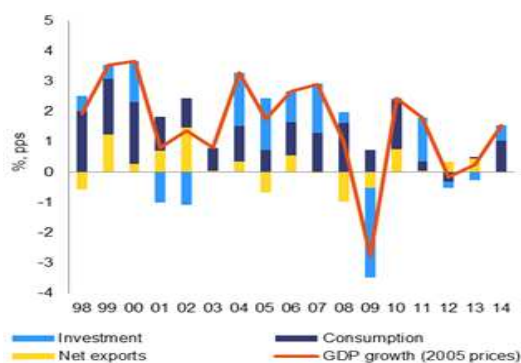
2.1. Macroeconomic scene setter

Having a small open economy, Belgium was strongly affected by the slump in world trade during the global economic crisis of 2008-09 (see Graph 1). Following the crisis, the Belgian economy has not been able to fully benefit from the rebound in global activity. This has largely been due to accumulated losses of competitiveness and a geographical focus on the weak European market (see section 2.2.3). Belgium's deteriorating competitiveness is also reflected in a lower potential growth (see Graph 2), with productivity growth below the level observed during pre-crisis years. In 2012, GDP contracted by 0.2% according to Commission estimates, while for 2013 an expansion by 0.2% is expected. In 2014, growth is projected to accelerate to 1.5%.

¹ As was the case last year, on the external side the AMR scoreboard highlighted a loss in export market shares. On the internal side, the high and increasing levels of private and public debt were identified as a matter of concern. Other indicators pointing to potential problems were rising house prices and the debt to equity ratio of the financial sector, increasing again due to losses incurred.

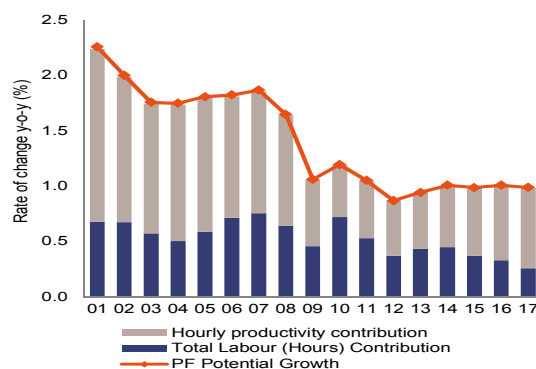
The subdued growth in 2012-13 can be attributed to weak domestic demand as shown in Graph 1 with net exports contributing positively to overall growth since 2010.

Graph 1: GDP growth decomposition



Source: Commission services

Graph 2: Potential growth rate



Source: Commission services

With respect to public finance developments, public debt had been on a steady downward path until 2007, when total debt amounted to 84% of GDP.² This substantial decline³ was essentially due to high – albeit decreasing – primary surpluses. Between 2007 and 2012, the public debt jumped back to 99.8% of GDP⁴. Around half of this increase resulted from the operations to stabilize the financial system, which amounted to more than 8% of GDP. The public deficit has slowly decreased since 2009, but still stands around 3% of GDP and is currently projected to rise again above this threshold in 2014. The public debt is projected to stabilize at around 101% of GDP in 2013-14 (see also section 2.3.1).

2.2. Assessment of the existence of external imbalances

The apparent stabilisation of the current account deficit does not take away concerns about the significant deterioration over the longer term, highlighted in the 2012 IDR. The driver behind this decline is the goods balance with the services balance improving. Belgian exports of goods have lost ground with respect to the expanding world trade, resulting in a loss in market shares. While the productivity level is still among the highest in the EU, productivity growth remains among the lowest and plays an important role in the fact that ULCs in Belgium continue to grow faster than in trading partner countries, eating into Belgium's cost competitiveness. Despite these negative developments, the Net International Investment Position (NIIP) of the country is positive and has been improving since 2008 (see Graph 3).⁵ This strong

² The assumption of the national railway company's debt in 2005 caused a temporary slowdown of the downward trend.

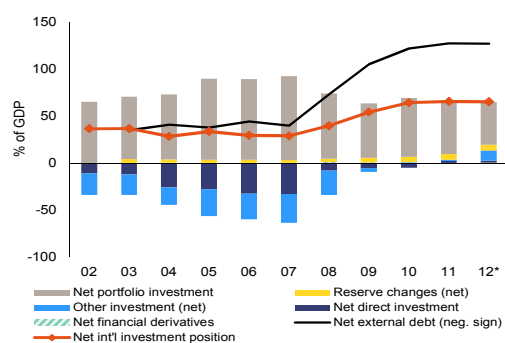
³ In 1993 the Belgian public debt peaked at 134.1% of GDP.

⁴ Commission services' Winter forecast 2013.

⁵ Among EU27 countries, only LU has a NIIP larger than Belgium in terms of GDP.

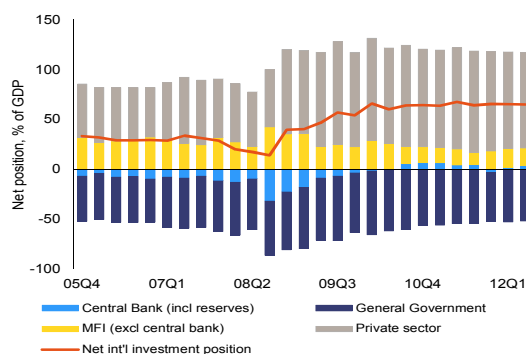
overall NIIP encompasses, on the one hand, sizeable net foreign liabilities by the Belgian government and, on the other hand, a large net foreign asset position by the Belgian private sector (see Graph 4).

Graph 3: Decomposition of Net IIP



Source: Commission services;
note: * indicates estimated figure using quarterly data

Graph 4: IIP by Sector



Source: Commission services

2.2.1. The evolution of the current account

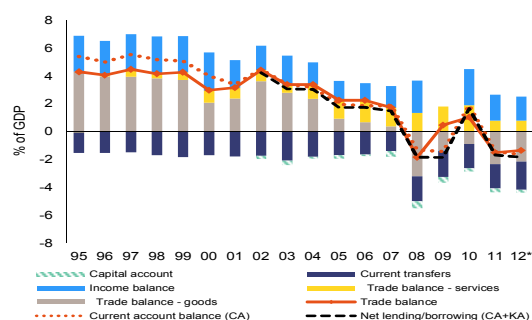
Rather than the level of the current account, the main source of concern remains its steep downward trend. After 1999 Belgium's current account balance gradually eroded and eventually turned negative in 2008 (see Graph 5). With the exception of 2010, Belgium's current account balance has remained negative ever since. For 2012, a deficit of around 1% is expected according to Commission estimates. The same level is projected for 2013-14.⁶ The bulk of this deterioration can be attributed to a declining surplus in the goods trade balance, which moved into deficit as of 2008. This deterioration was only partly compensated by the gradual improvement of the services balance. Moreover, the deficit in current transfers has grown over time⁷ while the income balance has remained positive at around 2% of GDP.

The deterioration of the goods balance can partly be attributed to rising net energy imports, which rose from EUR 6.7 bn in 2002 to EUR 19 bn in 2012 on the back of increasing international energy prices (see Graph 6). However, making abstraction of energy products, imports grew still by 3.5% on annual average between 2002 and 2012, compared to 2.9% export growth over the same period. Aside from higher energy prices, slower export growth can thus be blamed for the current account deterioration. In what follows, the focus will therefore be on export performance.

⁶ According to the national accounts definition, the same trend can be observed although the current account remained in surplus even in the crisis years 2008 and 2009. While between 1993 and 2004 the current account according to the national accounts definition fluctuated between 4% and 6%, this surplus gradually eroded and is currently fluctuating around 1.5% of GDP.

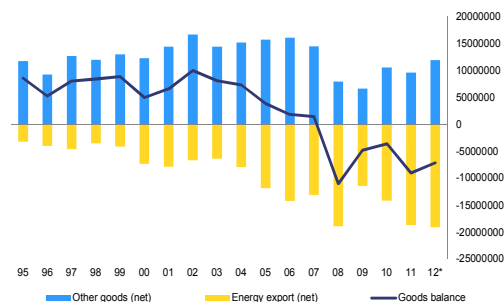
⁷ Reaching -1.8% of GDP in 2011 and -2.4% during the first nine months of 2012. This reflects outward transfers by immigrants as well as the fact that Belgium is a net contributor to the EU budget.

Graph 5: Evolution of the current account balance (BoP definition)



Source: Commission services; note: * indicates estimated figure using quarterly data

Graph 6: Evolution of the goods balance (national accounts)

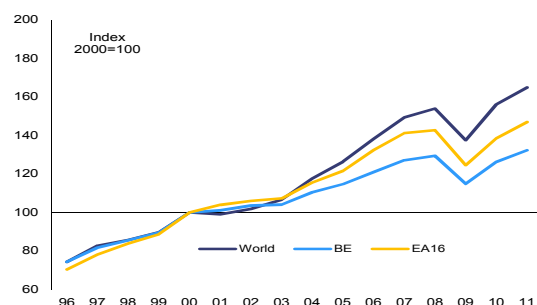


Source: NBB; note: * indicates estimated figure using quarterly data

2.2.2. The evolution of market shares

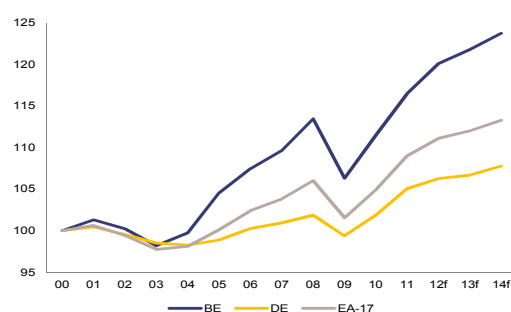
Belgian exports have been growing slower than global trade and are also outpaced by the exports of other euro area countries, most notably Germany (see Graph 7)⁸. As all EU15 countries have experienced losses in export market shares, Belgian losses could be explained by shifting global patterns. Changes in market shares at constant prices, however, show that Belgium already began losing ground in 2003. This indicates that aside from matters of cost competitiveness resulting in higher relative export prices (see Graph 8), elements of non-cost competitiveness also play a role in explaining Belgium's worse trade performance compared to the euro area.

Graph 7: Evolution of exports of goods and services (constant prices, 2000=100)



Sources: Euro area and BE: Commission services; IMF: World Economic Outlook Database, October 2012.

Graph 8: Deflator of export of goods (2000=100)

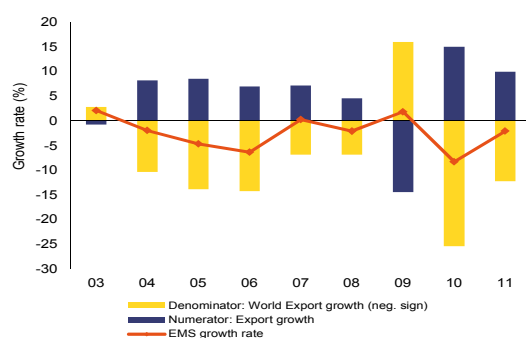


Source: Commission services

⁸ Belgian export performance would be close to the euro area average, if Germany was left out of the equation.

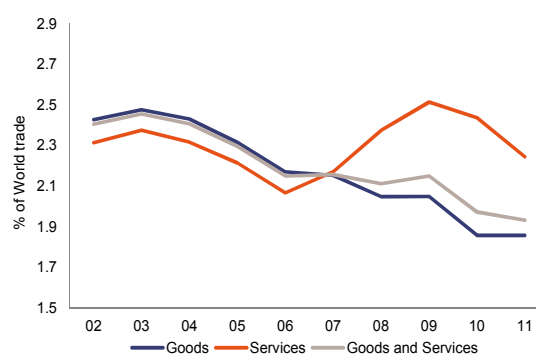
The loss of export market shares is only relevant for goods, with a better performance by services (see Graph 10). Indeed, the 5-year change in export market share for goods and services combined reached -10.2% in 2011⁹ with the loss in export market share for goods at -13.7% and a gain of 3.4% for services. As highlighted by the Federal Planning Bureau¹⁰, service sector exports are less price elastic. While services might be partially replacing goods as the main growth driver behind international trade, the challenge of increasing the competitiveness of goods remains. Export of services cannot be expected to fully occupy the space left by goods as witnessed by the overall loss in market share (see Graph 9) and the risk that the evolution of services might not be as positive in the future (see also 3.1.).

Graph 9: Export market shares decomposition



Source: Commission services

Graph 10: Balance of goods and services as percentage of world trade (BoP data)



Source: Commission services

The European Commission's recent Surplus Report (2012) looks into changes in export market shares by decomposing total nominal export growth per country (net of the global import growth) into four components (see Graph 11).¹¹ According to this analysis, in pre-crisis years (2000-07), Belgium benefited slightly from its initial export specialisation in terms of products and destination, though in general less so than other 'surplus countries'.¹² However, competitiveness changes in product as well

⁹ A loss of 10.2% between 2006 and 2011, compared to an AMR threshold of -6%.

¹⁰ H. Bogaerts and C. Kegels, 'Competitiveness of Belgium, Challenges and growth tracks', Planning paper 112, Federal Planning Bureau, 2012.

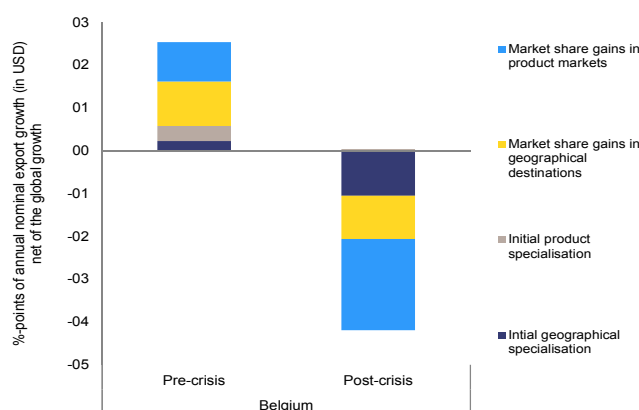
¹¹ The use of a shift-share analysis can contribute to the identification of the factors behind long-term changes in export market shares. The first two components (initial specialization) are structural factors, capturing the initial product and geographical specialization and reflecting whether a country is specialized in sectors with dynamic global demand and whether destination countries are dynamic markets. As such they reflect past export strategies and competitive advantages. The other two, dynamic components (market share gains) capture how successful a country has been in increasing its exports above market growth in product and geographical markets as a consequence of competitiveness developments. Competitiveness is understood in a broad sense, comprising both cost and non-cost elements.

¹² AT, BE, DE, DK, FI, LU, NL & SE.

as in geographical destination were much more outspoken drivers behind nominal export growth during 2000-07.

Since the crisis erupted, the strong orientation towards the slow growing EU market has contributed to Belgium's loss in market shares. While product specialisation proved to be a neutral factor, competitiveness changes, in geographical destination but particularly in product market, have been another contributing factor. Market share losses in product markets can loosely be interpreted as an indication of a loss in cost competitiveness (with geographical changes being more the result of demand-driven elements such as quality and preferences of export markets).¹³ It can thus be concluded that in recent years both geographical specialisation and competitiveness developments have caused Belgium to suffer a loss in market share. These individual elements are discussed in the following sections.

Graph 11: Decomposition of nominal export market growth



Source: COMTRADE and Commission services' calculations

2.2.3. Geographical and product specialisation

Belgian exports consist largely of intermediary goods that are traded with neighbouring or other euro area countries. As to its geographical specialisation (see Table 1), 60% of Belgian exports are oriented to euro area countries with the largest share going to DE, FR and NL – 50% of total exports and 80% of euro area exports. This is in accordance with the finding in the preceding section that Belgium's geographical specialisation has partly been responsible for observed losses in export market share. Nevertheless, compared with the situation in 2000, the trend in export orientation goes in the right direction. Between 2000 and 2011, the share of exports going to the largest emerging markets has increased from 4.7% to 8.4%. Furthermore, export growth towards these markets seems to have accelerated in recent years given the sluggishness of many traditional export markets: in 2010 extra-EU27 exports represented 25.8% of overall exports, rising to 28.1% in 2011. It should also be noted

¹³ LIME Working Group (2012), Measurement and Determinants of Non-Price Competitiveness.

that Belgian exporters benefited indirectly from the new markets through their exports towards Germany, which increased in importance compared to 2000.¹⁴

Table 1: Main trading partners (in % of total)

	exports		imports	
	2000	2011	2000	2011
Total	100	100	100	100
EU27 - INTRA	79.7	71.9	70.8	67.9
EU27 - EXTRA	20.3	28.1	29.2	32.1
DE	17.5	18.1	16.4	14.8
FR	18.3	16.5	12.7	10.7
NL	12.9	12.2	17.5	19.6
UK	10.4	6.9	8.6	5.9
US	6.0	5.1	7.5	5.7
Largest emerging markets¹⁵	4.7	8.4	5.9	11.1

Source: Commission services

Table 2 highlights Belgium's product specialisation in intermediate goods. Compared to neighbouring countries, Belgium is clearly more dependent on the export of these products, which represent 60% of total manufactured exports. This reflects Belgium's tight integration in international supply chains. Furthermore, the specialisation in intermediate goods, already a fact in 2000, has intensified over the past decade. This mirrors a decline in the prominence of capital goods, which play a smaller role in Belgium than in DE, FR and NL. This trade specialisation entails risks as intermediate products tend to be more easily substituted and thus more price elastic than capital goods. This product specialisation resonates with a limited proportion of manufactured exports being high-tech in nature, although it should be noted that the proportion of high-techn exports is increasing rapidly since 2000 (see also 2.2.7.).

In this regard it is also interesting to note that overall export similarity with China (a broad indicator of exposure to price competition) is rather low. Graph 12 shows the degree of overlap by sector in exports and indicates that traditional sectors such as textile, footwear and metals seem from this point of view more at risk than important sectors like vehicles and chemicals. Nevertheless, a continuation of the reorientation towards harder to imitate products higher upon the value chain is essential to render the Belgian export industry less exposed to international competition on cost factors.

¹⁴ Based on the import content of German exports and the Belgian share in German imports, the Belgian share in overall German exports has risen from 1.4% in 1999 to 2.2% in 2008.

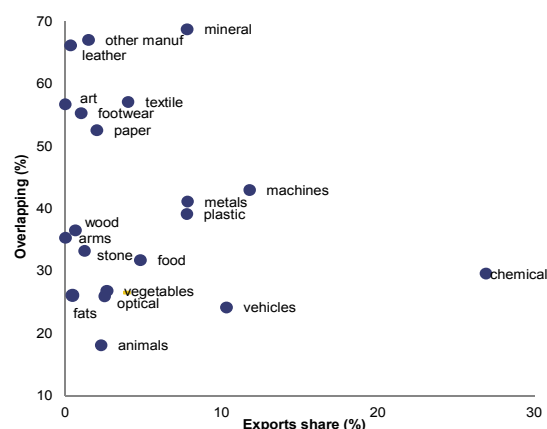
¹⁵ China, Brazil, Russia, India, Mexico, Indonesia & Turkey.

Table 2: Manufactured exports by type of goods (in % of total)

		2000	2011
BE	Capital goods	11.3	8.1
	Intermediate goods	56.4	59.6
	Consumption goods	31.6	31.2
	Unclassified goods	0.7	1.1
DE	Capital goods	22.0	20.7
	Intermediate goods	49.1	50.4
	Consumption goods	25.2	26.7
	Unclassified goods	3.7	2.2
FR	Capital goods	23.2	18.6
	Intermediate goods	47.4	48.7
	Consumption goods	28.0	30.6
	Unclassified goods	1.4	2.1
NL	Capital goods	18.5	19.6
	Intermediate goods	49.7	52.4
	Consumption goods	26.2	25.1
	Unclassified goods	5.6	2.9

Source: Commission services

Graph 12: Export similarity with China vs. share in total exports



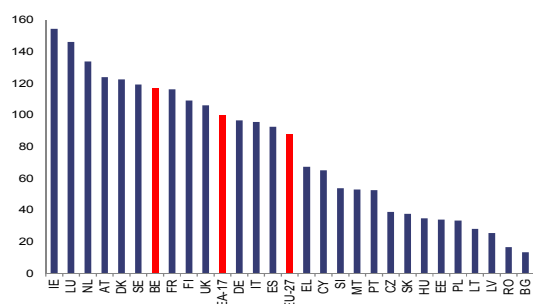
Source: Commission services

2.2.4. Cost competitiveness

As concluded above, the deterioration of the current account and the loss in export market shares can be attributed at least partially to Belgium's declining cost competitiveness. The latter is an important issue given the discussed specialisation in cost-sensitive products, the high tax wedge (see also section 2.3.1.) and the prolonged wage moderation by main trading partner Germany. The resulting wage differential vis-à-vis Germany could have been compensated by higher productivity growth. However, international comparison shows that, while in terms of productivity levels Belgium belongs to the top EU countries (see Graph 13), in terms of productivity growth, it is among the worst performing countries (see Graph 14).¹⁶ Although subdued productivity growth constitutes a general challenge for euro area countries, this does not take away Belgium's competitiveness issues. Given that capital intensity of production is already high, further increases are unlikely to yield the strong productivity gains that warranted rapid wage increases in the past. This highlights the importance of stronger total factor productivity, originating from innovation and technological advance or an improvement of public infrastructure.

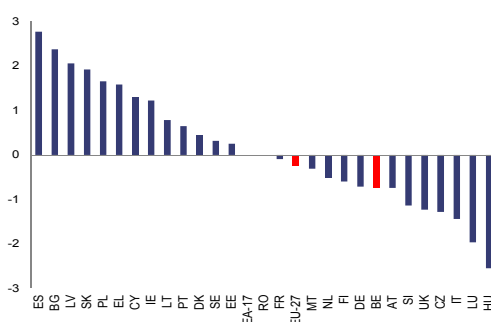
¹⁶ This slower rise in productivity is not a purely negative phenomenon since it mostly reflects a stronger employment growth with e.g. the inclusion of many low-productivity workers through the service voucher system.

Graph 13: Productivity level (2011) – GDP per person employed - EA17=100



Source: Commission services

Graph 14: Productivity growth (2011) - GDP per person employed - EA17=100



Source: Commission services

Belgium's deteriorating cost competitiveness is reflected in above-average increases in nominal unit labour costs (ULCs) relative to main trading partners (DE, FR, NL) and the euro area as a whole (see Graph 15). Although the ULC indicator in the scoreboard has not exceeded the indicative threshold since 2010, the ULC increases recorded compare unfavourably with all main trading partners since 2007, suggesting a worrisome trend.

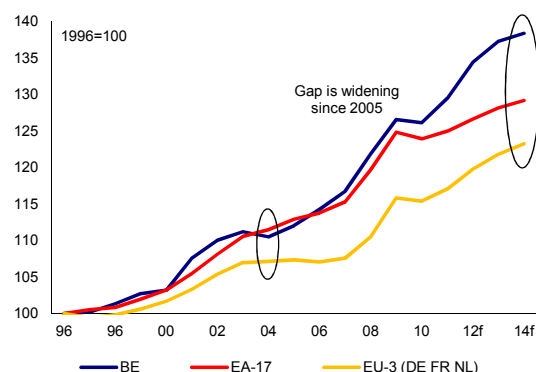
Graph 16 provides a breakdown of Belgian ULCs. It shows that both a higher wage and a lower productivity growth resulted in a widening gap vis-à-vis the EU3. When 1996 is taken as a base year¹⁷, the accumulated nominal labour costs surplus stands at 12.4% in 2011. Belgian ULCs are expected to continue outpacing the average euro area ULC in 2013. According to the latest estimates by the Belgian Central Economic Council¹⁸, the hourly wage gap amounted to 5.1% at the end of 2012. This figure does not take into account the effect of wage cost reductions through wage subsidies, which would reduce the gap by 1.8 pps according to the authorities.¹⁹ At the end of 2012, the authorities announced measures to narrow the wage gap, discussed lower (see Box 1).

¹⁷ As the Law on competitiveness was passed in 1996, that year is conventionally taken as a base year in the public debate on Belgian cost competitiveness.

¹⁸ Central Economic Council, Technical Report December 2012.

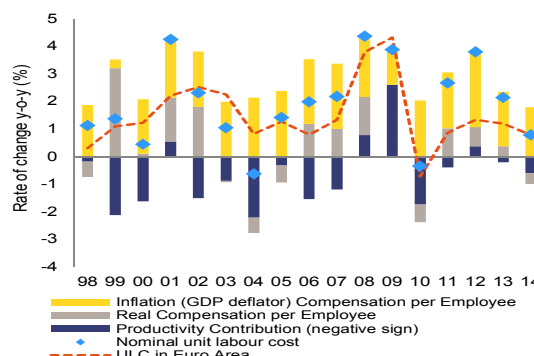
¹⁹ While it makes sense to incorporate wage subsidies when comparing overall labour costs – the more as such subsidies have increased fast in Belgium since 2005 – it should not be overlooked that neighbouring countries also have wage subsidies, which should evidently be taken into account as well for this exercise. To clarify matters, a panel of experts (comprising representatives from the Belgian National Bank, Eurostat, the Federal Planning Bureau, the High Council for Employment, the General Direction of Statistics and Economic Information and the Central Economic Council) has been requested by the federal authorities to determine the net wage gap as well as the impact of wage cost reduction measures in Belgium and the neighbouring countries. The expert panellists are required to report back before June 2013 and to include in the analysis a sectoral breakdown of Belgium's cost competitiveness position vis-à-vis neighbouring countries.

Graph 15: Evolution of nominal ULCs



Source: Commission services

Graph 16: Components of Belgian ULCs



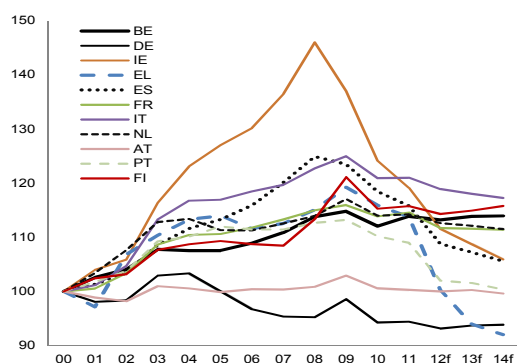
Source: Commission services

As the three neighbouring countries absorb 60% of Belgian exports, Belgium's euro area real effective exchange rate (REER) gives a more complete picture of cost competitiveness (see Graph 17). Belgium's REER appreciated since the late 1990s, indicating that Belgium has indeed been losing cost competitiveness. As can be seen in the graphs below, between 2000 and 2008, losses in price competitiveness vis-à-vis the euro area contrasted most sharply with developments in Germany.

This assessment is also reflected in the development of relative ULCs. While ULC increases in Belgium since 1996 kept pace with developments in France and the Netherlands until 2009, Germany clearly outperformed all three Member States throughout the entire period. As of 2010 however, Belgium has also been losing ground against FR and NL, a trend forecast to continue over the medium term horizon (see Graph 18). This is particularly worrisome as it is important for a small open economy like Belgium to keep pace with evolutions in its main trading partners. This has become even more important given recent developments in the wider European area. Indeed, several other important trading partners such as IE, IT and ES²⁰ have been pursuing significant labour market reforms, resulting in a fast improvement of their cost competitiveness as can clearly be seen for IE and ES in Graph 17.

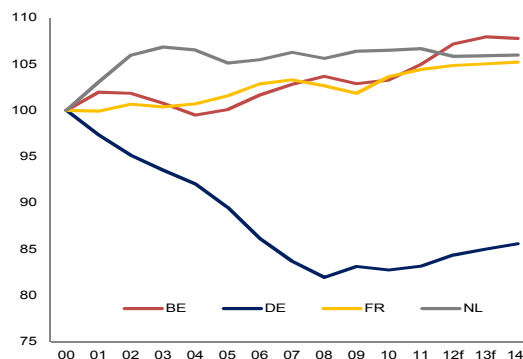
²⁰ Together these three countries represent 9.2% of Belgium's export markets.

Graph 17: REER vav 35 industrial countries



Source: Commission services

Graph 18: Relative ULC of the main trading partners vav euro area



Source: Commission services

2.2.5. *The wage setting mechanism*

The strong rise in nominal Belgian wages in recent years is linked to two characteristic elements of the Belgian labour market: the highly centralized wage bargaining system and the near-universal application of automatic wage indexation.²¹

Collective bargaining takes place at three levels. Every two years, social partner organisations represented in the National Labour Council conclude an 'inter-professional agreement' at national level. It sets a framework for the negotiations conducted at sectorial and firm-level by fixing the so-called "wage norm" and the minimum wage. At sectorial level, collective agreements are concluded on various topics within the framework of the inter-professional agreement, including on industry job classification systems and salaries. These sectorial agreements determine which wage increases are implemented and in what manner as well as the method to adapt wages to inflation²². Upon request by one or more of the signatory parties, they can be made legally binding by Royal Decree for all companies and employees represented by the sector committee. However, such extensions are conditional on approval by the government. Firm-level agreements, finally, are bound by the agreements concluded at sector level. They can go below the minima defined at industry level when this possibility is foreseen in the relevant sector agreement and when the conditions stipulated therein are met.

The so-called 'wage norm' was introduced by the 1996 Law on competitiveness to keep labour costs developments in line with these of the main trading partners (DE,

²¹ On the basis of the Wage Dynamics Survey conducted under the supervision of the ECB, the Belgian National Bank estimates that approximately 98.2% of all Belgian employees are covered by an automatic wage indexation system of some kind. This is slightly lower than in LU (100%) but higher than in most other countries in which price indexation of wage is widespread (CY, ES, MT, SI).

²² A wide range of wage indexation systems are applied at sectorial level, applying different periodicity rules or modification triggering systems and different methods of determining the moving average of the index. They also differ in coverage with some agreements on indexation of wages only applying to specific categories of employees.

FR, NL). The norm is fixed at the weighted average of the expected nominal average hourly wage increases in these countries. As indicated, this system has allowed Belgium to keep ULC increases since 1996 in line with developments in France and the Netherlands until 2009 but could not prevent a significant loss of relative cost competitiveness vis-à-vis Germany. What is more, since 2010 Belgium has been also losing ground against FR and NL, suggesting that a reform of the collective bargaining system is warranted.

The method by which the wage norm is determined suffers from several drawbacks. Conceived at a time of strong overall productivity growth, the wage norm does not take into account productivity growth differentials relative to reference countries. In recent years, productivity growth has been lower than in the reference countries while nominal wages have been increasing at a faster rate because the wage norm repeatedly overestimated the weighted average wage growth observed in the main trading partners. Taken together, this has resulted in the observed losses in relative cost-competitiveness.

Despite sector and regional productivity differentials, the wage norm applies to all sectors and regions in Belgium. This reduces the margin for sectorial and regional wage differentiation based on productivity differentials. As a consequence, incentives for labour mobility are weakened and labour market mismatches are likely to arise contributing to the large and widening regional differences in employment and unemployment rates currently observed in Belgium.

While the wage norm determines the maximum increase for labour costs, automatic wage indexation²³ ensures that the inflation rate sets the lower boundary. These indexation mechanisms help safeguard purchasing power, but have a number of disadvantages for Belgium's cost competitiveness. Most importantly, they narrow the margin for wage bargaining to the range between the inflation rate as measured by the health index and the wage norm and they embed incurred losses in cost competitiveness by complicating the adjustment of real wages. Also, the indexation system generates second-round inflationary pressures, explaining to some extent why inflation has in general been higher in Belgium than in neighbouring countries (cf. *infra*).

Another important disadvantage of the indexation system is the difficulty to apply *ex-post* corrections in cases where, as a result of forecast errors or unexpected inflation hikes, Belgian wage increases turn out to exceed those observed in the reference countries. According to the Law on Competitiveness, such *ex-post* adjustments cannot reduce the nominal wage increases below the level which would result from the application of the sectorial indexation mechanisms. Since the difference between the "wage norm" and the "health index" inflation level is often small, in practice, this implies that there is only little room for effective *ex-post* corrections. Moreover, efforts to reduce the growing wage gap were often offset by new overestimations of future wage developments in neighbouring countries. In this respect, the use of 'all-in clauses' could be useful: the determination of an overall margin that incorporates both

²³ Indexation schemes are agreed upon at sectoral level and are legally bound to refer to the so-called "health index". The latter was introduced by Royal Decree in 1994 and differs from the HICP in that it excludes the price evolution of alcoholic beverages, tobacco products and motor fuels.

inflationary adjustment and real wage increases so that unanticipated inflationary pressure can be neutralized by limiting real wage increases.²⁴

The wage norm was designed when Belgium was still realizing high productivity growth and it did have its merits in the past. However, as trade partners have made considerable efforts to contain wage pressures and increase productivity, the wage setting system has become a burden for the Belgian labour market. In this context, and given the fact that the 1996 Law was specifically adopted to preserve external competitiveness, a review of the current wage setting mechanism seems desirable.²⁵ Especially as it is questionable whether the tangible advantage of the indexation mechanism in terms of purchasing power protection²⁶ compensates for the creeping disadvantages in terms of growth and employment over the longer term. In an effort to tackle some of the identified problems, the Belgian authorities recently announced actions (see Box 1).

Box 1: Measures announced by authorities to improve cost competitiveness

On 19 December 2012, when proposing its 2013 draft budget, the federal government declared its intention to Parliament to gradually eliminate the accumulated wage gap with neighbouring countries over the next five years. The gap was estimated to amount to 3.4% (excluding the impact of wage subsidies). To reduce the wage gap the government decided on the following measures²⁷:

A freeze in real wages throughout 2013 and 2014 is expected to reduce the gap by 0.9 pp. according to the authorities although this will be contingent upon wage developments in the neighbouring countries. While indexation mechanisms and age-related increases will still be applied in full, no additional wage increases are allowed.

In addition, the wage indexation calculation formula has been revised to better take into account actual consumption patterns (e.g. taking into account the market share of different formulas for telecom contracts, using scanning data from supermarkets for food and household products, factor in the price effect of sales periods, measuring fixed energy contracts at time of effective use instead of time of purchase). The Belgian authorities estimate that these changes in measurement could reduce labour costs by 0.4pp over 2013-14.²⁸

²⁴ In fact, the real wage freeze for 2013-14 (see Box 1) boils down to an all-in agreement.

²⁵ The National Bank of Belgium discussed different ways to enhance the flexibility of the system in an elaborate 2012 study.

²⁶ This advantage should be put into perspective: the experience since 1996 of neighbouring countries demonstrates that the absence of an automatic indexation does not imply an erosion of purchasing power over the medium term. Real wages did not fall in these countries between 1996 and 2011 – on the contrary, they rose in all three countries and more in FR and NL than in BE –, while they were able to absorb sudden external shocks more easily through real wage adjustment.

²⁷ Actions to close the remaining wage gap after 2014 will have to be decided by the next government. General elections are scheduled for May 2014.

²⁸ While the actions announced should reduce inflationary pressure towards levels observed in neighbouring countries and prevent the wage cost differential from rising, this does not seem to correspond to a gain in cost competitiveness as the differential remains.

Also, the government has earmarked a budget of EUR 400 million/year for additional wage cost moderation measures in the form of targeted social security reductions. The social partners were requested to identify the target groups the reductions should focus on in order to maximise the employment impact. The government expects these additional reductions to further reduce the relative wage gap by 0.3 pps.

To reduce the risk of overestimating wage developments in neighbouring countries, a new method will be adopted to set the wage norm, which would not only be based on forward-looking projections but also on actual data regarding past relative inflation and wage developments. In addition, the mechanisms for ex-post corrections foreseen in the Law of 1996 on Competitiveness would be reinforced and the social partners would be required by law to ensure that the remaining losses in relative cost-competitiveness are compensated for by additional measures after 2015.

2.2.6. *Costs of intermediary inputs*

Wages represent an important part of total costs for companies. Cost competitiveness, however, is also determined by other factors. For exporting companies to stay competitive, the price of intermediary inputs also plays an important role. As has been discussed already in the 2012 IDR, the general price level in Belgium is higher than in the neighbouring countries and the euro area. Given Belgium's product specialisation, producers often cannot pass on these higher input costs to the price of their products. Deteriorating terms of trade have thus affected the cost competitiveness of Belgian companies.²⁹

An important share of the observed inflationary differential stems from higher energy prices. Belgian authorities have recently put in place policies to tackle the inflationary pressure resulting from rising energy prices. A price observatory has been granted extra powers and customer mobility has been fostered by enhancing competition between energy providers.³⁰ Following a temporary price freeze, energy prices are again determined by market forces, though they will have to reflect relevant and real input costs – i.e. (international) market prices for gas and electricity – and can thus no longer be linked to the oil price evolution or incorporate other items such as personnel or exploitation costs. Price formulae will also be simplified as to enhance transparency, while indexation for variable contracts is limited to once every quarter.³¹ Nevertheless, for some energy carriers prices remain more elevated in Belgium than in many other EU countries, so that vigilance by the Belgian authorities remains warranted. While progress has been made to reduce energy prices,

²⁹ As discussed infra, the profitability of Belgian companies does not reflect a big squeeze in margins. However, as indicated by the Federal Planning Bureau (2012), product subsidies have prevented margins from falling.

³⁰ Through the introduction of on-line price comparability tools for electricity and gas, the elimination of switching fees, a revision of the social tariff system and a freeze of distribution tariffs until 2014. More directly, the dominant player on the market, GDF Suez, has been forced to divest part of its production capacity (of amortised nuclear plants) and sell it on the market.

³¹ According to the federal energy regulator CREG, a reason for rising prices could be found in the monthly indexation of the energy component of electricity and gas bills, which was based on a formula that took into account the price of gas but also that of coal and oil.

distribution tariffs and transportation charges for electricity by the authorities constitute a large part of the final price.

Nevertheless, in recent years Belgium has also been performing worse than its neighbours and the euro area in terms of core inflation (i.e. excluding energy and food prices). Indeed, price levels for many other goods and services are higher in Belgium, as are price increases.³² For one part this can be attributed to relatively weak competitive pressures³³, especially in the retail sector, due to competition-restricting regulation, and in network industries (postal services, transportation and telecom, though recent measures seem to have enhanced competition in the latter), due to high entry-barriers with dominant incumbent firms, and a weak supervisory framework. The scope for product market enhancement in Belgium seems to be still considerable in other words. On the other hand, apart from the high weight of energy prices and weak competition, the higher inflationary pressure can also be partly attributed to stronger second-round effects generated by automatic wage indexation mechanisms as well as by the widespread practice of indexing prices in the services sector.

2.2.7. *Non-cost competitiveness*

There are a number of additional, non-cost factors that need to be taken into account when analysing the reasons behind the deterioration of the current account and the loss of market shares.³⁴ For example, technological competitiveness driven by the capacity to innovate as well as to increase efficiency is an important feature behind overall export performance.

The technological content of manufactured products reflects a country's ability to translate innovation into exportable products with a higher value added. Table 3 indicates that while the share in manufactured exports of high-tech products increased strongly between 2000 and 2011, it remains below levels observed in FR and NL, though close to Germany and the euro area. Moreover, Belgium's technological configuration has converged in general towards that of the euro area since 2000, implying an orientation towards medium-tech products. This is in line with the earlier finding that Belgium exports mainly intermediate products. The still moderate proportion of high-tech products in total exports can be related to R&D intensity, as discussed in section 3.2., which looks into relevant aspects of innovation.

³² See e.g. SPF Economie (2012), 'Niveau de prix dans les supermarchés', which found that the average price differential with the neighbouring countries fluctuates between 7% and 12%.

³³ The Belgian authorities have announced a reform of the Competition Authority, which should help to address this issue.

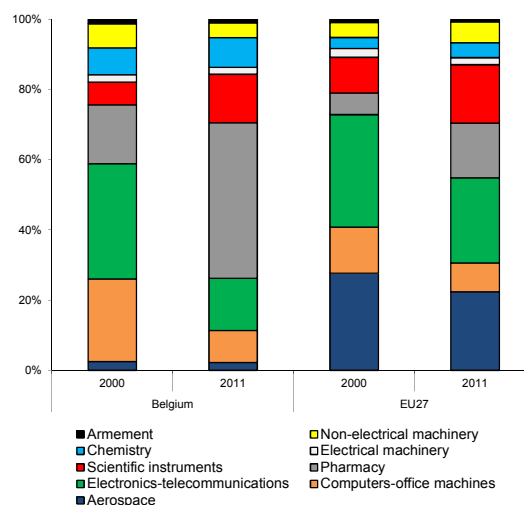
³⁴ A joint report by different Belgian institutions deals with the issue of non-cost competitiveness: see NBB, CCE and FPB (2011).

Table 3: Manufacturing exports by technological content (% of total)

		2000	2011
BE	High tech	14.1	18.0
	Medium-high tech	41.2	39.2
	Medium-low tech	19.9	24.2
	Low tech	24.8	18.6
EA17	High tech	22.5	19.6
	Medium-high tech	39.8	40.4
	Medium-low tech	16.8	21.5
	Low tech	20.9	18.4
DE	High tech	20.5	18.8
	Medium-high tech	49.9	50.5
	Medium-low tech	15.3	17.4
	Low tech	14.3	13.3
FR	High tech	31.5	26.2
	Medium-high tech	35.7	35.8
	Medium-low tech	14.7	18.0
	Low tech	18.1	20.1
NL	High tech	34.3	27.3
	Medium-high tech	26.2	28.4
	Medium-low tech	18.2	25.1
	Low tech	21.4	19.2

Source: Commission services

Graph 19: Break-down of high-tech exports



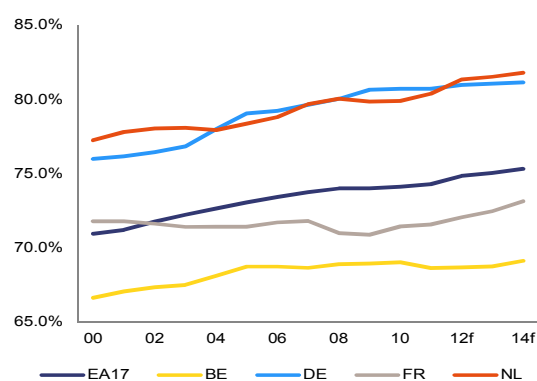
Source: Commission services

When looking into the composition of high-tech exports (see Graph 19), it can be observed that the main rise comes from a strong performance by the pharmaceutical sector while sectors such as ICT, telecom, office and transport equipment have lost importance. As highlighted by the Federal Planning Bureau (2012), the development of ICT activities has been modest in Belgium in comparison to other European countries.

The availability of appropriately skilled labour in sufficient amounts is another important factor with regard to external performance. While Belgian workers are in general highly skilled, in terms of volume there are clearly serious problems. Belgium suffers from a persistently low labour participation rate and the gap with neighbouring countries has widened further in recent years (see Graph 20). This reflects the fact that Belgium has a high share of long-term unemployment and particularly low participation rates among older and non-EU workers. The working life duration lies also significantly lower in Belgium than is the case in neighbouring countries (see Graph 21).

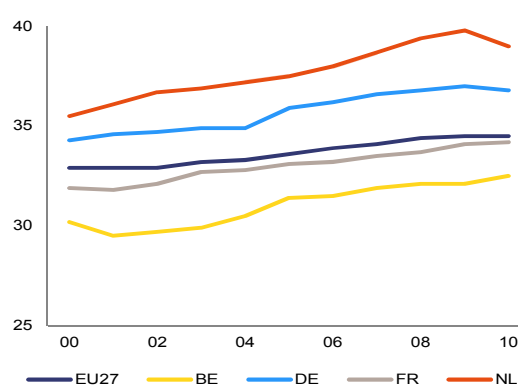
Furthermore, certain sectors suffer from structural mismatches between labour demand and supply. This results in the coexistence of high unemployment and a high number of vacancies. Both the low participation rate and the structural mismatches in labour allocation can be explained by the rigidities that characterise the Belgian labour market. The wage setting mechanism can be seen as the main driver as it introduces a high degree of real wage rigidity and limits the margin for wage differentiation, thereby hampering labour mobility towards more productive and tradable sectors as discussed under section 2.2.5. Also financial disincentives to work stemming from the existing tax and benefit system, ineffective activation policies and the continuation of early retirement schemes contribute to Belgium's labour market problems.

Graph 20: Participation rate (%)



Source: Commission services

Graph 21: Duration of working life (y)



Source: Commission services

2.2.8. Conclusion on external imbalances

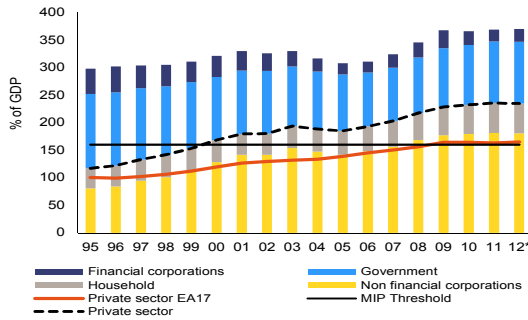
Belgium has been suffering losses in export market shares for goods over the past decade, mirrored in a dwindling of its current account surplus. This trend is unchanged from last year's IDR and reflects an erosion of Belgium's external competitiveness. Although further market share losses might be contained by the geographical reorientation of Belgian exports, Belgium's growing specialisation in cost-sensitive intermediary goods seems problematic. Goods exports could benefit from action with respect to both cost and non-cost competitiveness factors, although it seems to be more urgent to act on the cost side given the existing wage gap with neighbouring countries and the recent actions undertaken by other European countries to improve their cost competitiveness. In this regard, an enhancement of the flexibility of the wage setting mechanism would allow wages to progress more in line with productivity developments, absorb external shocks and could introduce more differentiation among sectors. Additionally, companies would benefit from a better functioning of product markets.

Regarding non-cost competitiveness, a push towards more sophisticated goods and services with a higher value added would shield the Belgian industry better from intense international price competition. A focused and concerted effort by the authorities on items such as R&D investment or currently underdeveloped ICT activities would assist the Belgian economy in its reorientation and allow it to reap its comparative advantages more aptly. Further considerations on the strengthening of the research and innovation policy will also be discussed in section 3.2.

2.3. Assessment of the existence of internal imbalances

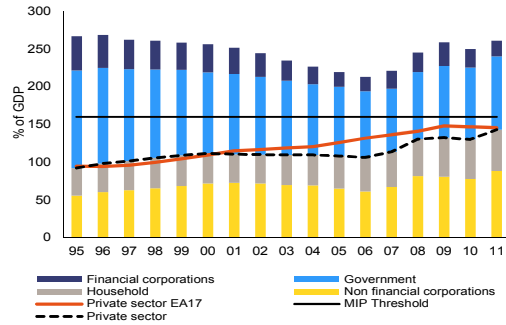
The overall indebtedness of the Belgian economy is substantially higher than that of the euro area as a whole: 348% of GDP in 2011, excluding the financial sector, against 253% of GDP in the euro area (see Graph 22). Both the indicator for (non-consolidated) private debt (237% of GDP in 2011) as well as the one for the consolidated public debt (98% of GDP) are above the scoreboard threshold. Non-financial corporations account for the bulk of the outstanding private debt (182.5% of GDP compared to 99.0% in the euro area), while household debt is relatively contained (54.3% of GDP compared to 64.2% in the euro area). However, the private debt is only at 144% of GDP in consolidated terms, i.e. netting out lending between non-financial corporations, just below the 146% for the euro area (see Graph 23). The risks related to the indebtedness of the different sectors are analysed in this chapter.

Graph 22: Decomposition of public and private debt (non-consolidated)



Source: Commission services; note: * indicates estimated figure using quarterly data.

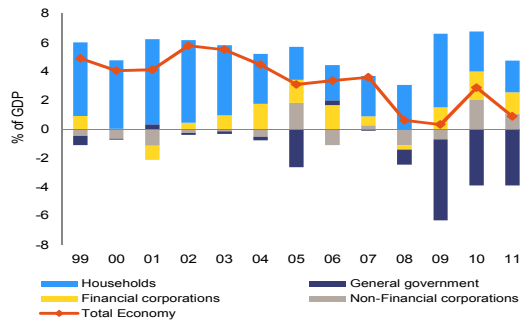
Graph 23: Decomposition of public and private debt (consolidated)



Source: Commission services

On the other hand, the economy is still in a net lending position despite the sizeable public sector borrowing in recent years (see Graph 24). Net lending of the financial sector, the non-corporate sector and households has been positive in 2010-2011.

Graph 24: Net lending/borrowing by sector



2.3.1. *Public sector indebtedness*

Belgian public debt rose from 97.8% of GDP in 2011 to 99.8% of GDP in 2012, which is substantially above the indicative scoreboard threshold of 60% of GDP. This makes the Belgian public debt ratio the 5th highest in the EU, after Greece, Ireland, Portugal and Italy. According to the Commission services' Winter Forecast, the debt ratio is expected to increase slightly further before stabilizing in 2014.

The Belgian public debt had declined from 134.2% of GDP in 1993 to 84.0% of GDP in 2007 due to primary surpluses and uninterrupted positive economic growth. From 2008 onwards, the debt ratio started to increase again (+16% of GDP), although the rise was more limited than in many other EU member states where government debt rose by +28% on average between 2007 and 2012. Rescue operations in the financial sector under the form of capital injections (Dexia, Fortis, Ethias), loans (KBC³⁵, Kaupthing) and the nationalization of Belfius amounted to almost EUR 25 bn (excluding interest payments and guarantee fees) or 7% of GDP at the time of the operations. The accumulation of deficits due to the impact of the crisis on public finances and the financing of stimulus measures led to a debt increase by 9% of GDP, while other stock flow adjustments (e.g. participation in the EFSF) accounted for the remaining debt increase (+1% of GDP).

Moreover, Belgium still carries substantial contingent liabilities due to guarantees granted in the context of the financial crisis, although the maximum amount of guarantees that financial institutions can use have recently been decreased. Belgium and France agreed to lower the maximum amount of guarantees to Dexia from 2013 onwards from EUR 90 bn to 85 bn. The Belgian share will be reduced from 60.5% to 51.45%, lowering the maximum risk for Belgium from EUR 54.5 bn to 43.7 bn (12% of GDP). On the other hand, the guarantee fee to be paid by Dexia has been lowered from an annual rate of 90 basis points to 5 basis points of the outstanding guarantees. At the end of 2012, Belgium and BNP Paribas agreed to put an early end to state guarantees of EUR 1.5 bn (0.4% of GDP) on an investment portfolio. The guarantee scheme granted to KBC has been reduced at the end of 2012 from EUR 15.1 bn to 9.4 bn (2.5% of GDP).

According to the European Commission's Fiscal Sustainability Report (EC, 2012), Belgium does not appear to face a risk of fiscal stress in the short term. However, risks to fiscal sustainability are high from a medium- to long-term perspective. This reflects the budgetary impact of the cost of ageing, which derives from a rapidly ageing population and a high level of expenditure on social transfers. Under a no-policy-change assumption, the public debt would increase to 106.7% of GDP by 2020 and to 147.4% of GDP by 2030.

³⁵ KBC has received total state support under the form of a loan for an amount of EUR 7bn, spread evenly over the federal state and the Flemish Region. KBC reimbursed EUR 500 mn in January 2012 and EUR 3 bn at the end of 2012. KBC intends to reimburse also EUR 1.17 bn to the Flemish Region in the first half of 2013 and EUR 4.67 bn by the end of 2013.

In addition, the recent increase in the debt burden did not go hand in hand with a high level of public investment or expenditure on growth-enhancing policies. On the contrary, gross fixed capital formation fluctuated around 1.7% of GDP between 2008 and 2012, while it accounted for around 2.5% of GDP in the euro area as a whole.

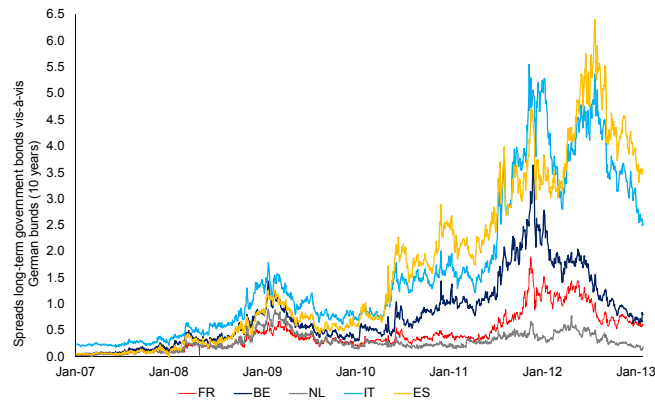
Finally, the fiscal space to service a higher debt or to reduce the debt burden is very limited. Belgium belongs to the group of EU countries with the highest tax levels, alongside the Nordic countries, France and Austria. At 44.1% of GDP, the Belgian total tax-to-GDP ratio was the third highest in the EU in 2011 (EU average 38.8%), while taxes on labour accounted for 24.0% in 2011 (EU average: 19.7%)³⁶. The high burden on labour mirrors primarily high taxation of personal income. The 2013 top personal income tax rate of 53.7% (EU: 38.3%) is the third highest in the EU. The 2011 tax wedge on labour income is among the highest in the EU, at 49.7% for low-wage earners and at 48.2% for average-wage earners in a two-person household. The implicit tax rate on labour employed is the highest in the EU at 42.8% in 2011. As a consequence, marginal effective tax rates on labour are in general significantly above the EU average while the unemployment trap is very high.

The high debt level makes Belgium particularly vulnerable to tensions in financial markets.³⁷ This has been illustrated by the sudden rise in risk premia that occurred at the end of November 2011. The spread on Belgian 10-year bonds (with respect to the German Bund) rose to more than 360 basis points, while, at the same moment, the spreads on French and Dutch bonds reached about 190 and 60 basis points, respectively. Since November 2011, the spread decreased steadily, but debt financing costs remain higher for Belgium than for France or the Netherlands (see Graph 25).

Graph 25: Evolution of government bond spreads (2007-13)

³⁶ European Commission, 'Taxation trends in the European Union – 2013 edition', forthcoming. (http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm)

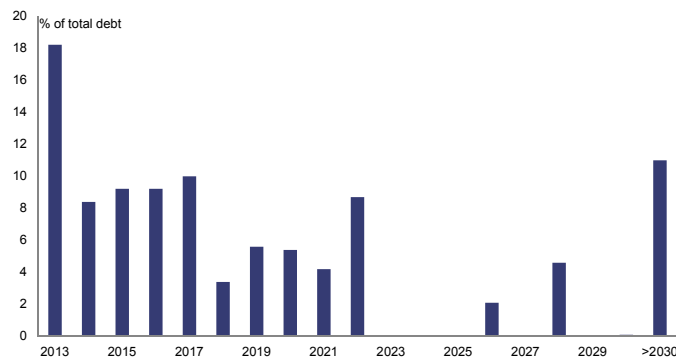
³⁷ According to a VAR analysis by the IMF, most of the variation in the Belgian government bond spread appears to be associated with external factors (IMF, 2012). However, two distinct periods in time have been identified in which domestic factors played temporarily a more important role. In late 2008 and early 2009, domestic factors are estimated to have accounted for an average of 15% of the increase in the spread reflecting the concerns around the banking sector and the needed capital injections by the state, which was already under strain due to the high debt level. From the end of 2010 onwards, the political deadlock and renewed concerns around Dexia pushed the spread up again, which dropped only after the announcement of a 2012 budget agreement at the end of November 2011.



Source: Commission services

The weighted average term to maturity of central government debt is around 6.8 years, which is relatively high compared to other euro area countries. Only 26% of outstanding debt is maturing before the end of 2014, which might temper somewhat the adverse effects of temporary rises in interest rates (see Graph 26).

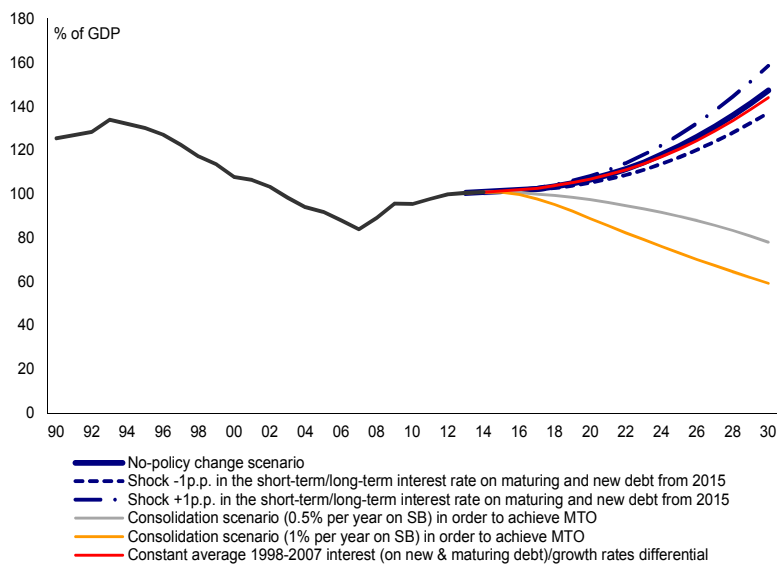
Graph 26: Maturity profile of Belgian public debt



Source: Commission services, January 2013

Due to the high public debt level, a sustained period of high interest rates could lead to an upward debt spiral. Increased interest payments can in turn lead to a further increase in the debt level (snowball-effect), as witnessed in the 1980s, making the debt developments unsustainable. Given the current financing and re-financing needs of the Belgian State, an increase in the average risk premium by 1 pp. during one year may cost the Belgian state EUR 700 mn or around 0.2% of GDP a year. A sustained increase in the risk premium by 1 pp. would lead to an additional increase in the debt level by 11 pps. by 2030 (see Graph 27).

Graph 27: Medium term debt projections and interest rate sensitivity



Source: Fiscal Sustainability Report 2012

An increased risk premium would not only endanger the sustainability of public debt, but could also have spill-over effects to the financial sector. It may negatively affect the asset value of bond holdings by Belgian financial institutions, which currently hold around EUR 70 bn of Belgian bonds. At the end of the third quarter of 2012, around 56 % of Belgian government bonds were held by Belgian residents (Belgian Debt Agency, 2012), mainly by financial corporations and pension funds. As mentioned above, the interlinkages between public debt and financial institutions also play in the other direction: pressure on financial institutions could fuel doubts about the creditworthiness of the sovereign due to guarantees and loans provided to financial institutions or due to market expectations about new rescue operations into the financial system.

Higher risk premia may not only affect the sustainability of public finances, but could also impact growth and competitiveness. A high interest rate for public debt may pass through to the private sector, driving up financing costs for domestic financial institutions and ultimately of non-financial companies and households, which would have a negative impact on investment and R&D expenditure. An additional channel is the fact that the perceived creditworthiness of private borrowers is influenced by the risks associated with the sovereign creditor.

Variable rates of mortgages are legally linked to interest rates on Belgian treasury certificates and 3 to 5 year bonds (although with a legal cap) so that an increase in bond rates leads to a loss in disposable income for house owners with a floating rate loan. An increase in non-performing loans would in turn have second-round effects on the banking sector. Nowadays, house buyers choose more often mortgage contracts with an interest rate which is fixed for the full term of the loan (over 80% of new mortgage loans in 2012). However, the level of the fixed rates financial institutions offer to new customers tends to follow bond rates. Hence, a shock in lending costs for the Belgian sovereign can filter through to the housing market, and thus affect activity in the construction sector.

The government's high debt service poses a drag on growth since it drives out more productive government expenditure and increases the (expected) tax burden, which weighs on labour and capital costs. Recent empirical studies on the subject confirm the existence of an inverse relationship between the level of public debt and economic growth.³⁸ In addition, interest payments to non-residents deteriorate the balance of primary income and thus the current account balance. Conversely, the loss of competitiveness discussed in the previous section renders high debt levels even more problematic as it weighs on growth prospects, which in turn makes it more difficult to put the debt ratio on a downward path. Lastly, the high debt burden reduces the margin for Belgium to tackle future shocks and loosen fiscal policy in times of recession. As such, it affects the stability of the economy as a whole.

2.3.2. *Non-financial corporations indebtedness*

As already observed in last year's In-depth Review on Belgium, the scoreboard indicator of the private sector debt³⁹ level (237% of GDP in 2011) is well above the scoreboard threshold of 160%. It has increased steadily since 2006. Non-financial corporations account for the bulk of this outstanding debt: 182.5% of GDP compared to 99.0% on average in the euro area.

The consolidated debt level of non-financial corporations – i.e. excluding intra-sector liabilities, thus eliminating the credit transactions between different companies or subsidiaries of companies inside Belgium⁴⁰ – is significantly lower. It stands only at 89.4% of GDP, against 81.4% of GDP in the euro area. Belgium is the country with the most prominent difference⁴¹ between non-consolidated and consolidated data, i.e. 93 pps. in 2011.

The sizeable difference between non-consolidated and consolidated data can be explained by the large credit provision between Belgian companies, mainly intra-group loans⁴². This in turn reflects the wide use of financial centres inside company

³⁸ For instance, Reinhart and Rogoff (2010) find a 2.6 pps. difference in median real GDP growth between advanced countries with public debt below 30% and above 90% of GDP. Kumar and Woo (2010) estimate that for advanced economies a 10 pps increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.15 pp., with some evidence of nonlinearity implying larger negative effects with initial debt above 90%.

³⁹ Private sector is defined as non-financial corporations, households, and non-profit institutions serving households. The nonfinancial corporations sector includes both private and public corporations.

⁴⁰ It should be noted that cross-border intra-group and intra-sector lending is still included in the consolidated data.

⁴¹ In Belgium, detailed statistical sources on an unconsolidated basis are used to compile the financial accounts. Differences in coverage with other Member States may blur the international comparison.

⁴² In the financial accounts, it is not possible to make a distinction between loans to related companies and loans between unrelated companies. However, data from the Central Balance Sheet Office gives an indication. According to the balance sheets of large companies, the amount of loans between related companies (EUR 465 bn in 2010) was around the same size as the sum of loans between companies (EUR 352 bn) and cross border non-bank loans (EUR 104 bn) in the financial accounts. This confirms that the high non-consolidated figure is largely explained by intra-group loans.

groups, which for accounting practices form part of the non-financial corporations sector. The origins of the large presence of such 'internal banks' in Belgium lies in the previously advantageous tax regime for the coordination centres (coordinating the financial and fiscal activities of multinationals) and non-financial holdings (operating as intermediary in the financing of companies). Since 2006, this tax regime has been substituted by an allowance for corporate equity (ACE). This system enables all companies subject to Belgian corporate income tax to deduct from their taxable income a fictitious interest (3% for tax year 2013, 3.5% for SMEs) calculated on the basis of their shareholder's equity (net assets). The main purpose of this measure is to reduce the tax discrimination between debt financing and equity financing, and safeguarding the attractiveness of Belgium for multinationals after the gradual phasing out of the coordination centre regime.

The ACE constitutes an incentive for a triangular construction, where a subsidiary provides capital to a financing vehicle of the same group, which in turn lends this capital to the same or another subsidiary.⁴³ The capital increase in the financing centre allows for a more extensive use of the notional interest deduction by the financing vehicle and thus a reduction in income taxation, while the interest on the internal loan paid by the subsidiary to the financing centre also reduces the taxable income of the subsidiary. Such an intra-group construction leads to an overall increase in the outstanding corporate debt in non-consolidated terms, but does not affect the consolidated debt level of the corporation. The above-described intra-group operations for tax optimization purposes do not constitute a risk in terms of macro-economic stability even under stressed conditions. Their only cost is that these operations blur the statistics and reduce tax revenues. A change in the treatment could possibly induce an internal reorganization of the financial architecture within each group, but should not affect the real economy, apart from making Belgium a less attractive location for multinationals to invest. On the other hand, loans between unrelated companies entail risks related to insolvency which could lead to contagion under stressed conditions.

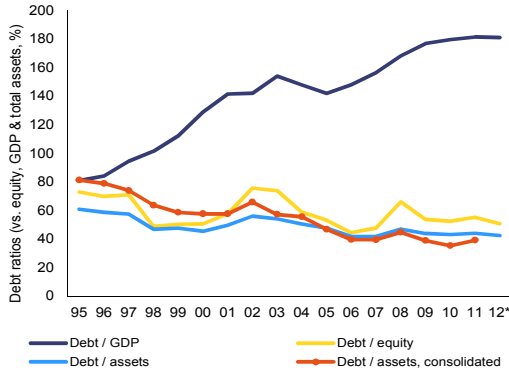
Various indicators of Belgian corporations' financial health do not point to any significant sustainability risks. As can be seen in Graph 28, the increase in the debt-to-GDP ratio is not mirrored by an increase in debt-to-asset or debt-to-equity ratios. On the contrary, these indicators point to a clearly declining trend in the leverage of non-financial corporations, and the indicators for Belgium are currently among the lowest in the EU. This could be due to the presence of the ACE system which seems to have decreased the leverage of corporations.⁴⁴ Also, as can be seen in Graph 29, the increased indebtedness of non-financial corporations was not accompanied by a decline in profitability.

Graph 28: Leverage of non-financial corporations

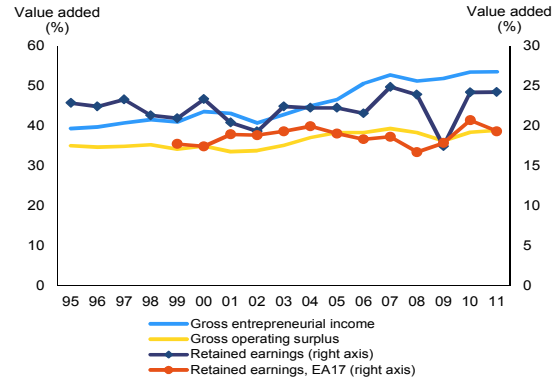
Graph 29: Profit margins of non-financial corporations

⁴³ The Belgian ACE does not contain anti-abuse rules to avoid such tax planning scheme.

⁴⁴ See for example Princen, S. (2012) who finds that the Belgian ACE decreased leverage of Belgian non-financial corporations by between 2 and 7%.



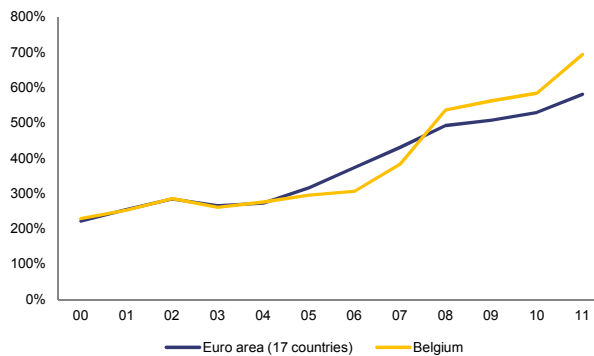
Source: Commission services; note: * indicates estimated figure using quarterly data.



Source: Commission services

The capacity to repay should also be taken into account when assessing the sustainability of debt levels. Gross operating surplus might provide a signalling of a firm's capacity to generate income and thus service its debt. From Graph 30 it can be seen that Belgium is following the increasing trend of the euro area as a whole, with the exception of 2008 and 2011 when the relative debt has been increasing more rapidly for Belgian companies. Again, this could possibly be explained by the establishment of financial centres of multinationals attracted by the notional interest system.

Graph 30: Consolidated debt of non-financial corporations as % of gross operating surplus



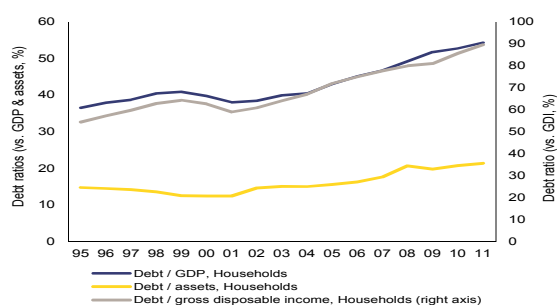
Source: Commission services

To sum up, despite the high levels of indebtedness of Belgian firms in non-consolidated terms, several factors call for a qualification of potential deleveraging pressures. Due to the high share of intra-group loans, the level is much lower in consolidated terms. Moreover, debt-to-asset and debt-to-equity ratios have been gradually declining.

2.3.3. Financial position of households

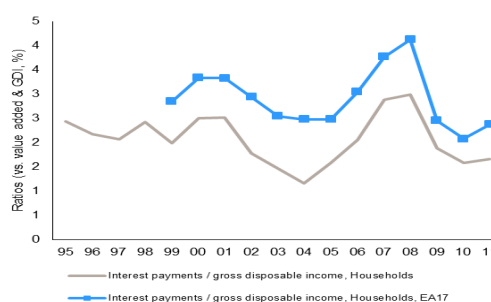
Household indebtedness is relatively low in Belgium (54.3% of GDP, compared to 64.2% on average in the euro area) but has been increasing steadily since 2001 (see Graph 31). As can be observed from the graph, the increase in the debt/asset ratio is far less pronounced, given that the accumulation of debt has been accompanied by an accumulation of assets. Indeed, more than 80% of the household indebtedness is mortgage related, and hence the rising indebtedness can be explained by rising house prices (see section 3.3). The decrease in interest rates could have been a driver for increased indebtedness. Also the more favourable tax treatment of mortgage loans since 2005 can explain part of the recent increase. Indeed, while household debt levels are increasing, the interest burden on households did not seem to have increased (see Graph 32).

Graph 31: Leverage of households



Source: Commission services

Graph 32: Interest burden on households



Source: Commission services

The net financial assets of Belgian households amount to about 200% of GDP, which is much higher than the average of the euro area (see Table 4). Looking at the evolution in recent years, a big impact of the fall in equity prices in 2008 can be observed (see Graph 33). Net financial wealth dropped from EUR 706 bn mid-2007 to EUR 616 bn by end-2008. Afterwards, net financial wealth of individuals started increasing again in nominal terms, to EUR 770 bn in mid-2012,⁴⁵ but the increase was insufficient to compensate for inflation.

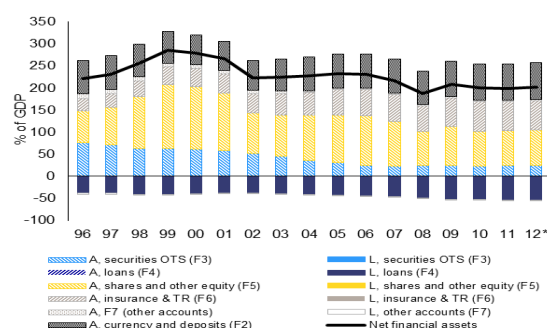
Table 4: Households' Net Financial Assets (2007-2011)

	Net Financial Assets (% of Gross Domestic Product)				
	2007	2008	2009	2010	2011
Belgium	217.2	188.1	208.6	200.4	199.3

⁴⁵ See <http://www.nbb.be/belgostat/PresentationLinker?TableId=347000044&Lang=E>.

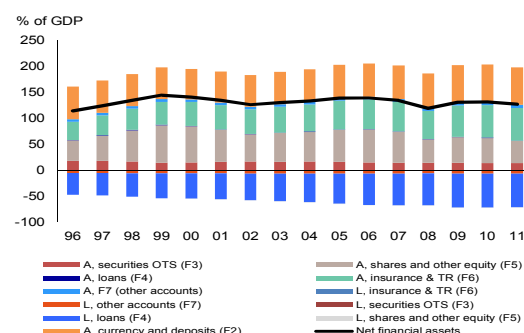
Euro area	134.9	119.7	131.3	132.3	127.6
Source: Commission services					

Graph 33: Households balance sheet (BE)



Source: Commission services

Graph 34: Households balance sheet (EA)



Source: Commission services

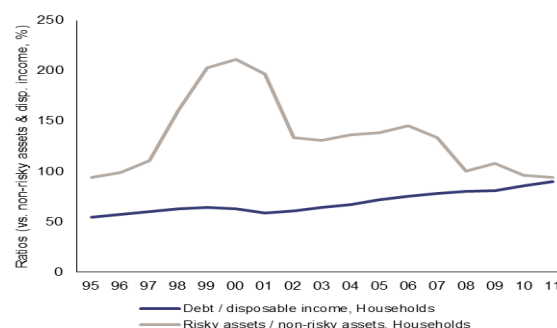
The large accumulation of net financial assets can be attributed to the high savings rate of Belgian households. Although the rate dropped considerably after the outbreak of the crisis, it is still among the highest in Europe (see Table 5). Furthermore, the deterioration in net financial wealth was accompanied by an increase in the value of non-financial assets (see section 3.3). Also, the share of risky assets (shares and other equity) in the portfolio of households is declining (see Graph 35).

Table 5: Household saving rate (2010-2014)

	Household saving rate (% of Gross disposable income)				
	2010	2011	2012f	2013f	2014f
Belgium	15.4	14.4	14.7	15.5	15.6
Euro area	14.1	13.5	13.3	13.3	13.3

Source: Commission services' 2013 Winter Forecast (Euro area excluding EL, LU, MT)

Graph 35: Balance Sheet Repair, Households



Source: Commission services

While the financial situation of households is reassuring, some risks associated with the housing market deserve further consideration. A growth in outstanding mortgages

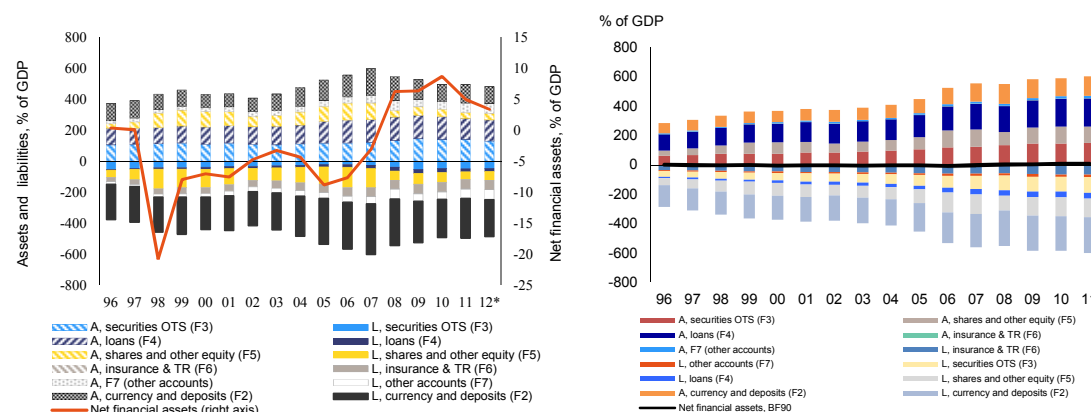
could be observed during the years prior to the crisis. The interest rate structure, dominated by fixed interest rates ensures some protection to households to interest rate hikes risks. The housing market developments will be analysed more in-depth in section 3.3.

2.3.4. The financial sector

Both the macro-economic situation as well the state of public finances are heavily interlinked with developments in the financial sector.

Total financial assets⁴⁶ of the Belgian financial sector are estimated to amount to 483% of GDP in 2012 (see Graph 36). Compared to other euro area countries, the Belgian financial sector is somewhat ahead in the deleveraging (NBB, 2012), because disinvestment was often a condition for receiving state aid. The adjustment of the Belgian banking sector is taking place through a divestment in foreign markets and a renewed focus on the domestic market. The sector is highly concentrated, although less than before the financial crisis, with the four largest banks holding more than 84.4% of total bank assets in 2011.

Graph 36: Balance Sheet Financial Corporations Belgium (left) and euro area (right)



Source: Commission services

Over the last year, the Belgian banking sector continued to reduce its exposure to the public sector of European peripheral countries.⁴⁷ On the other hand, Belgian banks further increased their holdings of Belgian government bonds, from around EUR 61 bn at the end of 2010 to EUR 69 bn at the end of September 2012. These holdings now represent over 44% of sovereign debt exposure. The geographical re-orientation can also be observed when looking at the breakdown of other assets. Not only the

⁴⁶ Excluding Monetary gold and SDR (F1)

⁴⁷ Public exposure to these countries decreased from EUR 16 bn or 11% of total public exposure at the end of 2011 to EUR 10 bn (6.6% of total public exposure) at the end of the third quarter of 2012, with Italian government bonds accounting for the bulk of this figure (EUR 6.8 bn).

exposure to foreign government bonds decreased, but also the exposure to the foreign private sector continues its strong decline since 2007, from EUR 322 bn at the end of 2011 to EUR 307 bn at the end of September 2012. On the other hand, despite the ongoing deleveraging, outstanding loans to Belgian counterparts remained relatively stable at around EUR 365 bn between the end of 2011 and September 2012. These figures illustrate the downsizing of Belgian banks to their core market, where they continue to play their intermediary role in the Belgian economy. As discussed in the previous section, loans to households have slowed down during the crisis rather than fallen, but credit standards for mortgages are tightening. Corporate loan growth was almost flat between November 2011 and November 2012, due to both demand and supply factors.

At the end of September 2012, the rate of non-performing loans had increased to 3.6% of total loans from 3.3% in 2011 (NBB). Before the financial crisis, it stood only at 1.5%. The increase stems predominantly from the corporate sector, but also non-performing retail loans (households and some SMEs) are steadily rising. The impaired claims are mainly of foreign origin, but recently the rate of domestic non-performing loans also started to increase. With a rather subdued growth outlook in Belgium and in the euro-area, the rate of non-performing loans may further rise which weighs on the asset quality of Belgian banks.

Risk-weighted assets stabilized in 2011 and declined in the first 9 months of 2012. As a consequence, solvency ratios improved (NBB).

On the liabilities side, a strong increase in the outstanding amount of customer deposits was observed during the first nine months of 2012, from EUR 500 bn to EUR 525 bn. Other liabilities are steadily being reduced⁴⁸ as part of the strategy to shrink balance sheets and lower the reliance on the wholesale market. As a consequence, the liquidity position and funding of Belgian banks has improved over the last year. The regulatory liquidity stress test continued to display an improvement while the loan-to-deposit ratio is stable at around 90%.

Profitability of Belgian banks remains weak, although it improved in 2012 due to a higher net interest income and lower impairments.

Overall, risks for the Belgian financial sector seem to have fallen substantially since last year, although the adjustment is still on-going. A particular case was Dexia, which was recapitalized by the Belgian and French State in order to remedy a negative net asset position and to allow the pursuit of the orderly resolution of the Group. The increased orientation of the banking sector towards the home market, also observed in other euro area countries, reinforces the interdependence and risks for spill-overs between the real economy, the public sector and the financial sector.

⁴⁸ Except central bank financing following the ECB's Long Term Refinancing Operation.

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

3.1. The role of services in the Belgian current account balance⁴⁹

3.1.1. *Evolution and orientation of trade in services*

As highlighted above, Belgium has been realising a growing external service surplus. According to the EC's Surplus Report (2012) this surplus reflects the shift towards an outward-looking, services-oriented economy and has, to some extent, offset the declining trend in the balance of goods. This warrants a closer investigation into the service balance and its composition.

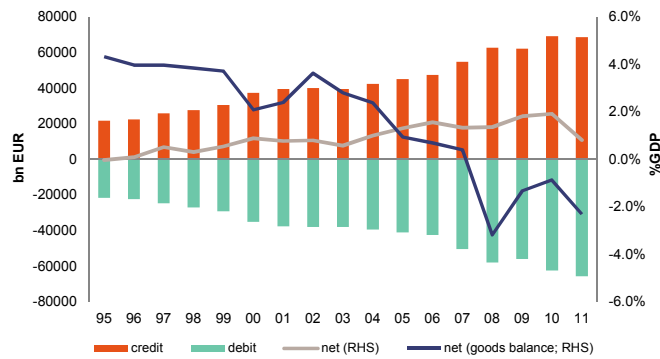
Both in terms of value added (77.5% vs. 73% for the EU27) and in terms of employment (75.3% vs. 69.1%) Belgium is more service-oriented than the average EU country. Nevertheless, when it comes to international trade, services are still dominated by goods: 22% of total exports are services, up from 20% in 2002. For the EU27 this ratio went from 23% in 2002 to 24% in 2011, though with important differences among Member States. In general, their intrinsic intangible nature makes services more vulnerable to trade constraints than goods. As it is often hard to distinguish between the production, the delivery and the consumption of a service, the proximity of supplier and customer may be required so that many producers offer their products by the establishment of foreign affiliates instead of cross-border transactions. This FDI channel – not incorporated in trade statistics – is often considered to be at least as important in value terms as ‘conventional’ international trade in services. In this regard, it should be noted that between 2008 and 2011 services represented on average 84% of the Belgian stock of outward FDI and 82% of the inward stock according to NBB data.

The National Bank of Belgium provides detailed statistics for the service balance as of 1995, the last year it turned (slightly) negative. Ever since, the surplus has steadily expanded as seen in Graph 38, reaching close to 2% of GDP in 2009-10, before falling back to 0.8% in 2011 as exports stagnated and imports (mainly travel) rose by 5%, marking the first time since 2003 that the surplus fell below 1%.⁵⁰

⁴⁹ This analysis of the trade balance in services does not cover all services in the economy but the tradable services. A tradable service can be sold in another location distant from where it was produced, as opposed to a non-tradable service that cannot be sold in another location.

⁵⁰ Based on data for the first three quarters of 2012 the surplus reaches 0.9% of GDP, with the 12 month moving average for net services increasing since Q2-2012.

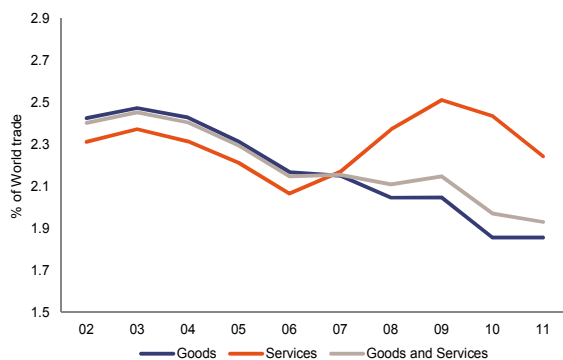
Graph 37: Service balance



Source: NBB

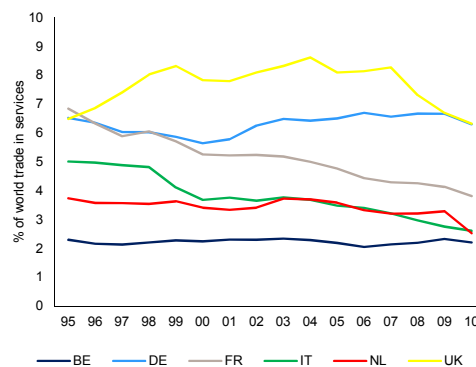
The growing importance of Belgium's service exports is also reflected in their export market share. While the downward trend for goods applied also to services until 2006, between 2007 and 2009 this loss was more than offset, even though in recent years services have again lost some ground as can be seen in Graph 38.⁵¹ Over a longer horizon, Belgium's share in world service exports (in current prices) remained broadly stable between 1995 and 2011 at about 2.25% as export growth has kept track with world growth. Though Belgium did not manage to increase its market share, over the same period many other European countries saw their market shares fall (see Graph 39). While the Belgian economy represents a little less than 3% of the EU GDP, its share in the EU's service exports towards the rest of the world reaches 5%, a level it has managed to retain over the past decade following a decrease during the 90s and despite the EU as a whole losing market share.

Graph 37: Goods and services exports as percentage of world trade (BoP data)



Source: Commission services

Graph 39: Share of services in world trade in services



Source: UNCTAD

⁵¹ As indicated by Duprez (2011), it should be noted that the increase in export market share for services in 2007 coincides with the introduction of a new data collection method for the BoP. Nevertheless, Belgium increased its market share further in 2008-09 under the new method, so that these gains reflect an economic reality.

Table 6: Service exports by destination

	EU27		Belgium	
	2004-07	2008-11	2004-07	2008-11
EU27	58.0%	56.3%	72.8%	67.9%
N. America	13.5%	11.9%	12.3%	10.5%
Asia	9.9%	10.8%	4.7%	7.2%
S. America	4.8%	6.0%	1.6%	2.4%
Arab Gulf	1.6%	1.9%	3.6%	3.7%
Africa	3.0%	4.7%	1.4%	4.0%
CIS	2.3%	3.5%	0.4%	1.7%
other	6.9%	4.9%	3.2%	2.6%

Source: Commission services

Table 7: Destination of intra-EU27 exports

	2005		2008		2011	
	1	UK	23%	NL	21%	FR
2	NL	22%	FR	21%	NL	20%
3	FR	18%	UK	15%	UK	15%
4	DE	14%	DE	14%	DE	14%
5	LU	7%	LU	6%	LU	6%
		85%		77%		76%

Source: Commission services

As shown in Table 6, other EU countries are Belgium's main trading partner, importing together about two-thirds of Belgian services. Even though this share has diminished in recent years, Belgium clearly exports less to the extra-EU27 market than the average European country. More than three quarters of all intra-EU27 services go to the five neighbouring countries (see Table 7). While this runs parallel to what is observed for goods, the underlying distribution contrasts as Germany is only the fourth intra-EU27 importer of Belgian services and the fifth overall importer, behind the US.

3.1.2. Breakdown of external service surplus

As can be read from both Graph 40 and Table 8, 'transportation' and 'business services' together account for almost two thirds of all service exports by Belgium – far more than in neighbouring countries – and are the main contributors behind the overall surplus with smaller contributions by 'government services', 'information and communication services' and 'financial services'.⁵² In fact, travel is the only category that has seen a net deficit ever since 1995. In this respect, Belgium stands out compared to most other EU27 countries that realize a (often sizeable) service surplus since for most of them this surplus is due to a strong performance in one particular sector such as travel⁵³, finance⁵⁴ or both⁵⁵ so that their net surplus can be considered to be the outcome of a 'single source'⁵⁶ while as for Belgium the surplus configuration is more diverse.⁵⁷ Individual sectors are discussed in what follows.

⁵² 'Construction' – incorporated under 'Other services' – does not include building activities abroad by Belgian companies taking more than one year as the proceeds of these works are regarded as income from direct. As a consequence, substantial amounts from e.g. dredging works are not incorporated in the service balance.

⁵³ BG, CZ, EL (transportation as well), ES, HU, MT, AT, PT & SI

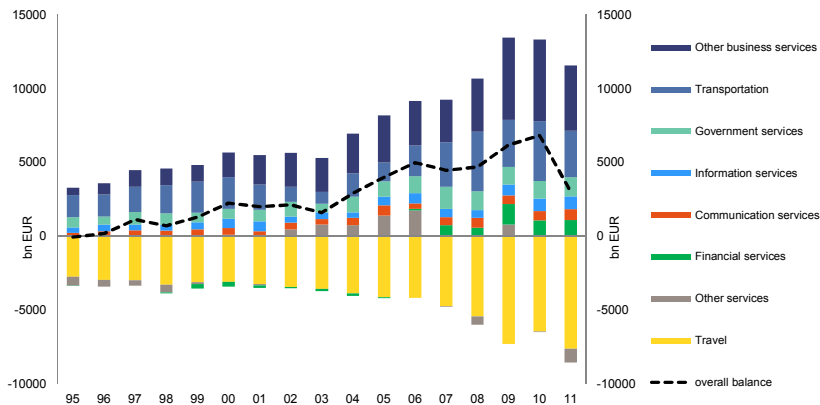
⁵⁴ LU & UK

⁵⁵ CY

⁵⁶ For DK, PL and the Baltic countries transportation dominates, with secondary contributions by travel for PL, EE and LT.

⁵⁷ This seems also to be the case for France with a transport deficit being compensated by most other sectors. The same can be said about the size of both countries' surpluses, which remain modest in terms of GDP compared to other countries, presumably a reflection of the broad underlying composition. Also the surpluses of the Netherlands (comparable to Belgium's in terms

Graph 38: Composition of service balance



Source: NBB

Table 8: Composition of service trade

	exports (avg 2009-11)						imports (avg 2009-11)						
	BE	FR	DE	NE	UK	avg	BE	FR	DE	NE	UK	avg	
Transportation	28%	23%	23%	22%	13%	22%	23%	27%	23%	17%	18%	22%	Transportation
Travel	12%	33%	15%	11%	13%	17%	26%	29%	30%	18%	30%	27%	Travel
Communications services	5%	3%	2%	4%	3%	4%	4%	3%	3%	4%	4%	3%	Communications services
Construction	2%	4%	5%	2%	1%	3%	2%	2%	3%	2%	1%	2%	Construction
Insurance services	1%	1%	2%	1%	3%	2%	1%	2%	1%	1%	1%	1%	Insurance services
Financial services	4%	2%	5%	1%	22%	7%	3%	2%	3%	2%	6%	3%	Financial services
Computer and information services	5%	1%	7%	5%	5%	5%	4%	2%	5%	5%	4%	4%	Computer and information services
Royalties and license fees	3%	7%	6%	20%	5%	8%	3%	4%	5%	18%	5%	7%	Royalties and license fees
Other business services	36%	23%	32%	31%	32%	31%	31%	26%	25%	32%	26%	28%	Other business services
Personal, cultural and recreational services	1%	1%	0%	1%	2%	1%	1%	3%	1%	1%	1%	1%	Personal, cultural and recreational services
Government services	2%	1%	2%	2%	1%	2%	0%	1%	0%	1%	4%	1%	Government services

Source: WTO

Transportation

As Belgium’s ports make the country a hub for international trade, transportation is an important sector, both with respect to exports as to imports. In terms of GDP, the net transportation surplus has been hovering around 1% of GDP since 2007, a level that had not been attained since the late 1990s. Transportation services are by default entangled with trade in goods. As such, the nominal fall in 2009 of both exports and imports reflects the contracting international goods trade that year (Graph 41).

Maritime freight services and related activities are predominantly responsible for the transport surplus. With Antwerp, Zeebrugge and Ghent, Belgium hosts three of Western Europe’s ten largest ports in terms of traffic volume – Antwerp being the second largest. Together the Belgian ports attributed a total direct value added in 2010 of EUR 14.7 bn (4.1% GDP) and direct employment of almost 102,000 fulltime equivalents (2.0% of the working population). Indirectly, another EUR 13.2 bn (3.7% GDP) value added is created, as well as 131,000 extra fulltime equivalents (2.6% working population) as stated by the Annual Report of the Flemish Port Authority (2012).

of GDP) and Sweden (higher structural surplus than BE, FR and NE) look more diverse in composition.

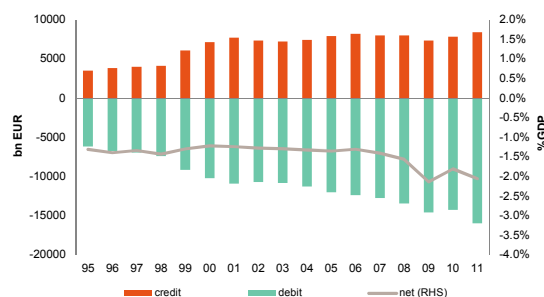
The transportation sector has maintained its relative position within Belgium's export services, as well as its market share in global transportation exports, with Belgium representing about 3% of global activity in the sector in 2011 according to UNCTAD data. This market share has been remarkably stable since 1980 and the same applies to the market share within the so-called Le Havre-Hamburg range (a cluster of big sea ports), which for the last two decades has stood at around 24% of total traffic volume despite the heavy competitive pressures that characterize the sector. In contrast, the EU's part in global transportation exports fell from 55% in 1980 to 46% in 2011.

Graph 39: Transportation services



Source: NBB

Graph 40: Travel services



Source: NBB

Travel

As mentioned, travel services are the only category that holds a substantial and structural deficit (Graph 42). This deficit has been widening as export transactions have stagnated while imports have risen steadily. In terms of GDP, the deficit expanded to around 2% in recent years, whereas until 2007 it was more stable at about 1.3%. However, little can be read from this deficit as these travel transactions are more a function of intrinsic attractiveness (climate, historic sites, nature...) and general income level than of competitiveness. This seems to be the case for Belgium as no other service sector reports a deficit.

Information and communication services

As ICT is an important driver of productivity growth in the overall economy a high propensity to trade would seem logical. But while ICT services together account for 10% of exports and 8% of imports, in general they are still little traded (Graph 43 and 44). This is not only the case for Belgium, but also for other EU countries.⁵⁸ According to a 2010 study by Copenhagen Economics, the EU could gain 4.1% of GDP by 2020 through the creation of a digital single market. Given Belgium's decent performance with respect to trade in ICT services, it is reasonable to assume that

⁵⁸ Only IE, FI and SE realized in 2011 a net surplus for IT services superior to 1.0% of GDP (0.4% for EU27; 0.2% for Belgium). For communication services this was only the case for Luxembourg (0.0% for EU27; 0.2% for Belgium).

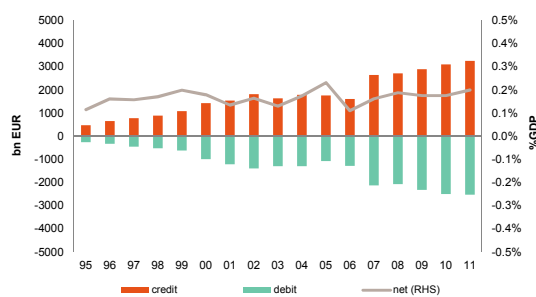
Belgium could reap important economic gains from such a digital push, though currently no detailed estimates are available.⁵⁹

Graph 41: Information services



Source: NBB

Graph 42: Communication services



Source: NBB

Government services

A modest but very stable surplus of 0.3% of GDP originates from government services (Graph 45). The bulk of export receipts originate from the EU institutions, considered to be extra-territorial. The amounts recorded under this heading resulted in total exports of EUR 1.4 bn in 2011 and net revenues totalling EUR 1.3 bn.⁶⁰ This entails two types of transactions: reimbursement of the collection costs relating to own EU resources and the operating expenses of the European institutions. Both are sizeable for Belgium. As a lot of the EU's trade with non-EU countries passes through Belgian ports, Belgium gets on average 9-10% of total EU reimbursement expenditure, amounting to EUR 527 mn in 2011. Operational spending by the EU such as rents is also recorded as government service receipts. With the seat of a number of major institutions located in Brussels the corresponding revenues surpassed EUR 830 mn in 2011, equal to one third of total EU expenditure on this item.

Graph 43: Government services

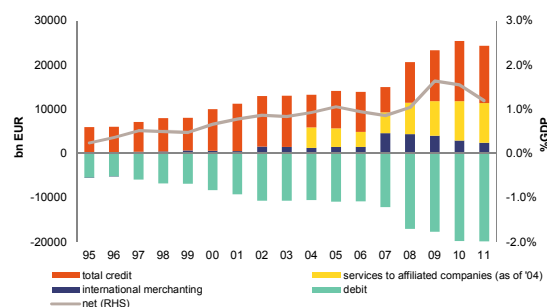
Graph 44: Other business services

⁵⁹ However, the Federal Planning Bureau points out that ICT activities are little developed in Belgium so that the Belgian industry hasn't reaped the full productivity gains from ICT innovation. A single market push for this type of products could render them more accessible for Belgian companies though, so that economic gains could originate from this side as well.

⁶⁰ Many revenues from services provided by Belgium to the EU are recorded directly under various other headings in the BoP (e.g. ICT). As a consequence, the EU contributed EUR 2.3bn to the Belgian service surplus in 2011.



Source: NBB



Source: NBB/Eurostat

Business services

This last category has been a fast grower and is the single largest contributor to the service surplus with a net balance of 1.2% of GDP in 2011 (Graph 46). Business services form a heterogeneous group that entails activities such as leasing, R&D, consultancy, legal advice, architecture and marketing. But also 'International merchandising', implying two consecutive transfers of ownership of a good: from a non-resident to a resident and vice-versa. The resulting merchandising margin is recorded in the balance of payments as a net item. Evidently, this service is very much related to the international trade in goods and Belgium's ports. Net merchandising exports are considerable for Belgium, both when compared to other services as when looked to neighbouring countries.⁶¹

Even more important are 'Services to affiliated enterprises'. These have grown strongly in recent years and involve those overhead expenses of parent companies and their subsidiaries or branches that cannot be allocated more precisely. Belgium's central location makes it attractive for regional headquarters of multinationals. For the period 2004-11, these services represented on average a third of all business service exports, with their share growing further in recent years.

3.1.3. Conclusions

Belgium has been moving progressively towards a service-based economy over the past decades and services have been realizing an important external surplus that has steadily grown to 2% of GDP. In this IDR, Belgium's services surplus has been examined in greater detail. Taking a closer look at Belgium's services surplus allows drawing conclusions as to the nature of this surplus and its prospects. The main findings of the in-depth analysis on this surplus are that:

- Belgian services have maintained their export market shares within the EU as well as globally, in contrast to Belgian goods;
- The net service surplus is more diverse in composition compared to other EU27 countries that realize a positive service balance as for these countries the surplus has its origin often in one single source;

⁶¹ The UK being the main consumer of international merchandising services explains why the country is one of the main trading partners for Belgium in the field of services.

- The Belgian surplus originates from four main sources, driven by goods shipments (transportation and international merchanting) and by the fact that Belgium hosts many multinationals and international organisations (government services⁶² and services to affiliated enterprises);
- Together these four sectors realize a net surplus of 2.5-3% of GDP with travel being the only negative contributor at around -2% of GDP;
- Whereas government services are a very robust revenue source, they are no driver of expansion with a constant net surplus of 0.3% of GDP ever since 1995. In contrast, the other three sectors have seen their surplus rise by 0.4 percentage points of GDP in recent years;
- As these three sectors are to a large extent subject to external factors (e.g. global trade, investment decisions by multinationals), keeping the general business climate investor-friendly seems a key element in nurturing future gains;
- Given that the share of high-tech goods (in particular ICT) in trade is rather modest, for Belgium as well as for EU27, services related to more high-tech products have not increased their export share and leave an important potential, also for the wider Belgian economy.

All in all, the trend observed for the Belgian trade in services is promising, even though it remains to be seen whether these activities can fully compensate for declining industrial activities, which at the present time is not the central scenario. Still, services mitigate the loss of market share by goods and the country would benefit from a full development of its potential. Policy actions might also take into account that many services operate in the periphery of industrial activity so that an accelerated deindustrialization may hurt services as well. As a consequence, tackling matters of cost competitiveness remains paramount for the Belgian economy and overall export performance. In this respect, it should be noted that the services sectors are less affected by price developments than is the case for goods⁶³, which helps to explain their better performance. At the same time, as services are also inputs into other industries' production processes, weak performance of sheltered service can be considered as a hindrance to the performance of other sectors and of the economy as a whole. Removing remaining restrictions on the large part of the service sector that is less exposed to competition through external trade would contribute to lower the cost of these services, improving in turn cost-competitiveness of exporting sectors.

3.2. Innovation in Belgium

Non-price competitiveness is a set of factors that determine the attractiveness of an economy and its innovation and adaptation potential, through quality, design and product differentiation offered, marketing of these products and

⁶² While ICT services, when taken together, realized a 0.4% GDP surplus in 2011, the surplus for government services (0.3%) had one single source, the EU, making it more relevant.

⁶³ Services are for example less energy-intensive than manufacturing activities so that high energy costs seem less of an issue.

the organization of the production process. Among the determinants of non-price competitiveness, we find the quantity and quality of capital stock, including infrastructure, the volume and the training of human capital, organization of work, R&D intensity, and the proper functioning of markets for goods and factors. Due to the already high capital intensity of production, productivity gains could better be achieved by innovation in products or processes. As identified in chapter 2.2.7 on non-cost competitiveness, Belgium is still specialised in medium technological goods, which are easily substituted and are thus more exposed to competition from lower wage countries, and the share of high tech goods in total exports - despite its increase- is still below 20%. In this chapter Belgium's strengths and weaknesses are analysed to understand better why this country does not reap all the innovation benefits although it is close to the innovation leaders.

3.2.1. *Belgium's strengths and weaknesses*

As set out in the 2010 and 2011 Innovation Union Scoreboard (IUS)⁶⁴, Belgium is an innovation follower, with a performance above the EU average. Relative strengths are in Human Resources, Open, Excellent and Attractive Research Systems and Linkages & Entrepreneurship. Relative weaknesses are in R&D Expenditures, Intellectual Assets and Economic Effects. Overall, the research and innovation system of Belgium displays a set of very strong indicators. According to the Innovation Union Competitiveness report of 2012, based on the 2011 IUS, the number of researchers per thousand employees is 7.6, well above the EU average of 6.3 researchers. The number of international scientific co-publications per million habitants is more than double the EU average, giving evidence of the degree of openness of the Belgian research and innovation system. Moreover, the quality of the scientific production is evidenced by the number of scientific publications within the top 10% most cited publications worldwide, as % of the total publications of Belgium (13.6%, well above the EU average). Finally, 38.3% of all innovative SMEs in Belgium introduced a new or a significantly improved product on the market, a figure only surpassed in Sweden.

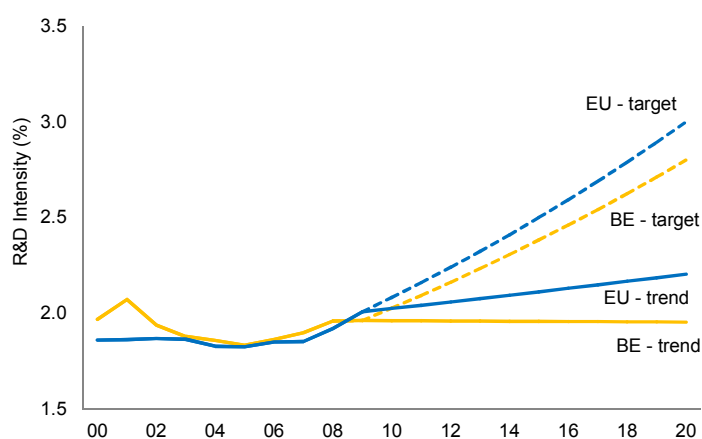
Nonetheless, the Belgian research and innovation system also has some weaknesses: in 2011, R&D expenses totaled an average of 2.03% of GDP in Belgium, a proportion almost equal to the average of the euro area, but well below those of the Nordic countries or Germany. Despite a slight increasing trends since 2005 (thanks to increases both in public R&D expenditure (from 0.56% to 0.65% of GDP) and in private expenditure on R&D (from 1.24% to 1.37%)), Belgium is not on track to reach its 2020 target (see Graph 47). Patent applications and conversion of knowledge to products is also below the average. According to its R&D profile, the Belgian growth rate is weaker than the EU in public and private expenditure on R&D, PCT patent applications, employment in knowledge intensive activities and percentage of researchers in the labour force.

⁶⁴ European Commission, 'Innovation Union Scoreboard 2011', 2012, available at http://ec.europa.eu/enterprise/policies/innovation/files/ius-2011_en.pdf

All innovation leaders (FI, SE, DK & DE), perform very well in business R&D expenditures, have higher than average scores in public-private co-publications per million habitants and excel in the marketing of their technological knowledge. Most of the innovation leaders also perform very well according to other innovation indicators related to firm activities. Comparing Belgium to the innovation leaders, it can be reaffirmed that Belgium's weaknesses are a lower level of public & private R&D expenditure, lower excellence in marketing of the innovations and less entrepreneurship.

In a nutshell, it can be said that Belgium has a high quality research system, but that, in order to enable the full exploitation of this strength, it needs to speed up the transition towards a more knowledge-intensive economy and broaden its innovation base.

Graph 45: Belgium R&D intensity projections, 2000-2020



Source: Commission services

3.2.2. Governance of public R&D policy

Since the early 1990s, most of the research policies have been decentralised across several Belgian governments, each enjoying complete autonomy of decision-making power in these matters. The regions (Flanders, Wallonia, Brussels-Capital) have authority on research policy for economic development purposes, thus encompassing technological development and applied research. The communities (French-, Flemish- and German-speaking) are responsible for education and fundamental research at universities and higher education establishments.

The federal state retains the responsibility for research areas requiring homogenous execution at the national level, and research in execution of international agreements (e.g. space research, defence research), as well as for fiscal instruments. Indeed, on top of grants provided by regional authorities to help companies to finance new R&D projects, the federal government has developed powerful tax incentives (in particular

a 75%⁶⁵ payroll tax exemption for researchers, as well as a patent tax credit) leading to a situation where foregone revenues due to R&D tax incentives are almost equivalent to the amount of direct public funding of business R&D.

There are formally seven independent Belgian authorities carrying out their own policy in the wider field of science, research, technology and innovation. In practice, there are only five active entities, since the region of Flanders and the Flemish community's governments have merged into one and the German-speaking community does not carry out any policy in the research area due to its small size.

This high degree of decentralisation of the responsibilities for research and innovation policies has not always been accompanied by the setting of appropriate coordination and cooperation mechanisms. As a result, opportunities for transregional synergies are missed. In order to address the possible lack of coherence, the idea of an Interfederal Plan for Research and Innovation has been conceived. This initiative would aim at ensuring a better coordination of the efforts made by the Regions and the federal government with regard to R&D and technological innovation, but it is still not developed.

Moreover, governance of research and innovation inside each region needs to be strengthened in order to ensure an overall strategic and integrated approach of research and innovation across the many organisations and instruments involved. This should be accompanied by a reinforcement of the mechanisms for monitoring and evaluating the performance of the organisations and of the instruments. Further simplification of the intermediary support structure could be envisaged. The preparation of the post-2014 period should be opportunity for a comprehensive review of the regional strategies, including the support instruments.

There is also a case for the national and regional research and innovation policy to integrate more systematically demand-side policy tools, such as innovative public procurement.

3.2.3. *Concentration of private R&D activity*

The business enterprise sector, which is the main contributor to R&D expenses in Belgium, saw its expenses shrink from 1.51% of GDP in 2001 to 1.37% in 2011, which is nonetheless still above the EU27 average of 1.26%. This decline is mainly due to two reasons: the economic structure becoming more service-oriented and a reduction in the R&D activities of the telecommunications and chemical sectors.

Even if this share is slowly decreasing, approximately two-thirds of Belgian research (66.3%) was performed in the business sector in 2010 (EU27: 61.52%). In 2007, 44.6% of business R&D expenditure (BERD) was performed by companies having more than 1000 employees.⁶⁶ Business R&D is indeed highly concentrated in Belgium and under foreign control: 59% of industrial R&D was realised by foreign-owned companies in 2007. The importance of BERD and the fact that a large part of

⁶⁵ Increased to 80% since 1 January 2013

⁶⁶ Data from Belgium Federal Science Policy Office.

the BERD activity is undertaken by foreign enterprises raises the threat of a long-term decline in R&D intensity if these enterprises are not encouraged to maintain their R&D operations in Belgium.

While Belgium performs well compared to the EU average in terms of R&D intensity and innovation rate, it underperforms in the conversion of knowledge into new products and processes. Belgium still outperforms the neighbouring countries in the field of innovation process, indicating a possible consequence of higher hourly labor costs, which is a permanent incentive in the quest of new process improvements. However, Belgium underperforms on product innovation, which has a major impact on export growth. Besides, the percentage of firms with marketing innovation between 2006 and 2008 was lower in Belgium than on average in the three neighbouring countries. This weak performance could be at least partially explained by the product specialization, skewed towards pharmaceuticals and chemicals, which are sectors enjoying a slower conversion rate than ICT in general.

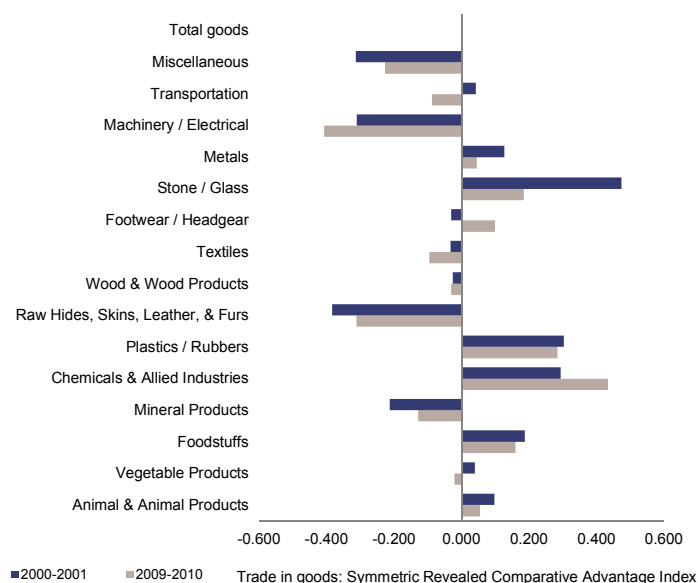
More than three quarters of BERD was performed in the manufacturing sector in 2009: 28% by the pharmaceutical sector (2009 data), 11% by chemicals and 5% by radio, TV and communication.

Over the period 2000-10, Belgium appears to have increased its comparative advantage in chemicals and pharmaceuticals, but has reduced its advantage in stone, glass, plastics, rubbers, transportation, machinery and food products (see Graph 48). This can be linked to the change in relative importance of R&D expenditure. Over the period, chemicals and pharmaceuticals increased their share of R&D expenditure while transportation and machinery (especially radio, television and communication equipment) saw their relative share declining. This concentration is reflected in the number of large companies and foreign owned multinationals in the chemicals, pharmaceuticals and biotech sectors.⁶⁷ In general terms one can say that research in Belgium is now more than ever dominated by life sciences.

The key challenge for Belgium is to generate similar dynamics, where R&D investments lead to trade performance, across a wider range of sectors. In order to speed up the transition towards a more knowledge-intensive economy, enabling the full exploitation of the strengths of its research system, Belgium needs to broaden its innovation base and fasten the renewal of its economic fabric. However, the weaknesses of Belgium in terms of entrepreneurship and firms' dynamics impede this necessary renewal. In order to address this bottleneck, further development of the support to clusters and better conditions for the growth of innovative firms, as well as the further development of entrepreneurship education and culture, are required.

Graph 46: Comparative advantages

⁶⁷ Agfa-Gevaert, Anheuser-Busch Inbev, Barco, Bekaert, Belgacom, Dexia, KBC, Solvay, UCB, Umicore were the top 10 R&D performers in Belgium in 2009 (IPTS Scoreboard) and are responsible for about 40 % of BERD.



Source: COMTRADE and Commission services' calculation

Areas of innovation that might be useful to emphasize in the current economic environment are innovation towards ICT, durable products, client services and organizational innovation, which are not yet sufficiently developed in Belgium, even if regional policies emphasize their importance in their R&D strategy.

3.2.4. Human Resources

Belgium disposes of a qualified workforce, reflected in the ambitious 2020 target in terms of education.⁶⁸ The total number of researchers is growing steadily over time (28.000 researchers in 1998; 38.000 in 2009) and exceeds the growth of the total population and the active population in Belgium. Most researchers work in the business enterprise sector (51.3%) and the Higher Education sector (41.1%). However, the number of graduates in science and technology is relatively low in Belgium, accounting for 15.8% of the new tertiary education graduates in 2008 compared to the EU average of 21.9%. This lack of interest does not only concern highly qualified technical staff, also in secondary schools fewer students choose technical orientations. There is still a mismatch between labour supply and demand resulting in many firms considering the lack of qualified staff as a significant barrier to innovation.

It is also important that workers are learning throughout their careers. In this respect, the percentage of the population aged 25 to 64 years who reported having received training declined between 2005 and 2008. Even if between 2008 and 2010 the Belgian indicator rose from 6.8% to 7.2% on average over the period, it is still lower, at 6.9%,

⁶⁸ The general 2020 target calls for a minimum of 40% of the population aged 30-34 to complete higher education. In 2010, this indicator already reached 44.4% in Belgium so that the 2020 target has been set at 47% for Belgium.

than the average of the three neighbouring countries (10.1%) and the euro area (8%). For graduates of higher education, the percentage is slightly higher (11.7% in 2008).

Most indicators identify entrepreneurship to be a problem in Belgium, as in many other European countries. According to the latest Eurobarometer survey on entrepreneurship, less Belgians (30%) would like to be self-employed than the EU average (37%). Demand prospects, recruitment of qualified personnel and strong competition represent major obstacles for SMEs.

3.2.5. *Conclusion*

Through business R&D investments, many firms have been able to exploit the quality of the Belgian research system leading to excellent export performance in the sectors in which these investments took place, translating notably in a fast increase of the share of high-tech products in the Belgian exports. The strengths of the Belgian research and innovation system have thus to some extent played a counter-balancing and mitigating role vis-à-vis the Belgian cost-competiveness issue.

Nevertheless, although Belgium is among the first of the innovation followers, in order to close the gap with the innovation leaders, Belgium should speed up the transition towards a more knowledge-intensive economy, enabling the full exploitation of the strengths of its research system. As identified in this chapter, the weaknesses of Belgium are the low level and concentration of R&D expenditure, the low conversion rate of innovation into products, the mismatch between labour market needs and supply and most importantly the low level of growth-oriented entrepreneurship. In order to move from the follower to the leader category, it appears useful for Belgium to move towards more ambitious and integrated research and innovation policy, addressing jointly the present shortcomings. Such a policy could aim at diversifying R&D to promising sectors and to increase the R&D expenditure towards the set target, encouraging students to take up scientific education and upgrade their entrepreneurship spirit, ensuring better conditions for the growth of innovative firms, further developing the support to clusters and strengthening multi-level governance of research and innovation.

1.1. **The housing market in Belgium**

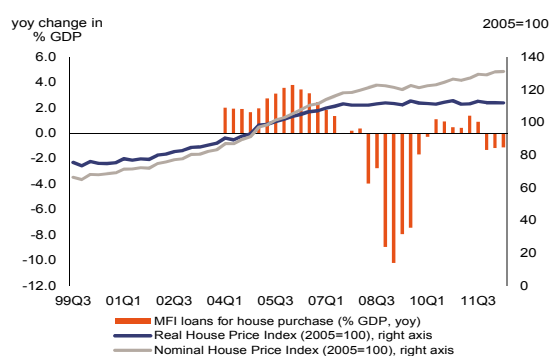
1.1.1. *House price evolution*

From the mid-1990s the sustained increased demand for housing led to higher prices on the Belgian housing market. Specifically, between 2005 and mid-2012, housing prices have increased by around 31% in nominal terms and 12% in real terms (see Graph 49). Contrary to other EU countries that saw large upswings in house prices over the same period, Belgium has not suffered a bust episode but rather a stabilization of real housing prices since 2008.

Graph 47: Evolution of House Price Index

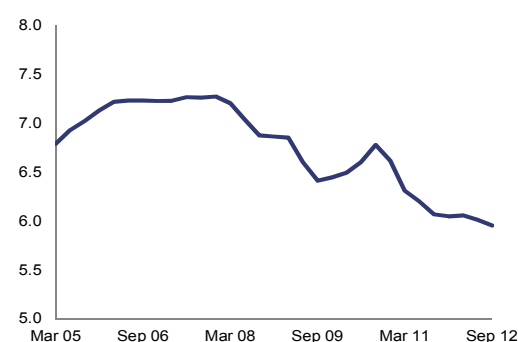
Graph 48: Residential investments (% of

and MFI Loans for House Purchase



Source: Commission Services

GDP)



Source: Commission Services

The price increase in the housing market could have led to an increase of investments in new dwellings as it may be pointing to an excess of demand in the market. However, this was only the case until 2007. Following the onset of the crisis, the share of the construction sector in GDP declined from 7.3% in the 4th quarter of 2007 to 6.4% in the 3rd quarter of 2009. During 2010, there was a temporary improvement due to fiscal measures ending in 2011. Overall, investment decreased from around 7% of GDP in 2005 to 5.9% in the 3rd quarter of 2012 (see Graph 50).

1.1.2. House price valuation

Assessing whether house price increases are sustainable remains a challenge. Several methods exist to determine the deviation from the long-term average. The price-to-rent ratio compares the evolution of house prices to the evolution of rent. Another method is based on the affordability, the price-to-income ratio, usually defined as a price index divided by income per capita. But while these are commonly used methods to assess house prices, they do not incorporate factors such as deductibility of borrowing costs or the characteristics of mortgage contracts like the term or the loan-to-value ratio.⁶⁹

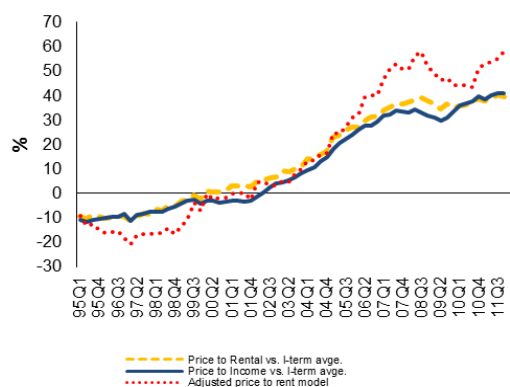
Graph 51 presents our analysis based on three indicators: the price-to-income ratio, the price-to-rent ratio and an econometric model that includes the interest rates in the price-to-rent ratio. All three of these indicators point to a current level of 41% to 58% above their long-term average. If these results point to either an important overvaluation compared to the long-term average or to an undervaluation in the past, they need to be interpreted with caution since they do not include changes in mortgage term and loan-to-value ratio while just one, the adjusted price-to-rent model, incorporates changes in interest rates. Our overall assessment of house price dynamics classifies Belgium as a country where no booming episode was identified, due to the reasonable amplitude and duration of the bull and bear phases but with high

⁶⁹ For a deeper discussion on the merits of these indicators and some qualifiers see LIME Working Group (2012), Assessment of house price dynamics.

downward price pressure according to the two first indicators and medium pressure according to the econometric model.

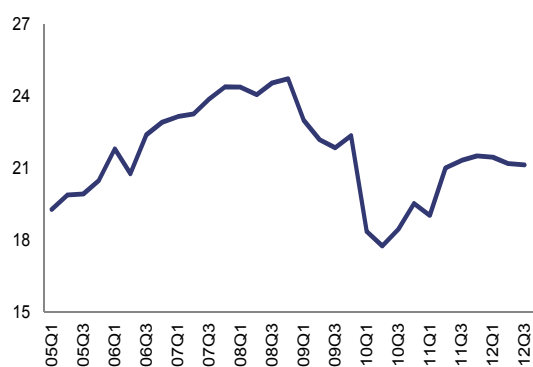
According to a study by the National Bank of Belgium⁷⁰, taking into account the mortgage term, the loan-to-value ratio and the general mortgage interest rates, the gap with the long-term average, even if lower compared to our analysis, still amounts to 16% in mid-2011.

Graph 49: Housing price ratios



Source: Commission Services

Graph 50: Affordability indicator



Source: Commission Services

In order to try to shed some light on the sustainability of prices, this IDR now takes a closer look at the annual financial effort households have to make to repay their mortgage. The annual financial effort indicator constructed by the National Bank of Belgium is the ratio between the monthly debt service and disposable income per household, including an average maturity of 20 years and a loan-to-value ratio of 80%. Looking at the evolution of this affordability ratio, just before and during the crisis, the annual financial effort of households increased from 18% to 22%, peaking at 24.2% in 3Q2008. According to our own calculations based on a similar affordability index⁷¹ (see Graph 52), the effort calculated with adjusted loan-to-value ratio and length of contract points to an annual financial effort of 19% in 2005 to 21% at the 3rd quarter of 2012 with a peak at the end of 2008 of 25%. On the one hand, the increase in effort until 2008 is a source of concern. On the other hand, both its current level and its stabilization are rather reassuring. Additionally, the loan-to-value ratio is low and decreased from 80% in 2005 to 65% in 2010 and financing at fixed rates is the common practice, with more than 80% of mortgages loans in 2012 being contracted under fix interest rates, indicating that the interest burden will not rise unexpectedly.

⁷⁰ According to this study, an accurate loan-to-value ratio would amount to 65%, down from the average of 80% commonly used, and the accurate mortgage term amounts to 22.2y on average until 2007 and 18y by 2011 instead of 20y on average.

⁷¹ Yaniz Igal, J., "The Spanish housing market: are we in for a soft landing?", ECFIN Country Focus, Volume 3, Issue 1, Directorate-General for Economic and Financial Affairs, European Commission, Brussels, 2006.

1.1.3. *The determinants of house prices*

While price increases do not seem to have reached unsustainable levels, the analysis of housing price fundamentals could reveal additional insights.

First, demographic factors such as a population growth and a decline in the average household size⁷², have led to an increase in the number of households. Second, stable growth of disposable income and stable GDP growth have ensured a climate of certainty encouraging private investment. Third, the fall in interest rates resulting from accommodative monetary and fiscal policies and financial innovations (coupled with softened and flexible credit conditions) have triggered an increase in the demand for loans. Interest rates have dropped from levels of 8 to 10% between 1986 and 1992 to levels between 5 and 7% between 1995 and 2002 and to levels of 3 to 5% between 2003 and 2012. With the decrease in interest rates, the average loan term has increased from a long-term average of 20 years to around 22 years until 2007 before decreasing again. Fourth, the financial crisis has shifted some of the investments in financial assets to property. Fifth, scarcer land availability also plays a role, particularly in Flanders, which may partly explain the faster price evolution in that region compared to Wallonia in the last 20 years. The combination of those factors helps to explain why house prices have increased over the years since demand has been fostered by structural features while supply has not kept pace.

On top of these drivers, government policies have supported house price growth. In the 2000s, the government incentivized households to invest through several measures such as a reduction of registration fees in Flanders (2002), Brussels (2003) and Wallonia (2009), a tax amnesty with part of repatriated capital being invested in housing⁷³, a deductibility scheme for capital amortization and interest payments⁷⁴ and tax incentives on refurbishment and energy efficiency works. Furthermore, cadastral incomes – used to calculate the tax on imputed rent – do not reflect market prices⁷⁵, leading to a bias towards existing dwellings compared to new ones.

1.1.4. *Risk factors*

Following the analysis above, housing prices seem unlikely to trigger renewed macroeconomic turbulences in Belgium, thus they do not constitute an emerging imbalance. However, in case emerging imbalances linked either to competitiveness or to excessive public debt become so deep as to put at risk the macroeconomic stability, current housing prices could put additional negative pressure on both the real economy and the financial sector, which would aggravate undoubtedly a vicious economic circle.

⁷² In Belgium, the average household size fell from 2.49 people in 1991 to 2.31 in 2008 due to an increase in single person households and independence of elderly people. This trend is to continue.

⁷³ The tax amnesty of 2004 (EBA/DLU) coincided with a jump in housing prices, continued in the years afterwards. There were continued amnesty possibilities as of 2005.

⁷⁴ This deductibility is limited in nominal terms.

⁷⁵ The assessed value of properties is based on 1975 values, which have been indexed to the development of CPI since 1991.

1.1.5. Possible macroeconomic impact

Demand for housing remains stable as the population is still growing, annual financial efforts remain stable, wages grow more rapidly than repayment, interest rates are still low. The supply side, meanwhile, is constrained by a building sector in crisis. Still, in the event of a fall in housing prices, it is to be expected that the macroeconomic impact will be less important in Belgium than what other EU countries (e.g. Ireland or Spain) have experienced since the beginning of the crisis because the increase in house prices has not gone hand in hand with an excessive increase in the interest burden of households⁷⁶ or growth of housing supply. The vast majority of property being owner-occupied, a house price correction would only trigger limited wealth effects on consumption since housing is mostly seen as home and not as investment. For the same reason, a fall in house prices will not affect in itself the capacity to repay loans for a vast majority of households. Furthermore, the default rate on mortgage loans is at a historically low 1.1%. The absence of remortgaging practice in Belgium will also limit the effect on consumption. On the supply side, the impact a price correction would have on housing investment would be limited since the construction sector in itself has remained stable in size, at around 5% of GDP, despite the surge in prices, indicating that the price elasticity of home building is low in Belgium.

4. POLICY CHALLENGES

The analysis in sections 2 and 3 indicates that macroeconomic developments in the areas of external competitiveness of goods and the implications for the real economy from the high level of public debt are the main challenges of the imbalances in Belgium. It should be recalled that these challenges were identified under the MIP in the first IDR last year and relevant policy responses were reflected and integrated in the country-specific recommendations (CSRs) issued for Belgium in June 2012. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of the Belgian National Reform Programme and Stability and Convergence Programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the challenges identified in this IDR.

Concerning the challenge of improving external competitiveness, a number of different avenues can be considered as regards:

⁷⁶ Household debt, although still lower than the EU average of 99%, reached a level of 88% of disposable income in 2011, a record for Belgian households. This should not represent a major risk since the net worth of households is very high and represents 324% of incomes.

Cost competitiveness and labour costs: The analysis in this IDR has pointed to the importance of cost competitiveness for the export performance. A key aspect to safeguard competitiveness is to ensure that wage cost developments do not contribute to an erosion of the external position. As also shown, in the case of Belgium there is furthermore a case to regain lost wage cost competitiveness in comparison to the main trading partners. There are different issues that can be considered. One key element is the role of the 'wage norm' and how it takes into account developments in labour productivity and competitiveness. It should be recalled that CSR No 4 from 2012 called for wage growth to better reflect developments in labour productivity and competitiveness, by ensuring the implementation of ex-post correction mechanisms foreseen in the 'wage norm' and promoting all-in agreements to improve cost-competitiveness and facilitating the use of opt-out clauses from sectorial collective agreements to better align wage growth and labour productivity developments at local level.

Against this background, the adjustment capacity of the labour market would be increased and the reallocation towards more dynamic firms and sectors would be facilitated if wage growth would better reflect trends at local and sectorial level. Moreover, cost competitiveness would be enhanced if the wage norm would not only be based on expected but also take into account past wage developments, a road the Belgian authorities have announced to consider as of 2015. The performance of the system might be further enhanced by broadening the scope through the inclusion of more trade partners in the comparison.

It should be noted that a number of reforms have been introduced recently. These should contribute to making the index used for wage indexation more representative for actual consumption patterns, thereby somewhat tempering the effects of price increases (see further below on role of energy prices for indexation). Nevertheless, the current index mechanisms are automatic, implying that second-round effects or exogenous shocks would translate into faster wage growth also in comparison to neighbouring countries. Additionally, wages will be frozen in real terms in 2013 and 2014.

The overall cost competitiveness of the Belgian economy could also be enhanced by a further shift in the tax burden from labour to other sources of revenue. Indeed, last year's CSR No 5 called for a tax shift from labour to less growth-distortive tax bases. Some measures have been taken in the 2013 budget in order to reduce the tax burden on labour, such as a reduction in employers' social contributions for specific sectors and groups. Different additional avenues for progress in this area could be considered so as to further reduce overall labour costs to be more in line with average European levels. This reduction may be funded by increasing environmental taxes (e.g. transport fuel taxes) and by increasing VAT efficiency (e.g. via limited use of VAT exemptions and reduced rates), by restructuring property taxation and by improving tax compliance.

Cost competitiveness, other elements: The analysis above has also pointed to the importance of general cost pressures for competitiveness, beyond wages. In this context, policies aiming at tackling the inflationary pressure resulting from surges in the prices of energy and commodities in order to address the loss of cost

competitiveness of the economy overall would play a role. A CSR in 2012 was calling, for example, for strengthened competition in network industries.

Energy prices remain more elevated in Belgium than in many other EU countries though. A better functioning of energy markets would exert downward pressure on energy prices and hence improve cost competitiveness. While important steps have been taken recently, such as enhanced mobility on the energy market with a view to fostering competition between energy providers, a continued enhancement of competition and supervision of the energy sector is a valuable goal in order to realize permanent gains. Competition in the wholesale market could benefit from a more stable framework for investment.

A reduction of the weight of energy products in the price index would also temper the effect of the automatic indexation system in times of high imported inflation in order to leave more scope to adjust wage growth in line with productivity and competitiveness as discussed above. Here, a price observatory has been granted extra powers and prices for end-users have been made more transparent, breaking the link with the international oil price. Distribution costs in Belgium account for a large proportion of the domestic and SME consumer bill and would need to be reviewed. A proper and independent regulatory oversight, endowed with the necessary resources, could ensure that all network tariffs reflect efficient costs and are incentive-based.

In addition, and as pointed to in the analysis, the fact that Belgium's core inflation is higher than in the neighbouring countries points to a lack of competition in other networking industries (telecom, postal services and transportation) and the services sectors, including the retail sector. A revision of still existing regulatory barriers and an enhancement of competitive pressure in these sectors would benefit economic agents and contribute to a moderation in general price pressures. The announced reinforcement of the Competition Authority is useful in this regard and might be usefully complemented by action at the administrative level.

Non-cost competitiveness: the analysis has also pointed to the important role of non-price cost competitiveness issues to explain the external performance and the fact that, Belgium would benefit from a further transition towards higher technology exports in which input costs play a smaller role.

In this context, a further stimulation of investment in R&D and ICT could increase the technology content of products as well as total factor productivity. Indeed, while public R&D spending is foreseen to rise across the different entities despite narrow budgetary margins, business R&D intensity is stagnating, implying that further efforts are required to reach the 2020 target of 3.0% GDP spending on R&D. In order to increase the R&D intensity of the economy, the federal government allows a 75% payroll tax exemption for researchers, and regions and communities have developed strategic innovation approaches covering major aspects of a successful innovation strategy. While the orientations taken by research and innovation policies in recent years are appropriate, becoming more demand driven, answering to major societal challenges and focusing on promising sectors, efforts need to be reinforced. In particular, further development of the support to clusters and better conditions for the growth of innovative firms, as well as the further development of entrepreneurship

education and culture, are required. There is also a case for the national and regional research and innovation policy to integrate more systematically demand-side policy tools, such as innovative public procurement. Besides, it could be ensured that better coordination and overall coherence among the various R&D policies undertaken at federal, community and regional levels are fully exploited. It is also necessary to attract more young talent into science and engineering studies in order to avoid skill shortages which may deter future private R&D investments. A stronger coherence between regional education, training and employment policies while continuing to invest in cooperation between regional authorities to boost interregional labour force mobility might lead to a better match between skills and labour market demand. At the same time, stronger incentives to work more and an increase in the effective retirement age would lead to a better utilisation of the full potential of the available labour force. Some of the 2012 CSRs were calling for such reforms.

With regard to geographical orientation, Belgian goods exports are still mainly oriented towards the largely saturated European market. A reorientation towards more dynamic regions would therefore allow a faster growth in the volume of goods exported and a more diversified export portfolio. Conditions in emerging markets are often more challenging for doing business. Hence, Belgian companies, especially smaller ones, would profit from customized support from public authorities to enter into new markets.

Concerning the challenge linked to the high level of public debt and the implications for the real economy, a number of issues could be considered:

Controlling risks from high public debt levels: the economy as a whole would benefit from a continued implementation of measures aiming at a consolidation of public finances in a sustainable way, putting the public debt on a determinedly declining path, in line with the commitment in the Stability and Growth Pact. A 2012 CSR suggested to address the implicit debt associated with an ageing population by curbing age-related expenditure in order to prevent a new increase of the debt level after an expected initial stabilisation. Since Belgium belongs to the group of EU countries with the highest tax levels, little scope is left to increase taxes which points to the need for structural expenditure cuts.

Over the past year, the Belgian authorities have also implemented budgetary measures aiming towards a correction of the excessive deficit. Amid a worsening macro-economic environment since the government agreement of end-2011, the government closely monitored the budget execution as to keep the 2012 deficit below 3% of GDP, albeit partly through additional one-off measures.⁷⁷ The average structural effort, measured as the change in the structural balance, only amounted to 0.3% of GDP between 2009 and 2012. The 2013 draft budget contains additional consolidation measures in order to keep the deficit in line with the Stability Programme. In 2012, the public debt is expected to rise to almost 100% of GDP. Under the current projections, the public debt ratio is not expected to stabilize before 2014.

⁷⁷ There is a risk that the budgetary impact of the Dexia recapitalization (0.8% of GDP) will push up the 2012 deficit to above 3% of GDP.

Interlinkages between the banking sector, the sovereign and the private sector: the large contingent liabilities stemming from the guarantees given to financial institutions remain a risk for public finances. By recapitalizing Dexia in late 2012, Belgium could prevent the activation of state guarantees granted to this group. Two of the biggest banks, Belfius and KBC, are restructuring their activities following nationalization (Belfius) and state support (KBC), which should allow them to continue to play their role as financial intermediaries in the Belgian economy.

Risks from an increase in interest rates and spreads are not to be discarded. Between November 2011 and January 2013, the spread between Belgian and German 10-year bonds decreased from 360 basis points to less than 100 points due to measures taken by the ECB and the progress towards a Banking Union, the reduced political uncertainty in Belgium and the consolidation strategy presented by the government. Even if interest rates on Belgian debt instruments are currently historically low, the steep rise in interest rate spreads in the second half of 2011 showed that such a situation can change rapidly. This would not only endanger the sustainability of the public debt, but could have spill-over effects to the real economy due to the large exposure of domestic financial institutions and households to the Belgian sovereign. Such an interest rate hike would also affect mortgages: variable mortgage rates are legally linked to interest rates on Belgian Treasury certificates and 3 to 5 year bonds (though with a legal cap) so that an increase in bond rates leads to a loss in disposable income for house owners with a loan. While fixed interest rates predominate for new mortgage contracts, the rates offered in new contracts tend to follow bond rates. Hence, a shock in lending costs for the Belgian sovereign can filter through to the housing market.

Lastly, putting the debt on a downward path would not only reduce the risk associated to sovereign debt, but will also provide the authorities with more latitude to implement a fiscal policy aimed at improving the competitiveness of the country, as well as to face unexpected developments in other economic sectors such as financial markets.

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