Report 2007

Economic and financial developments

NationalBank
OF BELGIUM

Eurosystem

The pictures at the beginning of each chapter in this report show details taken from designs for Belgian banknotes dating from the late 19th and early 20th century, housed in the National Bank's collections.

The complete designs are shown at the end of this volume (pages 221 and following), with a brief description of the artists and the context in which the designs were produced.

Foreword

by Guy Quaden, Governor

The global economy maintained brisk growth in 2007, expanding by around 5 p.c. in real terms. Growth was driven mainly by the emerging countries, led by China. Most of the advanced countries continued to record satisfactory growth, usually slightly below the previous year's figure. In the euro area, GDP growth is estimated at 2.6 p.c. against 2.9 p.c. in 2006. While the US economy had been an important engine of world growth in previous years, it proved to be the relatively weak link in 2007.

From August, the crisis on the US subprime mortgage market spread to numerous financial markets in the United States and throughout the world, leading to a general reappraisal of the risks on the part of market operators. This financial turbulence had hardly any immediate, noticeable impact on the real economy, but it has since greatly heightened the uncertainty surrounding the economic outlook.

The dramatic spread of this local crisis showed up structural weaknesses in the new forms of financial intermediation, and the dangers entailed in innovations lacking sufficient control. It highlights the need for prudent lending policies, both to ensure financial stability and to protect consumers.

The financial players and the supervisory authorities will need to draw lessons from this turbulence. The restoration of confidence undoubtedly requires the various financial institutions to be more transparent about the nature and scale of the risks incurred or transferred.

Faced with an unusually acute liquidity crisis, the Eurosystem reacted promptly by lending more to the banks – and at times absorbing surplus liquidity – in order to ensure that the money market operated smoothly and to stabilise very short-term interest rates at levels close to its key rate.

In the first half of the year, the Governing Council had continued the increases in that key rate which had begun in December 2005, raising it from 3.5 p.c. to 3.75 p.c. in March and 4 p.c. in June, considering that the persistent vigour of economic activity, the high capacity utilisation rate and the continuing rapid expansion of the money supply and lending confirmed the existence of risks to price stability. Those risks were still present in the second half of the year, but the Governing Council refrained from any further interest rate increase, feeling the need to gather and analyse additional information in view of the increased uncertainty generated by the financial turbulence.

In contrast to previous episodes since the beginning of this century, when periods of recovery rapidly ground to a halt, economic activity continued expanding vigorously in Belgium, as in the euro area in general. Despite a slight slowdown during the year, GDP growth is still estimated at 2.7 p.c. in 2007, having reached 2.9 p.c. in 2006.

On the one hand, foreign demand remained robust, originating mainly from the emerging economies of Asia and eastern Europe and from the oil-producing countries. The Belgian economy benefited, partly directly but primarily via the effects of the dynamism of those regions on Belgium's trading partners in the euro area. Furthermore, the sound financial position of Belgian firms and the improvement in the labour market situation in recent years have bolstered domestic demand for investment and consumption.

Firms recorded a further rise in their gross operating surplus. They also took on more staff. Over 70,000 new jobs were created, the great majority in the private sector. That is the biggest increase since 2000, and is the main factor behind the rise in household disposable income, estimated at 4.5 p.c. in nominal terms and 2.5 p.c. in real terms.

As an annual average, inflation fell from 2.3 p.c. in 2006 to 1.8 p.c. in 2007. However, that decline masks a jump to 2.7 p.c. in the final quarter of 2007, caused by the steep rise in energy and food prices, tempered only partly by a further appreciation of the euro.

The government narrowly missed achieving a balanced budget, which it had done consistently since 2000, sometimes – as in 2006 – with the aid of non-recurring measures.

Fortunately, there now seems to be a solid consensus in Belgium in favour of avoiding public deficits. However, good fiscal management cannot be confined to maintaining a nominal balance.

That is an inappropriate objective, since it disregards cyclical fluctuations. It is therefore regrettable that Belgium, unlike most other European countries, failed to take advantage of the cyclical upswing of the past two years to improve its budget position. Above all, it is insufficient to aim at a nominal balance in view of the costs (health care, pensions) which population ageing will soon entail, the burden of which must not be passed on disproportionately to future generations. The speedy formation of rising surpluses is vital to accelerate the reduction of the public debt before those costs increase.

Whatever the country's institutional architecture, all levels of government have a duty to ensure the sustainability of Belgium's public finances by respecting the principles of accountability, balance between responsibilities and resources, and coordination between the various entities constituting the Belgian State.

Ambitious policies are needed on other fronts, too.

The improvement in the economic situation, a reasonable development of wage costs and the reforms implemented to make the labour market more dynamic have led to the net creation of around 200,000 jobs in the past four years, and reduced unemployment to its lowest level since 2002. However, at 7.6 p.c. the unemployment rate is still too high and conceals major regional and local disparities. Moreover, the employment rate for the potential labour force is still below the European average, especially – and that applies in all regions of the country – for persons aged 50 and over. That discrepancy indicates an inadequate labour supply, particularly worrying in the context of population ageing.

Also, as in the other advanced economies, the maintenance of prosperity in Belgium depends increasingly on innovation, which in turn presupposes appropriate training, the strengthening of entrepreneurship and heavier investment in research and development. While the updating of products and production processes is an obvious requirement in the branches most directly exposed to international competition, it also concerns the more sheltered sectors, and even the government, where greater efficiency can and must promote the overall competitiveness of the economy and the nation's prosperity.

In a global economy presenting not only greater challenges but also more opportunities, Belgium must maintain its position among the countries with a high standard of living. It can achieve that by pursuing a forward-looking budget path, improving both the quantity and the quality of the labour supply, and reinforcing the competitiveness of its enterprises by stimulating the propensity to innovate and by keeping costs under control. Such a strategy requires the active cooperation of all the players concerned, in both the private and the public sector.

Contents

Report presented by the Governor on behalf of the Council of Regency

International environment

1. In many respects, global economic developments in 2007 perpetuated the previous year's trend, but the financial turbulence which occurred in the summer was something new, and its consequences are still uncertain. Growth remained vigorous at around 5 p.c., and was driven by the expansion of the emerging economies, whereas domestic demand continued to slow in the United States while remaining relatively robust in the other advanced economies. Combined with geopolitical tensions, the pressure of demand on limited supply fuelled further increases in the prices of commodities, especially oil and food. In a context of increased capacity utilisation, monetary policy was tightened in several countries. Substantial current account imbalances persisted, though the US imbalance was reduced for the first time since the 2001 recession, owing to the dual effects of the business cycle – which is out of phase with the rest of the world – and the depreciation of the dollar. From August onwards, the crisis on the US subprime mortgage market spread to numerous financial markets in the United States and throughout the world, leading to a general reappraisal of the risks. This financial turmoil did not have any immediate, noticeable effect on the real economy, yet it did heighten the uncertainty surrounding the economic outlook.

2. While the American economy had been one of the engines of world growth for a number of years, it proved to be the relatively weak link in 2007. Its slowdown – GDP growth dropped from 2.9 p.c. in 2006 to 2.2 p.c. in 2007 – was due mainly to a sharp fall in housing investment. The crisis in the residential property sector and its financial repercussions have so far had only a moderate impact on the other components of domestic demand. In conjunction with the renewed rise in commodity prices, those developments nonetheless began to depress consumption, investment and employment. In these circumstances, and in view of the moderating pace of underlying inflation, the Federal Reserve eased its monetary policy, cutting the federal funds rate in five stages, between September 2007 and the end of January 2008, from 5.25 to 3 p.c. The cyclical slowdown specific to the United States, and perhaps also the emergence of doubts about the US economy's ability to equal, in the long run, the rate of productivity gains achieved in the recent past, contributed towards the marked depreciation of the dollar. Continuing the trend of the past five years, that depreciation fostered an improvement in the external current account and bolstered activity in the United States.

3. In 2007 the weakening of the US economy had a limited impact on the rest of the world. However, the turmoil of the summer revealed that foreign trade and the exchange rate were not the only channels through which the US real estate crisis might spread. The problems on the US subprime mortgage market in fact caused a sudden reduction in liquidity on a number of markets, such as the interbank and short-term debt securities markets, and also affected certain institutions, such as medium-sized banks in Germany and the United Kingdom, which were apparently remote from the source of the problems. That contagion is due to the rapid development in recent years of credit risk transfer techniques and complex structured products, in an economic climate conducive to euphoria and excessive risk taking, in increasingly

integrated financial markets. A degree of risk reappraisal was opportune, but if the tightening of liquidity were to turn into a widespread credit squeeze, that would damage the world economy. Fortunately, financial institutions had done well in previous years and were in a sound starting position in terms of solvency. Moreover, some of them were able to arrange recapitalisation. Nonetheless, uncertainty persists over the scale and distribution of the losses in the banking sector, especially in the United States and Europe, and that is tending to cause some deterioration in lending conditions.

4. These events left the emerging and developing economies largely unscathed during the year under review. They continued to expand at the high average rate of 8 p.c. China, in particular, is the country which made the largest contribution to global expansion, with a growth rate of over 11 p.c. Besides this "decoupling" from developments in the American economy, rising inflationary pressures should encourage China – accompanied by other Asian countries with a current account surplus and net inflows of private capital – to allow its currency to appreciate further, instead of continuing to accumulate foreign exchange reserves at an unprecedented rate. Such a policy would favour an internal rebalancing while at the same time attenuating the threat of disorderly exchange rate movements and growing protectionism.

5. Most of the advanced economies other than the United States continued to record satisfactory growth, usually slightly below the rate achieved in the previous year, as in Japan and the euro area, and sometimes stronger as in the United Kingdom. The euro area produced real GDP growth of 2.6 p.c., against 2.9 p.c. in 2006, and growth differentials between Member States continued to diminish. Exports and business investment were the most dynamic components of final demand, while there was a marked deceleration in housing construction, though nothing comparable to the slump seen in the United States. Private consumption continued its moderate expansion, restrained somewhat by a significant increase in VAT in Germany at the start of the year under review, and by the rising cost of energy and food at the end of that year, but underpinned by the improvement in the labour market situation. In fact, as a result of a favourable economic situation since 2005, wage moderation and structural reforms implemented in various euro area countries, unemployment is down to 7.4 p.c. of the labour force, the lowest level for twenty-five years.

6. To augment the resilience of the euro area and step up its potential growth, it is vital to pursue a policy of macroeconomic stability and to deepen the structural reforms on the lines laid down by the Lisbon strategy. The example of Germany is illuminating here : a series of reforms helped the country out of the malaise which followed reunification, while the recent fiscal consolidation had no adverse effects on activity and boosted confidence. In most countries, fiscal policy should be more ambitious to prepare public finances for the effects of population ageing, and the reforms designed to improve the efficiency of the labour market and encourage innovation, entrepreneurship, competition and training should be implemented more resolutely in order to increase the employment rate and productivity, the recent acceleration of which having been mainly due to the business cycle.

7. The medium-term targets for growth, competitiveness and quality jobs under the Lisbon programme are in line with a strategy of sustainable development for the EU which, apart from economic prosperity, aims to promote environmental protection, social equity and cohesion, and solidarity with the rest of the world. Thus, in the past two years, the EU Council has issued a series of guidelines for combating global warming and the exhaustion of non-renewable natural resources, the long-term economic and human cost of which must be considered today ; greater efforts will be needed to achieve the agreed targets, which should not be regarded only as constraints but also as the opportunity to develop new activities.

Monetary policy and financial stability

Monetary policy

8. The ECB Governing Council aims to maintain the internal value of the currency, one of the conditions for sustainable growth of activity and employment. To perform that task as effectively as possible, the Governing Council, which has virtually no control over short-term fluctuations in the general price level, bases its policy on an in-depth study of the risks to medium-term price stability. In 2007, that analysis caused the Governing Council to continue the increases in the Eurosystem's key rate which had begun in December 2005, raising it from 3.50 to 3.75 p.c. in March and 4 p.c. in June. However, in view of the financial turmoil which occurred in August, the Governing Council subsequently kept the rate on hold. In addition, the Eurosystem took measures to manage money market liquidity – without altering its policy stance – in order to counteract the market tensions.

9. In the first seven months of the year the Governing Council considered that, by increasing the use of the available production factors, the persistent vigour of economic activity since the 2005 revival posed an upside risk to prices in the medium term, and required a tightening of monetary policy ; that policy was still accommodating, as indicated in particular by the on-going rapid expansion of the money supply and lending. The Governing Council therefore continued to raise interest rates, rightly disregarding the temporary dip in the annual inflation rate below the 2 p.c. mark, caused largely by the previous year's oil price fluctuations.

10. Subsequently, the Governing Council still considered that the risks to prices in the medium term were mainly upwards, not only as a result of shocks such as the increased price of oil and food – which in fact caused the year-on-year change in the harmonised index of consumer prices to jump to 2.9 p.c. in the last quarter of 2007 – or possible increases in administered prices and indirect taxes, but also because, in the most likely scenario of growth remaining at around its potential level, second-round effects could derail labour costs and prices. The Governing Council also considered that the strong expansion of the money supply and lending confirmed the existence of risks to price stability, although these were due partly to temporary factors such as the flattening of the yield curve, financial market volatility and the re-intermediation of some financing. Aware of the particular importance of firmly anchoring medium- and long-term inflation expectations under these circumstances, it stated that it was ready to act in a firm and timely manner to ensure that these risks do not materialise. However, it felt the need to gather and analyse additional information, in view of the increased uncertainty generated by the financial turbulence.

11. More particularly, the crisis on the American mortgage market gave additional upward impetus to the euro exchange rate. Between December 2006 and December 2007 it appreciated by 10.3 p.c. against the US dollar and by 5.4 p.c. on average against a basket of twenty-four currencies. Reflecting the relative weakening of the US economy, the depreciation of the dollar helped to curb the US current account deficit and attenuated the increase in the price of imports in the euro area, while requiring a particular effort on the part of the European firms most exposed to international competition. The euro did much to absorb the international imbalances. Conversely, the currencies of the Asian countries which are accumulating current account surpluses should appreciate not only against the US dollar but also against a broader array of foreign currencies.

12. The financial turmoil also caused some deterioration in financing conditions for businesses and households. Unsecured interbank lending rates increased, since the banks were reticent to grant funds in the face of the uncertainty regarding the exposure of their counterparties to

credit risks on the US mortgage market and their own liquidity needs. This increase in money market rates was partly passed on to the conditions which banks applied to short-term or variable-rate customer loans. Banks also had to tighten their lending criteria and increase their interest margins on long-term loans; in addition, there was a widening of corporate bond spreads according to debtor quality. Long-term borrowing thus became more expensive for corporations with less than the highest credit ratings, whereas interest rates on public debt securities declined owing to a "flight to quality". Overall, however, the tightening of debt financing conditions remained moderate, while non-financial corporations experienced only a slight fall in their share price.

13. Faced with an unusually acute liquidity crisis, the Eurosystem reacted promptly: it lent more to the banks, enabling them to achieve the required level of reserves at an earlier stage in the reserve maintenance period, and on occasion it absorbed excess liquidity, in order to prevent the overnight market rate from diverging too far from the benchmark, namely the minimum bid rate in the main refinancing operations. In addition, the Eurosystem lengthened the average duration of its loans to the banking sector by increasing the volume of outstanding three-month refinancing, and it took specific measures to contain the year-end pressure – including on the interbank market in US dollars, as part of concerted action by a number of central banks. These measures normalised the shortest segment of the money market to some degree, but restoring mutual confidence among market participants is the only way of reinstating normal conditions throughout the yield curve. While the Eurosystem operations were on an exceptional scale, they were still conducted in accordance with standard procedures, e.g. as regards the collateral required, and did not imply any easing of monetary policy, since they were intended solely to keep the overnight interest rate in the vicinity of the key rate.

Financial supervision

14. The deterioration of the American mortgage market highlighted the need for prudent lending policies, both to ensure financial stability and to protect consumers. Thus, by comparison, the more cautious practices and current regulations in Belgium proved their worth. While it is true that the forms of financial intermediation developed in recent years do offer some advantages, the dramatic spread of a local crisis showed up structural weaknesses in their operation, which will need to be remedied.

15. The desire of investors for bigger returns on their investments, combined with the increasing ability of the financial system to separate and price the multiple risk components, has sometimes led financial institutions to set up extremely – or even excessively – complicated instruments which are traded on narrow markets. The price of these products is difficult to determine, and is highly sensitive to general liquidity conditions, which are often inadequately taken into account by the banks' risk management systems. In the absence of trading, and hence a market value, the alternative valuation based on models may give rise to dispute. This complicated situation is associated with a broader problem, namely a lack of transparency concerning the nature of the risks transferred, the identity of the institutions underwriting them, and the form in which these risks could materialise.

16. It is also important to assess how the new ways of organising financial functions are affecting the incentives for the players concerned. When granting traditional loans, the banks try to overcome the information asymmetry between lenders and borrowers by taking charge of the whole operation on behalf of their depositors, from the initiation of the loan to its termination, including the funding, monitoring, management and, if necessary, the settlement of conflicts with the debtor. Nowadays, it is becoming steadily more common for these various operations to be handled by separate players and even subdivided into yet more specific tasks, taken on by brokers, insurers or rating agencies. This proliferation of parties involved may lead to

relaxation of discipline. Since the party arranging the loan no longer provides the finance, it is less concerned about the debtor's quality, while many investors rely on rating agencies to monitor the risks to their assets.

17. The broader risk distribution permitted by this new intermediation model may contribute to financial stability. However, recent events have revealed some weaknesses in the financial system of the most developed countries, and the dangers entailed in innovations in the absence of proper control. The authorities in charge of prudential regulation will need to draw lessons from the turbulence, especially for the supervision of the liquidity risk, which was manifestly underestimated.

18. Efforts to adjust must also continue in Belgium. While some major Belgian banks are exposed to credit risks on the American mortgage market, their positions are assumed indirectly, via instruments covering only a residual portion of those risks. Nonetheless, the lack of liquidity facing the markets in the second half of the year was also felt by Belgian financial groups, which are closely integrated into the global system.

19. Central banks have an essential role to play in preserving market liquidity in times of tension. For that purpose they have effective instruments and techniques which they can adjust to the new methods of integrated, multi-currency cash flow management applied by major credit institutions. Furthermore, their payment system function and their constant contact with the treasurers of financial institutions give them access to specific information on liquidity conditions. In many countries – including the great majority in the euro area – the prudential supervision of financial institutions has been entrusted to the central bank. Where that is not the case, it is important for the central bank and the supervisory body to maintain close links. In Belgium, that imperative was the reason why the 2002 law established an institutional framework for cooperation between the Bank and the CBFA, a key feature being the creation of a Financial Stability Committee comprising the management boards of both institutions. During the recent financial upheaval, the very regular operational contact between the two institutions proved its value, permitting joint day-to-day monitoring of the liquidity of the leading Belgian banks. However, the rapid expansion of the activities of these large groups creates the need for even closer links and deeper cooperation between the two institutions.

The Belgian economy

Main macroeconomic developments

20. Despite a slight slowdown during the year, Belgium still achieved GDP growth of 2.7 p.c. in 2007, compared to 2.9 p.c. in 2006. As in the euro area in general, activity has so far stood up well to the weakening of the US economy, particularly thanks to the sound corporate financial position and the improvement in the labour market situation.

21. Foreign sales of goods and services expanded fairly strongly, and Belgian firms probably saw an end to the loss of market share experienced in the preceding three years. However, net exports made a negative contribution to GDP growth since imports also showed a marked rise, particularly in the form of purchases of capital goods.

*22. Business investment was in fact one of the most dynamic components of demand, expanding by around 5 p.c., partly in response to the marked increase in capacity utilisation rates seen the previous year. While debt financing conditions deteriorated slightly, the cost of equity financing declined and a renewed rise in the gross operating surplus, outstripping GDP growth, further strengthened corporate self-financing capacity.

23. Firms also took on large numbers of employees, while the number of self-employed maintained the upward trend which had begun in 2005. In all, around 70,000 new jobs were created, the biggest increase since 2000, and unemployment declined from 8.3 to 7.6 p.c. of the labour force. The tightening of the labour market, particularly acute in the case of highly skilled workers and in Flanders, exerted some pressure on wages, but since the negotiated increases and indexations were moderate, the rise in hourly labour costs was only 2.9 p.c., as in 2006, slightly exceeding the increase recorded in the three main neighbouring countries.

24. The resulting rise in household disposable income was 4.5 p.c. – a little less than in 2006, when the tax reform had provided a substantial boost. However, in real terms this rise remained steady at 2.5 p.c., since the average increase in consumer prices was less. Private consumption also expanded by 2.5 p.c., leaving the savings ratio more or less unchanged. Investment in housing grew by just over 5 p.c., a slower rate of expansion than in the three preceding years. This deceleration was due to the increase in mortgage interest rates and the moderation of the rise in residential property prices on the secondary market.

25. As an annual average, inflation fell from 2.3 p.c. in 2006 to 1.8 p.c. in 2007. However, that decline masks a jump to 2.7 p.c. in the final quarter of 2007, caused by the rise in energy and food prices, tempered only partly by the appreciation of the euro. Internally generated cost pressure remained moderate. Nevertheless, a cyclical dip in productivity augmented the rise in unit labour costs, and in some cases profit margins were expanded on the occasion of commodity price rises.

26. A retrospective examination reveals that average activity growth has been more vigorous since the end of 2000 than in the previous periods of recession and recovery, beginning in 1980 and in 1992. It has derived stronger support from fixed capital formation by enterprises, and has generated more job creation. The credibility of the Eurosystem's monetary policy, which has made it possible to keep interest rates at low levels, has undoubtedly encouraged this progress, as have the reduction of the public debt ratio, wage moderation and the measures taken in Belgium and in other European countries to enhance the efficiency of the labour and product markets, and the expansion of the emerging economies.

27. Given the potential danger of a deterioration in the international environment and financing conditions in 2008, the government and the social partners need to preserve a domestic environment favourable to growth, eliminating all uncertainty regarding the progress of public finances and maintaining the competitiveness of Belgian businesses. Thus, while the price rises triggered by the increased cost of commodities may well justify redistributive measures in favour of those on the lowest incomes, since they are the persons hardest hit, those price rises cannot be systematically offset at the expense of businesses and public authorities. As the experience of the 1970s demonstrated, transferring to those sectors the relative impoverishment caused by a deterioration in the terms of trade ultimately leads only to inflationary pressure, loss of competitiveness and jobs, and a worsening public debt. Moreover, distorting the system of relative prices would prevent that system from performing its incentive role, which in this case means encouraging energy savings.

* One regent abstained from this paragraph.

28. Furthermore, in order to avoid distortions in pricing, particularly to the detriment of consumers, but also to augment the dynamic efficiency of the economy, it is important to ensure that competitive markets function well. In particular, it is essential to eliminate any price agreements and any abuse of dominant positions. The regulations governing market activity need to be reassessed.

29. In the medium and long term, Belgium still faces a series of structural changes. Globalisation and technical progress are powerful change factors which must be fully exploited to increase prosperity and consolidate the foundations of social protection, not by resisting change but by actively participating in it. Population ageing will mean heavier expenditure on pensions and health care, while curbing the expansion of the labour force. The management of ecological risks, such as the exhaustion of certain natural resources and global warming, is also transforming the economic reality. A shared vision and a strategy which consistently links together both short-term policies and the medium- and long-term objectives, as well as action by the various levels of government in multiple spheres, are essential to face these challenges. The reforms designed to encourage innovation, entrepreneurship and productivity, to boost the employment rate and strengthen training, will be central here, as will adherence to a prudent budgetary path.

Fiscal policy

30. The Belgian general government accounts ended with a small deficit in 2007, after having recorded a surplus in the previous year. This deterioration, which occurred despite the favourable influence of the economic situation and a further reduction in interest charges, was due mainly to the disappearance of the effect of non-recurring measures adopted in 2006 to improve the budget balance, but also to more structural changes concerning both revenue and primary expenditure.

31. For the first time since 2000, the government therefore narrowly missed achieving a balanced budget. Fortunately, there now seems to be a solid consensus in Belgium in favour of avoiding public deficits in order to reduce the debt burden, which has declined considerably since its peak of 134 p.c. of GDP in 1993 but still represented 85 p.c. of GDP at the end of 2007. However, good fiscal management cannot be confined to maintaining a nominal balance. Such an objective is inappropriate, since it takes no account of cyclical fluctuations. It is therefore regrettable that Belgium, unlike most other European countries, failed to take advantage of the cyclical upswing of the past two years to improve its budget position. Above all, it is insufficient to aim at a nominal balance in view of the costs which population ageing will soon entail, the burden of which must not be passed on disproportionately to future generations. The speedy formation of rising surpluses is vital to accelerate the reduction of the public debt before those costs increase. With that in view, the December 2006 stability programme included the target of a surplus of 0.3 p.c. of GDP in 2007, which was not achieved.

32. In March 2007 the "Public Sector Borrowing Requirement" section of the High Council of Finance recommended that, as a minimum, the surpluses should increase gradually from 0.5 p.c. of GDP in 2008 to 1.1 p.c. in 2011 and 2 p.c. in 2017-2019, in the context of a budgetary path aimed at long-term stabilisation of the public debt at a low level, and a balanced phasing of the effort required by the foreseeable increase in expenditure on health care and pensions. A large part of that increase would thus be financed by the reduction in interest charges resulting from rapid debt reduction, and by the decline in the surpluses from 2020 onwards. It is important to join this path as soon as possible. The reformed stability and growth pact calls on those countries which, like Belgium, have not yet achieved their medium-term objectives to improve their structural balance by at least 0.5 p.c. of GDP per annum.

33. The achievement of the planned budget surpluses will not be easy, as there is little prospect of a further decline in the implicit interest rate on the public debt. It requires stringent control over spending, efficient collection of revenues – ensured by regular, effective checks – and a realistic assessment of the economic and fiscal impact of any measures.

34. On the revenue side, there is little scope for any increase. Conversely, a further reduction in the burden of charges on labour, which still exceeds that in most euro area countries, would promote employment. The scope for offsetting such a reduction by recourse to other revenues – such as indirect taxes, levies designed to discourage environmentally harmful consumption, taxes on capital or the abolition of certain tax exemptions – is limited by the very open character of the Belgian economy.

35. Assuming that revenues expand in proportion to GDP, primary expenditure will need to grow more slowly than GDP in the coming years – and continue to do so thereafter in the case of expenditure unconnected with ageing. That implies a break with the historical trend. When the budget margins are so narrow, it is crucial to ensure that public intervention is effective. At all levels of government and in all spheres there is productivity potential to be exploited, and modernisation – via reorganisation, human resources management reforms and computerisation – can yield better quality services and greater cost control. Social benefits must also be judged in the light of their redistributive efficiency and the need to encourage participation in the labour market. Priority must be accorded to investments in physical and human capital which increase the economy's productive capacity and pave the way to sustainable development.

36. All levels of government have a duty to ensure the sustainability of Belgium's public finances. Whatever the institutional architecture of Belgium, the principles of accountability, balance between resources and areas of responsibility, and coordination must prevail.

Employment policy

37. The improvement in the economic situation, reasonable wage increases and the reforms implemented to make the labour market more dynamic have led to the net creation of around 200,000 jobs in the past four years – though a quarter of them are due to public sector recruitment and the net effect of the service voucher subsidies – and brought a particularly steep decline in unemployment in 2007.

38. This good performance must not engender complacency. The unemployment rate of 7.6 p.c., comparable to the European average, is still too high overall, and conceals major disparities. Thus, Flanders recorded an unemployment rate of just 4.5 p.c. in the first nine months of 2007, and only 2.6 p.c. for that region's highly skilled workers, whereas the figure was 10.6 p.c. in Wallonia and 17.5 p.c. in Brussels, and over 30 p.c. for the capital's low-skilled population. In addition, the employment rate for the population aged 15 to 64 years is still below the European average – particularly for the over fifties in all regions of the country. That discrepancy indicates an inadequate supply of labour. The relatively high proportion of inactive persons in Belgium, namely around one-third, is probably attributable mainly to a range of obstacles and insufficient incentives to work. This situation needs to be remedied in order to establish a sounder basis for maintaining prosperity and social security in the context of population ageing.

39. To absorb unemployment and stimulate employment it is necessary to influence the quality and quantity of both demand and supply on the labour market, by paying particular attention to the groups facing the greatest difficulties, usually typified by high unemployment and low participation rates: women and persons aged from 55 to 64 years, whose employment rate has risen but remains too low, young people, persons with low skills, and persons of foreign origin.

*40. An essential condition for expanding employment in an economy as open as Belgium is the maintenance of business competitiveness. In line with the request which the law on employment promotion and safeguarding competitiveness addresses to the social partners and the authorities, it is vital to ensure that wage setting does not jeopardise that position. Apart from the reference to the health index, which roughly halves the effects on wages of shocks caused by energy prices, the sectoral adjustment mechanisms which so far cover about a quarter of private sector employees are a contributory factor. Wage setting must also allow wages to adjust in line with the real situation specific to businesses and the productivity of their workers. The prohibition of scale increases based on age, in accordance with the European rules, and the collective agreement concluded recently by the National Labour Council concerning the grant of a bonus linked to corporate performance and dependent on the attainment of agreed targets, are in line with this approach.

41. Moreover, both the labour supply and demand for labour can be encouraged by further cuts in fiscal and parafiscal charges. However, budgetary constraints require these to be financed by recourse to other revenue or by expenditure cuts. Priority should be given to possible reductions where they will be most effective, i.e. particularly on low wages – overcoming the unemployment traps and increasing the job opportunities for low-skilled workers –, on the pay of workers starting or ending their career, whose employment needs to be encouraged, and on the salaries of researchers, fostering the development of innovation.

42. Augmenting the labour supply and improving the match between demand and supply will entail continuing and intensifying a set of policy measures, such as the stimulation of geographical and occupational mobility, the effective extension of working life, the fight against discrimination, the provision of moderately priced crèches, the encouragement of promotion for female staff, and guidance for the unemployed.

43. Finally, life-long learning is indispensable to the development of a competitive knowledge-based economy and adjustment to technical progress, and enables individuals to preserve or regain their employability. The resources which businesses devote to formal training and, despite a slight increase, the worker participation rate both still fall short of the targets set by the social partners and embodied in the pact on solidarity between the generations. The challenge is particularly great in the case of older people, since their extended participation in the labour market makes the effort devoted to their training both more necessary and more profitable.

Structural policies

44. The rising standard of living over the past decade shows that the Belgian economy has succeeded in taking advantage of technological developments and globalisation, not only by benefiting from cheap imports of manufactured products but also by modifying its production structures. As a small, very open country which is still relatively specialised in intermediate products, Belgium needs to secure its place in world trade by constantly increasing its productivity and by continually developing the supply of new or improved goods and services, with specific features which will ensure a good price. As in the other advanced economies, growth depends increasingly on innovation. While the updating of production processes and products is an obvious requirement in the branches most directly exposed to international competition, it also concerns the more sheltered sectors, and even the public services, where greater efficiency can promote the overall competitiveness of the economy and general prosperity.

* One regent abstained from this paragraph.

45. The European innovation scoreboard set up by the EC puts Belgium in an intermediate group of countries. The distance separating it from the Nordic countries of the EU, and Germany and Switzerland, indicates scope for progress in terms of both the resources devoted to innovation – education and training, research and development – and the results – patents and applications, such as sales of new products.

46. The quality of education is a major strength for the development of the knowledge-based society. The generally high score which Belgium achieves here, partly as a result of a fairly substantial proportion of persons completing higher education, masks major disparities and weaknesses, such as a shortage of science graduates and engineers. It is crucial to enhance the ability to adapt to economic and technological changes by upgrading the efficiency of the education system and by putting more effort into continuous training.

47. Belgium's R&D expenditure dropped below 2 p.c. of GDP in 2005. Both public and private funding are inadequate. The former is actually below the European average, while the latter is highly concentrated on a small number of firms and is very dependent on foreign decisions. Under the national reform programme, the federal and regional governments have undertaken to boost the resources devoted to R&D to 3 p.c. of GDP in 2010. Public investment, tax incentives and the organisation of collaboration between public authorities, educational and training institutions, research centres and businesses should permit progress in this matter.

48. The application and spread of innovations require an entrepreneurial spirit combining creativity, risk-taking and sound management. The percentage of Belgian firms of all sizes venturing into new processes or products in the technological sphere is relatively high, while innovations relating solely to organisation or marketing are a little less common. Conversely, the rate of entrepreneurial activity is particularly low, notably because Belgians seem to have a stronger preference than other people for employee status. Yet it is essential to establish and develop new firms in order to renovate production structures and ensure economic dynamism. It is therefore necessary to promote entrepreneurship, in particular by rewarding success and by not stigmatising failure, and to pursue measures such as administrative simplification, adjustment of the social status of self-employed persons, the relaxation of certain rules which hamper the launch or expansion of some activities – particularly in the service sector – and the provision of adequate financial resources for new businesses.

49. Opening up the markets to new participants is one of the vital aspects of a competition policy which, while permitting the use of economies of scale despite the country's size, must ensure that competition is keen enough to erode monopoly profits and encourage the drive for efficiency. Strengthening the bodies which supervise competition and regulate the network industries should intensify competition, particularly in the electricity, gas, telecommunications and trade sectors.

50. Furthermore, an energy policy geared to medium- and long-term objectives can contribute both to the overall competitiveness of the economy and to environmental protection by safeguarding the country's security of supply, encouraging the development of renewable energy, and promoting efficiency in relation to energy and the environment, especially in the case of buildings and transport. More generally, the development of more environment-friendly production and consumption must be encouraged, especially as that may generate innovations creating value added and jobs.

Conclusion

51. The global economy is undergoing a rebalancing process: the pressure which its strong growth has exerted on commodity prices, and the correction of financial excesses in the large country with the heaviest debt burden, namely the United States, are apparently forcing it to slow down. The euro area has strengths – such as the financial health of its businesses, the improved efficiency of its labour market and the credibility of its monetary policy – enabling it to maintain the dynamism of domestic demand and thus make a positive contribution to the transition to a new equilibrium. Better still, it has potential for increasing productivity, evident for example in the way it has lagged behind the United States in applying the new information and communication technologies. It still needs to consolidate those advantages and exploit that potential, presupposing the pursuit of macroeconomic policies aimed at stability and the resolute implementation of the Lisbon programme of reforms. For its part, the Eurosystem will continue to ensure the firm anchoring of expectations regarding the path of the general price level in the medium and long term, a policy which is all the more necessary to promote growth and employment in an uncertain environment.

52. Belgium needs similar policies. In a euro area where disparities in performance persist, Belgium ought to be among the best. To achieve that, it will be appropriate to follow a forward-looking budget path, to preserve cost competitiveness, to continue absorbing unemployment, to increase the supply of labour, to improve training and to stimulate innovation, entrepreneurship and productivity. The institutional reform which is being prepared must provide a lasting foundation for more effective public intervention, increased accountability and closer cooperation between the entities constituting the Belgian State. It is the task of political and social policy makers to agree on a coherent strategy for sustainable development and to swiftly implement the measures which will enable all participants in economic life to give full expression to their dynamism.

Brussels, 30 January 2008

[5] Guy Quaden, GOVERNOR
[1] Luc Coene, VICE-GOVERNOR
[3] Marcia De Wachter, DIRECTOR
[4] Jan Smets, DIRECTOR
[7] Françoise Masai, DIRECTOR
[6] Jean Hilgers, DIRECTOR
[2] Peter Praet, DIRECTOR
[8] Norbert De Batselier, DIRECTOR

Board of directors

2 4 5 6

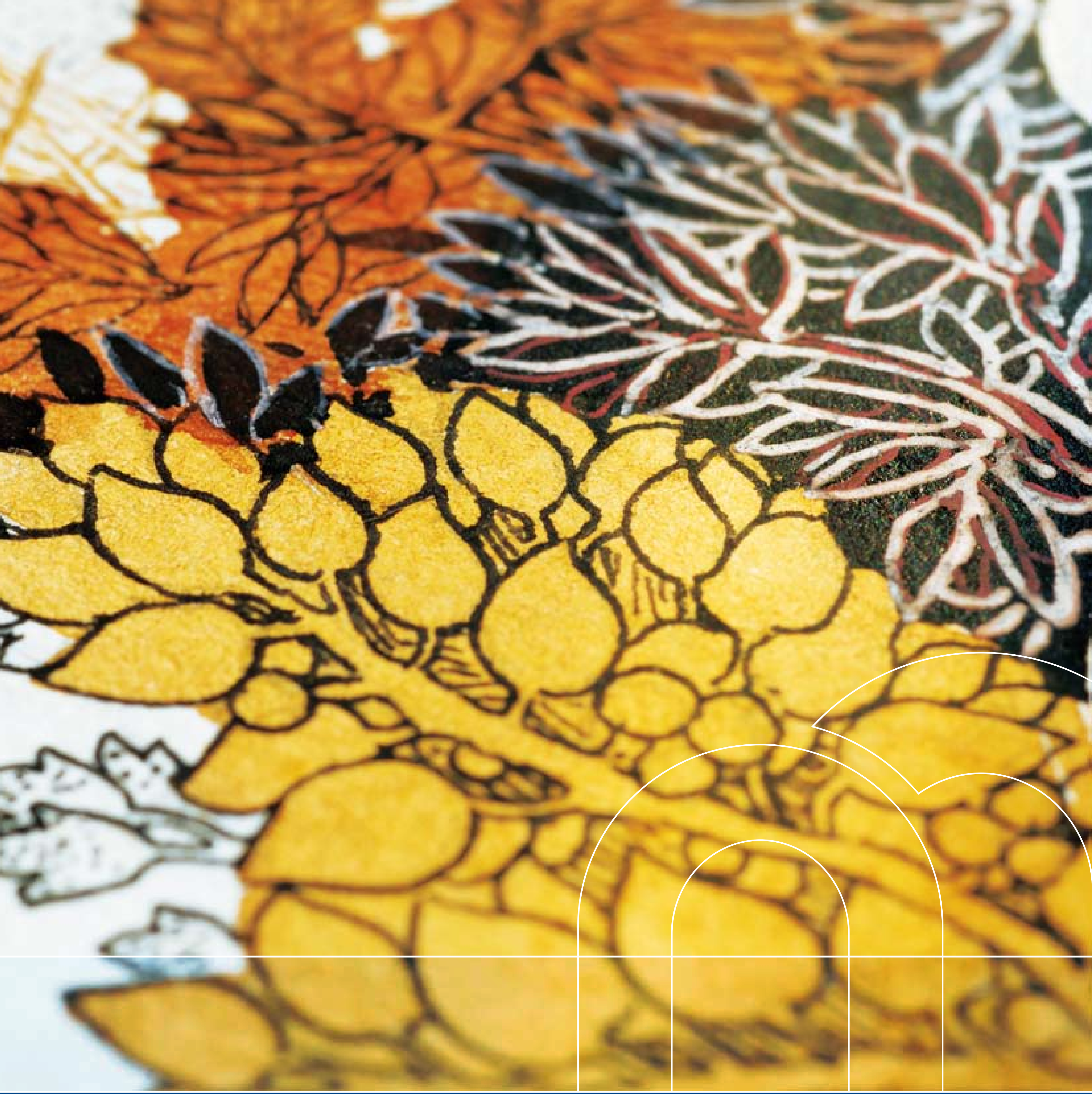
8

1 3 7

[14] Guy Quaden, GOVERNOR
[6] Luc Coene, VICE-GOVERNOR
[9] Marcia De Wachter, DIRECTOR
[16] Jan Smets, DIRECTOR
[17] Françoise Masai, DIRECTOR
[4] Jean Hilgers, DIRECTOR
[10] Peter Praet, DIRECTOR
[8] Norbert De Batselier, DIRECTOR
[19] Noël Devisch, REGENT
[18] Gérald Frère, REGENT
[13] Jacques Forest, REGENT
[3] Luc Cortebeeck, REGENT
[15] Martine Durez, REGENT
[7] Christian Van Thillo, REGENT
[2] Didier Matray, REGENT
[1] Rudi Thomaes, REGENT
[5] Pierre Wunsch, REGENT
[11] Rudy De Leeuw REGENT
[12] Jean-Pierre Arnoldi, GOVERNMENT COMMISSIONER

Council of Regency

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19



International environment

1.

1.1 Summary

In 2007 the global economy maintained the vigour of previous years. Driven mainly by the emerging countries, led by China, it expanded at close to the 2006 growth rate of 5 p.c., despite a further rise in commodity prices and the turbulence in financial markets from the summer onwards. The dynamism of the emerging economies combined with general conditions conducive to employment and corporate profitability limited the impact of these shocks. In the advanced countries, however, growth lost some of its momentum, the main reason being the slump on the housing markets, particularly in the United States. Nonetheless, like Japan, the euro area continued to enjoy relatively sustained growth of its economic activity, underpinned by domestic demand.

TABLE 1 GDP GROWTH IN THE MAIN ECONOMIES
(percentage volume changes compared to the previous year, unless otherwise stated)

	2005	2006	2007	*p.m. 2007 Contribution to world GDP growth* [1]
United States	3.1	2.9	2.2	*0.5*
Japan	1.9	2.2	1.9	*0.1*
Euro area [2]	1.6	2.9	2.6	*0.4*
Denmark, United Kingdom and Sweden	2.0	3.1	3.0	*0.1*
Other EU Member States [3]	4.8	6.6	6.1	*0.2*
Other advanced OECD countries [4]	3.0	2.7	3.2	*0.1*
China	10.4	11.1	11.4	*1.2*
India	9.2	9.4	8.8	*0.4*
Other emerging Asian countries [5]	4.9	5.4	5.2	*0.4*
Latin America [6]	4.3	5.2	4.9	*0.4*
Main oil-exporting countries [7]	6.2	6.0	6.3	*0.5*
Rest of the world	4.4	6.5	8.1	*0.6*
World	4.4	5.0	4.9	
p.m. World trade [8]	*7.6*	*9.4*	*7.0*	

Sources: EC, IMF, OECD.
(1) Contribution calculated on the basis of the GDP weight of the country or group of countries considered in 2007, on the basis of purchasing power parities; percentage points.
(2) Excluding Slovenia.
(3) Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia.
(4) Australia, Canada, Iceland, New Zealand and Switzerland.
(5) Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.
(6) Excluding Venezuela.
(7) Countries recording a current account surplus in excess of 25 billion US dollars over the period 2005-2007 (Algeria, Iran, Kuwait, Libya, Nigeria, Norway, Qatar, Russian Federation, Saudi Arabia and United Arab Emirates and Venezuela).
(8) Average exports and imports of goods and services.

The impact of the gloom on the American residential property market with respect to GDP growth seems to have been confined mainly to the United States in 2007, although it also generated increased uncertainty concerning the economic outlook and a tightening of credit conditions in the other advanced economies. Nonetheless, the impact on global financial markets was substantial. The proliferation of defaults on the American subprime mortgage market following the decline in property prices and excessive risk-taking on the part of both lenders and borrowers in fact triggered serious financial turmoil from the summer onwards. As shown in more detail in chapter 8 of this Report, these problems spread to other segments of the financial markets in the United States and in other regions, mainly in the other advanced economies, via relatively complex and extensive credit risk transfer mechanisms set up by financial intermediaries. This process created confusion over the market operators' direct and indirect individual exposure to potential losses on the American subprime market. In general, the loss of confidence became widespread, affecting all aspects of the securitisation of loans, particularly structured investment vehicles, which soon encountered financing problems, and the markets on which these instruments can be traded. The turbulence revealed the limitations of structured finance instruments in terms of their transparency and their effective liquidity. Market operators therefore became reluctant to grant one another liquidity, and that seriously disrupted the operation of the money markets. In response, a number of monetary authorities including the Eurosystem and the Federal Reserve had to inject substantial amounts of liquidity on multiple occasions, in order to stabilise the money markets. But at the end of 2007 serious tension re-emerged on the interbank markets in short-term finance, prompting the central banks of the United States, the euro area, the United Kingdom, Canada and Switzerland to make a joint announcement on 12 December regarding new measures to overcome these problems: the Federal Reserve, the Eurosystem and the National Bank of Switzerland thus conducted several joint liquidity injection operations.

Furthermore, these financial market developments also influenced the actual course of monetary policy. In view of the inherent potential risk to economic growth in the United States and the moderating pace of underlying inflation, the American central bank's federal funds rate – which had remained unchanged since June 2006 – was cut in several stages from 5.25 to 4.25 p.c. For its part, the Eurosystem which had raised its key interest rates on various occasions up to the summer did not tighten its monetary policy any further: the Governing Council felt the need to take account of the increased uncertainty and to give itself time to analyse the effects of the financial upheaval. At the same time, however, the Governing Council emphasised that it would continue monitoring the upside risks to prices, particularly the risks related to the surge in oil prices and the rising cost of agricultural products, in order to take pre-emptive action at the appropriate time to safeguard price stability. In Asia, the Bank of Japan also left its base rate unchanged after a 25 basis point increase in February 2007. Despite the high rate of capacity utilisation, the weakness of the yen and the marked increase in several commodity prices, deflation has still not been finally overcome. In China, the average rise in the consumer price index accelerated, mainly owing to the increase in food prices which have a one-third weighting in the index. In order to contain inflation expectations, the People's Bank of China imposed tighter reserve requirements, limited the maximum expansion of lending and raised the reference rates for loans and deposits.

As regards public finances, the stance was once again restrictive overall. While the cyclically adjusted public deficit edged upwards in the United States, the budget balance was structurally consolidated in the other leading economies. In the euro area, there was a further marked improvement in the balance, on average, attributable almost exclusively to a cut in primary expenditure. As in 2006, Germany made an impressive consolidation effort. In Japan, the structural budget deficit showed another substantial fall, but it was not sufficient to initiate a reduction in the gross public debt. China's fiscal policy also became stricter, one factor being a tax increase aimed at slowing the sustained growth of exports.

The large balance of payments imbalances persisted during the year under review. The United States current account deficit remained considerable, in both absolute and relative terms, although it did decline from 6.2 p.c. of GDP in 2006 to 5.6 p.c. American exports in fact maintained their vigorous growth, benefiting from the sustained expansion of activity in partner countries and the weakening of the dollar. At the same time, imports slowed as domestic growth ran out of steam. The surpluses of the other regions of the world, which counterbalance this deficit, are still attributable mainly to Asia and the oil-exporting countries. Furthermore, the Asian current account surplus has increased; conversely, that of the oil-exporting countries has diminished slightly. In China, the current account surplus reached a new peak at 11.2 p.c. of GDP. Exports were supported by the continuing focus of economic activity on foreign demand, and expanded at a very sustained rate, far outpacing the growth of imports. China's official reserves therefore continued to accumulate, reaching over 1,500 billion US dollars in December 2007. Japan, which traditionally is among the countries

TABLE 2 **CURRENT ACCOUNT BALANCES OF THE MAIN REGIONS OF THE WORLD** (1)

(billions of US dollars, unless otherwise stated)

	2005	2006	2007	*p.m. 2007, percentages of GDP*
United States	–754.8	–811.5	–768.7	*–5.6*
Japan	166.3	171.3	206.2	*4.7*
Euro area (2)	27.7	–1.6	18.3	*0.2*
China	160.8	249.9	360.8	*11.2*
Other emerging Asian countries (3)	90.7	121.0	131.0	*3.5*
Main oil-exporting countries (4)	382.3	453.9	398.8	*12.7*
Other countries	–67.1	–115.3	–147.8	*n.*

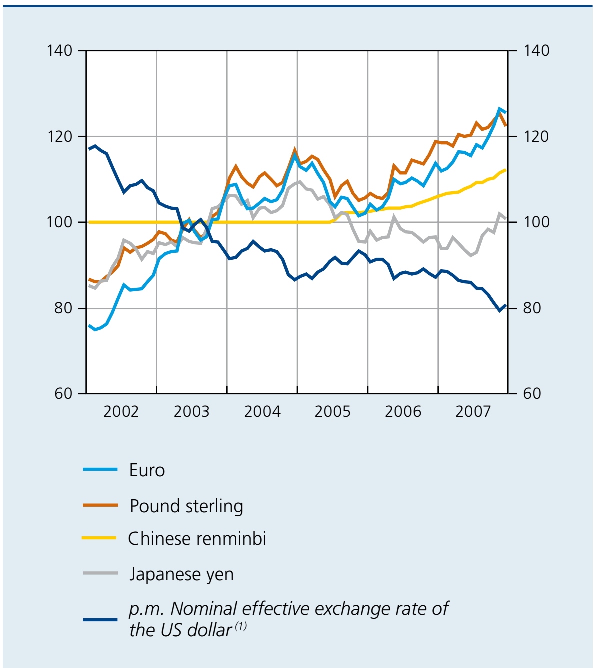
Sources: IMF, OECD.
(1) In principle, if the balance of payments figures for the various economies are added together, they should be in balance overall, but in practice there is a large net surplus for the period under review. Owing to the scale of the gross flows recorded in the balance of payments, these figures frequently contain substantial errors.
(2) Excluding Slovenia.
(3) Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.
(4) Countries recording a current account surplus in excess of 25 billion US dollars over the period 2005-2007 (Algeria, Iran, Kuwait, Libya, Nigeria, Norway, Qatar, Russian Federation, Saudi Arabia, United Arab Emirates and Venezuela).

with a substantial current account surplus, also saw its surplus amplified by the dynamism of exports, particularly to the emerging Asian economies. The main oil-exporting countries recorded only moderate growth of their exports in volume terms. Although the oil price continued to rise, oil production stagnated, one reason being a reduction in output among the OPEC member countries. At the same time, the main oil exporters recorded a strong rise in their imports, probably following the progressive "reallocation" of their oil revenues, particularly in Russia. Thus, goods exports by OECD member countries to Russia expanded strongly in 2007. Finally, the euro area's current account was nearly in balance, as in the previous year.

Following a period of relative stability at the beginning of the year, the weighted average exchange rate of the US dollar depreciated practically throughout 2007. Mixed signals regarding the US economic situation fuelled concern about the economic outlook, particularly for the residential property sector and the subprime mortgage market. The reduction in the interest rate differential between the United States and the euro area also contributed to the weakening of the American currency. This was amplified after the summer, in view of the unexpectedly serious deterioration of the American housing market. The anticipation of a reversal of interest rate policy, later borne out by the cut in the federal funds rate, also depressed the dollar. Overall, the weighted average exchange rate of that currency was around 4.7 p.c. lower, on average, than in the previous year.

CHART 1 **BILATERAL EXCHANGE RATES OF THE LEADING CURRENCIES AGAINST THE US DOLLAR**

(monthly averages, indices January 1999 = 100)



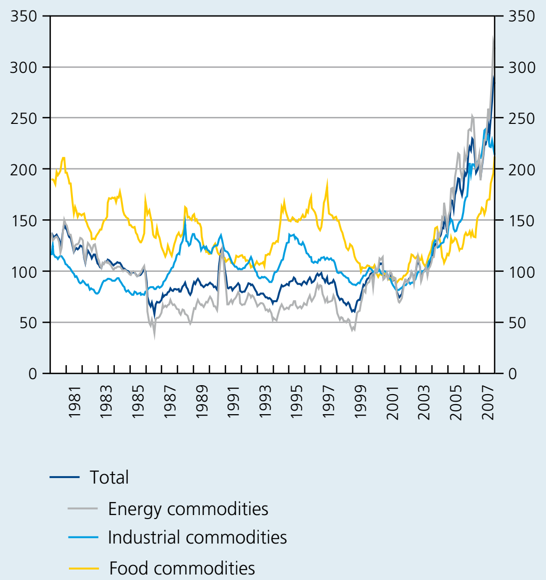
Sources: BIS, ECB.
(1) Average exchange rate of the dollar against the currencies of twenty-one advanced countries and four emerging Asian economies, weighted according to their share in US foreign trade.

While the US dollar depreciated against practically all leading currencies, with the notable exception of the Japanese yen, it was the decline against the euro that exerted the most downward pressure on its weighted average rate. The euro in fact rose strongly against the US dollar, appreciating by an average of 9.2 p.c. against the latter with respect to the previous year. The appreciation of the euro was supported not only by the relative movement in interest rates but also by the prospects for economic growth. On average, the pound sterling appreciated against the dollar to almost the same extent as the euro, though it did weaken against the euro during the year, falling by a total of 9.2 p.c. between the end of 2006 and the end of 2007, primarily because of the relatively significant turmoil on the domestic financial markets.

The Japanese yen fluctuated considerably during the year under review. To a large extent, those fluctuations were determined by the attitude adopted by international investors towards the carry trade transactions which, in their simplest form, are intended to finance investments in high interest rate currencies via borrowings in low interest rate currencies, including in this case the yen. In a context of low exchange rate volatility, and in view of the low level interest rates in Japan, that country's currency remained attractive at the start of the year as a source for these transactions, and the fall in the yen exchange rate seen since mid 2006 persisted. In the summer, the risk aversion caused by the international financial market turbulence associated with the uncertainty created by the developments in the subprime mortgage market in the United States prompted a radical reduction in the positions taken in carry trade transactions, causing the yen to recover strongly. In all, over the year as a whole, the bilateral exchange rate of the yen against the dollar was 1.1 p.c. below its 2006 level.

The Chinese renminbi appreciated against the US dollar at a somewhat faster pace than in 2006, its bilateral rate rising by 4.8 p.c. compared to 2.8 p.c. Nonetheless, this rise was far from sufficient to attenuate the internal and external imbalances facing China.

CHART 2 PRICES OF COMMODITIES
(monthly data, US dollars, indices 2000 = 100)



Source : HWWI.

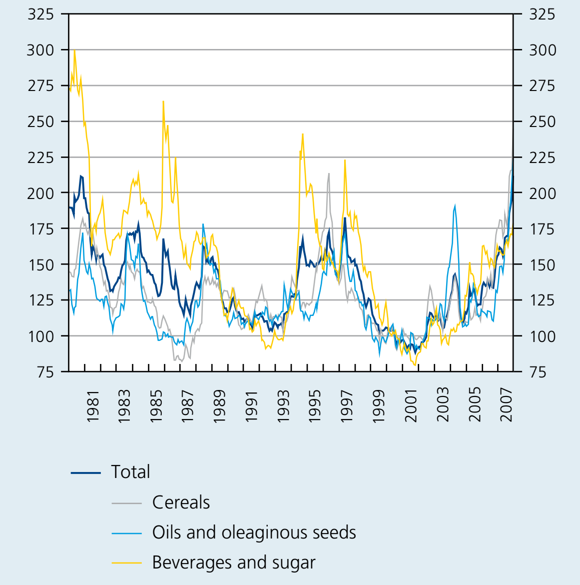
Commodity prices continued their upward trend which had begun in 2002. Expressed in US dollars, they increased by an average of 13.3 p.c. Food prices showed the sharpest increase, rising by 24.8 p.c. As explained in box 1, this rise is due to both temporary and structural factors, particularly the stronger demand for certain plant products resulting from their use in the production of biofuels, and the stronger demand from the emerging economies related to the increased purchasing power of their populations. Prices of industrial and energy commodities increased by an annual average of 15.4 and 11.7 p.c. respectively. This price rise is attributable to tensions between supply and demand and, in a number of cases, to low stock levels. Expressed in real terms, i.e. compared to the movement in the general price level, commodity prices reached their highest level since the beginning of the 1980s.

Box 1 – The strong rise in food commodity prices: causes and effects

The food commodity price increase seen in the year under review had already begun in 2002 and gathered pace significantly from the second half of 2006. Thus, prices in US dollars more than doubled over that period, and by the end of 2007 had reached a level comparable to the 1980 autumn peak. The recent price rise is exceptional from a historical angle in terms of its duration and because it affects almost all food commodity categories. In real terms, i.e. comparing their movement with the change in the general price level, these commodity prices can be regarded as relatively modest. Thus, in 2007, they were on average around 20 p.c. below the average prices recorded in the period 1980-2006.

FOOD COMMODITY PRICES

(monthly data, US dollars, indices 2000 = 100)



Source: HWWI.

Following a 10.9 p.c. rise in 2006, food commodity prices increased by 24.8 p.c. in 2007. Cereals and oils and oleaginous seeds recorded the largest price rises, in excess of 35 p.c. Within those categories, prices of palm oil, coconut oil and sunflower oil, soya oil and beans, maize and barley saw the steepest increases. With the exception of rice, tea and sugar, the other components of the food commodity index also increased significantly. The largely general trend towards rising food commodity prices on the international markets is also evident from the data supplied by the FAO on the movement in the prices of a number of commodities not included in the HWWI index, such as dairy products or meat, which produced a year-on-year increase in dollar terms of almost 80 and 5 p.c. respectively in the first ten months of 2007.

Food commodity prices were inflated by both temporary and structural factors. On the one hand, there was a considerable surge in demand from the emerging countries, particularly the Asian countries where the sustained economic growth of recent years has boosted the population's purchasing power. This is one reason why consumption patterns have shifted in favour of foods with a higher animal protein content (meat, dairy products, etc.). On the other hand, high energy prices, the targeted measures adopted by the American and European authorities and increased awareness of environmental problems have generated a growing demand for plant commodities used in the production of biofuels, principally maize, barley, sugar and edible oils. On the supply side, adverse climatic conditions in some regions of the world reduced the harvests, and there were various livestock disease outbreaks. In addition, stocks reached a low level in 2007 and production costs were driven up by the price of energy, which is a crucial factor in food production. Finally, the weakening of the US dollar exacerbated the pressure on prices.

The rise in prices of food commodities has major economic implications. In particular, it pushes up the cost of living, both directly – in view of its impact on food prices – and indirectly owing to the potential contagion, or 'second-round', effects. The impact varies between countries and depends on the weighting of food in the consumer price index. Since that weight generally diminishes as per capita income increases, the purchasing power of poor countries – and especially that of the most disadvantaged persons – is hit harder than that of advanced economies. Nevertheless, that effect may be offset by gains in the terms of trade for countries producing large volumes of food commodities, particularly when output exceeds consumption requirements.

In the case of industrial commodities, there were sharp price increases in all categories, be they agricultural products (timber, wood pulp, cotton, rubber, etc.), ferrous metals or non-ferrous metals. The strongest rise occurred for agricultural products, at 21 p.c., while prices of ferrous and non-ferrous metals increased by 12.3 and 13.4 p.c. respectively. Lead, nickel and tin recorded the biggest increases. Prices of many metals reached record levels during 2007, owing to sustained demand, interruptions in supply and the low level of stocks. Metal prices began falling from the middle of the year, mainly as a result of the unwinding of speculative positions and the less optimistic growth forecasts for some regions. However, they remained at a historically high level.

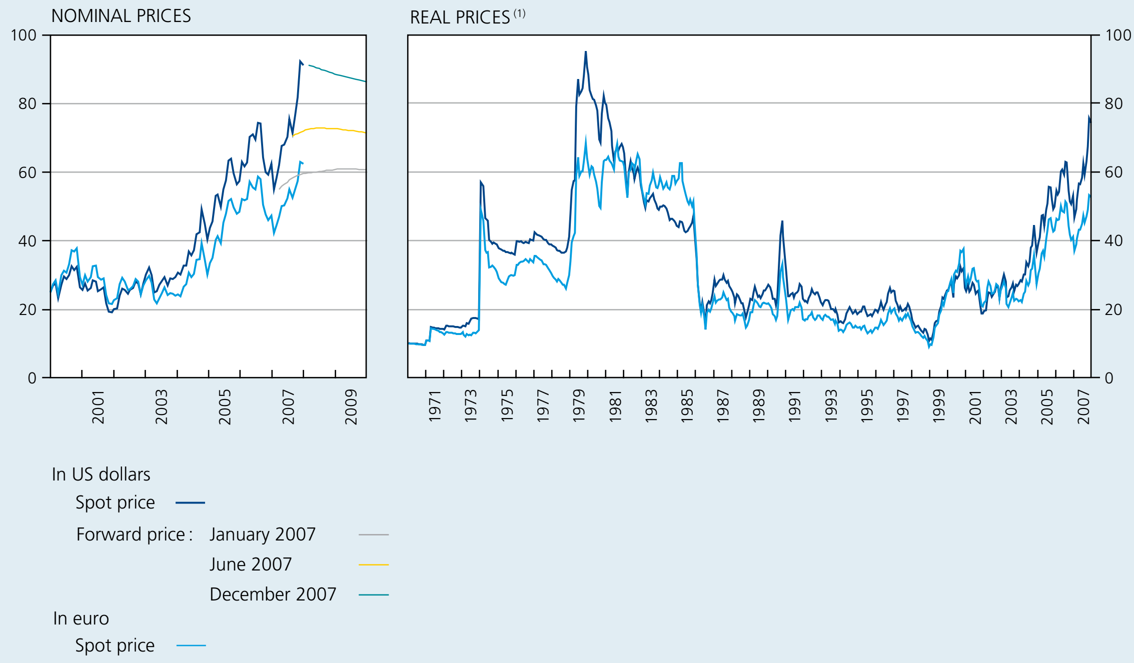
Turning to energy commodities, crude oil prices expressed in US dollars increased by an average of 9.6 p.c. in 2007, a less marked rise than in the four preceding years. However, this is an average figure which takes no account of the price volatility during the past year. After peaking at 78.2 dollars per barrel in August 2006, the Brent price declined almost continuously to reach 52 dollars per barrel in mid January 2007. However, oil prices began rising again from the end of January. Following a temporary dip in August, due to financial market turbulences, prices hit new record levels as from September, peaking on 27 November at 95.6 dollars. In real terms, oil prices increased significantly but now stand at a level comparable to that seen in the early 1980s. Expressed in euro, the increase in prices per barrel was tempered by the single currency's appreciation against the dollar, though new peaks were still reached in nominal terms from the beginning of November. The rise in energy commodity prices was not confined to crude oil. Prices of coal and natural gas also increased on the international markets.

The higher crude prices are largely attributable to the tension between supply and demand. Demand has risen steadily – albeit at a more modest pace than in the period 2003-2005 –, the main impetus coming from the emerging Asian countries, especially China, and the Middle East. Supply has remained more or less constant, as the expansion of production outside the OPEC area offset the output restrictions which OPEC had imposed since the end of 2006. Other factors were the resurgence of geopolitical tensions, mainly in the Middle East, and adverse climatic conditions. Finally, the weakening of the dollar influenced both supply and demand. On the supply side, producers tried to preserve their level of income in local currency, while the weakness of the dollar limited the negative impact of higher oil prices on demand outside the United States.

On the forward markets, crude prices remained high throughout the year, indicating that market operators regarded their increase as structural. During the summer, however, the profile of the forward price curve was reversed, reflecting concerns about the short-term availability of sufficient quantities of crude oil, in view of the sharp fall in stocks and their low level as from the third quarter.

CHART 3 CRUDE OIL PRICES

(per barrel of Brent)



Sources : EC, Intercontinental Exchange, Thomson Financial Datastream.

(1) Nominal prices deflated respectively by the CPI or, if available, the HICP (indices 2000 = 100) of the United States and the euro area. For the conversion of the euro price per barrel of Brent, figures prior to 1999 are based on the ecu rate against the dollar.

1.2 United States

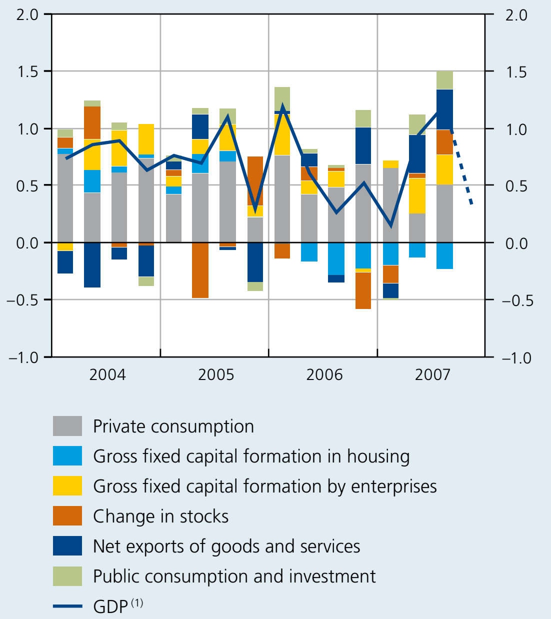
In 2007, the growth of the American economy was well down against the rate recorded in 2006, falling on average from 2.9 to 2.2 p.c., around ¼ of a percentage point below its potential. This fall was due mainly to less vigorous domestic demand, and in particular to a further decline in housing investment. The latter in fact slowed the expansion of economic activity by 0.6 percentage point of GDP. The other categories of domestic expenditure, excluding the change in stocks, continued to support growth and appeared to be only slightly affected by the crisis in the residential property market. In contrast to previous years, net exports made a substantial positive contribution to GDP growth. Inflation eased on average during the year, mainly owing to the slackening pace of energy cost increases. The labour market proved less dynamic : employment growth slowed and the unemployment rate increased from the second half of the year.

GDP growth was relatively volatile during the year under review. The slowdown which began in 2006 persisted in the first quarter, with growth dropping to 0.2 p.c. In the following two quarters it picked up again, reaching 0.9 and 1.2 p.c. respectively. In the fourth quarter, however, GDP growth fell sharply.

While households continued to step up their consumption expenditure at a sustained rate of around 3 p.c. as in the two preceding years, they made considerable reductions in their investments in housing, well in excess of the cuts made in 2006. These investments contracted by 17.2 p.c. The primary reason was the relative movement in the cost of building a new house compared to the prices prevailing on the secondary market : all other things being equal, a fall in those prices curbs the construction of new housing. After reaching a record level in the first quarter of 2005 at almost 16 p.c. year-on-year, and having persisted at abnormally high levels up to the beginning of 2006, existing house price rises as measured by the national Case Shiller index then slowed increasingly sharply, and a price fall set in from the beginning of 2007. In the third quarter, those prices were therefore 5 p.c. down against the peak reached in the second quarter of 2006. This price fall is due to the less buoyant demand for housing and the growing number of unsold homes. The property market correction was reinforced from mid 2007 by the crisis on the subprime mortgage market (for more details,

CHART 4 QUARTERLY PROFILE OF GDP AND THE MAIN CATEGORIES OF EXPENDITURE IN THE UNITED STATES

(seasonally adjusted data; contribution to the volume change in GDP against the preceding quarter, percentage points, unless otherwise stated)

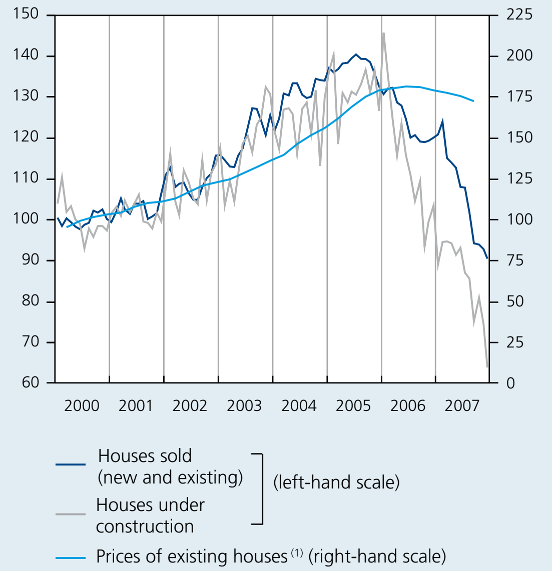


Sources: OECD, BEA.
(1) Percentage changes against the preceding quarter.

see box 2) and by the ensuing turmoil in financial markets in general. This prompted a tightening of the credit standards applied to the approval of mortgage loans and an increase in the rates applied to some of these loans, contributing to the continuing rise in the rate of default on mortgage loans and hence further downward pressure on house prices. In December, the numbers of houses sold or under construction were down by 35 and 56 p.c. respectively against the highest levels reached during the last residential property market boom.

CHART 5 ACTIVITY AND PRICES IN THE UNITED STATES' RESIDENTIAL PROPERTY MARKET

(indices 2000 = 100; monthly data, unless otherwise stated)



Sources: Standard & Poor's, Thomson Financial Datastream.
(1) National Case-Shiller index, quarterly data.

Box 2 – Developments on the American subprime mortgage market

The sustained growth of mortgage lending, and more particularly high risk or "subprime" loans, proved to be one of the main developments on the American financial markets in recent years. Such loans are granted to individuals presenting a high credit risk. That risk may be due to an adverse credit history or to other characteristics – such as a ratio of monthly repayments to income exceeding 55 p.c., or a loan-to-value ratio of over 85 p.c. –, which may be associated with a high probability of default. In addition, in recent years mortgage loans have increasingly been granted without the lender first having enquired about or been properly informed of the borrower's solvency.

Subprime mortgage loans are essentially an Anglo-Saxon phenomenon, and it is in the United States that they are by far the most significant, in relative terms. In 2006, loans of this type totalling around 600 billion dollars were granted, representing some 20 p.c. of all new mortgage lending in that year. At the end of 2006 – disregarding "Alt A" loans which are granted to borrowers for whom full references are not available but whose quality is better than that of high risk borrowers – there were around 7.5 million subprime loans totalling 1,300 billion dollars, or around 15 p.c. of the total mortgage loans outstanding. The majority of subprime mortgages are granted at variable interest rates. It is estimated that these represented approximately 90 p.c. of the new subprime loans granted in 2006 and around two-thirds of the total number of loans of that type. Recent years have seen the success of 2/28 and 3/27 mortgage loans, which carry very low fixed rates of interest during the first two or three years of borrowing and a significantly higher variable rate for the residual term of the loan.

The emergence of subprime mortgage loans dates back to the early 1980s, and was made possible by a series of legislative changes implemented during that period. These included the abolition of maximum interest rates (1980), the permission to issue loans at a variable rate (1982), and the provision whereby residential mortgages contracted for the purchase of owner-occupied housing are the only form of credit on which interest payments are tax deductible for households (1986).

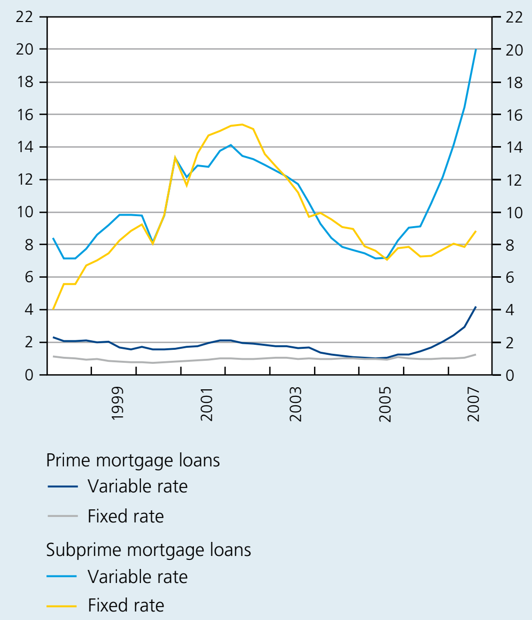
However, subprime mortgages did not begin to gain importance until the mid 1990s, with the real breakthrough coming in the period 2001-2006. Their expansion is due to various factors. First, the development of an active secondary market in mortgage loans and the changes made to the legal framework made possible the securitisation of these loans. With securitisation, the risk associated with the granting of such a loan is no longer borne by the lender, and is therefore transferred. The introduction of this originate-to-distribute model gave credit companies greater access to the capital markets, reduced transaction costs and, via securitisation, led to wider dispersion of the risks associated with the transfer of loans. Furthermore, there was a series of innovations such as the automation of the mortgage lending procedure and the development of credit-scoring models. These innovations, designed to improve the assessment of the risk associated with a loan, enabled lenders to optimise their costs. Finally, owing to the combined effects of the originate-to-distribute model, the strong demand for investments at high interest rates, and fierce competition in the mortgage sector, credit companies displayed greater flexibility in their lending, particularly in 2005 and 2006. New formulas were launched to make mortgage loans accessible to more borrowers, and credit standards on loans were eased. This led to a riskier borrower profile.

The subprime mortgage default rate – that is the number of loans in arrears of at least sixty days or with seizure of the mortgaged assets, expressed as a percentage of the total number of outstanding loans – increased from 7.6 p.c. in mid 2005 to 15 p.c. in the third quarter of 2007. The increase was most marked in the case of variable rate loans and those granted in 2005 and 2006. The rise in the subprime mortgage default rate is due to a combination of factors. First, the rate of increase in residential property prices slowed down, and prices actually fell from the third quarter of 2006, making it impossible to refinance the loans. Second, market interest rates went up as a result of increases in the policy rate by the Federal Reserve since June 2004, which was reflected in the rates on many loans. Third, the deteriorating economic situation and the unemployment rate in certain States also depressed household incomes. Furthermore, the steep rise in the number of houses purchased for purely speculative reasons – in the hope of making a swift profit by reselling the property after a short time, without even occupying it or letting it out – also pushed up the number of defaults. Finally, the easing of credit standards on mortgage loans in 2005 and 2006 and the contractual rate reviews on thirty-year 2/28 and 3/27 loans contributed to the rise in defaults.

At the end of the year, after consultation between the public authorities and the financial sector, measures were announced to curb the rise in mortgaged property repossessions and to limit the economic impact of the property crisis. These included, the freezing of the rate on some of these loans for a certain period at the rate applied in the first two or three years of the contract.

DEFAULT RATES BY MORTGAGE LOAN CATEGORY IN THE UNITED STATES

(payments at least sixty days in arrears and seizures of mortgaged property, quarterly data, percentages of the total number per loan type)



Source : Thomson Financial Datastream.

The buoyancy of private consumption during the year under review is due partly to the gains achieved by households on their financial assets, as a result of rising stock markets in the past few years, and partly to the accelerating growth of their disposable income, up from 3.1 to 3.4 p.c. in real terms. That growth is derived from the stronger increase in earned incomes, in turn attributable to the faster rise in wages, brought about partly by the payment of substantial bonuses and by employees exercising options on shares in their company. Conversely, after the dynamism of recent years, employment expansion moderated to 1.1 p.c. and the unemployment rate actually increased from the second half of the year. While rising house prices had been one of the main factors underpinning consumption in previous years, via the real estate wealth effect, particularly by the use of "equity withdrawal", that effect diminished considerably this year. The renewed rise in energy prices and the tighter lending conditions applied by credit institutions also depressed household spending. On average, household savings increased from 0.4 to 0.7 p.c. of disposable income, halting the downward trend seen in previous years.

Following a marked expansion from 2004 to 2006, US business investment lost momentum, growing by only 4.7 p.c. compared to 6.6 p.c. the year before, the main reason being less favourable economic prospects. Moreover, the uncertainty surrounding these forecasts intensified after the financial crisis erupted. The growth of expenditure on equipment and software slowed down, owing to the decline in spending on transport equipment. Conversely, there was a further marked rise in expenditure on non-residential construction, attributable to the high occupancy rate and a catching-up process in the context of the sluggishness of this sector in the preceding years. It was therefore possible to use part of the resources released by the slowdown in residential construction.

TABLE 3 ECONOMIC DEVELOPMENTS IN THE UNITED STATES

(percentage changes compared to the previous year, unless otherwise stated)

	2005	2006	2007
Expenditure (volume) [1]			
Final domestic demand	3.3	2.7	1.8
Final consumption expenditure			
Households	3.2	3.1	2.9
General government	0.8	1.4	2.0
Gross fixed capital formation			
Housing	6.6	–4.6	–17.2
Enterprises	7.1	6.6	4.7
General government	0.6	3.7	2.5
Change in stocks [2]	–0.2	0.1	–0.3
Net exports of goods and services [2]	–0.2	–0.1	0.5
Exports	6.9	8.4	8.1
Imports	5.9	5.9	2.1
GDP	3.1	2.9	2.2
Labour market [3]			
Employment	1.8	1.9	1.1
Unemployment [4]	5.1	4.6	4.6
Prices and costs			
Consumer prices (CPI)	3.4	3.2	2.8
Unit labour costs	2.2	3.0	3.9
Prices of imported goods and services	6.3	4.0	3.2
Terms of trade	–2.5	–0.6	0.3
Balance of payments and budget balance [5]			
Balance of current transactions	–6.1	–6.2	–5.6
Cyclically adjusted budget balance of general government	–3.6	–2.8	–3.0
p.m. Private savings ratio [6]	*0.5*	*0.4*	*0.7*
Gross debt ratio of general government [5]	*62.4*	*61.9*	*62.2*

Sources: OECD, BLS.
(1) Calendar adjusted data.
(2) Contribution to the change in GDP, percentage points.
(3) According to the household survey.
(4) Ratio between the number of unemployed and the labour force.
(5) Balance or outstanding total expressed as a percentage of GDP.
(6) Net savings expressed as a percentage of net disposable income.

During the year, economic growth was also reined in by the negative contribution of the change in stocks, as the rebuilding of stocks continued at a slower pace than in 2006, in response to the loss of momentum in domestic economic activity.

For the first time since 1996, the external sector made a positive contribution to the expansion of economic activity in 2007, totalling 0.5 percentage point of GDP, as export growth significantly outstripped the expansion of imports. This situation was due to the depreciation of the US dollar in recent years and the moderate growth of domestic demand in the United States in comparison with the country's main trading partners. The strengthening of net exports reduced the US current deficit from 6.2 to 5.6 p.c. of GDP, especially as there was an accompanying improvement in the terms of trade.

Owing to business cycle effects, apparent labour productivity grew by only 1.1 p.c. Labour costs per employee increased by 4.9 p.c. in 2007, against 4 p.c. in 2006. This movement is in line with the relative shortage of workers on the labour market, even though that moderated during the year. Overall, unit labour costs increased by 3.9 p.c. in 2007, the strongest rise since 2001.

Inflation measured by the change in the CPI dropped from 3.2 p.c. in 2006 to 2.8 p.c. That moderation is due largely to the slackening pace of increases in housing and transport costs, due primarily to the slower rise in energy prices, down from 11.1 to 5.5 p.c. Underlying inflation in fact only eased from 2.5 to 2.3 p.c. Overall inflation fluctuated around 2.5 p.c. until August before accelerating to over 4 p.c. from November, driven by an adverse base effect resulting from the decline in oil prices in 2006, after their peak in early August, and their rapid rise in 2007.

Having kept its policy rates on hold from July 2006 to July 2007, the US central bank took a series of decisions, in response to the financial market turmoil, in order to ensure the smooth operation of these markets and of the economy. At the beginning of August it conducted substantial open market operations with the aim of increasing liquidity on the short-term money markets. After that, in mid August the Federal Reserve cut the discount rate by 50 basis points and adopted supplementary measures. At its September, October and December meetings, the Federal Reserve's Federal Open Market Committee cut the target rate of the federal funds and the discount rate in three stages by a total of 100 basis points each, reducing them to 4.25 and 4.75 p.c. respectively. Finally, in December it again injected large amounts of liquidity, partly via joint interventions with the Eurosystem and the Swiss central bank.

The interest rate on government long-term bonds – more specifically ten-year bonds – remained relatively stable in the initial months of the year, before rising sharply in May and June following more optimistic forecasts for GDP growth. When the turbulence erupted in financial markets at the beginning of August, however, the rate on US bonds began to slide, since investors turned to these assets – regarded as safe havens – and the outlook for the US economy had meanwhile become more gloomy. During the second half of 2007, it therefore dropped below the level reached at the beginning of the year. In all, short-term interest rates displayed a sharper fall than long-term rates, so that the slope of the yield curve – which had been negative since the end of 2006 – reverted to positive.

The cyclically adjusted general government budget deficit deteriorated slightly, rising from 2.8 p.c. of GDP to 3 p.c. The growth of expenditure, particularly on social security and defence, was only partly offset by higher revenues, essentially those generated by direct taxes. The general government gross debt ratio edged upwards from 61.9 to 62.2 p.c. of GDP.

1.3 Japan

The period of economic expansion which started in Japan in 2003 continued during the year under review, although there was some loss of momentum compared to 2006. Japanese GDP grew by only 1.9 p.c., but that still exceeded its potential rate. As in previous years, activity growth was sustained by net exports and investments, the principal players being major manufacturing companies. In contrast, SMEs – concentrated primarily in the service sector – and households remained the weak link. Unemployment continued to fall, thus exacerbating the shortage of workers on the labour market. However, this tension did not drive up either wages or prices.

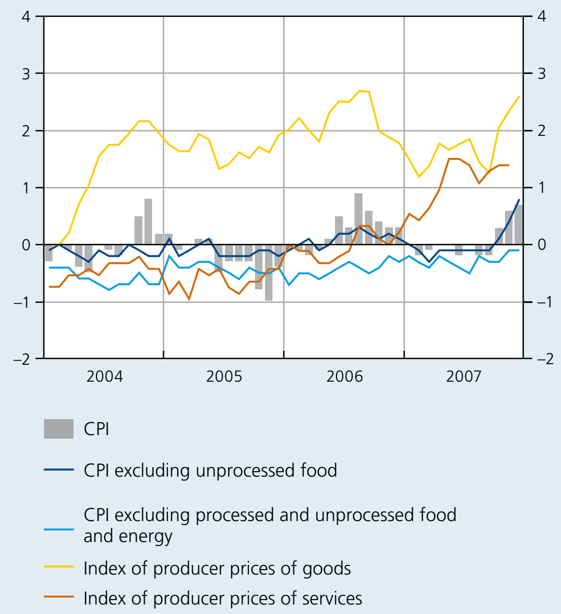
Confirming their confidence in the investment climate, companies again expanded their production capacity, although to a lesser extent than in 2006, and mainly in industry. This bears out the dichotomy between manufacturing industry, which benefited from growing global demand and saw its profits increase, and the other sectors of activity, chiefly those linked to services, which faced faltering productivity growth and stagnating profits owing to the relative weakness of domestic demand. Residential investments dropped sharply during the second half of the year, owing to the implementation of stricter safety regulations which considerably slowed down the granting of new building permits. Finally, the government made further cuts in its gross fixed capital formation.

The real disposable income of households rose by just 1.1 p.c. during the year under review. Furthermore, Japanese consumer confidence was eroded by a series of factors, such as the government's loss of around 500,000 pension records, a series of unfavourable tax measures and, at the end of the period, higher inflation expectations. Despite this context, household consumer spending proved dynamic and increased by 1.6 p.c., pushing the Japanese savings ratio down from 3.7 to 3.2 p.c.

Exports once again capitalised on the depreciation of the yen and the expansion of export markets. Thus, demand from the emerging Asian economies more than offset the slower growth in America. Conversely, imports grew at a more modest rate owing to the weakening of domestic demand. Among the various expenditure categories, it was therefore once again net exports that made the biggest contribution to the expansion of the economy. While the increase in the trade surplus thus augmented the current account surplus, which reached 4.7 p.c. of GDP in 2007, that increase is due mainly to the larger surplus on the income account, generated by the repatriation of profits from foreign subsidiaries by Japanese firms.

CHART 6 PRICE INDICATORS FOR JAPAN

(percentage changes compared to the corresponding month of the previous year)



Sources : Ministry of Internal Affairs and Communication (Japan), Bank of Japan.

TABLE 4 ECONOMIC DEVELOPMENTS IN JAPAN

(percentage changes compared to the previous year, unless otherwise stated)

	2005	2006	2007
Expenditure (volume) (1)			
Final domestic demand	1.8	1.3	0.9
Final consumption expenditure			
Households	1.6	0.9	1.6
General government	1.7	0.4	1.0
Gross fixed capital formation			
Housing	–1.3	1.0	–7.3
Enterprises	6.6	7.4	2.2
General government	–6.2	–7.4	–6.1
Change in stocks (2)	–0.1	0.0	0.0
Net exports of goods and services (2)	0.3	0.8	1.0
Exports	7.0	9.6	8.1
Imports	5.8	4.5	2.0
GDP	1.9	2.2	1.9
Labour market			
Employment	0.4	0.4	0.4
Unemployment (3)	4.4	4.1	3.9
Prices and costs			
Consumer prices	–0.6	0.2	0.1
Unit labour costs	–1.0	–0.4	–1.0
Prices of imported goods and services	8.3	11.0	6.4
Terms of trade	–6.4	–6.6	–3.5
Balance of payments and budget balance (4)			
Balance of current transactions	3.7	3.9	4.7
Structural budget balance of general government	–5.2	–4.8	–4.1
p.m. Private savings ratio (5)	*3.0*	*3.7*	*3.2*
Gross debt ratio of general government (4)	*177.3*	*179.7*	*180.3*

Sources: OECD, Ministry of Foreign Affairs and Communication (Japan).
(1) Calendar adjusted data.
(2) Contribution to the change in GDP, percentage points.
(3) Ratio between the number of unemployed and the labour force.
(4) Balance or outstanding total as a percentage of GDP.
(5) Net savings as a percentage of net disposable income.

The sustained economic expansion brought a further 0.4 p.c. rise in employment, while the unemployment rate dropped to 3.9 p.c., its lowest level since 1998. Despite the shortage of workers available on the labour market, the average wage per employee remained unchanged overall, as a result of strict wage moderation, a reduction in the bonuses granted, primarily in SMEs, and structural changes in the composition of the labour force. Those changes consist in the steady rise in the proportion of part-time work and in the replacement of the now retiring highly-paid baby-boom workers by young staff on more modest pay. This relative rejuvenation had an even greater impact in 2007 as the number of retiring baby-boom workers reached a peak. Labour productivity increased by around 1.5 p.c., so that unit labour costs continued to decline.

Despite the high capacity utilisation, the weakness of the yen and the surging prices of many commodities, Japan has apparently still not beaten deflation. From February to September 2007, the year-on-year change in the consumer price index was in fact flat or even negative. Towards the end of the year, however, inflationary pressure increased somewhat, owing to the steep rise in petroleum product prices, as well as base effects. Nevertheless, Japan still continued to languish in a situation of mild deflation, if food and energy products are excluded. The biggest price reductions affected consumer durables, and certain services such as telecommunications, which were deregulated. Conversely, the producer price index of goods has long been displaying an upward trend, which tallies with the rising price of energy and other commodities. It is only in the past year that the services index has moved in the same direction. The problem is that many firms, faced with the weakness of domestic demand and the pressure of keener competition in the retail trade, have delayed price increases for as long as possible, to the detriment of profit margins and wages. Nonetheless, prices of a range of processed foods and products with a large energy component, such as transport, have been increased in recent months, contributing to the upward adjustment to inflation expectations.

As the inflation figures did not correspond to the Bank of Japan's forecasts, the base rate was kept on hold at 0.5 p.c., following a 25 basis point increase in February 2007. The slow pace at which the bank is having to normalise interest rate levels was a factor contributing to the weakness of the yen, exposed to substantial capital outflows for much of the year.

The government has successfully pursued a restrictive fiscal policy in recent years: it halved the nominal budget deficit in the space of two years, and cut the structural deficit from 5.2 p.c. of GDP in 2005 to 4.8 p.c. in 2006, then to 4.1 p.c. in 2007. The fiscal consolidation was due mainly to the ending of a temporary reduction in personal income tax, an increase in corporate tax revenues, the corollary to economic expansion, an increase in pension contributions, a further contraction in public investment and effective control over current spending. The general government debt ratio, though more or less stable, is still exceptionally high, in the region of 180 p.c. of GDP in 2007.

1.4 China

China's economic growth, which was again driven by net exports and investments, accelerated further in 2007 to an average of 11.4 p.c. GDP thus recorded growth of 10 p.c. or more for the fifth successive year. In 2007, China also made the largest contribution to the expansion of global economic activity.

There was hardly any change in the domestic expenditure growth profile during the year under review. As in the previous year, private consumption expanded by around 11 p.c., fuelled by income growth, while fixed capital investments surged by 15 p.c. The investment ratio thus continued to rise, reaching 45 p.c. of GDP. Apart from local government policy and the continuing sustained demand for urban housing, the main factors in the vigour of gross fixed capital formation were the high profits of private sector businesses and foreign direct investment.

Exports remained buoyant in 2007, expanding by 21.3 p.c. In recent years, China has succeeded in diversifying its export markets. The American market declined in importance, while the EU has become China's main trading partner. The range of products destined for export has also been systematically extended, and the structure of exports, which used to consist of relatively simple consumption goods, now includes higher value added products such as more sophisticated consumption goods and investment goods. The higher value added in the production process has been achieved partly by the progressive replacement of imports by national equivalents, supported by a targeted industrial policy on the part of the Chinese authorities. This substitution process contributed to the marked slowing of import growth, despite accelerating domestic demand. The rate of import expansion dropped from 16 p.c. in 2006 to 11.9 p.c. In that context, the current account surplus continued to expand, reaching a record level of around 361 billion US dollars, or 11.2 p.c. of GDP.

The foreign exchange reserves, originating largely from the current account surpluses, continued to accumulate, totalling 1,528 billion dollars at the end of 2007. Since the amount of the foreign exchange reserves far exceeded the needs of the People's Bank of China, the Chinese authorities decided in 2007 to establish the Chinese Investment Company. It was endowed with initial capital of 200 billion dollars, obtained from the foreign exchange reserves. Around one-third of that capital is to be used to increase the return on the exchange reserves, via participations and investments in foreign companies, the other two-thirds being used to support domestic policy, for instance via the recapitalisation of two State banks. The Chinese authorities also tried to curb the growth of the foreign exchange reserves by influencing capital flows, e.g. by imposing restrictions on foreign investment and by selective encouragement of capital outflows. Although a more flexible foreign exchange policy may, in theory, also help to control the surpluses on the balance of current transactions, the impact of the May increase in the maximum permitted daily margin of fluctuation against the dollar, from 0.3 to 0.5 p.c., was ultimately only small, as the additional margin was not entirely utilised. While the renminbi was thus able to appreciate against the dollar by more than in 2006, it depreciated against other currencies, particularly the euro, with a 3.9 p.c. fall during

TABLE 5 ECONOMIC DEVELOPMENTS IN CHINA
(percentage changes compared to the previous year, unless otherwise stated)

	2005	2006	2007
Expenditure (volume)			
Final consumption expenditure of households	9.6	10.9	10.8
Gross fixed capital formation	16.8	15.0	15.1
Exports of goods and services	23.9	23.9	21.3
Imports of goods and services	13.6	16.0	11.9
GDP	10.4	11.1	11.4
Prices			
Consumer prices	1.8	1.6	4.5
Balance of payments and budget balance (1)			
Balance of current transactions	7.2	9.4	11.2
Budget balance of general government	0.2	1.0	2.0

Sources: IMF, OECD.
(1) Balance as a percentage of GDP.

the year. In Europe, too, there was therefore increasing frustration over Chinese exchange rate policy.

The average rise in the consumer price index came to 4.5 p.c. during the year under review, essentially owing to the higher price of food, which accounts for one-third of the index. Conversely, the prices of other goods in the consumption basket recorded only a moderate increase. The food price rises reflected both the developments on international markets and the impact of the negative supply shocks in China, such as a swine fever epidemic and floods affecting the south of the country. A growing supply shortage led to petrol prices at the pump being increased by 10 p.c. in November. Other administered prices – water, electricity, transport – were frozen during the last three months.

In order to control inflation expectations, the People's Bank of China implemented a variety of measures to contain the growth of the money supply (M2). As well as partly sterilising the inflow of foreign currency by issuing securities, it raised the banks' reserve requirement ratios during the year under review, in ten stages, from 9 to 14.5 p.c. and capped the credit growth at 15 p.c. on an annual basis. The benchmark rates on lending and deposits at one year were also increased several times, raising them to 7.47 and 4.14 p.c. respectively. Nevertheless, the strong inflation meant that real interest rates remained low, or even negative in the case of deposits. That situation is tending to distort the growth profile, causing among other things a very strong expansion of highly capital-intensive sectors in a country with an abundant reservoir of unskilled labour; it may also encourage speculative investments in the real estate sector and on the stock market.

Pointing to a more restrictive fiscal policy, the general government budget surplus doubled to 2 p.c. of GDP. Soaring corporate profits were one factor permitting tax revenues to rise more sharply than expenditure. In order to slow the strong export growth, VAT reductions applicable to a wide range of export products were also pruned, while an export levy was introduced on products consuming large amounts of energy. On the expenditure side, new measures were taken to extend and improve the range of social benefits, especially in the rural areas where the need is very great.

1.5 European Union

1.5.1 Euro area

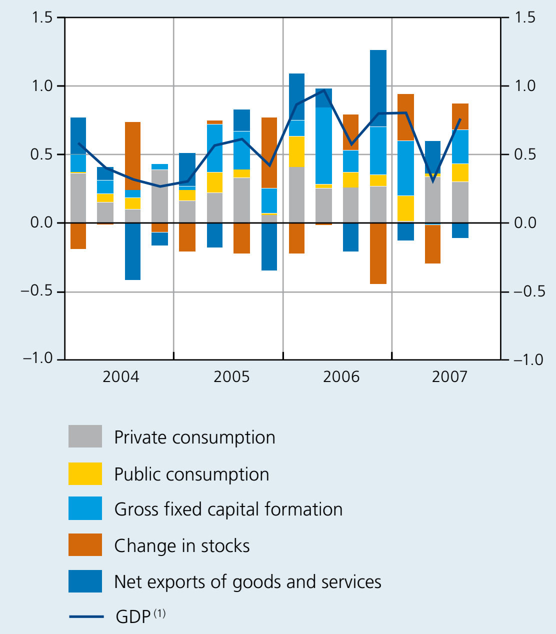
ACTIVITY, LABOUR MARKET AND BALANCE OF CURRENT TRANSACTIONS

Following an acceleration in the previous year, GDP growth in the euro area moderated during 2007, though on average it was still robust at 2.6 p.c. against 2.9 p.c. in 2006, a rate well above its potential, estimated at around 2 p.c. Economic activity maintained its vigorous expansion in the first quarter but, partly as a result of temporary factors, growth slowed significantly in the second quarter. However, in the third quarter it picked up again, despite the turbulence which erupted at that time on the financial markets.

As in the previous year, the main factor driving the expansion of activity was final domestic demand, though the latter's growth slowed slightly, mainly on account of the waning dynamism in housing construction. Exports of goods and services expanded at a rate which, though

CHART 7 QUARTERLY PROFILE OF GDP AND THE MAIN CATEGORIES OF EXPENDITURE IN THE EURO AREA

(data adjusted for seasonal and calendar effects; contribution to the volume change in GDP compared to the previous quarter, percentage points, unless otherwise stated)



Source: EC.
(1) Percentage changes compared to the previous quarter.

TABLE 6 ECONOMIC DEVELOPMENTS IN THE EURO AREA

(percentage changes compared to the previous year, unless otherwise stated)

	2005	2006	2007
Expenditure (volume)[1][2]			
Final domestic demand	1.8	2.6	2.3
Final consumption expenditure			
Households	1.6	1.9	1.6
General government	1.3	2.0	2.1
Gross fixed capital formation			
Housing	3.0	6.0	1.9
Enterprises	2.8	5.4	5.4
General government	2.8	2.4	5.0
Change in stocks[3]	0.1	0.1	–0.1
Net exports of goods and services[3]	–0.2	0.2	0.4
Exports	4.5	7.7	5.7
Imports	5.2	7.5	5.3
GDP	1.6	2.9	2.6
Labour market			
Employment[1]	1.1	1.7	1.6
Unemployment[4]	8.9	8.2	7.4
Prices and costs			
Consumer prices (HICP)	2.2	2.2	2.1
Unit labour costs[1]	1.1	1.0	1.5
Prices of imported goods and services	3.8	4.0	1.3
Terms of trade	–1.1	–1.2	0.1
Balance of payments and budget balance[5]			
Balance of current transactions	0.3	0.0	0.2
Structural financing balance of general government	–2.1	–1.1	–0.7
p.m. Private savings ratio[1][6]	*10.2*	*9.7*	*9.8*

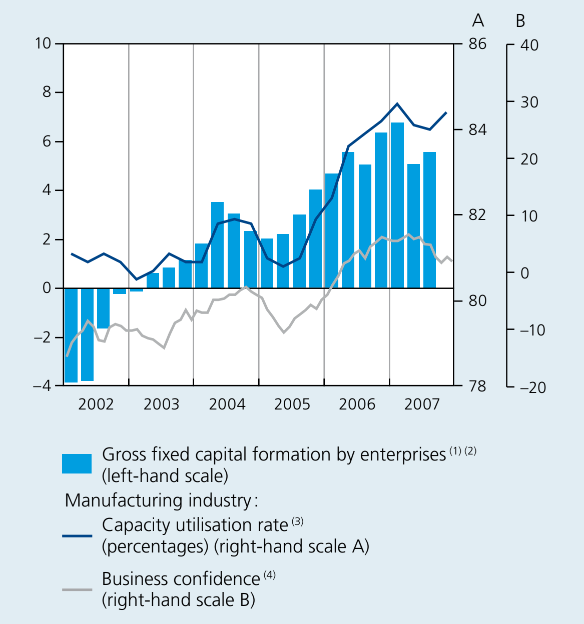
Sources: EC, OECD.
(1) Excluding Slovenia.
(2) Calendar adjusted data, except for exports and imports.
(3) Contribution to the change in GDP, percentage points.
(4) Ratio between the number of unemployed and the labour force.
(5) Balance as a percentage of GDP.
(6) Net savings as a percentage of net disposable income, except for Belgium, Spain and Portugal where the aggregate used for the calculations is only available on a gross basis.

sustained, was nonetheless below the 2006 figure. Import growth also slowed, so that the contribution of net exports to GDP growth remained positive, and even slightly exceeded that recorded in the previous year.

Gross fixed capital formation by enterprises, which had been relatively sluggish for several years before eventually becoming the engine of the euro area's recovery, remained highly dynamic overall during the year under review, in a favourable context of a continued rise in the profit margins of non-financial corporations and persistently robust corporate credit growth. In manufacturing industry, capacity utilisation reached a historically high level at the beginning of the year, while business leaders exhibited very strong confidence in the future. However, capacity utilisation did lessen slightly thereafter, as did business confidence from the second half of the year. The steady increase in long-term interest rates in the first half of the year, the appreciation of the euro, and the upward trend in oil prices may have curbed the expectations of business leaders and held back their investment projects. It is also possible that the turbulence afflicting the financial markets in the second half year may have dented business

CHART 8 BUSINESS INVESTMENT AND BUSINESS CONFIDENCE IN THE EURO AREA

(seasonally adjusted data)



Sources: EC, OECD.
(1) Calendar adjusted data, percentage changes in volume compared to the corresponding quarter of the previous year.
(2) Excluding Slovenia.
(3) Measured on the basis of the quarterly survey.
(4) Balance of replies to the monthly survey.

confidence, and the ensuing less favourable financing conditions may have restrained the pace of investment. In the second half of 2007, the results of the Eurosystem's bank lending survey showed a marked tightening of credit standards applied by banks to businesses, and to large companies in particular, which was attributed to global credit market developments. The expansion of gross fixed capital formation by the general government sector also contributed to the growth of domestic demand in 2007, accelerating from 2.4 to 5 p.c.

The expansion of private investment in housing showed a marked deceleration in 2007 : it declined to just 1.9 p.c. after speeding up to 6 p.c. in the previous year, against the background of still relatively buoyant price rises on the secondary markets in residential property. The increase in mortgage interest rates contributed to this sharp slowdown. Another key explanation lies in the profile of residential construction in Germany, which recorded only 1 p.c. growth in 2007, whereas in 2006 it had produced a noticeable rise for the first time in years, owing to such factors as the expiry of the subsidy system and the prospect of an increase in the rate of VAT at the start of the year under review. As explained in more detail in box 3, there was a general slowing of the rise in house prices from the second half of 2005, throughout the euro area, a tendency which was reinforced during 2007. This price factor was accompanied by a slowing of the growth of mortgage loans to households, which had begun in the first half of the previous year. Moreover, the results of the bank lending survey published by the Eurosystem reveal a tightening of the standards applied to mortgage lending in the second half of the year. Investment in housing slackened pace in the majority of euro area Member States, and in Ireland there was actually a sharp contraction.

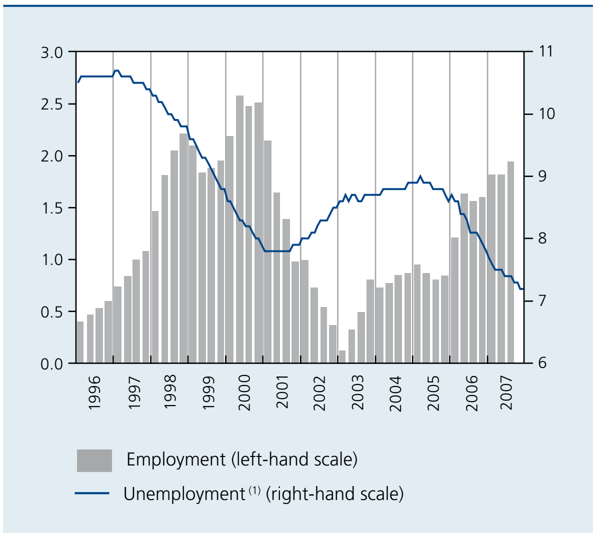
Private consumption expenditure expanded slightly more slowly than in 2006, at 1.6 p.c. against 1.9 p.c. It made no contribution to the growth of activity in the first quarter of 2007, largely reflecting the situation prevailing in Germany where the increase in the VAT rate clearly had a negative impact. Anticipating that increase, some German households had in fact brought forward to the end of 2006 some of their planned purchases of consumer durables. From the second quarter, however, the euro area – including Germany – recorded robust growth of private consumption. The latter was underpinned by the improvement in the general economic situation and by the economic outlook which propelled consumer confidence to a particularly high level. However, that confidence was eroded in the second half of the year, owing to the large price increases and perhaps also, to some extent, to the financial market turmoil, though it remained above the level of the past twenty years. The growth of public consumption was comparable to that in the previous year, at around 2 p.c.

Taking account of the structural reforms introduced in a number of euro area countries in recent years, and thanks to the economic revival, the labour market situation showed a further remarkable improvement. Employment expanded strongly again, despite faltering slightly from the second half of the year in practically all branches of activity. According to the data available up to the third quarter, it was the financial and business services sectors, in particular, which continued to generate jobs on a substantial scale. In the construction sector, job creation also persisted at a sustained rate, though it practically came to a halt nonetheless in the third quarter. In the rest of industry, there was no further noticeable decline in employment in 2006, and a slight increase was recorded subsequently. The favourable employment situation brought a further considerable fall in the unemployment rate, down to the historically low level of 7.4 p.c. in 2007.

The fall in unemployment was widespread in the euro area. In Germany, the labour market staged a strong recovery. After recording a decline or a modest rise in employment for several years, Germany saw job creation accelerate at a very brisk pace in 2007, last seen at the time of the 2000 expansion. In addition, the jobs created were predominantly permanent. The employment

CHART 9 LABOUR MARKET IN THE EURO AREA

(percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources : EC, ECB.
(1) Percentages of the labour force.

growth was accompanied by a sharp fall in the German jobless rate, which declined from 9.8 to 8.4 p.c. Despite the widespread nature of the decline in unemployment in the euro area, there continued to be disparities between Member States. The Netherlands recorded the lowest unemployment rate at 3.2 p.c. Unemployment was also relatively low in Slovenia, Luxembourg, Ireland and Austria. The unemployment rate remained above the euro area average in Greece, France, Germany, Spain, Portugal and Belgium. In the case of Spain, however, that should not detract from the excellent results which that country has achieved in more than a decade, i.e. an almost continuous decline in unemployment from 15 to 20 p.c. in the first half of the 1990s to a 8.3 p.c. in 2007.

The euro area's exports of goods and services recorded strong growth at 5.7 p.c., though this fell short of the 7.7 p.c. achieved in 2006. This is attributable primarily to developments in the export markets: while trade in goods remained vigorous, the expansion of the export markets in fact slowed down slightly, from 9.4 to 7.3 p.c. Overall, the euro area probably did not incur any greater loss of market share than in 2006, despite the appreciation of the weighted average exchange rate. While exports to the United States were evidently affected by this factor, as well as by the cooling of activity in that country, they on the other hand benefited greatly from the dynamism of Asia, and especially the main oil-exporting countries. In fact, their recycling of oil revenues has in recent years been increasingly beneficial for the euro area. Germany ceased to gain market shares during the year under review, while Italy, Ireland and Belgium suffered much smaller losses than in 2006.

The volume growth of imports of goods and services was also slower, down from 7.5 p.c. in 2006 to 5.3 p.c. As a result, net exports made a slightly larger positive contribution to GDP growth than in the previous year, up from 0.2 to 0.4 percentage point.

The current account of the euro area's balance of payments improved accordingly to record a surplus of 0.2 p.c. of GDP. Part of that improvement is also due to the albeit relatively marginal improvement in the terms of trade. Although prices of energy and other commodities tended to rise during the year under review, import prices increased on average by only 1.3 p.c. against 2006, compared to 1.5 p.c. for export prices. Apart from the gains associated with the appreciation of the euro, the terms of trade benefited from a favourable base effect since, year-on-year, crude oil prices remained below their 2006 level practically until August.

Economic growth differentials persisted between the Member States of the euro area. Growth was strongest in Slovenia, Luxembourg and Ireland, where GDP again expanded by between 5 and 6 p.c. Activity also continued to expand relatively strongly in Finland, Greece and Spain. Nevertheless, as in 2006, the dispersion of growth in the euro area diminished, notably because in some of the leading countries – Finland, Ireland and Luxembourg – the expansion of activity slowed by more than the euro area average, and in Portugal, at the bottom of the league, growth accelerated slightly.

Final domestic demand was the main engine of economic expansion in all Member States except Germany, where that role was shared with foreign demand. Investments were generally the most dynamic component, particularly business investment. Private consumption also remained a major supporting factor, with the notable – but in fact artificial – exception of Germany. Net exports of goods and services made a growth contribution more or less equivalent to that of domestic demand in Germany and Finland. Their role as the driver was considerable in a number of small countries, especially Austria, Ireland and Luxembourg. Conversely, in Spain in particular they exerted a significant restraining effect.

TABLE 7 GDP GROWTH IN THE EURO AREA COUNTRIES (1)

(calendar adjusted volume data, unless otherwise stated; percentage changes compared to the previous year)

	2005	2006	2007
Germany	1.0	3.1	2.6
France	1.7	2.2	1.9
Italy	0.2	1.9	1.8
Spain	3.6	3.9	3.8
Netherlands	1.5	3.0	3.0
Belgium	2.0	2.9	2.7 e
Austria	2.3	3.1	3.3
Greece	3.7	4.3	4.1
Ireland	5.9	5.7	5.2
Finland	2.9	4.9	4.2
Portugal	0.5	1.3	1.8
Luxembourg	5.0	6.0	5.2
Slovenia (2)	4.1	5.7	6.0
Standard deviation	1.7	1.5	1.4

Sources: EC, OECD, NBB.
(1) The euro area countries are ranked according to the size of their GDP in 2007.
(2) Non calendar adjusted data.

In contrast to previous years, when Germany often recorded relatively weak growth, the revival seen in the euro area since 2006 is also due to that country's recovery, underpinned both by the sustained export growth and the accelerating pace of domestic demand. During the year under review, investment in equipment remained dynamic in Germany, and activity growth was still relatively strong despite the slowing effect of factors such as the aforementioned increase in VAT on household spending, especially private consumption. Moreover, the deceleration of exports was more marked in Germany than in the rest of the euro area.

Box 3 – House prices in the European Union

Since the mid 1990s, the rise in house prices has tended to accelerate in many advanced economies. Japan and Germany are the main exceptions to this general trend. In recent years the property market boom has spread to other regions such as a number of Central and East European countries and certain fast-expanding cities in Asia.

In the past decade, nominal house prices roughly doubled in the United States before decelerating in 2005 and actually declining during 2006. In the United Kingdom, the increase was even stronger, but a marked slowdown had already been recorded in 2004. The euro area also experienced a considerable, albeit more modest, increase in house prices. In the past few years, nominal price rises there accelerated to 8.3 p.c. during the first half of 2005, before subsiding to 4.9 p.c. year-on-year in the first half of 2007. In Sweden and Denmark, property prices also climbed. The available statistics for Central and Eastern Europe indicate that the average annual price increases between 2004 and 2006 came to 6 to 8 p.c. in Poland and Slovakia and exceeded 30 p.c. in the Baltic countries, Bulgaria and Romania.

Examined over a long period, house prices in the main advanced economies seem to have followed a broadly similar pattern, although the picture was slightly more volatile in the United Kingdom. In real terms, the increase during the 1990s was in line with a trend already apparent in the 1970s. Owing to rising prosperity, population growth and changes in household structure, demand for housing has expanded constantly in a context of increasingly scarce land, and regulations designed to limit the number of developments. The improvements in housing quality and the relatively low productivity growth in the construction sector also contributed to the rising prices. In comparison with the long-term trend, however, the boom phase recorded since the mid 1990s has been fairly prolonged and pronounced. Easier access to mortgages, thanks to financial product innovations, and the general decline in long-term interest rates up to 2005 also played a role in this expansion. The fall in short-term interest rates up to 2005 may equally have exerted some influence, particularly in countries with a substantial proportion of variable-rate mortgages.

However, around the long-term trend there have been many medium-term fluctuations which have differed between the main economies. Thus, according to the EC, an international comparison of house price cycles between 1970 and 2007 generally reveals that the volatility of the property market cycle is relatively weaker in the EU countries than in countries outside the European Union. Furthermore, the interaction between the residential property market on the one hand, and investment in housing, private consumption and economic activity on the other also appears to be relatively lower in the EU.

In the euro area too, the course of house prices displayed significant disparities between Member States. These divergences were due both to differing developments in purchasing power, demography, land use planning and taxation, and to variations between the national mortgage credit markets. Rising property prices also had an impact on economic activity, particularly on investment in housing which was often most vigorous in the Member States recording the strongest price rise. Thus, the ratio of residential investment to GDP was very high in Ireland and Spain in the past decade, whereas in Germany it declined for a number of years up to 2005.

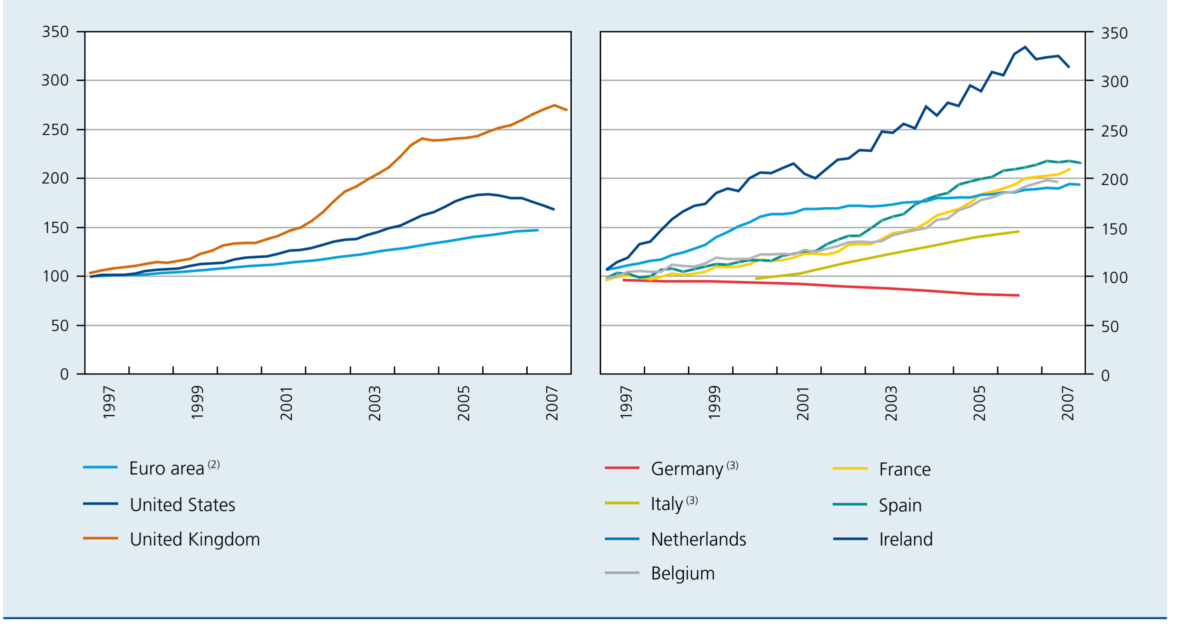
More specifically, Germany was the country where residential property prices deviated the most from the average pattern in the euro area. In response to the protracted gloom on the German property market, real house prices in 2006 – i.e. house prices corrected for the general movement in prices – were well below their 1996 level. This "recession" on the German property market is generally regarded as a long-term adjustment process following the creation of excess capacity after the country's reunification, and particularly in the Länder which were part of the former East Germany.

Conversely, house price rises outpaced the general increase in prices in the majority of other euro area countries. There was a particularly strong price rise in Ireland, but the real increase was also well above the euro area average in Spain, France, the Netherlands and Belgium. In some euro area countries, particularly Ireland but also Spain, the real increase since the mid 1990s has been higher on average than in the United States. The exceptional rises recorded in the United Kingdom were actually exceeded by those in Ireland. The marked contrast between house price movements in Germany and in certain euro area countries with strong growth and relatively high inflation, particularly Spain, also needs to be examined in the light of the convergence of nominal interest rates towards the German level in the run-up to EMU, and the divergent pattern of real interest rates since then resulting from inflation differentials.

However, the rise in house prices throughout the euro area, particularly in the economies with the strongest increases, clearly began to slow down during 2006, notably in the context of rising interest rates. Calculated as the ratio between disposable income and house prices, the affordability of housing has tended to decline throughout the euro area since 2001 or – when corrected to take account of the charges incurred on loans concluded with a

REAL HOUSE PRICES (1) IN THE EURO AREA, THE UNITED STATES AND THE UNITED KINGDOM

(indices 1996 = 100 ; quarterly data, unless otherwise stated)



Sources : EC ; IMF and OECD, Workshop on Real Estate Price Indices (Paris, 6 and 7 November 2006) ; Standard & Poor's ; Thomson Financial Datastream ; Stadim ; CBS ; Department of the Environment, Heritage and Local Government (IE) ; Kadaster (NL) ; Ministerio de Vivienda (ES) ; ECB ; NBB.

(1) Nominal house prices deflated by the CPI or, if available, the corresponding national HICP.

(2) Half-yearly data.

(3) Annual data.

view to purchasing a house, which depend on the movement in mortgage interest rates – since 2006. According to the quarterly national data available for some Member States, house prices continued to moderate in 2007, with a very pronounced slowdown in Ireland since the end of 2006.

In the United Kingdom, house price rises were also fuelled by the restrictions on housing developments and by the shortage of building plots, so that the supply of new housing produced only a limited response to demand, well short of that in most other countries. In 2004, a parliamentary review committee published the "Barker Report" containing recommendations on increasing the supply of new housing and improving the operation of the housing market in general. Although house prices picked up again, after a marked slowdown during 2004 and 2005, signs of a deceleration did emerge in the final months of the year under review. The effects of the rising interest rates were amplified by events on the financial markets which, in certain cases, may have reduced the availability of credit.

In many Central and East European Member States, the introduction of mortgage loans at the beginning of this decade was a key factor in the house price boom. The emergence of this type of credit was made possible by the takeover of local banks by foreign financial institutions with the necessary expertise, and by changes to the law which permitted the use of property as collateral. In the run-up to EU membership, the foundations were also laid for improved macroeconomic stability, triggering a steep decline in nominal and real interest rates. Furthermore, robust economic growth led to an upward revision in income expectations. The price rises also reflected major improvements in quality and strong foreign demand, manifested primarily in the capitals and in tourist resorts. Although the average household debt ratio is still relatively low in some countries compared to that of the euro area, an increase in interest rates or the depreciation of the local currency could have serious adverse consequences. In fact, the majority of the mortgage loans in Poland, Hungary and the Baltic States are issued at variable rates, and loans are often denominated in foreign currencies, mainly in euro or Swiss francs.

PRICES AND COSTS

Inflation in the euro area, measured by the harmonised index of consumer prices (HICP), came to 2.1 p.c., which was slightly below the previous year's figure. From September 2006 to August 2007, it remained below the 2 p.c. mark before beginning to rise again. Inflation dynamics were greatly influenced by the movement in energy prices. In view of the soaring oil prices during the first eight months of 2006, favourable base effects during the corresponding months of 2007 exerted a moderating influence on price fluctuations. However, during the final four months of 2006 oil prices subsided, before climbing again to a record level during the second half of 2007. The base effects were therefore reversed in September, and inflation gathered pace from then on to reach a peak of 3.1 p.c. in December. The rise in unprocessed food prices averaged 3 p.c. in 2007, broadly matching that in the previous year, although there was slight volatility in the spring as a result of abnormal climatic conditions.

The inflation differential between the euro area countries with respectively the largest and smallest price rises continued to diminish, amounting to 1.4 percentage point.

TABLE 8 PRICE INDICATORS FOR THE EURO AREA
(percentage changes compared to the previous year)

	2005	2006	2007
HICP	2.2	2.2	2.1
p.m. Inflation differential in the euro area [1]	*3.0*	*2.3*	*1.4*
Underlying inflation rate [2]	1.5	1.5	2.0
GDP deflator	1.9	1.9	2.2
Compensation per employee [3]	1.2	1.8	2.4
Labour productivity	0.5	1.2	1.0
Unit labour costs [3][4]	1.1	1.0	1.5
Prices of imported goods and services	3.8	4.0	1.3

Sources: EC, OECD.
(1) Inflation differential between the countries with the highest and lowest rates respectively during the year in question.
(2) Measured by the HICP excluding unprocessed food and energy.
(3) Excluding Slovenia.
(4) Unlike the item relating to labour productivity, this does not include information with respect to work performed by self-employed persons.

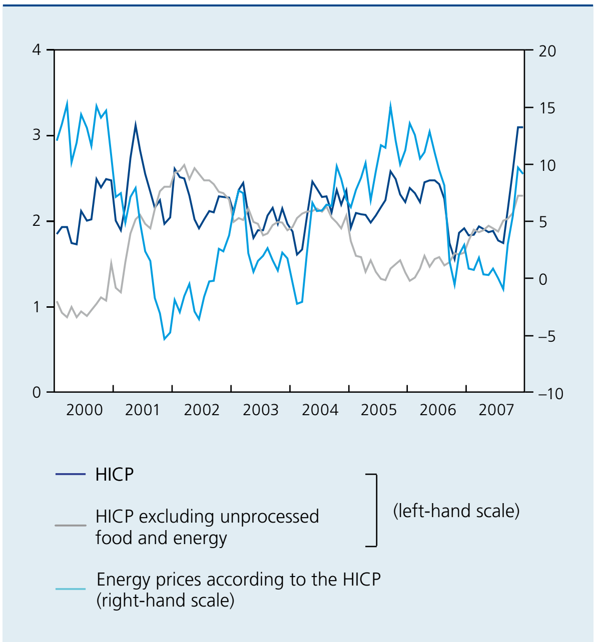
The lowest inflation rate, namely 1.6 p.c., was recorded in Finland, France and the Netherlands, while Greece had the highest inflation rate at 3 p.c.

The underlying inflation rate, i.e. inflation excluding unprocessed food and energy, increased steadily from 1.8 p.c. at the beginning of the year to 2.3 p.c. at the end of the period. This rise was due not only to the business cycle, which reached its peak during the year under review, but also to the January increase in VAT in Germany from 16 to 19 p.c., the accelerating inflation in the service sector, where it is easier to pass on higher costs to consumers, and the sharp year-end increases in the prices of processed foods. Conversely, the movement in the prices of non-energy industrial products was again modest, notably because imported inflation was restrained by the strengthening euro.

In view of the increasingly tight labour market, labour costs measured by compensation per employee in the private sector rose by 2.4 p.c. during the year under review, against 1.8 p.c. in 2006. In a number of countries, particularly Greece and Ireland, labour costs actually climbed by more than 4 p.c.

CHART 10 INFLATION, UNDERLYING INFLATION RATE AND ENERGY PRICES IN THE EURO AREA

(percentage changes compared to the corresponding month of the previous year)



Source : EC.

TABLE 9 UNIT LABOUR COSTS IN THE EURO AREA COUNTRIES [(1)] [(2)]

(percentage changes compared to the previous year)

	2003	2004	2005	2006	2007	Average 1999-2007
Germany	0.5	–0.2	–1.6	–1.4	0.3	0.0
France	1.8	1.2	1.7	1.6	2.3	1.9
Italy	3.8	2.5	4.4	2.6	1.8	2.8
Spain	3.4	2.6	2.8	2.7	3.1	3.1
Netherlands	2.6	–0.1	–0.6	0.8	1.1	2.2
Belgium	0.8	0.0	1.2	1.5	1.7	1.6
Austria	1.0	–0.3	1.3	1.1	1.0	0.7
Greece	3.0	5.6	2.3	1.6	3.7	4.0
Ireland	3.0	5.5	4.6	4.8	2.3	3.5
Finland	0.8	0.3	2.3	–0.4	0.5	1.2
Portugal	3.4	2.2	2.6	1.9	0.2	3.0
Luxembourg	2.0	1.4	1.9	2.5	2.0	2.5
Euro area	1.9	1.1	1.1	1.0	1.5	1.6

Source : OECD.
(1) The euro area countries are ranked in order of the size of their GDP in 2007.
(2) Excluding Slovenia.

The growth rate of labour productivity slowed by 0.2 percentage point during the year under review. Combined with the rise in labour costs per employee, this pushed up the rise in unit labour costs from 1 p.c. in 2006 to 1.5 p.c. However, this average for the euro area masks structural differences between member countries. Thus, since the start of monetary union, Germany, and to a lesser extent Austria and Finland, have benefited from substantial wage moderation, whereas a steep rise in unit labour costs has been recorded since then in other countries such as Italy and Spain, owing to the weak productivity growth, in Ireland owing to a tight labour market, and in Portugal and Greece to an even greater extent, owing to the process of economic convergence. In 2007, the discrepancies between countries declined, on the one hand because the movement in unit labour costs in Germany became positive again for the first time in years, and on the other hand because the increase in those same costs was attenuated in Ireland and Portugal, after a number of years of strong growth. The biggest increases were recorded in Greece, where second round effects influenced wages, and in Spain where labour productivity was more or less static.

FISCAL POLICY

Since 2003, when it reached its highest level, actually exceeding the limit of 3 p.c. of GDP defined by the Maastricht Treaty, the general government financing requirement of the euro area as a whole has fallen each year and even displayed a marked improvement in 2006 and 2007. According to the EC's autumn projections, it dropped to 0.8 p.c. of GDP in 2007. This overall reduction conceals very divergent movements within the euro area Member States. However, it does bear witness to the impressive consolidation efforts made by Germany in the past two years. Apart from the fact that the reduction is structural – the structural deficit having fallen from 3.1 p.c. of GDP in 2003 to 0.7 p.c. in 2007 –, three-fifths of it are due to the decline in primary expenditure as a percentage of GDP, while interest charges and revenues

TABLE 10 GENERAL GOVERNMENT BUDGET BALANCE IN THE EURO AREA COUNTRIES (1) (2)
(percentages of GDP)

	2003	2004	2005	2006	2007		
					Actual figures (3)	Stability programme target (4)	Difference
Germany	–4.0	–3.8	–3.4	–1.6	0.1	–1.5	1.6
France	–4.1	–3.6	–2.9	–2.5	–2.6	–2.5	–0.1
Italy	–3.5	–3.5	–4.2	–4.4	–2.3	–2.8	0.5
Spain	–0.2	–0.3	1.0	1.8	1.8	1.0	0.8
Netherlands	–3.1	–1.7	–0.3	0.6	–0.4	0.2	–0.6
Belgium	0.0	0.0	–2.3	0.4	–0.1 e	0.3	–0.4
Austria	–1.6	–1.2	–1.6	–1.4	–0.8	–0.9	0.1
Greece	–5.6	–7.3	–5.1	–2.5	–2.9	–2.4	–0.5
Ireland	0.4	1.3	1.2	2.9	0.9	1.2	–0.3
Finland	2.5	2.3	2.7	3.8	4.6	2.8	1.8
Portugal	–2.9	–3.4	–6.1	–3.9	–3.0	–3.7	0.7
Luxembourg	0.5	–1.2	–0.1	0.7	1.2	–0.9	2.1
Slovenia	–2.7	–2.3	–1.5	–1.2	–0.7	–1.5	0.8
Euro area	–3.1	–2.8	–2.5	–1.5	–0.8	–1.4	0.6
p.m. Idem, structural balance	*–3.1*	*–2.8*	*–2.1*	*–1.1*	*–0.7*		

Sources: EC, national stability programmes, NBB.
(1) The euro area countries are ranked according to the size of their GDP in 2007.
(2) Including, under the rules laid down for the excessive deficit procedure (EDP), net interest gains on certain financial transactions such as swaps or forward rate agreements (FRAs).
(3) According to the EC's autumn economic projections (2007), except for Belgium, for which figures are based on the Bank's estimate according to the Eurostat methodology.
(4) On the basis of the stability programme updates at the end of 2006, except for Austria (March 2007).

both made equivalent contributions. It was also reflected in the movement in the consolidated public debt of the euro area which, between 2003 and the end of the year under review, declined by 2.6 percentage points from 69.1 to 66.5 p.c. of GDP.

On average, the targets set for the year under review were fulfilled and even exceeded. The reduction in the financing balance, amounting to 0.7 p.c. of GDP, was due largely to structural factors since the structural budget deficit of the euro area as a whole contracted by 0.4 percentage point of GDP.

In Germany, the general government accounts are likely to have ended the year under review without a deficit, for the first time since the early 1990s with the exception of the year 2000, when the accounts had benefited from the revenues generated by the sale of UMTS licences. By achieving a modest surplus, that country exceeded its stability programme target by more than 1.6 p.c. of GDP. The improvement in Germany's budget balance apparent since 2003 is due entirely to reductions in expenditure, down from 48.5 p.c. of GDP in 2003 to 43.8 p.c. in 2007. This dramatic decline is in part the corollary to the favourable developments on the labour market, which reaped the benefit of significant reforms, particularly the Hartz package aimed at increasing labour market flexibility and encouraging the participation of a larger number of people in active life by measures such as the relaxation of the employment protection legislation, a limit on the period of entitlement to unemployment benefits, compulsory immediate registration with an employment agency in the event of redundancy, the application of sanctions in case of refusal to take an appropriate job, measures to encourage the conversion of undeclared employment into legal jobs and by the creation of mini jobs paying low wages (for more details, see box 2 in the 2004 Report). But it is also due to strict budget management, including on the part of the Länder and the local authorities. However, the spending cuts were not achieved by reducing public investment – as has too often been the case in episodes of fiscal consolidation in the euro area countries, though such austerity measures are liable to damage long-term economic growth – since that investment was stepped up. In 2007, the decline in revenues resulting from the reduction in social contributions from 42 to 40.5 p.c., a measure conducive to a higher employment rate, was offset by a sharp increase in the standard rate of VAT, up from 16 to 19 p.c. on 1 January, and by the strong rise in direct taxes levied, in particular, on corporate profits and to some extent on wages. Overall, the German authorities increased their structural budget balance by 1.3 percentage point of GDP in 2007, representing by far the biggest effort in the euro area. On 5 June 2007, the Ecofin Council therefore decided to abrogate the excessive deficit procedure initiated against Germany.

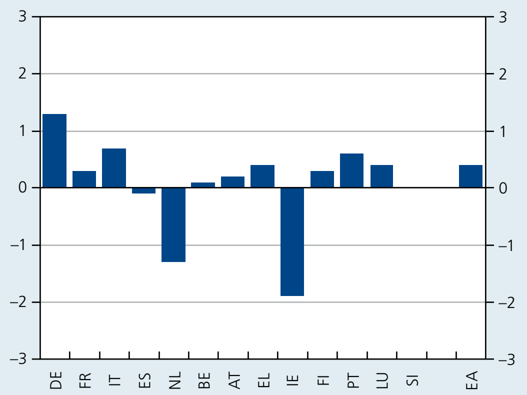
Between 2003 and 2006, France had opted to augment public revenues in order to rectify its excessive deficit. In contrast, in 2007 it adjusted its fiscal policy stance by cutting the fiscal and parafiscal burden on labour. As regards expenditure, however, it was impossible to avoid a serious overrun on health care spending. At over 53 p.c. of GDP, France's public expenditure is by far the highest in the euro area. Since 2005 the budget deficit has fallen below 3 p.c. of GDP, prompting the Ecofin Council to abrogate, on 30 January in the year under review, the excessive deficit procedure initiated against France.

Following a Council decision dated 28 July 2005, Italy was in an excessive deficit situation which it had to correct by 2007. That budget target, specified in the stability programme, was more than achieved since the nominal public deficit dropped from 4.4 p.c. of GDP in 2006 to 2.3 p.c. of GDP. While this fall is due partly to an exceptionally strong increase in corporate tax revenues, apparently resulting from the fight against tax evasion, the bulk of it, namely 1.4 percentage points of GDP, comes from non-recurring measures such as a tax on the revaluation of business assets, the sale of buildings and the transfer to public authorities of the reserves accumulated by firms for the purpose of effecting redundancy payments; that transfer therefore implies that the government will be responsible for those payments in the future. Under pressure from the social partners and various interest groups, it was also decided to embark on substantial new expenditure, including some public investment projects.

The public finances of the other Member States present a mixed picture. A sudden shortfall in their revenues took some Member States by surprise: examples were the Netherlands, which saw a reduction in revenues from gas sales, and Belgium which was unable to implement scheduled non-recurring measures to match the 2006 volume, but also Ireland where, owing to the crisis on the housing market, property taxes – which are very lucrative for the Treasury – were disappointing. Greece saw its deficit rising again as a result of unexpected expenditure caused by the forest fires which broke out in August. Conversely, other Member States continued to improve their budget balance, even if they were already recording a surplus. That was the case for Finland, where social security accumulated further reserves in anticipation of population ageing, and Luxembourg which, by modifying the indexation mechanism, curbed the rise in civil service salaries and social spending. Portugal was obliged to make an effort since it was in an excessive deficit situation which had to be corrected by no later than 2008. This goal was reached

CHART 11 STRUCTURAL BUDGET BALANCE OF GENERAL GOVERNMENT IN THE EURO AREA (1) (2)

(change in 2007 compared to 2006, percentage points of GDP)



Source : EC.
(1) According to the EC, the structural budget balance of general government corresponds to the cyclically adjusted budget balance net of one-off or temporary measures and factors.
(2) The euro area countries are ranked according to the size of their GDP in 2007.

in the year under review as Portugal succeeded in increasing the structural budget balance by 0.6 percentage point of GDP. That was achieved by a substantial rise in corporate taxes and measures aimed at restraining expenditure, particularly a reduction in public sector employment to limit the rise in the civil service wage bill. Finally, Spain's large budget surplus remained stable, as the cut in the rates of personal and corporate income tax in no way prevented a rapid increase in revenues.

1.5.2 EU Member States not belonging to the euro area

With the exception of Denmark and Hungary, all the EU Member States not belonging to the euro area recorded an expansion of economic activity outpacing that in the euro area. This applied in particular to the nine East and Central European countries, as has been the case for several years. In fact, in these relatively less prosperous countries, the growth is due partly to a process of catching up with the euro area.

In the United Kingdom, economic growth accelerated for the third consecutive year. In particular, private consumption was boosted by the positive wealth effects resulting from the constant rise in residential property prices. Business investment, which had expanded considerably in 2006, stimulated by high profitability and low financing costs, stabilised at that high level owing to the rise in interest rates and perhaps, to some extent, a scarcity of financing options in the second half of the year. Public investment continued to make a positive contribution to growth, in line with the British government's long-term policy designed to improve the quality of public services. With an employment rate well in excess of the Lisbon target of 70 p.c., the labour market remained one of the best performing in the EU. Unlike in the euro area, the already low unemployment rate did not decline further, partly owing to the massive influx of foreign workers. That influx, which has now begun to subside, had a moderating effect on wages. Despite the rising prices of oil and food, inflation dropped during the year under review from a peak of 3.1 p.c. in March to 2.1 p.c. in December. The annual average figure came to 2.3 p.c. Owing in particular to the strong expansion of lending, the Bank of England raised its main policy interest rate on several occasions during 2007, until the eruption of the financial turbulence caused by the subprime crisis in the United States : on 5 July it reached 5.75 p.c., its highest level since April 2001. In view of the tightening of credit conditions caused by this turbulence and the more favourable outlook for price stability, the official rate was cut to 5.5 p.c. on 6 December. The pound sterling depreciated against the euro by almost 9 p.c. during the year under review, essentially from mid September onwards. At the end of the year, the sterling/euro exchange rate stood at 0.73, its lowest level since the introduction of the euro. The strong expansion of public investment did not prevent the nominal public deficit from remaining below the limit of 3 p.c. of GDP and even showing a slight improvement in structural terms.

In Sweden, domestic demand was also the driving force behind the vigorous economic growth, even if the latter was less sustained than in 2006, which had been a record year. Private consumption again expanded rapidly, owing to the marked increase in disposable income resulting from tax cuts, wage increases and the growing number of jobs. Private investment was up, stimulated by high corporate profitability and the continuing expansion of housing construction. Public spending, particularly that of local authorities, also contributed to the burgeoning economy. In Denmark, GDP growth was well below the figure recorded in the other countries and in previous years. Private consumption faltered slightly following the rise in interest rates and the sluggishness of the residential property market. The risk of inflation forced the *Sveriges Riksbank* to increase the repo rate in four stages during the year, by 0.25 point each, raising it from 3 to 4 p.c. The Danish key rate moved in parallel with that of the euro, which allowed the Danish krone to stay close to its central rate in the ERM II throughout the year.

TABLE 11 ECONOMIC SITUATION IN 2007 IN EU MEMBER STATES NOT BELONGING TO THE EURO AREA (1)

	GDP in volume	HICP	Unemployment	Public finances		Balance of payments current account	Monetary policy objective
			(percentage changes compared to the previous year)	Financing balance	Debt		
	(percentage changes compared to the previous year)			(percentages of GDP)			
EU members before 2004							
United Kingdom	3.1	2.3	5.3	–2.8	43.6	–3.1	Inflation target
Sweden	3.4	1.7	6.1	3.0	41.1	7.1	Inflation target
Denmark	1.9	1.7	3.7	4.0	25.0	1.3	ERM II, 2.25 p.c. margin
Average	*3.0*	*2.2*	*5.2*	*–1.5*	*41.6*	*–1.4*	
New EU Member States							
Poland	6.5	2.6	9.6	–2.7	46.8	–4.3	Inflation target
Czech Republic	5.8	3.0	5.3	–3.4	30.2	–2.8	Inflation target
Romania	6.0	4.9	6.7	–2.7	12.5	–13.7	Inflation target
Hungary	2.0	7.9	7.2	–6.4	66.1	–4.4	Inflation target and exchange rate targets
Slovakia	8.7	1.9	11.3	–2.7	30.8	–4.4	ERM II, inflation target
Bulgaria	6.3	7.6	6.9	3.0	19.3	–18.1	Currency board system (2)
Lithuania	8.5	5.8	4.3	–0.9	17.7	–13.9	ERM II, currency board system (2)
Latvia	10.5	10.1	5.9	0.9	10.2	–23.8	ERM II, 1 p.c. margin
Estonia	7.8	6.7	4.9	3.0	2.8	–14.6	ERM II, currency board system (2)
Cyprus	3.8	2.2	3.9	–1.0	60.5	–6.0	ERM II
Malta	3.1	0.7	6.3	–1.8	63.1	–3.8	ERM II, fixed anchoring
Average	*6.0*	*4.1*	*7.8*	*–2.8*	*37.3*	*–7.0*	
Euro area	2.6 (3)	2.1	7.4	–0.8	66.5	0.2	

Sources: EC, OECD.
(1) The countries are grouped according to the size of their GDP in 2007.
(2) The currency board implies that the central bank ensures the unlimited convertibility of the national currency at a fixed exchange rate, with no restrictions on either current or capital transactions with other countries.
(3) Excluding Slovenia.

Except for Hungary, where fiscal consolidation inhibited economic activity, the new Central and East European Member States recorded exceptionally high growth rates, even Poland which, in the past, was often among the countries expanding relatively more slowly. Consumption and private investment were generally the engines of that growth. Private consumption grew strongly in the majority of countries, as a result of the steady rise in employment and wages, though the expansion of credit was also a factor. In addition, private investment was boosted by the inflow of foreign direct investment and the steady expansion of housing construction. Factors stimulating the latter were the development of the mortgage market, which was also made fiscally attractive, the need to improve the quality of the housing stock, and strong foreign demand from non-residents and property developers, primarily manifest in the capital cities and tourist centres.

Hungary, Slovakia and the Czech Republic were the only countries where net exports contributed to growth; substantial export capacity has been developed there in recent years, particularly as a result of the robust foreign investment. In other countries, GDP growth was curbed by the negative contribution of net exports. This was particularly true in the Baltic States, Bulgaria and Romania.

Overall, the "Visegrad" countries, namely Poland, the Czech Republic, Hungary and Slovakia, have enjoyed relatively strong and sustainable growth in recent years, supported by both domestic demand and exports, in a stable environment of controlled inflationary pressure and improving budget balances. Dynamic growth and expenditure restraint have pushed the financing balance in the right direction, reducing it to well below 3 p.c. of GDP in Poland and Slovakia in 2007. The Czech Republic brought its budget deficit down to 3.4 p.c. of GDP in 2007, and according to the EC it should be capable of cutting it below 3 p.c. in 2008. Hungary was the only country to suffer a sharp deterioration in the position of its public finances in recent years, with a borrowing requirement peaking at 9.2 p.c. of GDP in 2006, notably as a result of the derailment of expenditure on health care and social transfers, aggravated by a degree of political instability in recent years, which has prevented corrective measures. This development was liable to compromise the country's aim of joining the euro area by 2010, and put pressure on its currency. Consequently, following the June 2006 elections, the Hungarian government decided to launch a "New Balance" Programme for 2006-2008, which aimed to reduce the public deficit below 3 p.c. of GDP in 2009. In 2006, several measures to increase revenues were adopted and they had an immediate impact on the deficit. In 2007, fiscal consolidation continued via spending restrictions, such as the freezing of civil service pay, the reduction in the number of civil servants and cuts in public investment.

Under the influence of steep increases in indirect taxes combined with the reduction in subsidies on energy and transport, inflation in Hungary gathered pace temporarily to reach 7.9 p.c. in 2007, a level well above the 3 p.c. target set by the *Magyar Nemzeti Bank*. However, the confidence which the financial markets gained from the fiscal consolidation measures simultaneously helped to keep the forint below its central rate of 282.36 forints to the euro and to reduce the official interest rate from 8 to 7.50 p.c. in two stages. In Poland, the vigour of domestic demand forced the *Narodowy Bank Polski* to modify its policy of cutting interest rates, a policy which it had pursued continuously since the end of 2005, in order not to exceed its inflation target of 2.5 p.c. (with a 1 percentage point margin). It raised its key rate by 25 basis points on four occasions during the year under review, bringing it to 5 p.c. from the end of November. While the Czech central bank, the *Česká národní banka*, succeeded in meeting its 3 p.c. inflation target (with a 1 percentage point margin), that was achieved only by raising its key rate by 25 basis points on four occasions, bringing it to 3.50 p.c. Since the Slovak koruna, a currency participating in ERM II, was appreciating continuously against the euro, the EU, the ECB and the central bank of Slovakia decided on 19 March 2007 to revalue it by 8.5 p.c. Next, the *Národná banka Slovenska* made two cuts in its key rate, reducing it to a level close to the official interest rate of the Eurosystem. The Polish zloty and the Czech and Slovak koruna continued to appreciate against the euro during the year under review.

Romania, Bulgaria and the Baltic States recorded very strong GDP growth, with domestic demand being sustained by the abundant supply of credit on favourable terms and the improvement in the labour market. Owing in particular to the emigration of productive workers to other EU countries, there were actually shortages on certain labour market segments, such as construction, which in turn triggered wage increases well in excess of labour productivity growth. This situation caused the economy to overheat, as the increase in aggregate demand outstripped the growth of production capacity. This was then followed by accelerating inflation and a large external deficit, although these imbalances were less marked in Romania. Revised downwards each year, the inflation target of the *Banca Naţională României* stood at 4 p.c. with a 1 percentage point margin at the end of 2007. The key interest rate was cut by 175 basis points in several stages during the first half of the year, in response to the appreciation of the leu exchange rate and the improving inflation outlook. However, the policy interest rate had to be raised by 50 basis points in November after the leu began to depreciate against the euro in response to the financial market turmoil which broke out in August, and the inflation outlook had been revised upwards. In contrast, Bulgaria, Estonia and Lithuania were unable to use their key interest rate or their exchange rate to remedy somewhat the overheating of their economy, since their respective currencies are anchored to the euro by a currency board system. Although the interest rates on the three-month market did rise by more than in the euro area, real short-term interest rates remained negative owing to the sharp rise in inflation. Latvia, which participates in ERM II but has unilaterally pegged its currency to the euro with a 1 p.c. margin, experienced similar developments, although the central bank raised its official interest rate from 5 to 6 p.c., and intervened on the foreign exchange market several times in order to keep the lats within its narrow fluctuation margins. The fact that public finances show large surpluses or, at most, a small deficit, and a sharp decline in the debt-to-GDP ratio, makes it politically difficult to use this channel to moderate domestic demand. Bulgaria has so far succeeded in financing its current account deficit via foreign direct investment, but in the Baltic countries lending in foreign currencies to individuals has increasingly formed the counterpart to the current account deficit.

The economic catching-up process is less marked in the case of Cyprus and Malta, since these are more mature new Member States. In these countries, growth was propelled by domestic demand, particularly private consumption which expanded as a result of favourable labour market developments, and in Malta also as a result of the reduction in the cash reserves with a view to the introduction of the euro. In contrast to the situation in Malta, net exports depressed GDP growth in Cyprus, despite the increased revenue generated by tourism and financial services. The currencies of both countries remained stable within the ERM II: their central banks gradually aligned their key interest rates with that of the Eurosystem.

Following the publication of favourable convergence reports in May 2007 by the ECB and the EC, and the suspension, on 5 June 2007, of the excessive deficit procedure, the EU Council decided on 10 July 2007 that Cyprus and Malta could join the euro area on 1 January 2008, bringing the number of member countries to fifteen. The Council also adopted a regulation fixing the irrevocable euro conversion rates of the Cyprus pound and the Maltese lira. The respective conversion rates were set at CYP 0.585274 and MTL 0.429300. These two conversion rates correspond to the respective central rates decided on 2 May 2005 when these two currencies entered the exchange rate mechanism (ERM II).

The monetary policy of the Eurosystem

2.

2.1 Summary

The financial market tension which erupted during the summer of 2007 presented major challenges for monetary policy. Up to the beginning of August, the majority of the indicators confirmed that the revival of economic activity in the euro area, which had begun in 2005 and gathered momentum in 2006, was also going to persist in 2007. Moreover, economic growth was similarly projected to approach or even slightly exceed its potential level in 2008. There were therefore no longer any reasons to maintain an accommodating monetary policy stance. Consequently, the Governing Council decided to continue the increases in the Eurosystem key rates which had begun in December 2005. The minimum bid rate of the main refinancing operations was raised in two stages from 3.50 p.c. at the start of the year under review to 4 p.c. in June 2007. Furthermore, in the early summer the Governing Council stood by its opinion that the monetary policy stance remained accommodating, thus creating expectations of a continuing cycle of interest rate increases. Its main fear was that the vigour of economic activity combined with a very high rate of capacity utilisation and the improvement in labour market conditions, in a context of strong expansion of the money supply and lending, might jeopardise price stability. Having regard to the forward-looking nature of monetary policy, the growing risks to price stability in the medium term, identified by both economic and monetary analysis, thus prevailed over the simple finding that, during this period, inflation was slightly below the 2 p.c. mark. Guaranteeing medium-term price stability is in fact the primary objective of the Eurosystem's monetary policy, in accordance with the Treaty establishing the European Community. Thus, monetary policy fosters an environment conducive to sustainable growth and job creation.

During August, however, the Governing Council had to assess the effects of the financial turmoil and the implications for the conduct of monetary policy. Two separate challenges emerged.

First, following the upheaval on the financial markets, and particularly the tension on the money market, the Eurosystem soon felt the need to inject exceptional volumes of liquidity into the financial system, as did a number of central banks of advanced economies. The purpose of that intervention was to ensure the smooth operation of the money market and to stabilise very short-term interest rates at a level close to the minimum bid rate of the main refinancing operations. The Eurosystem therefore continued, in practice, to conduct a policy of steering interest rates. Since the granting of liquidity becomes endogenous under such a policy – supply is steered according to demand for liquidity, in order to stabilise the overnight rate – it gives no signal regarding the monetary policy stance. The sometimes ample injections of liquidity effected by the Eurosystem therefore did not in any way indicate a relaxation of the monetary policy stance. That stance is determined unambiguously by the level of the key interest rates, particularly the minimum bid rate of the main refinancing operations.

The second challenge facing the Governing Council consisted in assessing the extent to which the financial market turbulence might affect the path of the key interest rates. While the upside risks to price stability identified in the first part of the year became more acute after the summer, owing to the surge in prices of petroleum products and the transmission of the food price rises to consumer prices, the ferment on the financial markets led to higher risk premiums, the appreciation of the euro and the spectre of bank credit rationing. These factors may in turn depress the outlook for growth and hence the inflation prospects, whereas the euro appreciation may also have a more direct impact on inflation via import prices. The growing uncertainty caused by the financial market volatility prompted the Governing Council to exercise prudence, and first gather all the necessary relevant information. It thus decided to keep the key interest rates unchanged at the meetings in the final four months of the year, though it nevertheless continued to draw attention to the upside risks to price stability. In practice, that meant that the expected interest rate hike did not materialise, and the market also revised downwards its expectations of future interest rates.

2.2 The operation of the money market

Liquidity management by the Eurosystem

The banking system as a whole has a structural liquidity deficit which is due primarily to "autonomous factors", i.e. factors unrelated to monetary policy (for more details, see box 4). In the euro area, that deficit is also amplified by the obligation upon credit institutions to create reserves in the form of deposits on accounts with the NCBs. The Eurosystem remunerates these reserves at the marginal rate of the main refinancing operations, so that this does not place a burden on the banking system. The existence of a structural need for liquidity makes credit institutions dependent on the Eurosystem, facilitating liquidity management and the steering of the overnight interest rate.

Since the reserve requirements have to be met on average over what is known as a reserve maintenance period of about one month, credit institutions can allow their current account assets to fluctuate. This characteristic enables them to cushion unexpected liquidity shocks, helping to stabilise the market interest rate during the reserve maintenance period, but this stabiliser effect disappears at the end of the period. Even though the reserves provide a symmetrical buffer for liquidity shocks – during the reserve maintenance period, the current account assets may deviate upwards or downwards from the reserve requirements, provided that the requirements are met on average – credit institutions generally make sure that they meet their reserve requirements relatively early in the reserve maintenance period. Since January 2005, in order to cater for this time pattern of the demand for reserves, and hence to maintain the overnight interest rate close to the minimum bid rate of the main refinancing operations, the Eurosystem has conducted a relatively generous allotment policy during the weekly main refinancing operations. The amounts allotted by the ECB are therefore slightly greater than the benchmark amounts announced prior to the main refinancing operations. Those amounts are calculated so as to enable the credit institutions to fulfil their reserve requirements in a balanced manner up to the settlement of the next main refinancing operation (see box 4).

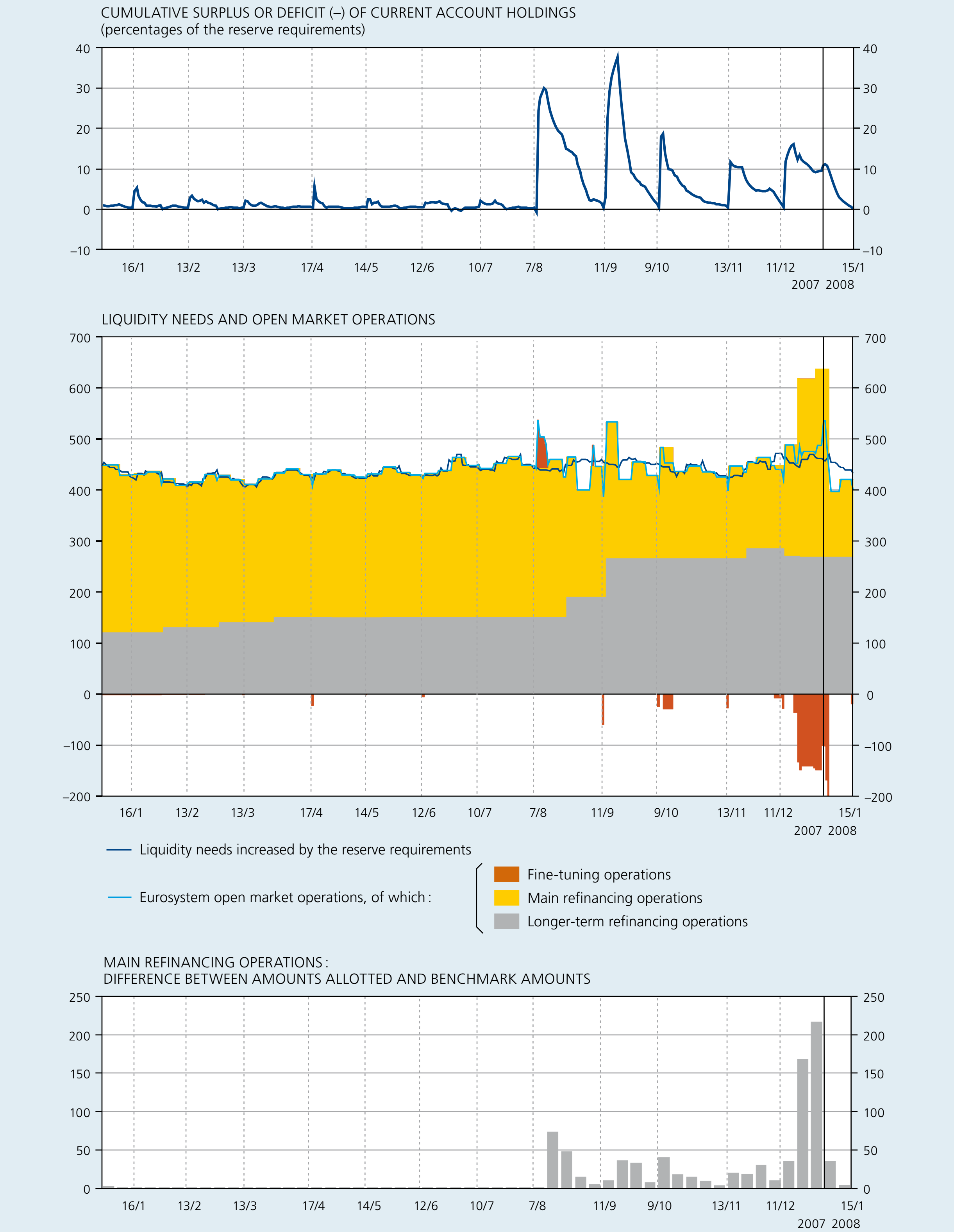
These albeit small differences imply that, at the beginning of the reserve maintenance period, the current account assets held by credit institutions exceed the reserve requirements. The cumulative surplus thus created on the current accounts at the start of a reserve maintenance period – which, during the period from January to July in the year under review, reached 2 to 5 p.c. overall – is then gradually reabsorbed in order to ward off any downward pressure on the overnight interest rate. Such an approach in fact makes it possible to prevent the surplus liquidity allocated at the start of the reserve maintenance period from being placed on the interbank market at the end of the period. That would depress the money market interest rate at the end of each reserve maintenance period, contrary to the objective of stabilising the market rate at a level close to the minimum bid rate of the main refinancing operations. Since the reserve requirements cease to perform a stabilising function at the end of a reserve maintenance period, a fine-tuning operation is generally carried out at that point in order to keep the money market rate stable. During the first seven reserve maintenance periods in 2007, six operations of this type were conducted, representing an average volume of 6.3 billion euro in absolute terms.

By conducting such a policy, the Eurosystem generally succeeds in maintaining the overnight interest rate at a level close to the minimum bid rate. Thus, the average spread between the Eonia and the minimum bid rate – which stood at 3.50 p.c. at the start of the year under review, before being raised to 3.75 p.c. in March and 4 p.c. in June –, came to 6 basis points between 1 January and 7 August. Moreover, this spread displayed little volatility during that period, since its standard deviation only came to 5.8 basis points. The marginal rate and the weighted average rate paid in the weekly main refinancing operations also recorded small positive but stable spreads in relation to the minimum bid rate: those spreads averaged 6 and 7 basis points respectively. Stabilising the interest rate at the short end of the money market at a level close to that of the minimum bid rate for the main refinancing operations preserves to the best possible extent the function of that rate in signalling the monetary policy stance.

On 9 August, the money market experienced very severe stress, mainly owing to the announcement by a large French financial institution of the temporary closure of two of its money market funds in view of the problems encountered in valuing their underlying assets. These problems were due mainly to the deteriorating situation on the American subprime mortgage market during the first part of the year, which in June had prompted rating agencies to downgrade the rating of a number of portfolios of asset-backed securities created by securitisation of American subprime mortgage loans. In the wake of this turbulence, a major correction to the assessment of market risks took place on the financial markets. This tension also spread rapidly to other market segments, and particularly to the segment comprising structured finance instruments in the broad sense, which had become very difficult to value. In that context, it was particularly hard

CHART 12 **OPERATIONAL CONDUCT OF THE EUROSYSTEM MONETARY POLICY IN 2007** [1]

(daily data, billions of euro, unless otherwise stated)



Source: ECB.

(1) The vertical grey lines indicate the last day of the reserve maintenance periods.

to assess the potential exposure of the financial institutions to the various market segments affected by serious tension. Like their American counterparts, the banks active on the European market very soon proved reluctant to lend funds on the interbank market, pending clarification of their own liquidity situation and the exposure of their counterparties. The lack of transparency regarding this last factor had a particularly marked impact on activity in the unsecured interbank market. The resulting liquidity shortage forced the ECB to inject substantial amounts of liquidity into the money market to ensure that it functioned smoothly and to stabilise the very short-term interest rates.

Particularly strong demand for current account assets with the Eurosystem then developed within the banking system, in order to be able to cope with liquidity shocks without needing to resort to the interbank market. This also implied that the banks were able to satisfy the reserve requirements relatively early in the reserve maintenance period. The Eurosystem responded to that increased demand for frontloading via its open market operations, in order to keep the overnight market rate as stable as possible. Consequently, the cumulative surplus on the current accounts at the start of the reserve maintenance period expanded significantly. During the reserve maintenance period running from 8 August to 11 September, the cumulative surplus peaked at around 30 p.c. on 12 August. During the next reserve maintenance period, from 12 September to 9 October, it actually attained a cumulative maximum of 37 p.c. on 16 September. Although the demand for frontloading subsided somewhat from October, it still remained substantial.

Box 4 – Liquidity needs of the banking sector and benchmark amounts for the main refinancing operations

The consolidated balance sheet of the Eurosystem offers an overview of liquidity supply and demand. The assets side of the balance sheet presents items whose expansion has a positive impact on the liquidity available to the banking sector, while the liabilities side presents items whose expansion causes a reduction in banking sector liquidity. The banking sector faces a structural liquidity need, and that makes credit institutions dependent on the Eurosystem. It is precisely by determining the conditions applicable to the refinancing of the banking system that the Eurosystem is able to steer the overnight interest rate. The whole of the refinancing need of credit institutions comprises what are known as "autonomous factors", the reserve requirements imposed on credit institutions and the unremunerated excess reserves which credit institutions hold on their current accounts with the Eurosystem. During the year under review, this liquidity need averaged 441 billion euro, representing an increase of 4.4 p.c. against the previous year.

The autonomous factors are determined by the behaviour of the public and institutional mechanisms, and are unrelated to the conduct of monetary policy. The public's demand for banknotes represents a substantial liquidity need, although it grew less strongly in 2007 than in 2006. The short-term variability of the refinancing need is due mainly to the deposits which governments hold with the NCBs. The net assets in gold and foreign exchange and all the other autonomous factors – which include, apart from the Eurosystem's portfolio investments, the revaluation accounts, claims on public authorities and the capital of the Eurosystem – constitute a source of liquidity. The other autonomous factors increased strongly during the year under review, following the Eurosystem's expansion of its portfolio investments. The fact that the sum of the autonomous factors which drain liquidity and are shown on the liabilities side exceeds that of the autonomous factors topping up liquidity and shown on the assets side implies a structural liquidity deficit for the banking sector.

The structural need for refinancing is accentuated by the reserve requirements imposed on credit institutions. These are calculated by multiplying the reserve basis – namely most of the short-term liabilities of credit institutions – by a 2 p.c. reserve ratio. During the year under review, the average reserve requirements moved in parallel with the balance sheet of credit institutions, reaching 187.4 billion euro.

CONSOLIDATED AND SIMPLIFIED BALANCE SHEET OF THE EUROSYSTEM

(average daily outstanding amounts, billions of euro)

Assets	2006	2007	Liabilities	2006	2007
Autonomous liquidity factors			**Autonomous liquidity factors**		
Net gold and foreign assets	329.1	323.7	Banknotes in circulation	578.0	629.6
Other autonomous factors (net)	46.6	106.5	Government deposits	55.6	52.5
			Current accounts		
			Reserve requirements	163.7	187.4
			Excess reserves	0.7	1.9
Monetary policy instruments			**Monetary policy instruments**		
Main refinancing operations	307.0	263.6			
Longer-term refinancing operations	115.5	183.3	Fine-tuning operations (net)	0.0	5.4
Marginal lending facility	0.1	0.2	Deposit facility	0.2	0.5
Total	**798.3**	**877.3**	**Total**	**798.3**	**877.3**

Source: ECB.

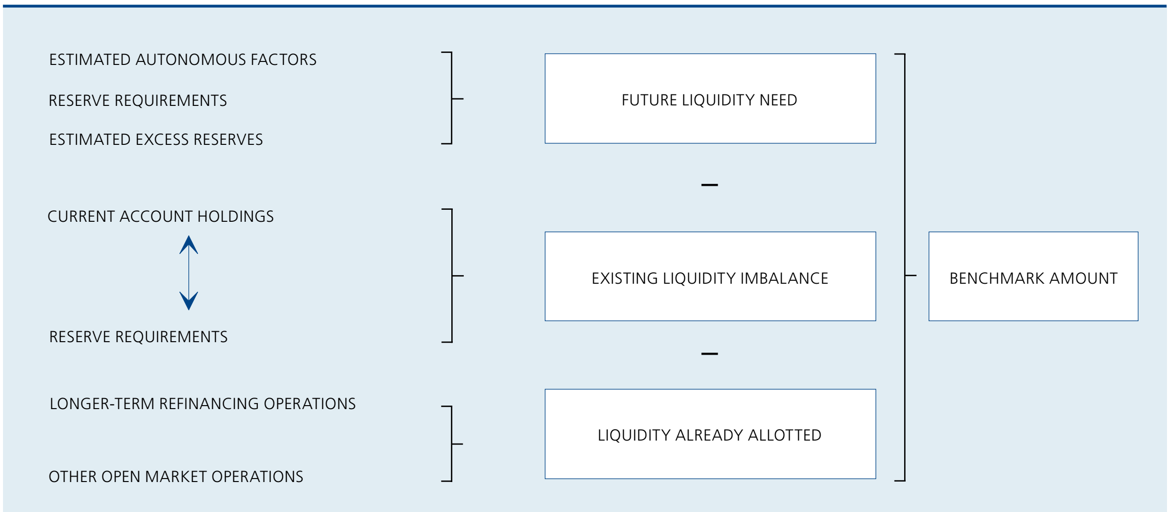
Any – often very small – excess reserves make up the third component of the liquidity needs of credit institutions. On average, those institutions thus held around 1.9 billion euro on their current accounts in excess of their compulsory reserves.

The banking sector's liquidity needs are refinanced by the Eurosystem, mainly via the open market operations, i.e. the weekly main refinancing operations, the longer-term refinancing operations and the fine-tuning operations. Recourse to the marginal lending facility or the deposit facility is therefore generally very limited.

In order to keep the counterparties sufficiently informed of the total liquidity needs of the banking sector and to provide an adequate supply of liquidity in its weekly main refinancing operations, the Eurosystem systematically estimates the need for liquidity, and on that basis calculates the benchmark amount for the tender. This benchmark amount is fixed so that credit institutions can meet their reserve requirements in a balanced manner until the next main refinancing operation. For that purpose, account is taken not only of the projected liquidity need, but also of the liquidity imbalance which has already built up since the start of the reserve maintenance period. All other things being equal, a high (low) level of assets held on current account at the start of the reserve maintenance period therefore leads to lower (higher) benchmark amounts later in the reserve maintenance period. In calculating the benchmark amount, account is also taken of the liquidity already allocated in the longer-term refinancing operations and the other open market operations.

Since March 2004, to help bidders to decide the amount of their bids, the Eurosystem has published, on the main refinancing operation allotment date, an update of the benchmark amount published the day before at the time of the announcement of the main refinancing operation.

CALCULATION OF THE BENCHMARK AMOUNTS OF THE MAIN REFINANCING OPERATIONS



The benchmark amounts are based solely on parameters valid for the consolidated banking sector in the knowledge that, under normal market conditions, credit institutions can easily place their liquidity surplus or deficit on the interbank market. However, when market conditions are strained and individual credit institutions do not wish to place their surplus on the interbank market, the total demand for liquidity addressed to the Eurosystem significantly exceeds the normal benchmark amounts. In the face of the increased demand for central bank reserves, it is desirable at such times to deviate from the benchmark amounts and increase the supply of liquidity in order to stabilise the overnight interest rate.

As the sudden demand for current account assets during the reserve maintenance period from 8 August to 11 September was totally unexpected, the Eurosystem initially responded via four successive fine-tuning operations, each available until the next working day. These operations injected liquidity in successive amounts of 94, 61, 47 and 7.7 billion euro. After these additional ad hoc injections of liquidity, the demand for front-loading was met by allocating amounts which, from the first ensuing weekly main refinancing operation, were considerably higher than the pre-announced benchmark amount, especially at the start of the reserve maintenance period. During the reserve maintenance period, an attempt was then made to reduce these differences in stages, so long as that did not impair the objective of stabilising the interest rate. Altogether, in the main refinancing operations conducted between 15 August 2007 and 8 January 2008, the Eurosystem allocated on average sums which were 38.7 billion euro higher than the benchmark amounts calculated, whereas this positive differential had amounted to 1 billion euro on each occasion during the first seven reserve maintenance periods of the year.

It was principally in the main refinancing operations on 18 and 28 December that the Eurosystem allotted a sum well in excess of the benchmark amount, in order to curb the rising tension on the money market. The end of the year traditionally generates some nervousness, even under normal market conditions, in view of the closure of the credit institutions' annual accounts, but this tension was far more acute in the year under review. On 30 November 2007, the Eurosystem had therefore already announced that, by way of exception, the duration of the 18 December operation would be extended by a week to two weeks, in order to reassure the banks before the Christmas holiday period regarding the availability of funds falling due after New Year. At the same time, it specified that this operation would not replace the one scheduled for 28 December, thus offering the banks an additional opportunity to meet their year-end liquidity needs. Furthermore, the day before the 18 December operation it was announced that all bids equalling or exceeding 4.21 p.c. – the average rate of the previous main refinancing operation – would be satisfied in full. This led to the allotment of a considerable volume : during this operation, the Eurosystem allotted 348.6 billion euro, so that the deviation from the benchmark amount came to 168.1 billion euro. This abundant allotment resulted in a negative benchmark amount for the 28 December operation. However, in response to demand from the banks, 20 billion was allotted on that date, i.e. 217 billion more than the benchmark amount.

On 12 December, five central banks – the Bank of Canada, the Bank of England, the ECB, the Swiss National Bank and the US Federal Reserve – announced additional measures to deal with the renewed money market tension at the end of the year. In consultation with the Federal Reserve, the Eurosystem conducted two US dollar liquidity-providing operations against ECB-eligible collateral, i.e. assets denominated in euro. The dollars were made available to the Eurosystem via a foreign exchange swap with the Federal Reserve and the interest rates applied were those which the Federal Reserve sets for its corresponding transactions with its US counterparties. In these two operations, unwound on 20 and 27 December, the planned maximum amount of 10 billion dollars was allotted for periods of 28 and 35 days respectively. The purpose of these operations was to facilitate the dollar financing of European banks and they had no implications for the management of liquidity on the euro money market.

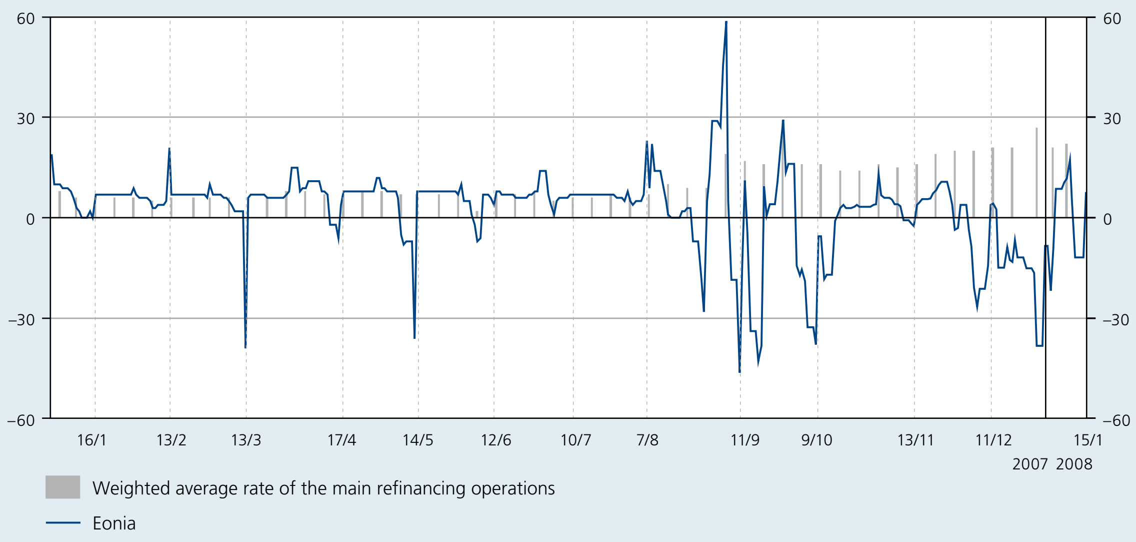
On the euro money market, the Eurosystem also had to make more systematic use of sometimes extensive fine-tuning operations, and not just in the initial days of money market tension during August. Moreover, these operations were not confined to the last day of the reserve maintenance period. Thus, on 6 September, a liquidity-providing fine-tuning operation totalling 42.2 billion euro was conducted in order to calm the growing upward pressure on the overnight rate. The day before, that rate had in fact reached 4.70 p.c. Also, owing to the banks' massive front-loading, it was necessary on several occasions to absorb excess liquidity in order to counteract downward pressure on the overnight rate. Moreover, the amounts of these operations were substantial. That was systematically the case on the last day of the reserve maintenance period. On 11 September, 9 October, 13 November, 11 December 2007 and 15 January 2008, the Eurosystem thus absorbed liquidity amounting to 60, 24.5, 27.75, 21 and 20 billion euro respectively. In addition, liquidity was occasionally drained from the market at times other than the end of the reserve maintenance periods. On 12 October, 30 billion was absorbed for the five-day period preceding the settlement of the next main refinancing operation, because the overnight rate had fallen that very morning to 3.66 p.c. Between 7 and 12 December and between 17 and 19 December, liquidity amounting to 8 and 36.6 billion euro respectively was mopped up. The very abundant allotment in the main refinancing operation on 18 December generated serious downward pressure on the overnight rate as soon as settlement took place the next day. That pressure persisted after the allotment of the main refinancing operation which took place on 28 December. To counteract that pressure, the Eurosystem then embarked upon a series of fine-tuning operations which made it possible to absorb the excess liquidity in a flexible way, i.e. according to market conditions. Between 19 December and 3 January, the day preceding the first main refinancing operation of 2008, the Eurosystem thus absorbed liquidity in amounts ranging between 101.6 and 200 billion euro.

In August and September, the Governing Council also decided to organise two longer-term supplementary refinancing operations lasting three months, as there was substantial demand for finance in the longest segment of the money market. The volume of these longer-term refinancing operations came to 40 and 75 billion euro respectively. They supplemented the usual monthly longer-term refinancing operations lasting three months, the volume of which the Governing Council had already decided to increase from 40 to 50 billion with effect from 1 February. On 8 November, the Governing Council also decided to renew the two supplementary longer-term refinancing operations when they matured, and to grant 60 billion on each occasion. When the first additional operation was renewed on 23 November, the outstanding amount of longer-term financing increased to 285 billion euro, subsequently declining to 270 billion on 12 December when the second additional operation was renewed. At the time of the renewal of a standard longer-term refinancing operation on 20 December, liquidity was very abundant owing to the large volume allotted in the main refinancing operation on 18 December. Demand for longer-term finance was therefore inadequate and the Eurosystem was able to allot only 48.5 billion of the 50 billion which matured. The outstanding amount of longer-term refinancing thus declined slightly at the end of the year to 268.5 billion. Overall, there was a massive increase in the share of the longer-term refinancing operations in the total liquidity granted, up from around 33 p.c. in the first half of the year to 60 p.c. by the end of the year.

The flexible use of the operational framework described above places the banking sector in a relatively comfortable situation. At the start of the reserve maintenance

CHART 13 INTEREST RATE DIFFERENTIALS IN RELATION TO THE MINIMUM BID RATE IN 2007 (1)

(daily data, basis points)



Source : ECB.
(1) The vertical grey lines indicate the last day of the reserve maintenance periods.

period, it is easy to obtain liquidity, while any surplus liquidity can be unloaded without heavy penalties later in the period, as the fine-tuning operations aimed at absorbing liquidity are conducted at the minimum bid rate of the main refinancing operations. However, that does not mean that individual credit institutions can always secure such attractive terms from the Eurosystem. If they apply to the Eurosystem outside the open market operations, they in fact have to make use of the standing facilities. These offer credit institutions the opportunity to borrow or deposit funds for one day with the Eurosystem, at pre-announced rates which form a symmetrical corridor of 100 basis points on either side of the minimum bid rate. These rates also represent the limits within which the overnight rate will fluctuate. There was no notable increase in the use of these standing facilities during the period of financial turmoil ; as in the first seven months, use of those facilities was due partly to the sometimes unbalanced distribution of liquidity among credit institutions during the reserve maintenance period, and partly to underbidding at the time of the fine-tuning operations intended to absorb liquidity at the end of that period. The Eurosystem was therefore unable to mop up the desired amount of market liquidity so that, at the end of the day, credit institutions had to place it in the deposit facility.

The Eonia was much more volatile than usual during the period of financial turmoil, highlighting the problem of matching the liquidity supply precisely to demand. Although the average deviation of the Eonia in relation to the minimum bid rate was virtually zero between 8 August 2007 and 15 January 2008, its standard deviation increased considerably to 17 basis points. The spread between the weighted average rate and the minimum bid rate of the main refinancing operations – giving an indication of the extent to which credit institutions are willing to pay for refinancing by the Eurosystem – reached a relatively high level compared to that recorded in the past. On average, this spread increased to 18 basis points, while the spread between the marginal rate and the minimum bid rate widened to 15 basis points. The dispersion of the rates offered by credit institutions for both the main refinancing operations and the longer-term refinancing operations was also significantly higher during the period of financial turmoil.

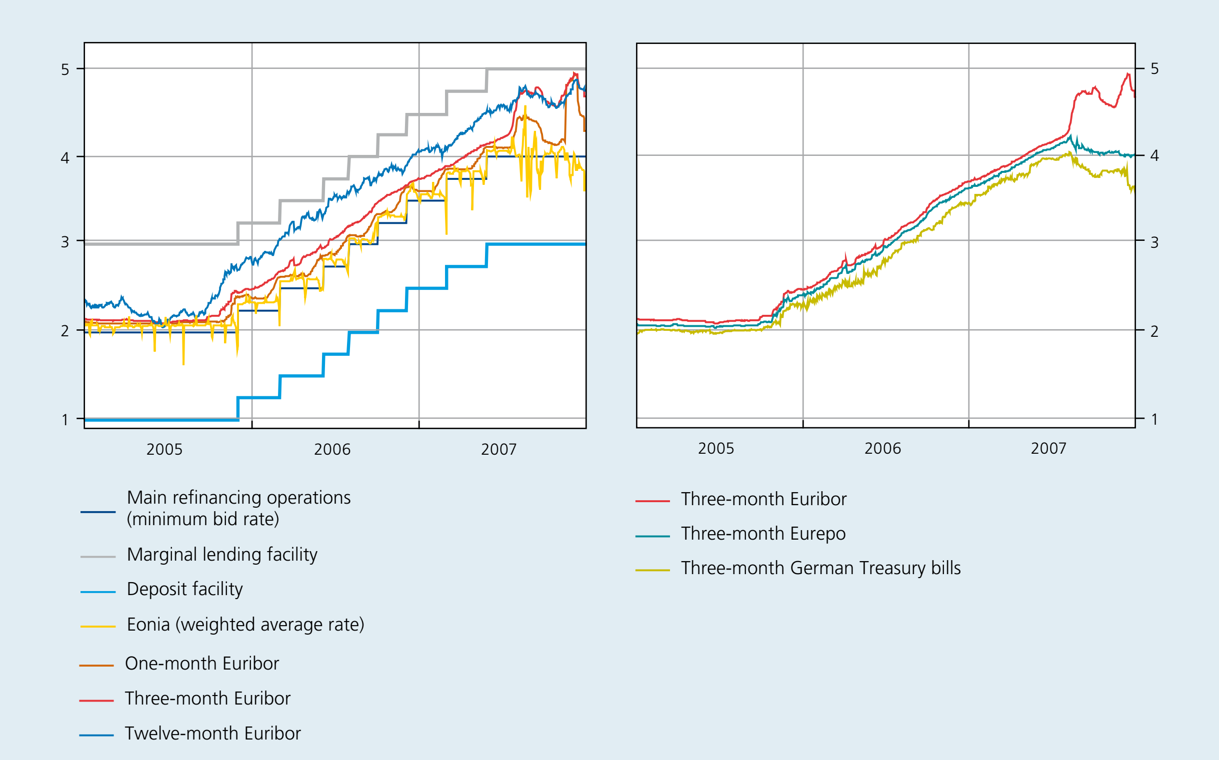
The fact that the Eurosystem aligns the allocation of liquidity with demand, in order to stabilise the overnight interest rates at a level close to the minimum bid rate for the main refinancing operations, is precisely why that allotment does not signal the monetary policy stance. The sometimes substantial injections of liquidity arranged by the Eurosystem therefore never presaged an easing of the monetary policy stance, which remained unchanged, as indicated by the absence of adjustments to the key rates during the period of money market tension and the steering of the overnight rate at a level fairly close to the minimum bid rate for the main refinancing operations.

The term structure of money market interest rates

Interest rates on unsecured interbank loans increased sharply at the beginning of August at the long end of the interbank market. Thus, on 7 September, the three-month Euribor increased to 4.75 p.c., compared to around 4.2 p.c. at the beginning of August. Partly as a result of year-end effects, the three-month rate on the unsecured interbank market increased at the beginning of October to 4.8 p.c. From that date onwards, the repayment of three-month loans falls due after the end of the year. This same factor accounts for the marked rise in the one-month Euribor at the end of November. The three-month Euribor then dropped slightly during October as the money market tension lessened somewhat. In contrast, in November and December the tension was rekindled, triggering a renewed rise which pushed the rate even higher than the level recorded at the beginning of October. The very abundant allotments in the main refinancing operations on 18 and 28 December, which were intended to attenuate the year-end tension, drove down interest rates at the end of the period, particularly for horizons of up to one month.

Beyond the very short term, interbank market interest rates are influenced by expectations regarding monetary policy decisions. They also include a term premium which compensates for the uncertainty over future movements in interest rates. During the second half of the year under review, that premium mainly reflected an increased preference for longer-term financing. Finally, the interbank interest rates comprise a premium to cover the possible risk of default – the Euribor is in fact the rate on unsecured interbank lending. It is evident from the movement in the three-month Euribor (the rate at which banks lend funds to one another without collateral) and the three-month Eurepo (the rate at which banks lend funds to one another against security) that this risk premium played a major role in the steep rise in unsecured interest rates. Having stood at around 7 basis points during the first half of the year, this premium in fact increased to 70 basis points at the beginning of October. Subsequently,

CHART 14 TERM STRUCTURE OF MONEY MARKET INTEREST RATES
(daily data)



Sources : Bloomberg, ECB.

following a decline up to mid November, the spread between the three-month Euribor and the three-month Eurepo widened again to an average of 82 basis points in December. This movement reflected the uncertainty over the extent of the credit institutions' exposure to structured finance instruments.

During August and September, the Eurepo declined slightly once expectations of subsequent interest rate increases had waned. This factor also accounts for the falling yields on German Treasury certificates during this period. That yield was also affected by the use of government bonds as a safe haven, which is common practice in periods of financial market tension. That effect may be considerable on a market where supply is relatively inelastic.

The expected risk premium can be calculated for an exact moment in the future by comparing the prices on forward contracts relating to secured and unsecured three-month loans. This comparison shows that, at the end of December, the markets expected the premium covering the risk of default to be around 40 basis points in March 2008, dropping to 25 points in June and remaining steady from September at 20 points, namely twice the level recorded before the outbreak of the financial market turbulence. This stabilisation bears out the view that the reassessment of the risks is a structural process, although it also implies that the risk premium should fall sharply compared to the level reached in the second half of the year under review.

The fluctuations at the long end of the money market, caused by the behaviour of the credit institutions and their risk perception, are beyond the control of the Eurosystem. By managing the supply of liquidity, it can in fact only exercise direct control over very short-term interest rates. The marked fluctuations on the interbank market are taken into account in decisions on the monetary policy stance, since they may have repercussions extending beyond the interbank market. Thus, many credit institutions use the three-month interbank rate (measured by the Euribor) as the benchmark for a wide range of interest rates applicable to loans granted to households and non-financial corporations. If the increase in the three-month Euribor is reflected in the debit interest rates, that actually implies tighter financing conditions, even in the absence of any adjustment to the Eurosystem's key rates.

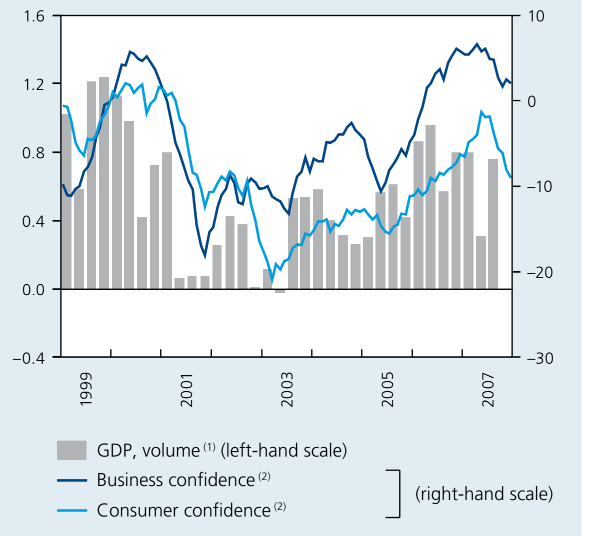
2.3 Decisions on the monetary policy stance

The first seven months of 2007 : continuing interest rate rises

Following economic growth of 2.9 p.c. in 2006, the Governing Council considered, from the start of the year under review, that economic activity would slow down somewhat in 2007 and 2008, though still recording robust growth at a rate close to its potential. Nonetheless, some uncertainty persisted owing to the increase in the VAT rate in Germany which took effect on 1 January 2007. However, these fears dissipated relatively quickly as the first indicators of business activity became available. Thus, after some hesitancy in January, both business and consumer confidence continued rising strongly during the first half of the year, suggesting that the change in indirect taxation in the largest euro area country might have less impact than initially expected.

The encouraging economic data and the publication of the figure for the volume growth of GDP for the last quarter of 2006, indicating a rise of 0.9 p.c. quarter-on-quarter, prompted many international institutions, and likewise the Eurosystem, to revise upwards the outlook for economic growth for 2007 and, to a lesser extent, for

CHART 15 ECONOMIC ACTIVITY AND CONFIDENCE INDICATORS IN THE EURO AREA



Source : EC.
(1) Data adjusted for seasonal and calendar effects, percentage changes compared to the previous quarter.
(2) Balance of replies to the monthly survey.

2008. The view was that economic expansion would also be broadly based. The vigour of world growth looked set to continue driving the euro area's exports, and hence economic activity. On the domestic demand side, investment was expected to remain sustained, owing to an extended period of highly favourable financing conditions, the marked improvement in corporate profitability and the restructuring of company balance sheets. Private consumption seemed likely to continue benefiting from the sharp expansion of employment.

Nonetheless, the Governing Council stressed that this reference scenario for growth was still subject to downside risks in the medium term. The risks – mainly of external origin – were connected with the possibility of a renewed rise in oil prices, in view of the persistent geopolitical tensions in the Middle East, fears of a resurgence of protectionism following numerous failures in the Doha round of talks, and concern about how a sudden correction of the global imbalances might affect long-term interest rates and exchange rates. The slowdown in American economic activity was also beginning to become more worrying, as the indicators pointed to a rapid deterioration in conditions on the United States property market. It was feared that these developments might affect US household consumption, but above all, that they might be accompanied by excessive financial market volatility caused by a possible reversal of sentiment on the part of the market players.

Subsequently, the national accounts data showed that the volume of GDP had increased by 0.6 p.c. – later revised to 0.8 p.c. – in the first quarter, exceeding expectations, mainly on account of a very substantial contribution from gross fixed capital formation. These results were the main factor prompting a further – modest – upward revision of the growth forecast for 2007, while for 2008 the relatively high oil prices and the gradual appreciation of the euro exchange rate exerted a slight downward influence, according to the Eurosystem's projection exercise among other forecasts.

Inflation remained below the upper limit of the definition of price stability during the initial months of the year under review, despite the upward influence on prices of the VAT increase in Germany. The Governing Council also

TABLE 12 PROJECTIONS FOR GDP GROWTH AND INFLATION IN THE EURO AREA

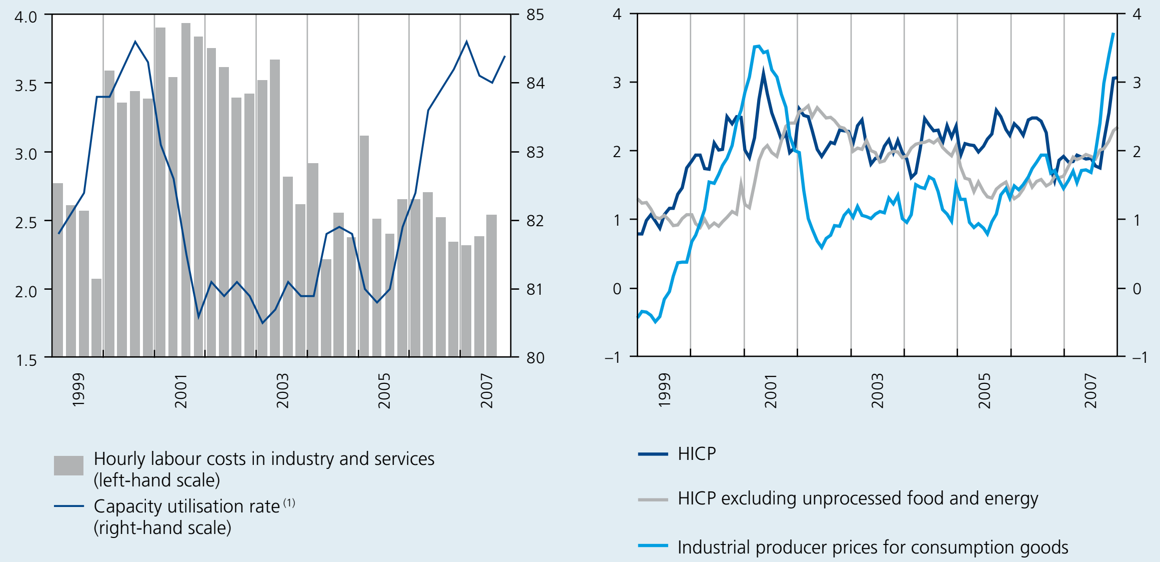
(annual percentage changes)

	Projections for 2007				Projections for 2008			
	1st quarter 2007	2nd quarter 2007	3rd quarter 2007	4th quarter 2007	1st quarter 2007	2nd quarter 2007	3rd quarter 2007	4th quarter 2007
GDP (volume)								
EC	2.4	2.6	2.5	2.6	–	2.5	2.5	2.2
IMF	–	2.3	–	2.5	–	2.3	–	2.1
OECD (1)	–	2.7	–	2.6	–	2.3	–	1.9
Consensus Economics (2)	2.1	2.5	2.6	2.6	2.1	2.2	2.2	2.0
SPF (3)	2.1	2.5	2.7	2.6	2.1	2.3	2.3	2.1
Eurosystem	[2.1 – 2.9]	[2.3 – 2.9]	[2.2 – 2.8]	[2.4 – 2.8]	[1.9 – 2.9]	[1.8 – 2.8]	[1.8 – 2.8]	[1.5 – 2.5]
Inflation								
EC	1.8	1.9	2.0	2.0	–	1.9	1.9	2.1
IMF	–	2.0	–	2.0	–	2.0	–	2.0
OECD (1)	–	2.0	–	2.2	–	2.0	–	2.2
Consensus Economics (2)	2.0	1.9	2.0	2.0	1.9	1.9	2.0	2.1
SPF (3)	2.0	1.9	2.0	2.0	1.9	1.9	2.0	2.0
Eurosystem	[1.5 – 2.1]	[1.8 – 2.2]	[1.9 – 2.1]	[2.0 – 2.2]	[1.3 – 2.5]	[1.4 – 2.6]	[1.5 – 2.5]	[2.0 – 3.0]

Sources: EC, IMF, OECD, Consensus Economics, ECB.
(1) Excluding Slovenia.
(2) Averages of forecasts produced by a panel of financial sector experts.
(3) ECB survey of professional forecasters.

CHART 16 INDICATORS OF INFLATIONARY PRESSURE IN THE EURO AREA

(percentage changes compared to the corresponding period of the previous year, unless otherwise stated)



Source : EC.

(1) Measured by the quarterly survey of firms in manufacturing industry in the euro area.

indicated that inflation was highly likely to remain below the 2 p.c. mark until the end of the summer, owing to significant, favourable base effects resulting from the rapid rise in the price of Brent per barrel during the first three quarters of 2006 and the subsequent reduction in that level up to August 2007. On average, inflation thus stood at 1.9 p.c. during the first seven months. In addition, underlying inflation, which hovered around that same level during the same period, remained relatively moderate, although it had accelerated in January, the main reason being the adjustments to indirect taxation in the largest country of the euro area. In fact, the movement in hourly labour costs remained limited overall, suggesting that wage moderation was persisting in the euro area as a result of globalisation and the structural reforms implemented on the labour market in many Member States.

Despite the relatively favourable inflation profile at the beginning of the year, the Governing Council exhibited concern about the outlook for inflation. Some international organisations and the Eurosystem made a slight upward adjustment to their inflation projections for 2007 and 2008 during the second quarter. The Governing Council also drew attention to the existence of upside risks. It feared increases in oil prices, indirect taxes and a series of regulated prices. Furthermore, stronger wage pressure could not be ruled out, particularly in a context in which vigorous economic growth and the accompanying improvement in labour market conditions were rapidly using up the residual production capacity. Moreover, inflation expectations measured by the implied five-year forward break-even inflation rate five years ahead, derived from indexed bonds, increased slightly to an average of 2.29 p.c. in July, compared to 2.19 p.c. in January.

The presence of upside risks to inflation was borne out by monetary analysis. The expansion of the broad aggregate M3 in fact continued to gather speed during the first seven months of 2007, with growth averaging 10.5 p.c. compared to 8.4 p.c. in 2006 ; that represents by far the strongest expansion since the start of the third stage of EMU. The Governing Council attributed this dynamism primarily to the vigour of economic activity and to the low level of short-term interest rates over an extended period. Nonetheless, it emphasised that, despite accelerating expansion of M3, the increase in the ECB's key interest rates had still exerted an influence on monetary developments in the form of substitution between the various components of M3 and some moderation of lending.

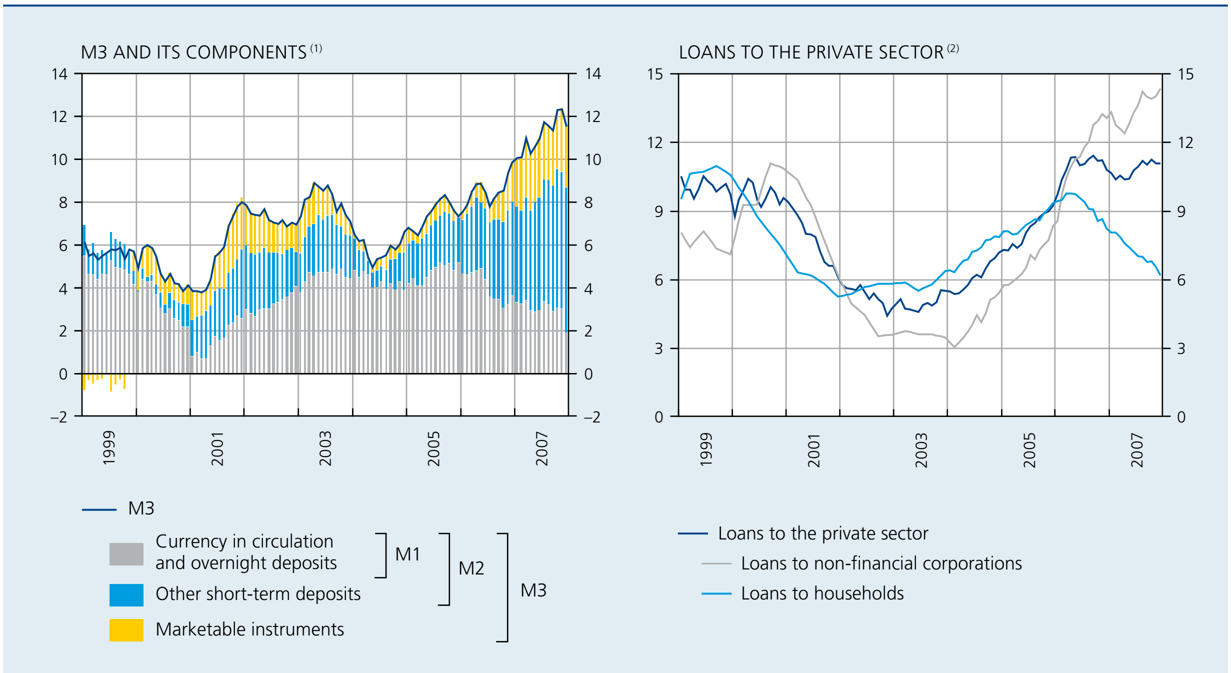
Thus, the rise in short-term interest rates enhanced the attraction of term deposits at up to two years, to the detriment of overnight deposits and deposits redeemable at notice of up to three months. Since the remuneration of term deposits generally mirrors very closely the movement in market interest rates, a growing discrepancy between the remuneration of those assets developed as the monetary authorities progressively increased the cost of borrowing.

In addition, the Council indicated during the second quarter that, in the short term, monetary developments were affected by specific factors, and more precisely by portfolio movements, which made it fairly difficult to interpret them, especially in real time (for more details, see box 5). Thus, the relatively flat yield curve encouraged the holding of short-term financial assets included in M3, to the detriment of longer-dated assets. The dynamism of M3 was also stimulated by the net external position of financial intermediaries, reflecting the positive sentiment of investors regarding the financial assets of the euro area, mainly on account of the diverging economic growth prospects between the euro area and the United States. Despite these developments, the Council stood by its view that the underlying growth rate of the money supply remained strong and therefore implied upside risks to price stability.

The Council also expressed particular concern about lending to the private sector which, despite moderating slightly as a result of the progressive increases in the key interest rates, was still growing very strongly. Thus, the expansion of lending to the private sector declined from 10.9 p.c. in 2006 to 10.6 p.c. in the first seven months of 2007. This slight deceleration concealed contrasting movements. The year-on-year rise in lending to households continued the downward movement that had begun in mid 2006, dropping from 9.3 p.c. in 2006 to 7.7 p.c. in the first seven months of the year. This reduction was due essentially to the slackening pace of property price rises and activity in the real estate sector in many euro area countries, and to a gradual increase in interest rates on loans granted to households. Conversely, the annual growth rate of lending to non-financial corporations accelerated further to reach an extremely high average level of 12.9 p.c. in the first seven months, against 11.3 p.c. in the previous year. The generally favourable financing conditions, vigorous economic activity and investment, and the funding need for mergers and acquisitions are the main factors fuelling the strong demand for loans from non-financial corporations. On the credit supply side, lending criteria remained favourable overall, partly as a result of the more widespread practice of securitisation on the part of the banks, and the revival of interest in syndicated loans.

In response to the upside risks to medium-term price stability identified by its economic and monetary analysis, the Governing Council preferred the Eurosystem's key interest

CHART 17 MONETARY AGGREGATES AND LOANS TO THE PRIVATE SECTOR



Source : ECB.
(1) Data adjusted for seasonal and calendar effects; contribution to the change in M3 compared to the corresponding month of the previous year, percentage points.
(2) Percentage changes compared to the corresponding month of the previous year.

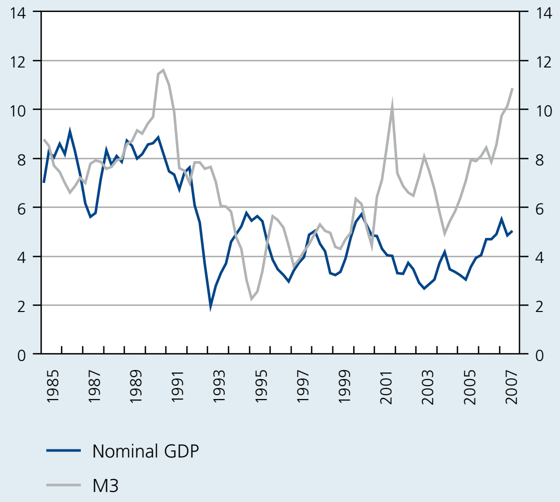
rates to maintain an upward trend in the first seven months. The Council considered it appropriate to increase the minimum bid rate of the main refinancing operations by 25 basis points on two occasions, namely 8 March and 6 June, thus increasing that rate from 3.50 p.c. at the beginning of the year to 4 p.c. It continued to believe that the monetary policy stance remained accommodating. However, there was some change in the exact definition of this term as the key rates were raised. Thus, whereas at the beginning of the year that definition had been based mainly on the – initially low and subsequently modest – level of interest rates, the Governing Council later placed more emphasis on the favourable character of general financing conditions. This change in the ECB Governing Council's communication was intended gradually to signal that the monetary policy stance was becoming less accommodating as the key interest rates were raised. However, the fact that the Council continued to mention that monetary policy remained accommodating suggested that it was inclined to pursue the cycle of interest rate increases if its reference scenario for future economic activity and inflation materialised. In fact, despite the two successive increases in March and June, the markets still expected the key interest rates to be raised further. This factor also helps to explain why long-term interest rates increased during the first half of the year.

Box 5 – Relevance of monetary analysis

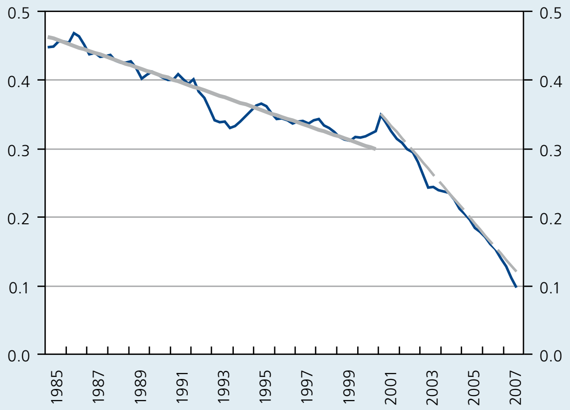
The ECB's monetary policy strategy is based on an analytical framework comprising two pillars, namely economic analysis and monetary analysis. The former aims to assess economic and financial developments and their risks to price stability. The latter originates from the fact that historical observations tend to show a close link between fundamental inflationary trends and the growth of the money supply. The monetary analysis aims to assess the fluctuations in the money supply, lending and their respective components, and to investigate the relevant signals for the longer-term trend in inflation.

DEMAND FOR TRANSACTION PURPOSES, MONEY SUPPLY AND VELOCITY OF M3 IN THE EURO AREA

M3 AND DEMAND FOR TRANSACTION PURPOSES
(percentage changes compared to the corresponding period of the previous year)



VELOCITY OF M3 (= GDP/M3)
(logarithmic scale)



Sources : ECB, NBB.

It is generally acknowledged that abnormally strong growth of the money supply eventually leads to accelerating inflation. However, the accuracy of this premise depends very much on the stability of demand for money. Since 2001, there has been strong monetary growth without any notable increase in inflation. Moreover, since the expansion of activity has deviated little from its trend rate, nominal GDP growth has remained below that of M3. Overall, this has accelerated the downward trend in the velocity of M3. In practice, that has been declining for many years, notably because financial wealth tends to rise faster than GDP, and also as a result of financial innovations. From the monetary policy angle, however, it is important to know the factors which have recently tended to slow down the velocity still further. This box identifies three potential factors.

First, the slower velocity may be due to a structural change in demand for money. That would mean that the slowing is permanent and that the strong growth of the money supply does not herald accelerating inflation. Second, the deceleration may also be due to ephemeral shocks affecting money demand. Those shocks imply that the economic agents temporarily wish to hold more money than they need purely for transaction purposes, given the current short-term interest rates, e.g. following portfolio reallocations designed to replace non-monetary assets with monetary assets. The fact that portfolio considerations then account for the accelerating growth of M3 is precisely why it is unlikely that the increased liquidity is being used to finance transactions, and why the upside risks to price stability are probably limited. Third, the vigorous growth of the money supply may indicate surplus liquidity, resulting for example from the low level of interest rates, as this reduces the opportunity costs of holding monetary assets. The probability of such a surplus being used for transaction purposes is much higher, and – since the factors relating to aggregate demand may influence economic activity in the short term, but not in the long term – the main effect of that increased liquidity will ultimately be to drive up inflation. In that case, the strong monetary growth will normally be accompanied by a rapid expansion of lending. A marked increase in transactional money therefore points to the existence of upside risks to price stability.

The changes seen in M3 and its velocity may, of course, be due to a combination of several of these factors. The theory of a structural break cannot be ruled out. It could be due to a change in behaviour caused by the new environment of price stability and low interest rates. A series of shocks affecting money demand can also be identified. Thus, between 2001 and 2003, given the heightened uncertainty on the financial markets, international portfolios underwent major adjustments for the purpose of replacing financial assets offering uncertain returns with more liquid, more secure assets forming part of M3. On the MFI balance sheet, these adjustments were accompanied by an increase in net external assets, as the non-financial sector liquidated its foreign exchange investments, so that the substantial growth of the money supply was not accompanied by strong expansion of lending during that period. Conversely, since 2007, the flat structure of interest rates seems to have prompted portfolio reallocations which have stimulated strong monetary growth, since short-term investments – some of which make up M3 – have become attractive. It should also be noted that assets presenting a low risk profile proved more tempting during the second half of the year, owing to the financial market turmoil. Furthermore, the analysis of lending growth is complicated by the possibility that the figures recorded may have been partially inflated by the re-intermediation of loans which were formerly securitised.

Since it is not easy to determine in real time the extent to which money demand is dictated by a transaction motive – it is mainly this type of money demand that has implications for price stability – the monetary analysis is only one of the elements, albeit an important one, forming the basis of the monetary policy decisions adopted by the Governing Council. Thus, the latter stressed that temporary factors were affecting the dynamism of M3, even though the increase in the key interest rate was beginning to produce effects. The Council nevertheless continued to reiterate during the year under review that the underlying dynamism of the money supply and lending was strong, indicating upside risks to price stability.

The monetary analysis may also permit identification of periods of financial instability or of excessive asset price rises. The identification of these periods at an early stage may prove valuable for monetary policy in order to safeguard financial stability and, more indirectly, to limit the potentially damaging effects that a subsequent fall in asset prices might have on economic activity, inflation and other economic fundamentals. The fact that the bursting of the financial bubble on the stock market at the beginning of the 21st century and, more recently, the crisis on the US housing market both had serious consequences for financial markets in general is sufficient indication of the significance of excessive fluctuations in asset prices for financial stability, and more generally for the economy. A debate has already been in progress for some time on whether monetary policy should respond (pro)actively to strong asset price fluctuations. No consensus has emerged as yet. However, before any decision on whether or not it is appropriate to take account of asset prices in conducting monetary policy, suitable instruments are needed for early identification of an excessive rise in asset prices. Monetary analysis can make a contribution here.

Various studies (1) have tried to answer the question whether or not the movements in the money supply and lending herald an excessive increase in asset prices. Thus, Borio and Lowe (2002 ; 2004) showed that sustained and persistent growth of lending combined with strong increases in asset prices considerably heightens the risk of a period of financial instability or a banking crisis. Detken and Smets (2004), and Adalid and Detken (2007), also highlighted the importance of the growth of the money supply and lending as effective indicators for making an early distinction between bubbles which are harmful (measured by the subsequent decline in the volume of GDP) and those which are less so. The (real) growth of the money supply is much stronger before the emergence of a harmful bubble, and the expansion of lending is much more sustained during these episodes of rising asset prices. Bruggeman (2007) examined the periods of excess liquidity and tried to determine whether they were followed by a surge in asset prices. It was found that periods of excess liquidity, featuring strong growth of lending and GDP, low interest rates and moderate inflation, are clear signs of a greater risk of an asset price boom.

(1) Sources quoted in the box : Adalid R. and C. Detken (2007), *Liquidity shock and asset price boom/bust cycles*, ECB, Working paper 732 ; Borio C. and P. Lowe (2002), *Asset prices, financial and monetary stability : exploring the nexus,* BIS, Working paper 114 ; Borio C. and P. Lowe (2004), *Securing sustainable price stability : should credit come back from the wilderness ?,* BIS, Working paper 157 ; Bruggeman A. (2007), *Can excess liquidity signal an asset price boom ?,* NBB, Working paper 117 ; Detken C. and F. Smets (2004), *Asset price booms and monetary policy,* ECB, Working paper 364.

August – December 2007 : financial market turmoil

From August onwards, the financial market turmoil described above obliged the Governing Council to assess the implications not only for liquidity management on the money market but also for the monetary policy stance, and more particularly for the path of the key interest rates. In the wake of those tensions, there was a widespread tightening of monetary and financial conditions. The loss of confidence in securities backed by American subprime mortgages, which very quickly spread to other markets, drove up the risk premium incorporated in financial assets. Also, taking account of the growing concern over the situation across the Atlantic, the euro appreciated considerably against the dollar in the second half of the year. After reaching an all-time record of 1.49 on 21 November, the euro was trading at 1.47 dollars at the end of the year. Finally, in view of the situation on the financial markets, the confidence of the economic agents began to deteriorate in all economic sectors, while still remaining at a high level.

These developments, which coincided with a substantial rise in the cost of petroleum products and food, cast a shadow over the outlook for economic growth in the euro area, though their impact was difficult to quantify. Since September, numerous international bodies have progressively downgraded their projections for economic growth in 2008, while the forecast for growth in 2007 remained broadly unchanged overall. However, the Governing Council considered that the fundamentals of euro area economic growth remained sound since, in a global context, world growth was driven by the emerging countries and may become decoupled from the American cycle. Nevertheless, the Governing Council took the view that the financial market volatility and the repricing of market risks had significantly increased the uncertainty over the outlook for the expansion of activity in the short and medium term. In general, it considered that the risks surrounding that outlook were more on the downside. Thus, it believed that if the downturn in activity in the United States became worse, it might have a greater adverse effect on foreign demand for the euro area and further heighten the financial market volatility. In addition, there was the risk of a continuing appreciation of the euro. On the domestic demand side, consumption was liable to be impaired by the high prices of petroleum products and food, if these continued to rise, while investment might be affected by a tighter than expected squeeze on financing conditions.

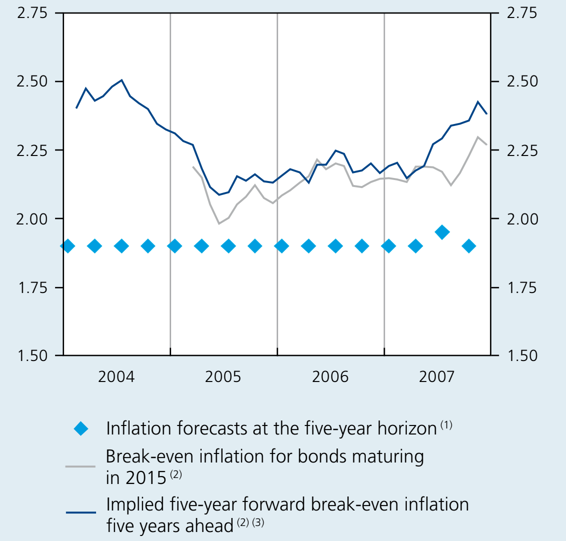
During this period, GDP growth of 0.3 p.c. was announced for the second quarter. However, the Council explained that this figure most likely reflected the volatility intrinsic in the quarterly GDP growth rates, and that it expected a rebound in the second half year, with a growth rate hovering around its potential level. That is in fact what happened: the initial GDP growth estimates for the third quarter indicated a jump to 0.7 p.c., due mainly to the vigour of domestic demand. This result suggested that the upheaval on the financial markets had not so far had any real impact on the economic activity of the euro area.

Regarding the movement in prices, in the first half year the Council already considered that adverse base effects would drive inflation beyond the 2 p.c. mark from the end of the summer. The sharp rise in the cost of petroleum products and food commodities, though restrained by the appreciation of the euro, still pushed inflation to levels well above those originally predicted. These tensions became particularly acute towards the end of the year. Thus, inflation increased from 1.7 p.c. in August to 3.1 p.c. in December. Underlying inflation also tended to rise, reaching 2.3 p.c. in December against 2 p.c. in August, since it includes the price of processed foods. These commodity market developments were also at the root of the upward revisions in the inflation forecast, primarily for 2008. This upward revision was particularly pronounced for the Eurosystem's projection exercise, the results of which were published in December, since it was possible to take account of additional information. Moreover, the Council considered that there were still serious risks to medium-term price stability, including in particular those connected with the persistent increases in commodity prices and the possibility of large increases in labour costs. In this context, at its 6 December meeting it stressed the importance of eliminating any indexation scheme linking nominal wages to prices.

However, these fears about the emergence of contagion – or 'second-round' – effects did not materialise during the second half of 2007, as the movement in labour costs remained modest overall. Yet long-term inflation expectations continued to rise. Thus, the implied five-year break-even inflation rate five years ahead, derived from indexed bonds, recorded a 9 point rise during the second part of the year, from an average of 2.29 p.c. in July to 2.38 p.c. in December. However, this rise may also partly reflect an increase in the inflation risk premium. Moreover, inflation

CHART 18 INFLATION EXPECTATIONS IN THE EURO AREA

(percentage changes compared to the corresponding period of the previous year)



Sources: SPF, ECB.
(1) ECB survey of professional forecasters.
(2) Break-even inflation corresponds to the difference between nominal government bond yields and yields on indexed government bonds. Seasonally adjusted data.
(3) Estimates based on the term structure of break-even inflation. Seasonally adjusted data.

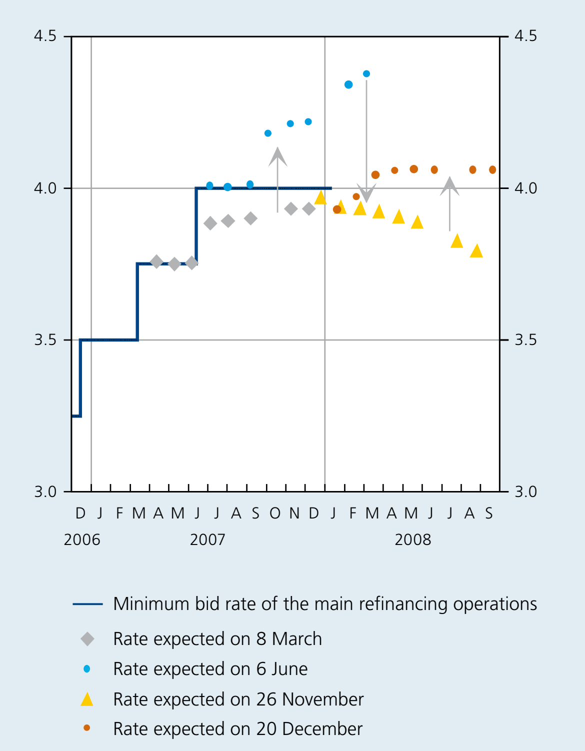
expectations at the five-year horizon as measured by the ECB's quarterly survey of professional forecasters were slightly higher in the third quarter, though they later subsided to the level recorded in the four preceding years, namely 1.9 p.c. Apart from the rise in expectations, the inflation perception of consumers – measured by an EC survey – recorded a considerable jump at the end of the year, thus reflecting the notable rise in inflation.

During the second part of the year, the Governing Council continued to take the view that the monetary analysis revealed upside risks to price stability in the medium term, and thus confirmed the signals given by the economic analysis. The Council stated that the underlying growth of the monetary aggregates and lending was extremely vigorous, but nevertheless considered that temporary factors were fuelling the strong growth of these aggregates and their counterparts. Thus, the flattening of the yield curve continued to hamper the interpretation of the signals provided by monetary analysis. Moreover, the Council considered that the financial market turmoil could have had a considerable influence on monetary developments. It was in fact possible that market participants preferred less risky assets, particularly those included in M3, thus augmenting the expansion of M3. In that context, the

Council took the view that monetary developments could supply relevant information on the reactions and changes in behaviour of financial intermediaries, households and businesses in the face of the financial market volatility. Regarding the counterparties, lending to the private sector remained robust. However, the Council did mention that these developments were difficult to interpret. There was a possibility that this dynamism might reflect re-intermediation of certain finance, returning it to the bank balance sheet, owing to the liquidity crisis which was affecting numerous credit market segments, and more particularly the market in asset-backed securities.

Overall, the Governing Council stated in the second half of the year that the cross-checking of the results of the economic and monetary analyses continued to confirm the existence of upside risks to price stability in the medium to long term. At the same time, it emphasised that the financial market volatility and the repricing of risk by market participants had considerably heightened the uncertainty. In the light of that uncertainty, the Council considered it wise not to adjust the key interest rates. Initially, it stressed the crucial importance of obtaining more information in order to be able to draw new conclusions for monetary policy. However, in December, the Council placed more emphasis on the risks to price stability owing to the intensified inflationary pressure at the end of the year, and in that context stressed that it was vital to avoid second-round effects. It also continued to emphasise that it would monitor all developments very closely and that it would take firm and timely action to stave off the upside risks to price stability in the medium term. It is essential that medium- and long-term inflation expectations remain securely anchored at levels compatible with price stability. In the closing months of the year, although it kept the Eurosystem key rates unchanged, the Governing Council continued making gradual adjustments to its communication, particularly in the light of the tightening of global financing conditions. In October, it thus deliberately chose to cease describing its monetary policy stance as accommodating, while still stressing that the economy continued to exhibit strong growth of the money supply and lending, and that risks to price stability persisted.

CHART 19 SHORT-TERM INTEREST RATE EXPECTATIONS IN THE EURO AREA [1]



Sources : Bloomberg, ECB.

(1) Measured by the Eonia one-month forward swap rate, adjusted for the effects of the reserve maintenance period and the average differential between the Eonia and the minimum bid rate on the main refinancing operations.

After the outbreak of the financial turmoil, the financial markets revised downwards their expectations regarding monetary policy. That process was interrupted at the end of the year following the Governing Council meeting of 6 December. This factor, combined with the flight to quality, triggered a sharp fall in long-term interest rates, witness the decline in the German *Bund* yield, down from 4.6 p.c. in June to 4.24 p.c. in December.

Monetary and financial conditions

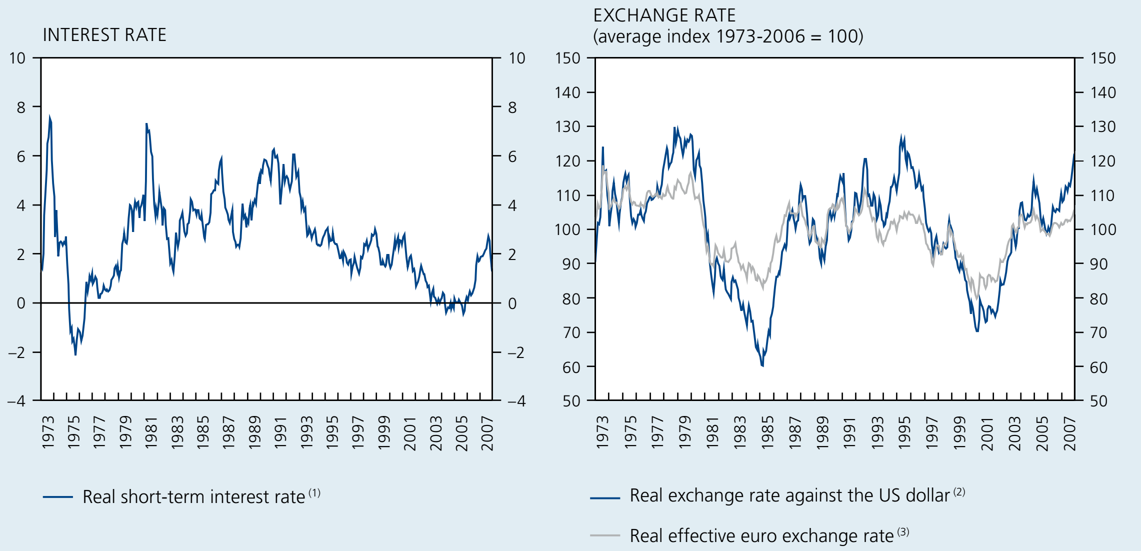
MONETARY CONDITIONS

During the year under review, monetary conditions tightened somewhat in the euro area. The real short-term interest rate continued the rise which had begun at the end of 2005. This movement essentially reflects the gradual increase in the Eurosystem's key interest rates, and was reinforced by the money market turmoil and, more specifically, by the increase in the risk premium comprised in the three-month rates on the unsecured interbank market (Euribor) during the second half of the year. However, when viewed in a historical perspective, real interest rates remained relatively modest.

The year 2007 also brought major developments on the foreign exchange market and in particular a sharp rise in the real euro exchange rate, thus reinforcing the movement recorded by real interest rates. After appreciating

CHART 20 INDICATORS RELATING TO MONETARY CONDITIONS IN THE EURO AREA

(monthly data)



Sources: BIS, OECD, Thomson Financial Datastream, ECB.

(1) Nominal three-month interest rate on the interbank market in Germany (1973-1998) and in the euro area (1999-2007) minus the percentage annual change in the CPI or, if available, the HICP.

(2) Nominal exchange rate of the German mark (1973-1998) and the euro (1999-2007) against the US dollar, deflated by the ratio between the CPI or, if available, the HICP, in the United States and Germany (1973-1998) or the euro area (1999-2007).

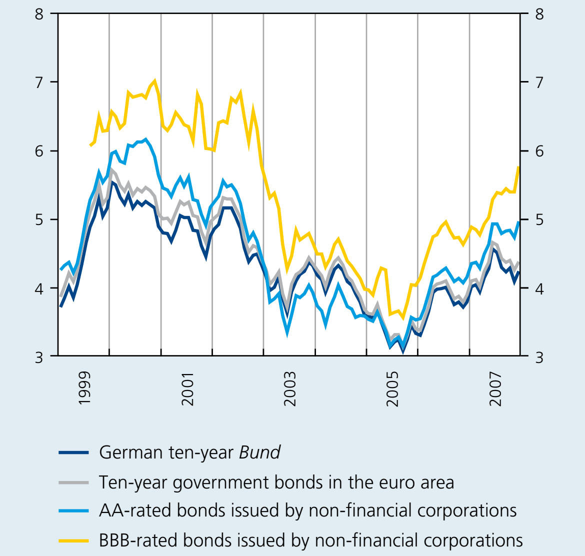
(3) Average exchange rate of the euro against the currencies of thirty OECD member countries and sixteen non-member economies, weighted according to their share of the euro area's foreign trade.

gradually in the first half year, the nominal exchange rate of the euro against the dollar recorded a sharp increase, reaching a new peak at 1.49 on 21 November. Finally, at the end of the year it stood at 1.47, representing a rise of around 12 p.c. since the end of 2006. The divergent growth prospects and the associated monetary policy decisions and expectations were the main factors behind this development. This had a greater impact in the second half of the year, as players made significant downward adjustments to their growth forecasts for the United States, in the wake of the publication of numerous disappointing indicators, particularly for the property market and the labour market. This appreciation is therefore mainly a reflection of the changing fundamentals in the two economies and thus constitutes a rebalancing mechanism, on the one hand in the euro area – particularly via the moderation of inflationary pressure – and on the other hand in the United States, via a reduction in the current account deficit. The real effective exchange rate of the euro also appreciated somewhat, though to a lesser extent, by an average of 2.1 p.c. against 2006.

FINANCIAL CONDITIONS

Long-term interest rates continued rising during the first part of the year. Thus, the yield on the German *Bund* increased from 4.1 p.c. in January to 4.6 p.c. at the end of June. Subsequently, the heightened risk aversion and the associated flight to quality triggered stronger demand for government bonds, causing the yield on the German *Bund* to fall sharply by around 32 basis points from the end of June. In view of a diminished appetite for risk, agents preferred these German securities as they enjoy greater liquidity and a better rating. Consequently, the decline recorded by the government bonds of other sovereign issuers in the euro area was less marked, as is indicated by the smaller 27 basis point fall in the average yield on bonds issued by the Member States. Apart from portfolio reallocations, the downward revision in interest rate expectations caused by the financial market turmoil also encouraged the low yields on long-dated government securities.

CHART 21 LONG-TERM INTEREST RATES IN THE EURO AREA



Source : Thomson Financial Datastream.

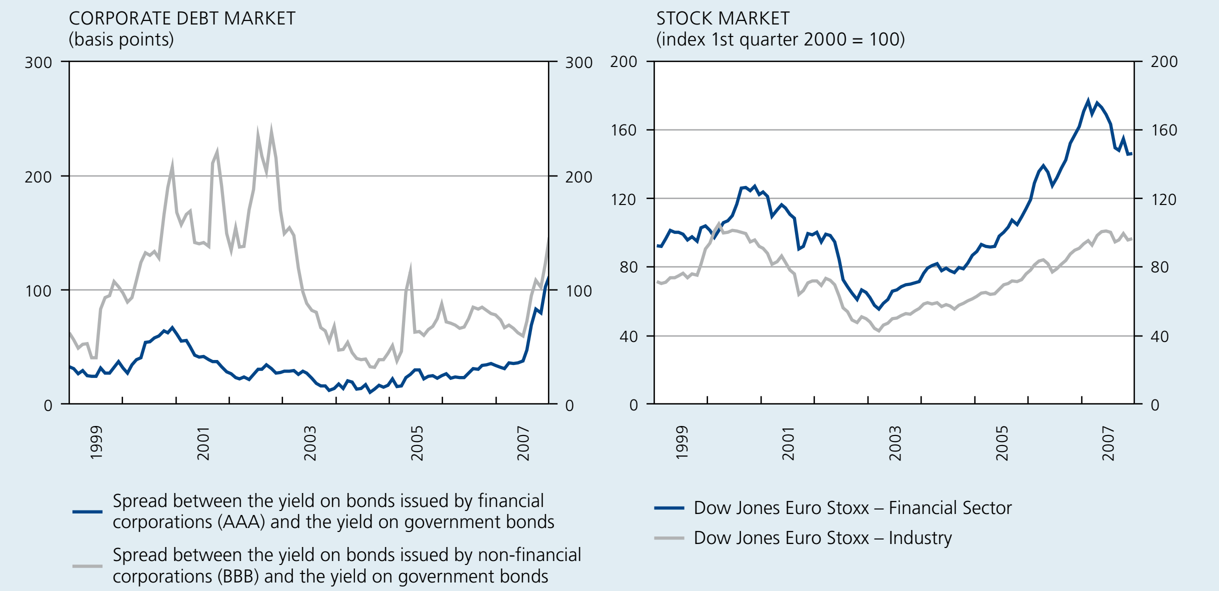
While the financing conditions of non-financial corporations via bond issuance broadly followed the yield on government bonds in the first part of the year, the risk premium incorporated in these loans was subsequently affected by the financial market upheaval. As is usually the case during periods of financial market volatility, poorer quality corporate bonds suffered larger losses than those with a lower credit risk. Thus, the yield on BBB-rated bonds issued by non-financial corporations increased by 48 basis points between June and December, whereas that on AA-rated bonds issued by non-financial corporations increased by 4 basis points.

Stock markets also felt the effects of the reassessment of risk, but on the Dow Jones Euro Stoxx index the correction was small in the case of non-financial corporations. In historical terms, the financing conditions for non-financial corporations on the financial markets remained relatively favourable, particularly in comparison with the period 2000-2002, when the corporate debt market underwent substantial corrections owing to the bursting of the technology bubble and the accounting irregularities which came to light at that time.

However, a distinction should be made between the situation of financial enterprises and that of non-financial corporations. Owing to the greater exposure of financial institutions to structured finance instruments, their financing conditions – and particularly those of the banks – deteriorated considerably as a result of the financial market turmoil. Thus, bonds issued by financial

CHART 22 FINANCING CONDITIONS OF ENTERPRISES ON THE FINANCIAL MARKETS

(monthly averages)



Source : Thomson Financial Datastream.

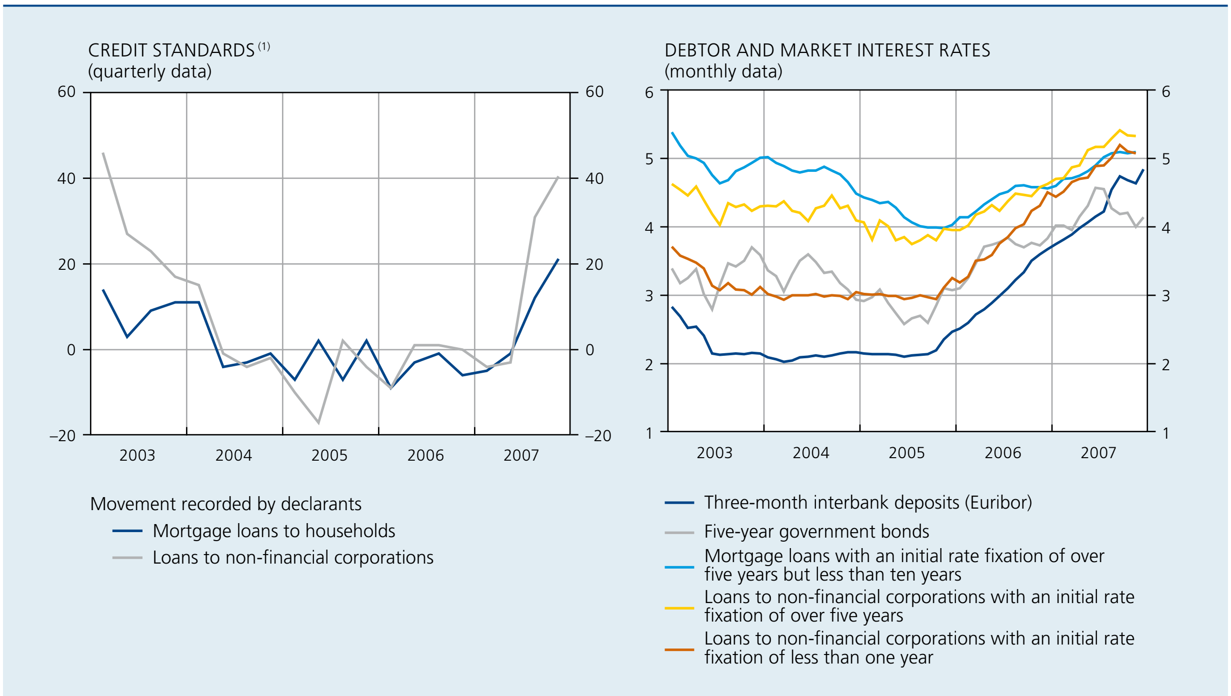
corporations, including those with a high rating, suffered very substantial losses, as is evident from the much larger increase in the interest spread on these fixed-income securities. Moreover, that increase is substantial when viewed in a long-term perspective. The spread between yields on bonds issued by AAA-rated financial corporations and the yield on government bonds widened by 72 basis points to reach 112 basis points in December, compared to an average of 40 basis points in the period 2000-2002. At the same time, the losses recorded by stock market indices for financial assets were considerable, in the order of 13 p.c. between the start of the financial market turbulence and the end of 2007.

In response to the severe tension, credit institutions began tightening the financing conditions applied to their customers. According to the Eurosystem bank lending survey, financial institutions in the euro area reported a significant tightening of financing conditions for non-financial corporations and, to a lesser extent, for households in the third and fourth quarters, in view of the deterioration in their equity capital, their liquidity management problems and the rise in their cost of funding. Worsening expectations regarding general economic activity also contributed to this development. This tightening of credit standards mainly took the form of an increase in margins on both standard loans and riskier loans, reductions in the sums lent, shorter maturities, and more stringent collateral requirements.

Nonetheless, the data on MFI lending rates, available up to November, do not yet confirm these findings. In general, in the second half of the year the banks continued gradually passing on the recent key rate increases in the interest rates on loans to their customers. The interest rate on corporate loans with an initial fixed-interest period of less than one year and on those with an initial fixed-interest period of over five years increased by 19 and 12 basis points respectively in the second half of the year, while the three-month Euribor gained 49 basis points during that same period. For mortgage loans with an initial fixed-interest period of less than one year and those with an initial fixed-interest period of more than five but less than ten years, interest rates increased by 10 and 19 basis points respectively. Also, the decline in long-term rates on government bonds was not passed on in the interest rates which financial institutions applied to their customers.

In general, during the year under review, and more specifically in the second half of the year, monetary and financial conditions tightened in the euro area. However, in historical terms those conditions, except for those applied to

CHART 23 CONDITIONS APPLIED TO BANK LOANS IN THE EURO AREA



Source : ECB.
(1) Net percentage of responses by banks to the Eurosystem bank lending survey, indicating the degree of tightening or easing (–) of the credit standards.

financial corporations, did not appear exceptional at the end of 2007, and they therefore should not significantly curb economic activity. This new environment was taken into account in the discussions of the Governing Council and, as indicated above, was one of the key elements in the changes which it made to its description of the monetary policy stance in October.

Output, expenditure and current transactions in Belgium

3.

3.1 Summary

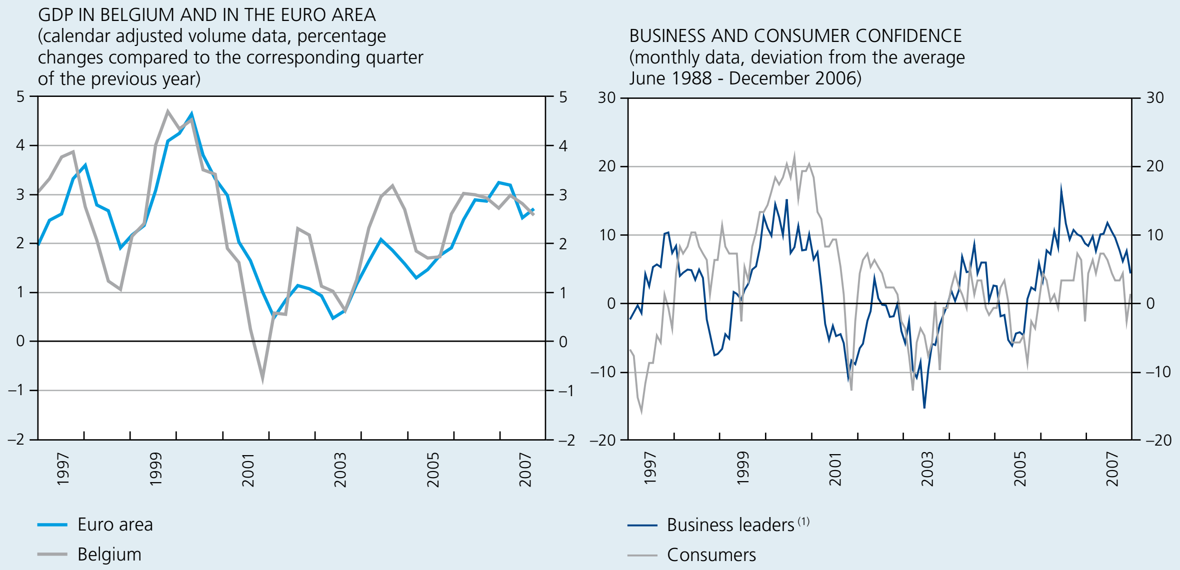
Maintaining the previous year's momentum, activity in Belgium again expanded strongly in 2007. Annual GDP growth came to 2.7 p.c., against 2.9 p.c. in 2006, thus exceeding the economy's potential growth rate for the second year running.

This performance was similar to growth seen in the euro area as a whole, and the contributory factors were the same in both cases. On the one hand, despite the slowdown in America, foreign demand remained robust, and was generated mainly by the economies of Eastern Europe, Asia and the commodity-producing countries. The Belgian economy benefited directly to some extent, via its foreign trade, but also – and to a greater degree – via the effects which the dynamism of those regions had on the foreign trade of Belgium's partner countries in the euro area. Also, in those countries as in Belgium, rising corporate profitability and the labour market improvement observed in recent years gave a significant boost to domestic investment and consumption.

In contrast to previous episodes since the beginning of this century, when periods of economic revival soon ground to a halt, activity has thus continued expanding vigorously for almost two years. However, some loss of momentum was apparent in the second half of 2007, though it was moderate in view of the simultaneous developments in the external environment, namely the turmoil on the financial markets, the sharp appreciation of the euro and the further steep increase in the prices of energy and agricultural commodities. While their effect on the actual pattern of activity and demand was slight,

CHART 24 GDP AND CONFIDENCE IN BELGIUM

(seasonally adjusted data)



Sources : EC, NAI, NBB.
(1) Overall synthetic business survey curve, gross series.

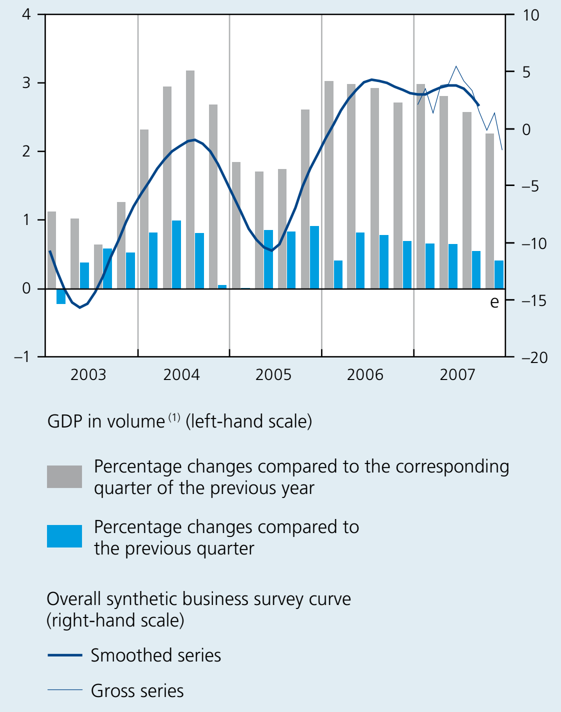
these events primarily created a more uncertain outlook. In particular, the rising inflation dented consumer confidence at the end of the year.

3.2 Activity

Year-on-year real GDP growth came to between 2¾ and 3 p.c. throughout 2006 and in the first half of 2007. It lost a little of its vitality from the third quarter, dropping to 2.3 p.c. at the end of the year. Such a deceleration can be regarded as normal after a period of vigorous activity growth. Moreover, it began before the various shocks originating from the international environment had fully materialised, and those shocks seem to have had very little aggravating effect.

The Bank's business survey indicators bear witness to both the soundness of the economic situation at the start of the year under review and the relatively limited character of the slowdown in the second half. In fact, in contrast to the sharp falls which usually occur following a cyclical peak, the Bank's overall smoothed business survey indicator remained at a high level for quite a while after peaking in July 2006. A fall set in from July, which – according to the gross indicator – continued during the final months of the year, reflecting a deterioration in the business climate in the second half year.

CHART 25 GDP AND BUSINESS SURVEY INDICATOR
(seasonally adjusted data)



Sources : NAI, NBB.
(1) Calendar adjusted data.

This decline was moderate, since the results of the synthetic indicators of the various branches still exceeded their long-term average at the end of the year. It was evident mainly in manufacturing industry and in the business services sector.

In these two branches, it was primarily the demand outlook that became gloomier, as the corresponding indicators fell to a level below their long-term average at the end of 2007. In contrast, although business leaders were less upbeat about actual activity than they had been at the time of the June 2007 peak, their confidence remained above the long-term average level. In industry, capacity utilisation also remained high, corroborating the picture of sustained activity throughout the year. Moreover, in both branches, the prospects for employment remained buoyant, auguring a continuing consolidation of the labour market. In addition, it should be noted that, during the past two years, business confidence has been relatively little affected by the appreciation of the euro, as that has occurred in a context of robust global demand, thanks to the increasingly important position held directly and indirectly by the emerging economies.

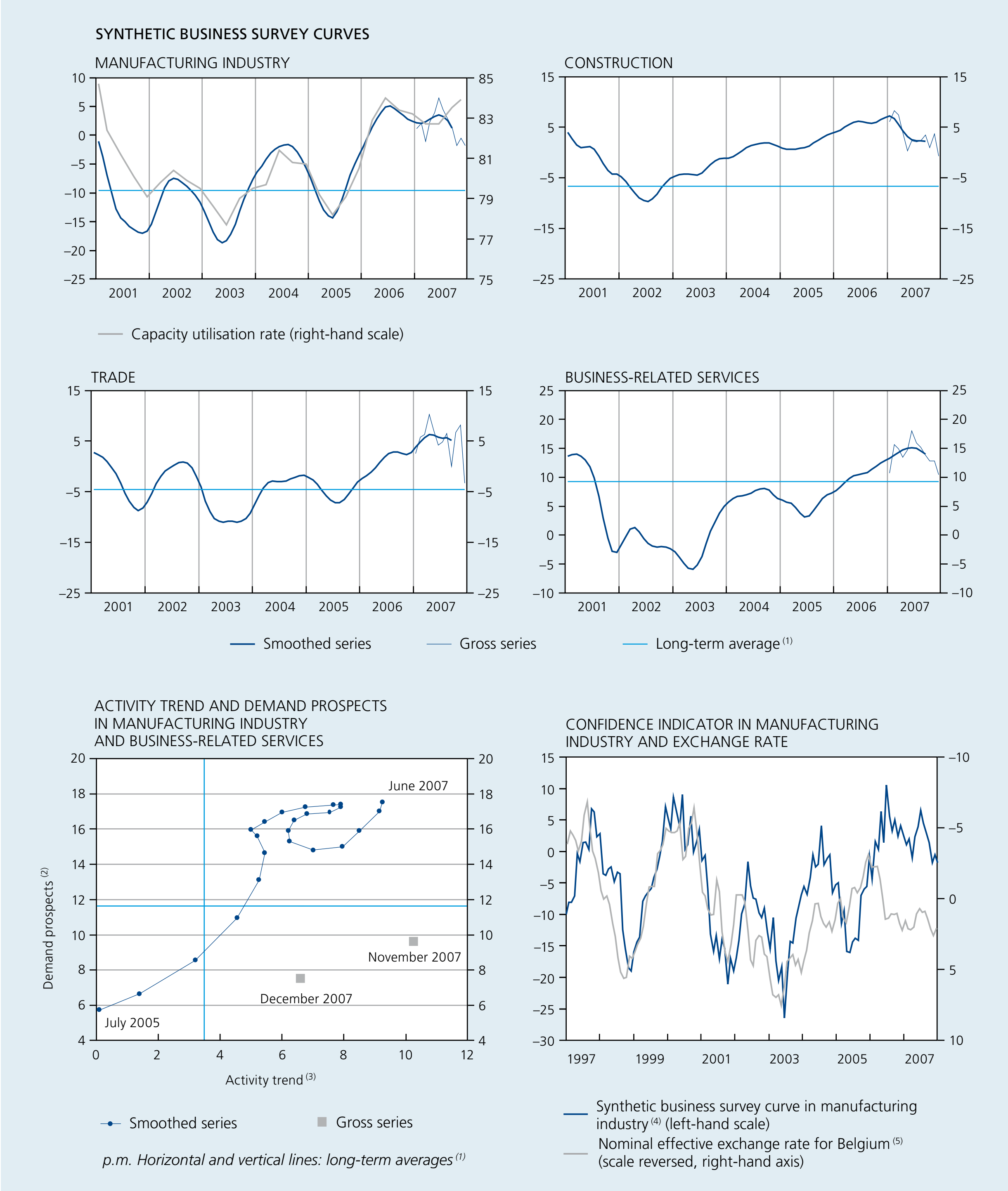
The cyclical slowdown recorded in the second half of the year had relatively little impact on trade. Leaving aside the month-by-month fluctuations, the gross synthetic indicator remained steady at a high level in the second half of 2007. For this branch, too, confidence was bolstered mainly by the favourable trend in the assessment of turnover, while the demand forecasts deteriorated slightly.

Construction presented an atypical cyclical profile compared to the three other main branches of activity covered by the monthly business survey. The sustained recovery which had begun in mid 2002, and had propelled the indicator to a very high level by the end of 2006, gave way to a marked fall in the initial months of 2007. According to the gross figures, the situation stabilised in the second half of the year, in contrast to what happened in industry and business services.

In parallel with the deterioration in confidence, the rate of expansion measured by the national accounts also returned to normal in the construction sector. Following exceptionally strong growth of 9.1 p.c. in 2006, value added rose by a further 4.5 p.c. during the first three

CHART 26 INFORMATION SUPPLIED BY THE BUSINESS SURVEY INDICATORS FOR BELGIUM

(seasonally adjusted monthly data, unless otherwise stated)



Sources : BIS, NBB.

(1) Average of the gross series calculated between the beginning of the business survey (June 1994 for business-related services, January 1980 for the other branches of activity) and December 2006.

(2) Average of the "*demand forecasts*" in manufacturing industry and the "*forecasts of activity*" in business-related services according to the business survey.

(3) Average of responses to the questions in the business survey concerning "*the trend in the production rate*" in manufacturing industry and the "*activity trend*" in business services.

(4) Gross series.

(5) Weighted average exchange rate in relation to fifty countries, including the partner countries of the euro area (excluding Slovenia) and, principally, China, India, Israel, Japan, Poland, South Korea, Sweden, Switzerland, Turkey, the United Kingdom and the United States; gross data, percentage changes compared to the corresponding month of the previous year.

quarters of 2007 compared to the corresponding period of the previous year. This moderating pace of expansion is attributable to the respective increases in mortgage interest rates and building costs, which dampened the residential building segment, as is also evident from the decline in the number of building permits issued compared to 2006. This development was also accompanied by a less steep rise in prices on the secondary housing market. Although its growth slowed down, the construction sector remained the most dynamic branch of activity after agriculture. There is therefore certainly no parallel between this pattern and what was seen in the residential construction sector in the United States, where activity really collapsed.

Thanks to an accelerating rate of expansion at the end of 2006, industrial activity grew by 3.2 p.c. year-on-year in the first three quarters of 2007, a rate comparable to that recorded for 2006 as a whole. Industrial output largely reflected the vigour of the components of domestic expenditure. Thus, following a temporary lull, capacity utilisation in firms producing consumer goods increased during 2007, while in firms producing semi-finished goods, destined mainly for export, it remained stable. At the level of the industrial sub-branches, this was reflected in slight contractions in metalworking and the production of building materials, due respectively to a fall in demand for semi-finished products and the slower expansion of activity in the construction sector.

Services, which represent around three-quarters of value added in Belgium, recorded the lowest growth rate of the main branches of activity. That is attributable to non-market services, whereas market services produced growth at a rate similar to that of industry, on which their activity is largely based. The most sustained expansion was seen in trade, the "transport and communication" branch and business services. Conversely, value added declined in financial institutions and in the hotel and restaurant sector.

TABLE 13 VALUE ADDED IN THE BRANCHES OF ACTIVITY

(calendar adjusted volume data ; percentage changes compared to the previous year, unless otherwise stated)

	p.m. Weight [1]	2003	2004	2005	2006	2007 First three quarters [2]
Agriculture	*0.9*	–7.6	5.2	–5.4	–5.8	4.9
Industry	*19.3*	–1.3	2.9	0.1	3.2	3.2
Construction	*5.1*	1.0	3.9	3.3	9.1	4.5
Services	*74.7*	2.1	1.9	2.5	2.5	2.7
of which : market services [3]	*51.6*	2.4	2.2	3.1	3.1	3.3
Total	***100.0***	**1.3**	**2.2**	**2.0**	**2.9**	**2.8**
p.m. GDP		*1.0*	*2.8*	*2.0*	*2.9*	*2.8*

Source : NAI.
(1) Percentages of total value added in 2006.
(2) Percentage changes compared to the corresponding period in 2006.
(3) Trade and horeca, transport and communication, financial and insurance services, and real estate and business services.

Box 6 – Has the Belgian economy become more resilient?

Since mid 2005, activity in Belgium has been thriving. Average quarterly GDP growth has exceeded the economy's potential growth rate for two years and, after reaching a cyclical peak in mid 2006, the overall synthetic business survey indicator has remained at a persistently high level. The slowdown apparent at the end of 2007 was moderate in view of the substantial shocks – the appreciation of the euro, the rising price of oil and agricultural commodities, and the financial turbulence – facing the economy.

This represents a continuation of the period which began at the end of 2000, in which cyclical slowdowns have been relatively minor. The economy therefore seems to have become more resilient, and that is reflected in higher cumulative growth across the cyclical fluctuations.

This box examines the possibility of improved economic resilience by comparing the cumulative movement in a selection of macroeconomic aggregates over sufficiently long periods, starting with the quarters which, during the past three decades, preceded a marked fall in GDP. In practice, three episodes were thus identified for Belgium, starting in this case in the first quarter of 1980, the first quarter of 1992 and the fourth quarter of 2000.

FINDINGS

Measured over a period of twenty-seven quarters, cumulative GDP growth since the end of 2000 was 2.3 percentage points higher than that recorded after the beginning of 1992, and outstripped the figure recorded from the beginning of the 1980s by an even bigger 7.4 percentage points.

The relatively more sustained expansion during the latest episode is due to the stronger support from domestic demand, while exports displayed a similar pattern to the other periods considered. It was mainly investment in fixed capital by enterprises that exhibited greater dynamism, while private consumption presented a similar picture in all three cases. The developments observed for Belgium since 2000 are also comparable to those for the euro area as a whole. A similar analysis by the EC shows that, for the euro area, too, the strengthening of economic growth originated largely from domestic investment (1).

Even surpassing the gain in terms of economic growth, the most striking feature of the current decade lies in the intensity of job creation. During this period, employment has in fact expanded by 0.5 p.c. for each percentage point of economic growth, whereas between 1992 and 1999 that elasticity was only 0.3. However, this result contrasts most strongly with the period 1980-1987 when employment fell sharply, despite the expansion of activity. The moderate movement in real compensation per employee made a substantial contribution to the expansion in job creation. That in turn underpinned the total wage bill in the economy, leading to consumption growth comparable to that of the other periods considered.

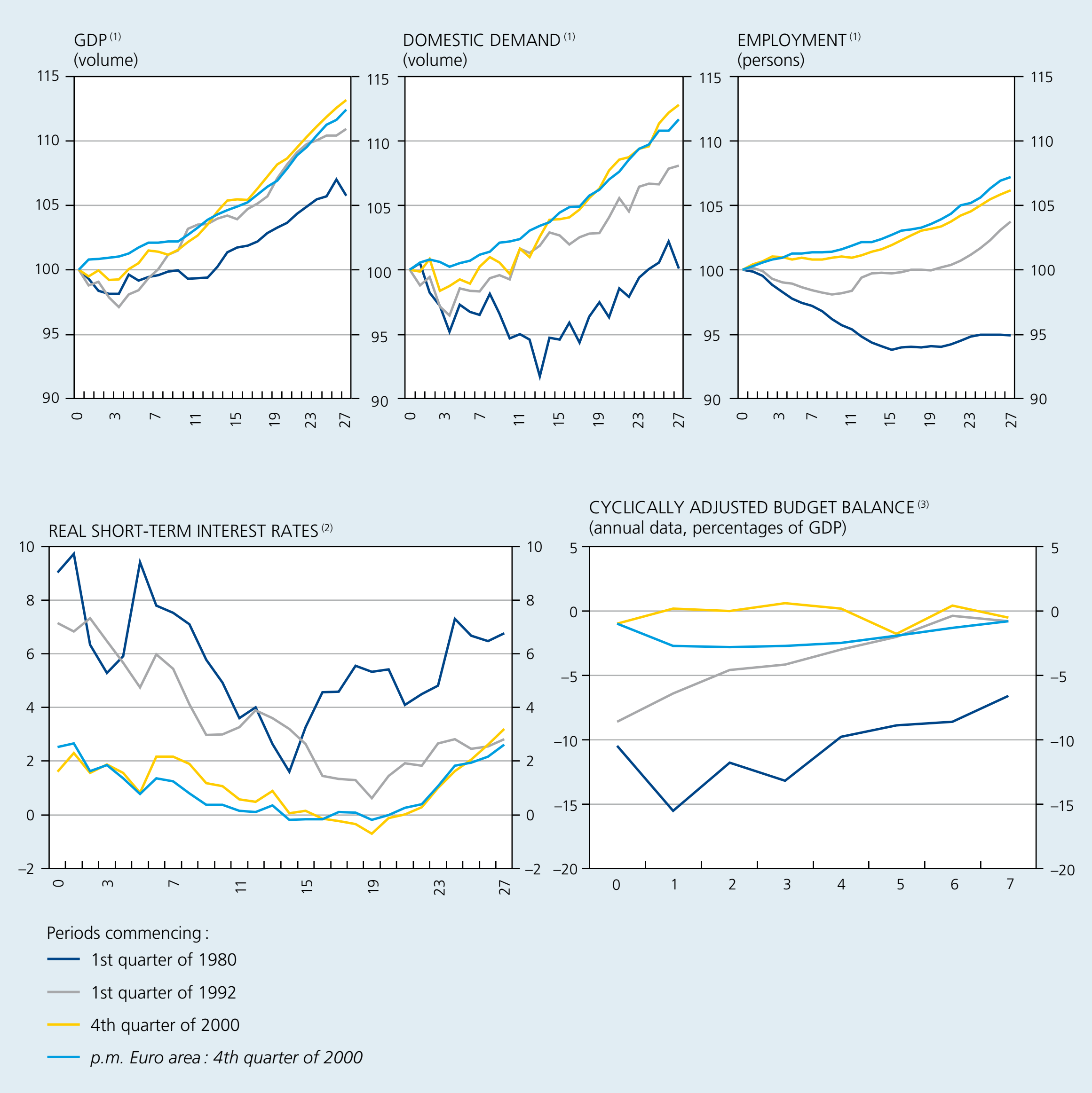
DETERMINANTS

The strengthening of the economic base, attributable in particular to domestic demand, occurred in an environment in which monetary and fiscal policies provided greater support than in the past. On the one hand, the firm anchoring of inflation expectations at a modest level – reflecting the credibility of monetary policy – meant that real interest rates could be kept at low levels, averaging around 1 p.c. since 2000, against 5.7 and 3.6 p.c. in the previous episodes. With the expansion of corporate internal financing capacity, discussed in box 7, the favourable external financing conditions resulting from the low interest rates contributed to the dynamism of investment.

(1) EC (2007), *The resilience of the euro area economy*, Quarterly Report on the Euro Area, III, pp. 30-41.

ECONOMIC DEVELOPMENTS FOLLOWING A CYCLICAL PEAK

(quarterly data, unless otherwise stated)



Sources : EC, NAI, NBB.

(1) Data adjusted for seasonal and calendar effects ; index for the quarter preceding the fall in GDP in Belgium = 100.

(2) Short-term nominal interest rate reduced by the year-on-year percentage change in the national CPI (up to 1996) or the HICP (from 1997).

(3) According to the EC's method of calculation. Periods commencing in 1980, 1992 and 2000 respectively.

Moreover, the budget situation was very different during the last period considered. With a cyclically adjusted budget balance which was practically in equilibrium throughout that period, public finances were much healthier than in the past, and thus helped to support the confidence of economic agents. Conversely, the parlous state of public finances at the beginning of the two preceding periods had forced the public authorities to pursue a restrictive policy, in order to negate the snowball effect of interest charges on the public debt and, in the 1990s, also to enable Belgium to join EMU and in that connection to comply with the stability and growth pact.

Thus, the cyclically adjusted budget balance had improved by 3.9 and 7.8 percentage points of GDP respectively over the periods considered.

Externally, too, the situation was more stable and more conducive to growth. First, Belgium benefited from the strengthening of the euro area as a whole. More generally, the emergence of strongly growing economies in Eastern Europe, Asia and Latin America triggered an acceleration and a rebalancing of global economic growth.

Apart from these factors concerning economic policy and external support, measures designed to improve the efficiency of the labour and product markets and to boost productivity may also have helped to augment the economy's resilience and adaptability. Moreover, the euro area countries where these markets underwent the most in-depth reforms appear to be gaining greater benefit from the dynamism of the global economy.

3.3 Real developments in the main sectors

In 2007, activity in Belgium was buttressed by the vigour of final domestic demand and by the recovery in the volume of foreign sales. Despite the revival of the latter, the contribution of net exports to the expansion of GDP became negative, at 0.2 percentage point. The effect of the change in stocks was neutral, in contrast to the previous year when it had added 0.8 percentage point to growth. Final demand was based on sound economic fundamentals – namely the high level of corporate profitability and a favourable labour market situation – which cushioned the potential effects of the deterioration in the general environment in the second half of 2007.

TABLE 14 GDP AND MAIN CATEGORIES OF EXPENDITURE

(calendar adjusted volume data; percentage changes compared to the previous year, unless otherwise stated)

	2003	2004	2005	2006	2007 e
Final consumption expenditure of individuals	0.7	1.4	1.4	2.1	2.5
Final consumption expenditure of general government	2.1	1.8	–0.2	0.0	2.1
Gross fixed capital formation	–0.3	7.5	6.7	4.2	5.2
Housing	3.6	10.0	10.1	7.4	5.2
Enterprises	–1.8	7.4	4.6	3.9	5.1
General government	1.3	1.9	13.0	–3.2	5.4
p.m. Total final domestic expenditure	*0.9*	*2.7*	*2.1*	*2.0*	*3.0*
Change in stocks (1)	0.0	0.1	0.4	0.8	0.0
Exports of goods and services	2.9	6.3	4.1	2.6	4.6
Imports of goods and services	2.8	6.5	4.9	2.5	5.0
p.m. Net exports of goods and services (1)	*0.2*	*0.2*	*–0.4*	*0.2*	*–0.2*
GDP	1.0	2.8	2.0	2.9	2.7

Sources: NAI, NBB.
(1) Contribution to the change in GDP, percentage points.

Enterprises

Enterprises continued steadily expanding their production capacity, in line with the trend which had begun in 2004. In 2007, their gross fixed capital formation increased by 5.1 p.c. in real terms, following average expansion of 5.3 p.c. from 2004 to 2006. Coming after a period of downward adjustment, following the bursting of the stock market bubble in 2001, this sustained dynamism over the past four years boosted the gross investment ratio, expressed in real terms, from 12.3 p.c. of GDP in 2003 to 13.7 p.c. in 2007. This level is close to the peak attained in 1990, following the wave of investments associated with the creation of the single European market and the opening up of Eastern Europe.

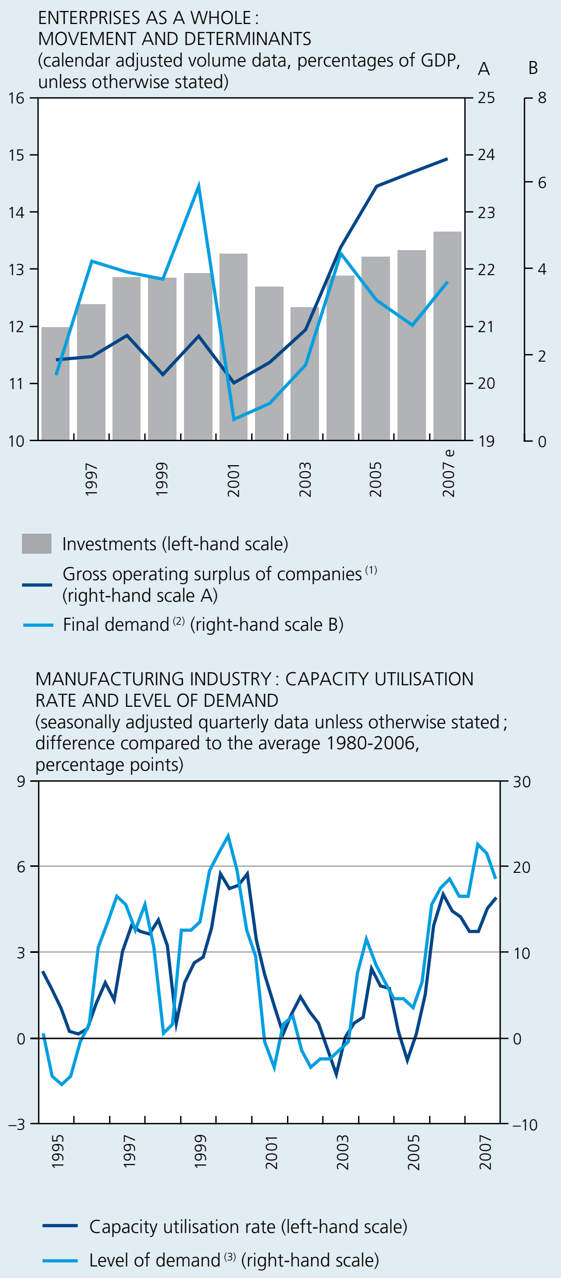
The majority of branches of activity shared in the dynamism of investment. According to the data from the VAT returns, during the first ten months of the year industrial firms on average increased the nominal amount of their gross fixed capital formation by 12.2 p.c. compared to the corresponding period in 2006, whereas non-industrial firms increased it by 13.7 p.c.

Various factors may explain the strong corporate propensity to invest. Thus, the substantial growth of final demand in recent years led to increased capacity utilisation in manufacturing industry. In 2007, it hovered around 83 p.c., as in 2006, whereas from 1980 to 2006 it averaged only 79 p.c. Furthermore, in 2007, barely 46.8 p.c. of companies mentioned insufficient demand as a factor explaining under-utilisation of production capacity in the quarterly business survey conducted by the Bank, whereas an average of 66 p.c. did so during the period 1980-2006. So long as demand prospects remain favourable, high capacity utilisation augments the demand for additional capacity in terms of both labour and capital. Consequently, job creation accelerated and business investment increased.

As regards external financing conditions, the movement was less favourable in 2007 than in the four preceding years. On the one hand, continuing a process which had started in early 2006, credit institutions further increased the rates charged on their lending, in response to the rising long-term interest rates, while the yield differentials on corporate bonds as opposed to government bonds widened considerably from August 2007. Moreover, obtaining finance via the stock markets became more expensive during the year, although on average over the year it was considerably cheaper than in 2006. After maintaining a resolutely upward trend from mid March 2003, in common with other stock markets, the Belgian All Shares Index peaked on 23 May 2007. It subsequently became volatile, but never regained that high level.

Nevertheless, the deterioration in external financing conditions had only a limited impact on investment. In fact, firms benefited from a reduction in the cost of equity financing, owing to the entering into force in 2006 of the notional interest deduction. That measure led to a net inflow of equity capital. In addition, as in previous years,

CHART 27 INVESTMENTS BY ENTERPRISES



Sources : NAI, NBB.
(1) Value data, not calendar adjusted.
(2) Percentage changes compared to the previous year.
(3) Proportion of firms which did not mention a shortage of demand as a factor explaining the under-utilisation of production capacity in the Bank's quarterly survey of manufacturing industry ; data not seasonally adjusted.

the gross operating surplus of companies grew rapidly, and in 2007 was 5.5 p.c. higher in nominal terms than the previous year's figure. This robust growth is due to the stronger expansion of the volume of sales, which regained dynamism on the export side and remained buoyant on the domestic market, and to the 1.2 p.c. increase in the gross operating margin per unit of sales. Costs of domestic origin in fact only recorded a moderate 1.2 p.c. increase, whereas selling prices – mainly export prices – rose by a total of 2.1 p.c.

Since 2002, the annual rate of increase in the income which companies derive from their activity outpaced that of the primary incomes generated by the economy in general: altogether, the share in GDP of the gross operating surplus of companies increased by 3.9 percentage points. This expansion of the main component of the disposable income of companies was reflected in a sharp rise in their financing balance as a percentage of GDP. In fact, while the expansion of gross fixed capital formation was significant in volume terms, it was tempered in nominal terms by the moderate movement in the investment deflator. Moreover, in 2007, companies reduced their stock building, and the net capital transfers which they received were slightly higher, as a percentage of GDP, than they were in 2006. In all, the financing balance of companies came to 3.1 p.c. of GDP, the largest surplus since 1990.

TABLE 15 MAIN COMPONENTS AND DETERMINANTS OF THE GROSS OPERATING SURPLUS OF COMPANIES, AT CURRENT PRICES

	2003	2004	2005	2006	2007 e
Determinants of the gross operating surplus of companies (percentage changes compared to the previous year)					
Gross operating surplus	5.5	12.7	9.2	6.0	5.5
Gross operating margin per unit of sales (1)	3.5	7.3	6.0	2.9	1.2
Unit selling price (1)	–0.2	2.7	3.3	2.9	2.1
On the domestic market (1)	1.9	3.1	2.4	2.2	1.0
Exports	–2.2	2.4	4.1	3.4	3.1
Costs per unit of sales (1)	–0.8	2.0	2.9	2.8	2.3
Imported goods and services	–2.0	2.8	4.4	4.0	2.7
Costs of domestic origin per unit of output (1) (2)	0.4	0.4	0.2	1.3	1.2
of which: unit labour costs	0.2	–0.7	0.9	1.5	2.1
Final sales in volume terms (1)	1.9	5.0	3.0	3.0	4.3
On the domestic market (1)	0.8	3.3	2.5	3.5	3.8
Exports	2.9	6.5	3.6	2.6	4.7
Main components of the companies account (percentages of GDP)					
Gross disposable income					
Gross operating surplus	20.9	22.4	23.4	23.7	23.9
Other components of disposable income (3)	–7.2	–7.7	–8.6	–8.0	–8.2
Uses					
Gross capital formation	12.2	12.9	13.0	13.7	13.6
Capital transfers (4) (5)	0.7 (6)	–0.1	–0.4 (7)	–0.8	–0.9
Financing balance	0.9 (6)	1.9	2.2 (7)	2.7	3.1

Sources: NAI, NBB.
(1) Including changes in stocks.
(2) Apart from compensation of employees, this item covers indirect taxes net of subsidies and gross mixed income of households.
(3) Net property incomes and net current transfers, including changes in the net claims of households on pension funds.
(4) These are net amounts, i.e. the difference between transfers paid to other sectors and those received from other sectors.
(5) Including net acquisitions of non-financial non-produced assets. These comprise, for example, land or patents and goodwill.
(6) Including the capital transfer of 1.8 p.c. of GDP effected by Belgacom in return for the government's assumption of its pension liabilities.
(7) In accordance with the data published by the NAI, excluding the capital transfer of 2.5 p.c. of GDP effected by the Railway Infrastructure Fund (RIF) in favour of the BNRC in respect of the assumption of its debt, as these two entities are part of the non-financial corporations sector. According to Eurostat, the RIF is part of the general government sector, and this debt assumption should be recorded as a capital transfer received by non-financial corporations from the general government sector.

Individuals

In 2007, final consumption expenditure of individuals grew by 2.5 p.c. in real terms, outstripping, as in 2006, the average growth of 1.7 p.c. recorded over the period 1996 to 2005. During the two preceding years, private consumption was sustained by the increase in disposable income.

In 2006, disposable income was boosted mainly by the implementation of the final stage of the tax reform which had begun in 2001, as the increase in current transfers paid by individuals to other sectors, in this case taxes, was well short of the 3.9 p.c. rise in primary incomes. Conversely, in 2007 the increased purchasing power was due mainly to a 4.6 p.c. rise in the gross primary incomes of households, owing to the acceleration of net job creation, and hence the substantial increase in compensation of employees. The incomes of self-employed persons, supported by household demand, and net property incomes also strengthened. In contrast to the situation in 2006, current transfers from households to other sectors increased in 2007 at a rate comparable to that of gross primary incomes, so that the nominal growth of household disposable income slowed down, though remaining strong at 4.5 p.c., against 5.2 p.c. in 2006. However, this deceleration was offset by the fact that inflation, measured by the private consumption deflator, dropped from 2.5 to 2 p.c. Thus, in real terms, disposable income increased by 2.5 p.c. in 2007, following a 2.6 p.c. rise in the previous year.

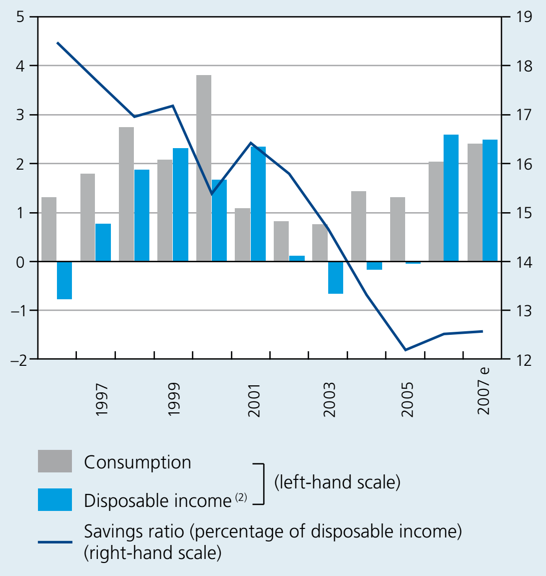
The vigorous growth of household disposable income over the past two years has been reflected in a slight rise in the household savings ratio. After declining almost continuously since 1993, it increased from 12.2 p.c. of disposable income in 2005 to 12.5 p.c. in 2006 and 12.6 p.c. in 2007. This is explained partly by the fact that households tend to smooth their consumption expenditure when faced with large, temporary changes in their real disposable income. Moreover, the high degree of uncertainty prevailing in the second half of the year under review is likely to have dented consumers' confidence, and more specifically their expectations concerning the general economic situation and their ability to save. In such a situation, households tend to reserve part of their additional disposable income in the form of precautionary savings, rather than spending it.

At the same time, investment in housing increased again in 2007, recording a rise of 5.2 p.c. in real terms. In that respect, there was some return to normality after households had stepped up their expenditure on housing construction and renovation by 9.2 p.c. on average in the three preceding years. This cooling was also apparent in the main determinants of investment in housing. On the one hand, the slackening pace of property price rises, which had begun in 2006, became more marked in 2007; also, the interest rates charged on mortgage loans have displayed an upward trend since 2005, having reached an exceptionally low level during that same year.

Despite the slower growth in 2007, investment in housing expressed as a percentage of GDP again grew faster than the savings of individuals, further reducing their financing capacity to 0.3 p.c. of GDP.

CHART 28 CONSUMPTION, DISPOSABLE INCOME AND SAVINGS RATIO OF INDIVIDUALS

(percentage changes in volume compared to the previous year [1], unless otherwise stated)



Sources : NAI, NBB.
(1) Non calendar adjusted data.
(2) Data deflated by the private final consumption expenditure deflator.

TABLE 16 **DETERMINANTS OF THE GROSS DISPOSABLE INCOME OF INDIVIDUALS, AT CURRENT PRICES**

(percentage changes compared to the previous year, unless otherwise stated)

	2003	2004	2005	2006	2007 e	*p.m. 2007 e, billions of euro*
Gross primary income	0.5	2.3	2.8	3.9	4.6	*239.0*
p.m. In real terms [1]	*–1.2*	*–0.3*	*0.0*	*1.4*	*2.5*	
Compensation of employees	2.0	2.8	3.2	4.5	4.5	*169.4*
Number of employees	0.2	0.8	1.2	1.3	1.6	
Compensation per person	1.8	1.9	1.9	3.2	2.9	
Gross operating surplus and gross mixed income	2.0	1.9	2.7	3.6	3.9	*42.5*
of which : income from self-employed activity	3.0	3.4	–0.4	1.6	3.6	*21.8*
Income from movable property [2]	–9.2	–0.2	0.5	0.7	6.6	*27.2*
Current transfers [2]	–1.7	1.9	3.0	–1.4	4.9	*–42.2*
Current transfers received	3.6	3.9	3.6	3.0	3.8	*69.7*
Current transfers paid	1.5	3.2	3.4	1.3	4.2	*111.9*
Gross disposable income	1.0	2.3	2.7	5.2	4.5	*196.8*
p.m. In real terms [1]	*–0.7*	*–0.2*	*–0.1*	*2.6*	*2.5*	
Final consumption expenditure	2.5	4.0	4.1	4.6	4.5	*173.7*
Savings ratio [3]	14.7	13.3	12.2	12.5	12.6	

Sources : NAI, NBB.
(1) Data deflated by the private final consumption expenditure deflator.
(2) These are net amounts, i.e. the difference between incomes or transfers received from other sectors and those paid to other sectors, excluding transfers in kind.
(3) Gross savings, as a percentage of gross disposable income, these two aggregates being taken inclusive of the change in the net claims of households on pension funds.

Box 7 – Financing balance of individuals and companies

Economic activity generates "primary" incomes, which remunerate the factors of production, namely labour and capital. Apart from the net taxes levied directly on production and imports, primary incomes are divided mainly between wages and the gross operating surplus of companies. They also include the gross mixed income of self-employed persons comprising – as the term suggests – the combined remuneration of their labour and the capital which they have mobilised. Despite differences of level, connected mainly with the structure of the economies, the last two decades have seen a downward trend in wages as a percentage of GDP in many countries. This has driven that ratio down to a historically low level, whereas the gross operating surplus of companies reached a peak. A number of recent studies have tried to explain these developments[1]. The two main reasons put forward are technological progress, which has increased the capital intensity of the production process, and the development of the global economy, which has considerably expanded the global labour supply and weakened the workers' bargaining position. Finally, in many European countries the share of wages has also declined as a result of the expansion of the tertiary sector, the average pay in the services branches being generally lower than in industry.

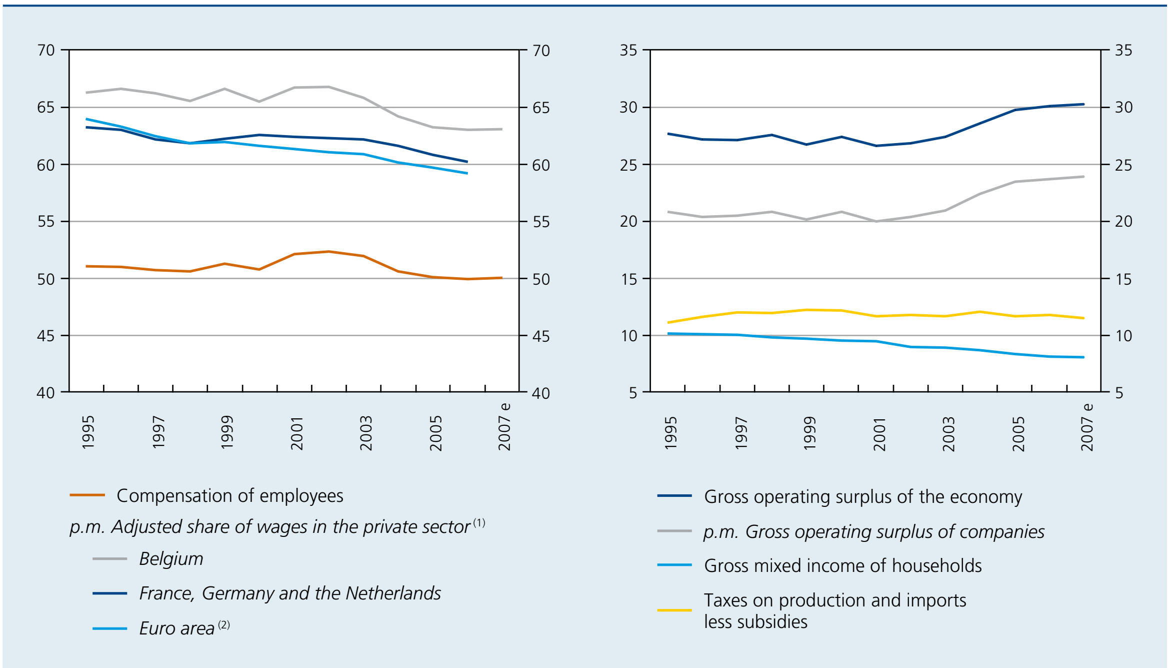
(1) See, for example, EC (2007), *The labour income share in the European Union*, Employment in Europe 2007, pp. 237-272, and IMF (2007), *The globalisation of labor*, World Economic Outlook, April, pp. 161-192.

In that context, this box comments on developments in Belgium concerning the breakdown of the economy's value added among the various income categories. Apart from the analysis of primary incomes, the intention is also to observe the extent to which these developments have been offset by income redistribution between sectors, via property incomes and State intervention, or by changes in the expenditure of the sectors, before possibly being reflected in the financing balances of the latter.

After peaking at 52.4 p.c. of GDP in 2002, compensation of employees increased less rapidly than economic activity, dropping to around 50 p.c. of GDP in 2005, and remaining at that level thereafter. This fall appears all the steeper if the share of wages is adjusted by imputing to self-employed persons a notional wage in compensation for their activity, taking account of the relative decline in their numbers as a percentage of total employment. Apart from that, the reduction in the share of wages in GDP is due mainly to wage moderation, which – via the law on the safeguarding of competitiveness – reflected the low pay rises in Germany. In addition, from 2002 to 2004, firms also carried out restructuring which curbed the expansion of employment. In relation to the euro area and the three main neighbouring countries as a whole, the decline since 2002 in the percentage of GDP represented by wages in Belgium has been relatively large. However, it should be stressed that this decline followed a period of stability whereas, in most other countries, the decline had already begun in the second half of the 1990s. The corollary to these developments lies in the share represented by the economy's gross operating surplus, which increased from 26.8 p.c. of GDP in 2002 to 30.3 p.c. in 2007, this being attributable solely to companies, for which that surplus increased from 20.4 to 23.9 p.c. of GDP. In relation to the other euro area countries, this last

PRIMARY INCOMES OF THE ECONOMY

(percentages of GDP, unless otherwise stated)



Sources : EC, OECD, NAI, NBB.

(1) Compensation of employees in the private sector and estimated notional incomes from activity of self-employed persons, obtained by multiplying their number by the average private sector pay, as a percentage of value added in the private sector.

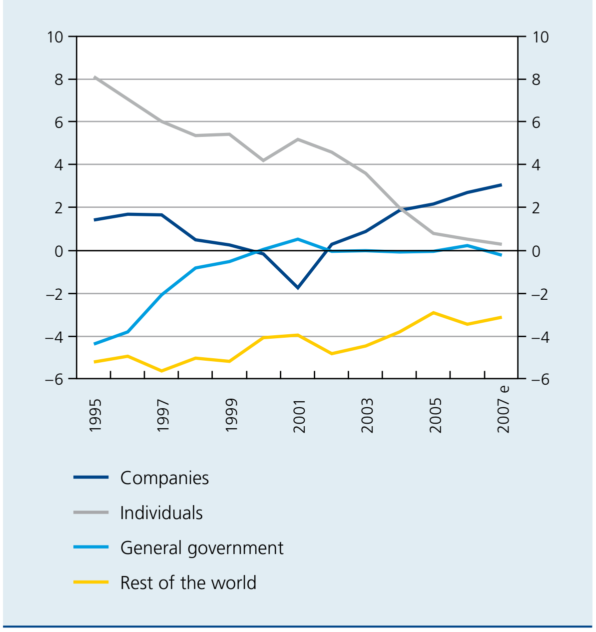
(2) Excluding Slovenia.

rise appears significant. It follows a slight contraction between 1995 and 2002, a period in which the share of the gross operating surplus in GDP remained stable in France and the Netherlands, and increased in Germany.

During the period 2005-2007, the gross disposable income of individuals averaged 59.4 p.c. of GDP, against 63 p.c. in 2002, thus displaying a more marked fall than wages. In terms of gross national income, it dropped from 62.2 to an average of 58.8 p.c. over the past three years. While levies in the form of direct taxes and social contributions declined as a percentage of GDP, that effect was more than offset by the reduction in net property incomes due to the falling interest rates. Although their consumption expenditure also grew by less than GDP between 2002 and 2005, individuals tried to soften somewhat the impact of the slower growth of their disposable income. The very sharp increase in expenditure on housing construction and renovation from 2004 also contributed to the reduction in the financing capacity of individuals, which dropped from 4.6 p.c. of GDP in 2002 to 0.8 p.c. in 2005. In 2006 and 2007, both the gross disposable income and the final consumption expenditure of individuals remained relatively stable in proportion to GDP. However, the sustained growth of their expenditure on investment in housing led to a further fall in their financing capacity, which reached a historically low level of 0.3 p.c. of GDP in 2007.

The gross disposable income of companies as a percentage of GDP came to 16.3 p.c. in 2007, against 12.8 p.c. in 2002, matching the rise in the gross operating surplus. Owing to that rise, firms paid more taxes, amounting to some 15 p.c. of their gross surplus, but this development was offset by the less marked growth of net dividends paid. Also, after consolidating their balance sheet following the bursting of the stock market bubble and the general economic slowdown in 2001, firms stepped up their investment expenditure, including in the form of stocks, from 12.2 p.c. of GDP in 2002 to 13.6 p.c. in 2007. Their financing capacity therefore increased by slightly less, as a percentage of GDP, than their gross disposable income, rising from 0.3 p.c. in 2002 to 3.1 p.c. in 2007.

FINANCING BALANCE OF THE MAIN ECONOMIC SECTORS
(percentages of GDP)



Sources : NAI, NBB.

Following the deterioration between 1997 and 2001, the improvement in the financing capacity of companies during the period 2002-2007 appears significant. It enabled them to consolidate their balance sheet by cutting down their borrowings in relative terms. From the point of view of the economy as a whole, however, this was more than offset by the decline in the financing balance of individuals and, to a much lesser extent, of general government. In all, the financing of the rest of the world by the domestic sectors as a whole dropped from 4.8 p.c. of GDP in 2002 to 3.1 p.c. in 2007, a tendency which is mirrored in the balance of payments figures.

General government

In 2007, the final consumption expenditure of general government increased by 2.1 p.c. in real terms, whereas it had recorded an average rise of 0.5 p.c. from 2004 to 2006. That increase is largely due to the expansion of social benefits in kind, especially health care expenditure, and to that of current purchases of goods and services. Following the particularly modest rise in health care expenditure in 2005 and 2006, the 2007 figure can be regarded as a return to the sustained growth typical of this spending category. In 2007, civil service pay increased by 1.1 p.c. in real terms, a rate comparable to that in the three preceding years.

General government investment expanded by 5.4 p.c. in real terms in 2007, a substantial rise compared to the average growth of 0.1 p.c. recorded from 2001 to 2006. However, this acceleration is due solely to sales of public buildings in 2006, considered according to accounting practice as disinvestment on the part of the general government sector. If these sales are excluded, public investment declined by 6.4 p.c. in 2007, after recording an average rise of 2.1 p.c. from 2001 to 2006. Such a slowdown is not unusual in the year following that of the local council elections – as was the case in 2007 – since local authorities generally cut their investment spending after a strong expansion in the previous year.

Rest of the world

Having been sluggish for much of the year, exports of goods and services strengthened considerably towards the end of 2006 and that trend continued during the year under review. In all, they produced volume growth of 4.6 p.c. in 2007, against 2.6 p.c. in the previous year.

This quickening pace was due to trade in goods from the fourth quarter of 2006, as suggested by the improvement in the business survey indicator relating to the assessment of foreign orders. In the context of the euro's appreciation since early 2006, there was nevertheless some loss of momentum in the second quarter of 2007 owing to the weakening of foreign demand, particularly that from the United States. For the first time since 2001, the euro area's markets expanded as strongly as those of countries outside that zone.

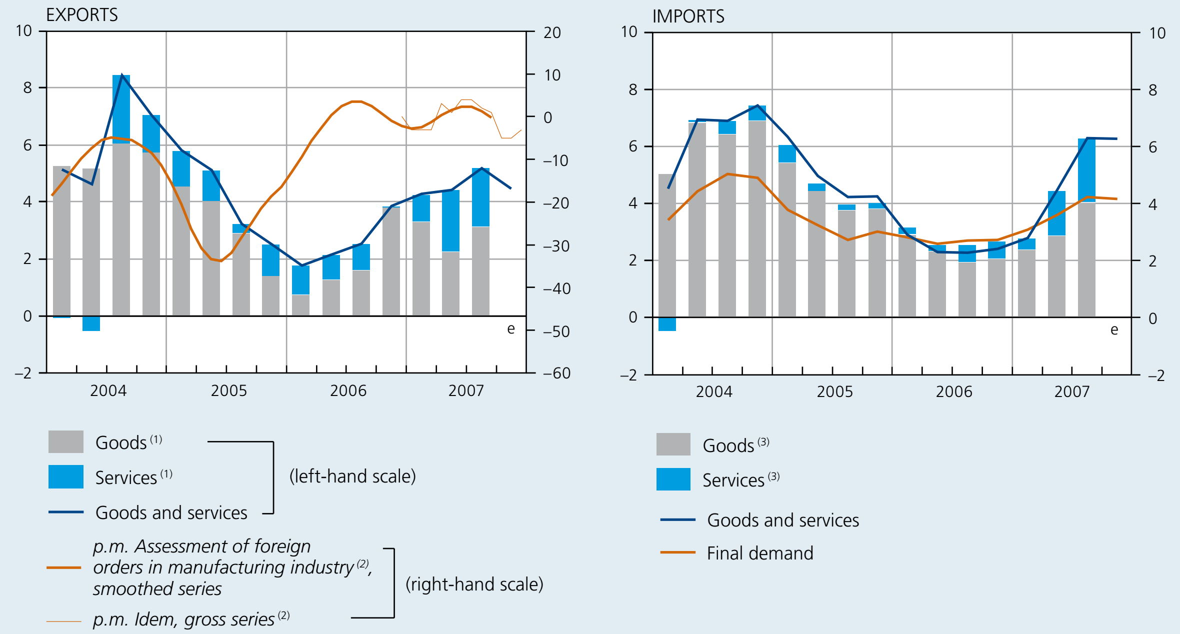
From the beginning of 2007, export growth also derived significant support from transactions recorded under services. In the second quarter, they actually contributed 2.2 percentage points to the 4.4 p.c. growth of total exports compared to the corresponding period of the previous year. Nevertheless, the introduction of a new system of collecting source data for the balance of payments could explain much of the unusually large contribution from services. That new system in fact provides a fuller estimate of international trade in services, in the case of both services provided by Belgian residents to foreign customers and those of foreign service providers in Belgium.

Thus, services also made a substantial contribution to the growth of imports of goods and services, where the acceleration was quite marked, with an increase of 5 p.c. in 2007 against 2.5 p.c. in 2006. They were driven not only by the dynamism of exports but also by the expansion of business investment, these two components of final demand having the largest import content. During the year under review, the contribution of net exports to the volume growth of GDP was therefore negative, at 0.2 percentage point.

However, the decline in the net volume of foreign trade in goods and services was offset by the favourable movement in prices, as the terms of trade increased by an average of 0.4 p.c. in 2007. The rise in the import deflator in fact dropped to 2.7 p.c., against 3.9 p.c. in the previous year, while the increase in the export deflator was steady at around 3 p.c.

CHART 29 EXPORTS AND IMPORTS OF GOODS AND SERVICES

(data adjusted for seasonal and calendar effects, percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



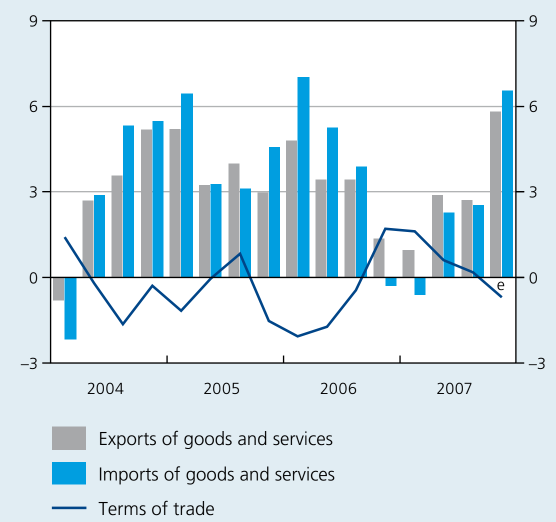
Sources : NAI, NBB.
(1) Contribution to the total change in exports.
(2) Seasonally adjusted data, level.
(3) Contribution to the total change in imports.

This improvement in the terms of trade contrasts with the deterioration recorded in the previous four years, caused mainly by the rising commodity prices. It is due principally to the temporary dip in prices of energy – oil and particularly gas – in the fourth quarter of 2006 and at the beginning of 2007. Since September, however, the renewed rise in oil prices has again fuelled an increase in the foreign trade deflator, particularly that applicable to imports.

Although the euro area countries account for over 60 p.c. of Belgium's foreign trade, the appreciation of the euro also contributed to the improvement in the terms of trade by attenuating the movement in the import deflator. In fact, the goods and services for which costs are denominated in foreign currencies can be traded at a lower price in euro without impairing the profitability of foreign producers. For their part, if they have sufficient market power, euro area exporters can reflect the movement in the euro exchange rate in their foreign currency prices, but in general they will be more likely to cut their margins on account of the competition. The nominal BLEU exchange rate against a basket of currencies of thirty-four advanced or recently industrialised countries appreciated by 2.3 p.c.

CHART 30 DEFLATORS OF FOREIGN TRADE

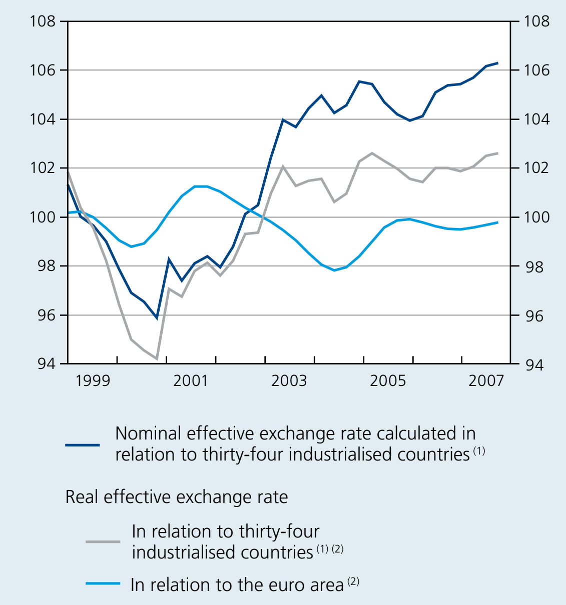
(data adjusted for seasonal and calendar effects, percentage changes compared to the corresponding quarter of the previous year)



Sources : NAI, NBB.

CHART 31 EFFECTIVE EXCHANGE RATE OF THE BLEU

(indices 1999 = 100)



Source : EC.

(1) Weighted average exchange rate against the currencies of the rest of the EU and the following countries : Australia, Canada, Japan, Mexico, New Zealand, Norway, Switzerland, Turkey and United States.

(2) Nominal effective exchange rate deflated by unit labour costs for the economy as a whole.

between the fourth quarter of 2005 and the third quarter of 2007. Measured in terms of labour costs, however, the deterioration in cost competitiveness was less marked since, taking account of the relative movement in unit labour costs, the real effective exchange rate appreciated by only 1 p.c. over that same period. Moreover, the real effective exchange rate remained relatively stable in relation to the euro area trading partners.

Since the methods used in the various countries to estimate movements in foreign trade prices and volumes are not harmonised, an international comparison on that basis is liable to produce biased results. Until that situation is rectified, it is appropriate – as explained in chapter 3 of the 2006 Report – to use value analyses to arrive at a balanced assessment of Belgium's export performance. However, since value changes are affected by exchange rate fluctuations, the comparison has to be confined to the euro area countries.

In value terms, Belgium's exports of goods and services grew by 7.8 p.c. per annum from 2004 to 2007, a rate comparable to the average for the main neighbouring countries. However, that figure masks considerable variations in reality, as the annual export growth was only 5.2 p.c. in France, compared to 8.6 p.c. in the Netherlands and 9.9 p.c. in Germany. The evolution of exports can be related to the development of the foreign markets, the latter being calculated as the sum of the imports of the partners weighted according to their importance as customers. This shows that, like the other euro area countries, Belgium suffered losses of market share in value terms from 2004 to 2006. However, although those losses were comparable in scale to the unweighted average for the euro area countries in the first two years, they were heavier in 2006, reaching 6 p.c. In 2007, the growth in the value of Belgium's exports was 1.8 percentage points higher than that of competing markets, though this improvement lagged behind that recorded in Germany and the Netherlands, and the average for the euro area.

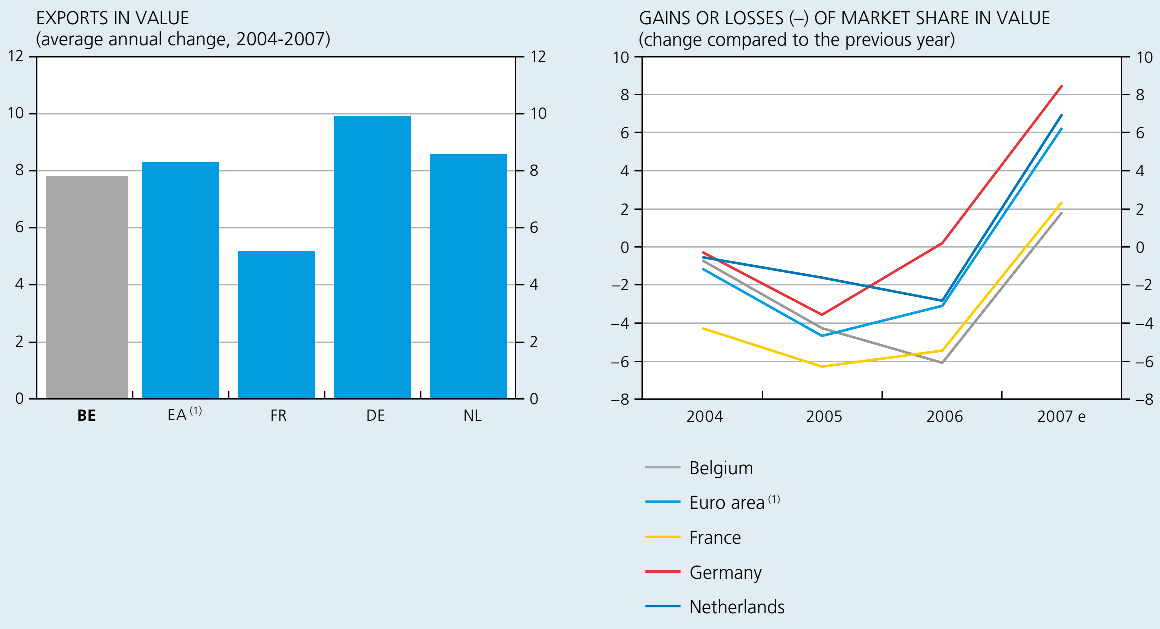
Looking at the trend since 1995, Belgium's exports have grown at an annual rate which is 1.7 percentage points below the market growth. Although the market losses have therefore been significant, they have remained relatively similar to those recorded in France, Italy, Portugal and, to a lesser extent, Finland. Losses are to some extent natural, in the context of the rapid opening up to international trade of large emerging economies, which are contributing to the considerable expansion of international trade. In that process, the share of the economies which were industrialised and internationalised at an earlier stage inevitably tends to diminish. However, that relative decline varies in intensity, or is even halted, according to the capacity of the economies to withstand the increased competition, particularly via an export structure geared to products attracting sustained demand. Thus, Germany, the Netherlands and Austria more or less maintained their position between 1995 and 2007, while Spain, and particularly Ireland, have gained market shares.

Balance of payments

While the volume of imports of goods and services grew faster than exports, this deterioration was amply offset, particularly by the improvement in the terms of trade. Thus, at current prices Belgium's trade surplus expanded in 2007, reaching 8 billion euro against 7.7 billion the previous year. This growth, which follows four years of contraction, was generated mainly by service transactions. According to the data available for the first three quarters of 2007, that is attributable to triangular trade, transport and financial services, where the improvement in the results counterbalanced the decline in the balance of transactions in a number of service categories, such as advertising and legal services. The surplus in transactions in goods also grew over the same period, but the increase

CHART 32 EXPORTS OF GOODS AND SERVICES AND MARKET SHARES

(percentage changes)



Sources : EC, OECD, NAI, NBB.
(1) Unweighted average of the euro area countries, excluding Luxembourg and Slovenia.

would have been negated in the fourth quarter by the rising cost of commodities.

Factor incomes generated a surplus of 6.5 billion euro during 2007, against 6 billion in 2006. This increase came about because the rise in net interest received by residents outstripped the growth of net dividends paid to other countries. The simultaneous increase in dividend payments on the one hand and interest income on the other hand is particularly noticeable in the case of the coordination centres. Under the impetus of tax rules concerning the notional interest deduction, these centres, like other companies, enjoyed an inflow of equity capital from non-resident shareholders, which enabled them in turn to increase the loans granted to affiliated companies in other countries. The flow of interest payments on interbank loans also increased in terms of both revenue and expenditure, as a result of the rise in short-term rates. At the same time, the traditional surplus of earned incomes contracted slightly during the first three quarters of 2007.

Owing to Belgium's position as a net contributor to the EU budget, the balance of current transfers is traditionally negative. In 2007, that deficit increased from 5.3 to 5.7 billion, the main reason being a decline in the insurance sector balance. In the case of government transfers, there was a slight increase in the total amount of Belgium's contributions to the EU budget, and a small reduction in transfers received under the common agricultural policy (CAP). Regarding the contributions, it was mainly customs duty refunds that increased. In regard to transfers to the agricultural sector, the rise in world prices for that sector's products reduced the level of market aid. At the same time, as explained in box 11, following the 2003 CAP reform, direct aid to producers is tending to gain in importance compared to market aid, making the total transfers less sensitive to price fluctuations on the global markets.

With the proceeds from the sale in 2006 of the Belgian embassy site in Tokyo, the capital account ended with a deficit of 0.7 billion, the same amount as in 2005. In 2007, as in the previous year, it was influenced by the system of trading greenhouse gas emission quotas, set up by the EU under the Kyoto agreement. In net terms, Belgian companies in fact buy more emission quotas than they sell.

Overall, Belgium's net lending to the rest of the world, which – according to the balance of payments concepts – corresponds to the sum of the current and capital account balances, came to 8.1 billion. As a percentage of GDP,

TABLE 17 NET LENDING TO THE REST OF THE WORLD

(balances ; billions of euro, unless otherwise stated)

	2004	2005	2006	2007 e	First nine months 2006	First nine months 2007
1. Current account	10.2	7.9	8.4	8.8	6.6	8.1
Goods and services	10.7	8.7	7.7	8.0	4.7	6.4
Goods	7.8	4.7	2.6	n.	1.7	2.8
Services	2.9	4.0	5.1	n.	3.0	3.6
Factor incomes	4.6	4.2	6.0	6.5	6.1	6.4
Earned incomes	3.7	3.9	4.1	n.	3.0	2.7
Incomes from direct and portfolio investment	1.0	0.3	2.0	n.	3.1	3.7
Current transfers	–5.2	–5.1	–5.3	–5.7	–4.3	–4.7
Transfers of general government	–3.8	–3.8	–4.3	n.	–3.6	–3.6
Transfers of other sectors	–1.4	–1.3	–1.1	n.	–0.7	–1.1
2. Capital account	–0.4	–0.7	–0.3	–0.7	–0.5	–0.6
3. Net lending to the rest of the world (1 + 2)	9.8	7.1	8.1	8.1	6.0	7.6
p.m. Idem, percentages of GDP	*3.4*	*2.4*	*2.6*	*2.4*	*2.5*	*3.1*
Financing capacity of the domestic sectors, percentages of GDP	*3.8*	*2.9*	*3.4*	*3.1*		

Sources : NAI, NBB.

that represents a reduction of 0.2 percentage point, since net lending fell from 2.6 p.c. in 2006 to 2.4 p.c.

3.4 Structural developments

The increasing globalisation of the world economy, with stronger competition from emerging, low wage countries, is forcing the old industrialised economies to find other ways of preserving and improving their overall competitiveness, limiting their loss of market shares and thus taking advantage of the rising average level of development in the world. This applies particularly to Belgium as a small, open economy specialised in intermediate products. To meet this challenge, innovation and entrepreneurship are two key elements of an appropriate structural policy to permit and facilitate the adjustment of the economy, and to change its focus to new activities.

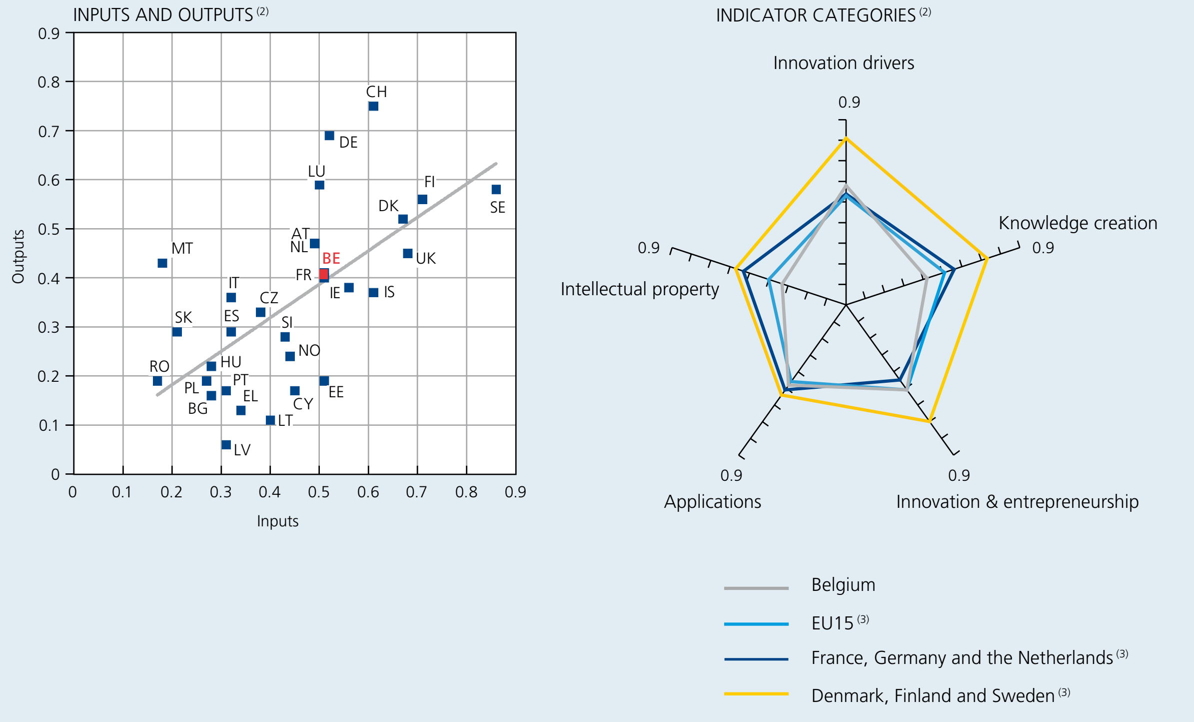
Innovation and entrepreneurship are moreover central policy concerns at all levels of power : regional, national and supranational. At this last level, the EU and the OECD have adopted similar approaches. On the basis of structural indicators covering a broad range of spheres (innovation, entrepreneurship, employment, economic reform, etc.), they establish benchmarks to highlight the strengths and weaknesses of the various Member States. Having thus identified the salient points, they can then make recommendations, the implementation of which is constantly monitored.

Overview of innovation

Innovation is the outcome of complex and varied relationships between multiple players (teachers, scientific researchers, enterprises, government, consumers) interacting within a system. An economy's innovative performance is therefore difficult to assess, and particularly tricky to represent in a single indicator. In that respect, the European Innovation Scoreboard (EIS) developed by the EC presents a set of indicators offering information on the various dimensions of innovation, and positioning Belgium in a European context. It compiles twenty-five indicators covering five themes, which are themselves divided into two groups, one comprising innovation inputs and the other outputs. The innovation drivers, knowledge creation and innovation & entrepreneurship come under inputs, while applications and intellectual property come under outputs.

CHART 33 INNOVATION INDICATORS

(average of normalised indicators [1])



Source : EC (European Innovation Scoreboard 2007).

(1) Each country's score for each of the twenty-five indicators is obtained by the following normalisation :
(country indicator – minimum (thirty countries)) / (maximum (thirty countries) – minimum (thirty countries)). It is therefore between 0 and 1. Extreme values are disregarded. The scores per category, and for inputs and outputs, are obtained as an unweighted average.

(2) Innovation drivers, knowledge creation and innovation & entrepreneurship are innovation inputs ; applications and intellectual property are innovation outputs.

(3) Unweighted average.

With all the usual caveats, including as regards an indicator's reference to an "input" or an "output", innovation performance appears to depend to some extent on the resources put in. Among the thirty European countries considered, namely the EU Member States, Iceland, Norway and Switzerland, Belgium is in an intermediate position, as are France and the Netherlands. Despite a comparable level of inputs, Germany produces the best performance in the EU, reflecting remarkable innovative efficiency. The three Nordic EU countries also achieve better results by allocating more resources to innovation.

Each of the five themes considered by the EIS represents a dimension of innovation. In the first instance, an economy's innovative capacity is founded on the innovation drivers. On the basis of the indicators used by the EIS, relating almost exclusively to education, this is the sphere in which Belgium scores highest in relative terms, outperforming in particular the unweighted average score of its three main neighbours. However, this generally favourable picture, due partly to the high percentage of graduates, masks certain shortcomings, namely the insufficient number of science and engineering graduates, and inadequate continuous training. In 2005, Belgium had 10.9 science graduates and engineers per thousand of population aged from 20 to 29 years, against 12.9 per thousand in the EU. In 2006, 7.5 p.c. of the population aged from 25 to 64 years had recently participated in further training, against 9.6 p.c. in the EU and 11.1 p.c. in the EU15.

The Belgian innovation system produces its weakest scores in the areas which come more directly under actual knowledge, be it in regard to inputs (knowledge creation, essentially R&D) or outputs in the form of intellectual property applications and registrations. In 2005, the level of R&D expenditure in Belgium amounted to 1.8 p.c. of GDP, comparable to the EU average, having peaked at 2.1 p.c. of GDP in 2001. It was thus well short of the 3 p.c. target set by the EU for 2010 under the Lisbon strategy and confirmed by Belgium itself in its National Reform Programme 2005-2008. Belgium is notable for the relatively small contribution from public funding whereas, in most European countries, it is mainly private funding that lags behind. In Belgium, private funding also features heavily concentrated expenditure and foreign dependence, factors which cause great volatility in R&D activity.

Apart from patents and other trade mark applications, innovation should also lead to economic applications generating activity, jobs and income. Here, too, Belgium lags behind the three neighbouring countries and the Nordic EU countries, especially in terms of high technology exports and sales of new-to-market products.

The last category addressed by the EIS, entitled "innovation & entrepreneurship", focuses mainly on the innovation effort at the level of the firm, particularly SMEs. Belgium is in a favourable position for this theme as a whole, and in particular outperforms the average for the three neighbouring countries owing to the innovative activities of SMEs according to survey findings.

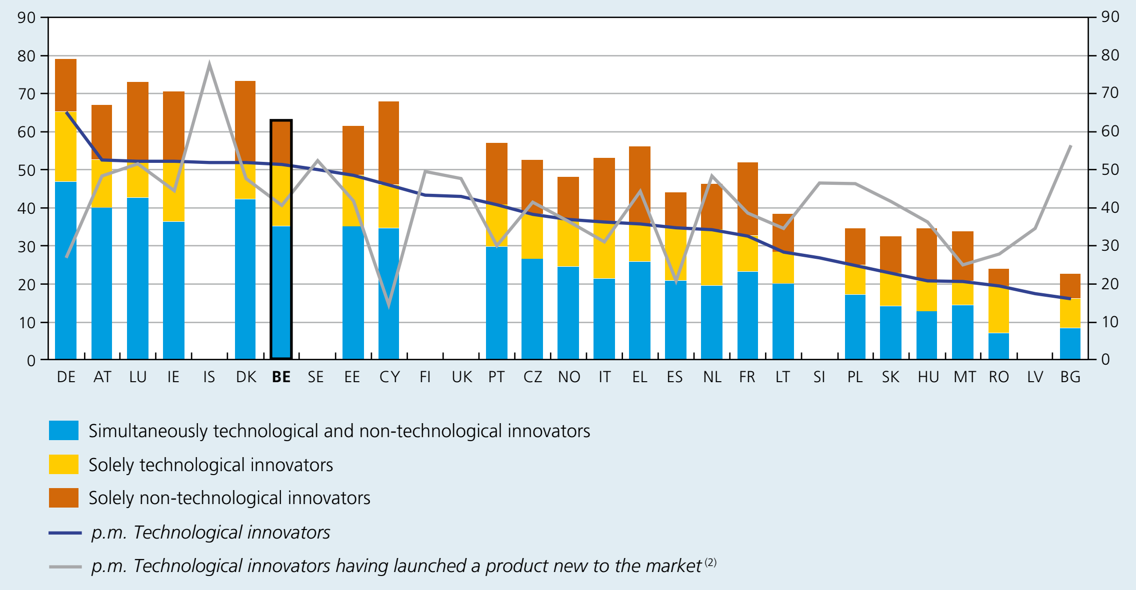
Innovative activities and entrepreneurship

In practice, innovation is mainly implemented by firms and therefore goes hand in hand with the development of entrepreneurship.

According to the Community Innovation Survey (CIS), from which a number of EIS indicators are taken, and which was last published in 2004, Belgium ranks seventh in terms of technological innovation out of a total of twenty-nine European countries. 51.3 p.c. of enterprises of all sizes reported that, between 2002 and 2004, they had launched a new or significantly improved product on the market or introduced within the firm a new or significantly improved process. Only Germany, the front runner, does noticeably better with a score of 65.1 p.c. However, the product innovations of Belgian firms seem to be more a reflection of adjustment to existing technologies. In fact, Belgium comes only 17th in terms of the percentage of innovative firms which have launched a product which is new not only to the firms themselves but also to the market.

CHART 34 INNOVATIVE ENTERPRISES [1]

(2002 to 2004 ; percentages of the total number of enterprises, unless otherwise stated)



Source : EC (CIS4, 2004).

(1) The CIS4 covers the twenty-seven EU countries plus Iceland and Norway. However, the distinction between technological and non-technological innovations is available only for twenty-three of those countries.

(2) Percentages of the number of technologically innovative firms.

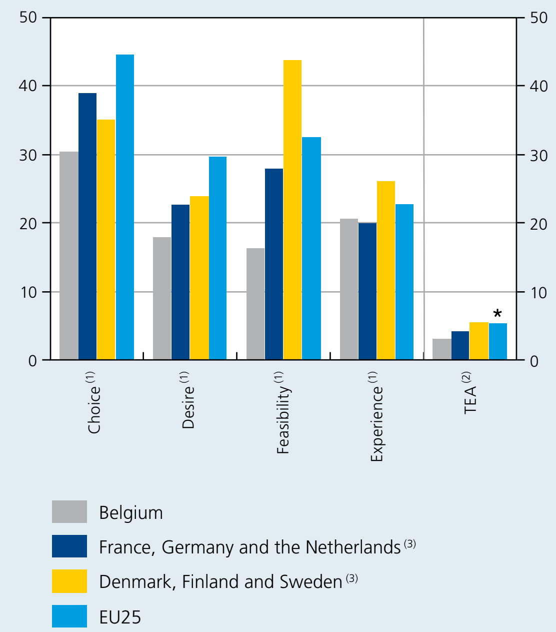
However, an innovation is not necessarily technological in character. According to the CIS, technological and non-technological innovations often go hand in hand, particularly in the best ranked countries. The marketing of a new product may in fact be accompanied by a revised marketing strategy, just as the introduction of a new production process may prompt a review of the firm's organisation. Yet the proportion of companies introducing solely non-technological innovations is quite considerable, including in countries where technological innovation concerns over 50 p.c. of firms. Belgium belongs to this group, but is somewhat lagging behind with only 11.5 p.c. of firms introducing solely non-technological innovations.

Like innovation, entrepreneurship is a difficult concept to measure. Use is therefore made of proxies, such as the number of entries and exits of firms or the number of self-employed persons, or of results of surveys, the two best known of these being the Global Entrepreneurship Monitor (GEM) and the Flash Eurobarometer established at the request of the EC. These two surveys cover the population of working age, the first considering forty-two countries throughout the world, though not including all the EU countries, and the second covering the EU25 plus Iceland and Norway.

A look at the key questions in these surveys reveals that Belgium is often ranked last or second to last among the EU25 countries. Thus, according to the Eurobarometer, Belgians have a particularly strong preference for employee status as opposed to self-employed status. Among those who are not self-employed, there are very few Belgians who consider it desirable or feasible to become so. According to the GEM data, Belgium has the lowest score – apart from Austria – for total entrepreneurial activity, namely the proportion of the population of working age who have recently embarked on an entrepreneurial activity or are preparing to do so: only 3.2 p.c., against an average of 5.4 p.c. for the EU25 countries considered. The difference is smaller for individuals at the preparatory stage, which could lead to higher effective rates of entrepreneurship in the future. Moreover, despite a recent improvement, Belgium is also performing below the European average in terms of high-potential entrepreneurship, particularly as regards the desire to expand the business to a staff of at least twenty workers within five years.

The GEM and the Eurobarometer indicate that Belgians engage in enterprise primarily to seize an opportunity, but rarely out of necessity. Compared to other countries, Belgium does not have specific financing problems, either in the form of venture capital or otherwise. The explanation for the low level of entrepreneurship therefore

CHART 35 ENTREPRENEURSHIP
(percentages of the population considered)



Sources : Flash Eurobarometer 2007, Global Entrepreneurship Monitor 2007.
(1) The Eurobarometer questions addressed to persons aged 15 and over relate successively to the choice of self-employed status as such ; the desire to become self-employed in the next five years and the feasibility of doing so in the case of the non-self-employed only ; past and present experience in setting up a business.
(2) Total entrepreneurial activity rate (TEA) : persons aged between 18 and 64 who have been pursuing an entrepreneurial activity for over three months but less than forty-two months or who have taken some action towards creating a new business in the past year. The GEM did not publish data for Germany in 2007, so that the figure used for this country is the one published in 2006.
(3) Unweighted average.
* Unweighted average of the TEA of the sixteen EU25 countries included in the GEM 2007, and that of Germany in the GEM 2006.

seems more to do with cultural and societal factors, e.g. because entrepreneur status has less kudos or because of the perception of social protection and administrative formalities.

Structural policies

Since 2004, the Belgian authorities have adopted a number of measures to improve the structural framework of economic activity and enhance its potential. More particularly, in order to encourage research and innovation, various tax measures were introduced at federal level to reduce the cost of R&D and make its financial returns more attractive. The regional governments for their part focused mainly on establishing centres of competitiveness or competence covering specific spheres of activity. These centres are intended to foster collaboration between firms, training centres, and public and private research centres.

Much effort has also been devoted to administrative simplification at all levels of power. The federal authorities have steadily reduced the time required to set up a company, e.g. by implementing a single enterprise number. In 2007, this time was cut down to three days in certain cases. Various improvements made to the social status of self-employed persons should also promote entrepreneurship. Furthermore, new legislation has facilitated the establishment of new shops, more particularly hypermarkets, and increased the flexibility of retail opening hours and shopping days.

Despite these reforms, the EC and the OECD are urging Belgium, like the other EU countries, to continue efforts to create a more competitive knowledge-based economy. Although most of the recommendations concerning structural policies, and certainly the most significant ones, addressed to Belgium relate to the labour market, a number of them also concern the product market. Thus, in most countries including Belgium, the international bodies have pointed out the lack of competition in services, particularly professional services and retail, and in the network industries. In the case of electricity and gas, the Belgian authorities are asked to strengthen the conditions of competition, particularly via independent and efficient regulators, and by reducing the influence of the incumbent transmission and distribution entities. The federal telecommunications regulator is encouraged to make progress in analysing the broadband market.

In regard to innovation, the EC has stated that many countries will fail to meet their target for R&D expenditure in 2010. That also applies to Belgium, where the ratio of R&D expenditure to GDP recorded almost the largest fall in the EU between 2000 and 2005. In that regard, the points for attention mentioned by the EC concern the need to increase the level and impact of public funding and to step up the coordination between the federal and federated entities, as the resources allocated to research and innovation are fragmented among a large number of institutions and instruments. Moreover, apart from measures relating to patents, the EC did not rate Belgium favourably for either the improvement in the framework conditions – which also include initiatives to attract highly skilled personnel and to encourage innovation through public procurement – or for specific policies promoting SMEs. More could be done to develop entrepreneurship, e.g. via education.

Labour market and labour costs

4.

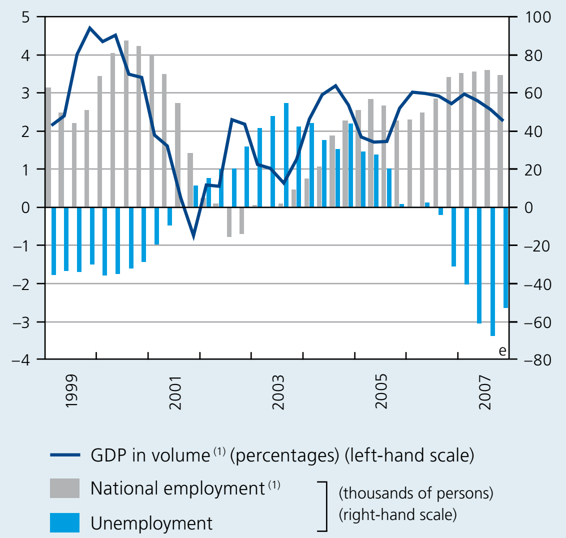
4.1 Labour market

Employment and working time

In the wake of the strong growth of economic activity in 2006 and early 2007, employment expanded considerably during the year under review. Since the beginning of 2003, apart from a small, brief lull in 2005, year-on-year employment growth strengthened in each successive quarter to reach a peak in the third quarter of 2007. At that point, the number of jobs was 72,000 higher than a year earlier. Although the pace slackened thereafter, thus displaying the usual time lag of two to three quarters after the decline in the rate of GDP growth, the expansion of employment nevertheless continued at a high level, so that in 2007 the number of persons in work averaged 71,000 more than in 2006, an increase of 1.6 p.c. During the past decade, 2000 was the only year featuring stronger job creation, with 80,000 extra persons employed, representing an increase of 2 p.c., but GDP growth had also been higher at almost 4 p.c. Since 2003, domestic employment has expanded by a total of around 200,000 jobs.

CHART 36 ACTIVITY AND THE LABOUR MARKET

(changes compared to the corresponding quarter of the previous year)



Sources: NAI, NEO, NBB.
(1) Data adjusted for seasonal and calendar effects.

The steep rise in employment in recent years has occurred mainly in the private sector. In 2006 and 2007, the numbers employed in government and education in fact remained more or less stable. The influence of public authorities on employment is obviously not confined to their own staff. For instance, by reducing charges and by granting subsidies, they support job creation and the maintenance of employment in the private sector. That support is limited overall, but it is decisive for the development of certain activities, e.g. in the health and social work sector where employment is largely subsidised. Thus, in the private non-market sector, which essentially corresponds to that branch, the number of employees is estimated to have increased at a steady rate in 2007, as it has for several years, namely by 10,000 units. Similarly, the service voucher system subsidies are a major factor in its success: it is estimated that, on average, around 13,000 new jobs were created in the market services sector via this scheme in 2007.

In the branches where activity is greatly influenced by the business cycle, the rise in the number of employees showed a further sharp acceleration. On average, the workforce there increased by around 46,000 units, or 14,000 more than in 2006. While paid employment continued to decline in industry, many jobs were created in construction, and particularly in the service branches.

The number of self-employed persons increased by 14,000 units whereas, following a lengthy, unbroken period of decline or stagnation, from 1997 to 2004, the increase had averaged 8,000 units per annum in 2005 and 2006. A substantial proportion of the new self-employed workers would originate from the East European countries which recently joined the EU. Although the restrictions on nationals of those countries wishing to pursue an occupation as employees in Belgium were eased in 2006, there were still many East Europeans, primarily Poles and

Romanians, who registered as self-employed workers in Belgium. According to the NISSE data, they accounted for about half of the increase between 1 January and 31 December 2006.

The growing importance of the tertiary sector in the economy has gone hand in hand with a structural trend towards a higher percentage of women on the labour market. Service activities in fact employ relatively more women, who are proportionately more likely to work part time. For a number of years, employment growth has been sustained by the expansion of this form of working. Use of part-time employment permits more flexible organisation of working time and, if appropriate, the development of new activities. Since it divides a given volume of work among a larger number of persons, it also contributes to broader participation in the labour market. By making it easier to achieve a work-life balance, this system of working expands the labour supply, including the supply of older workers who can thus extend their working life while reducing their hours. However, it should be noted that part-time employment does not always correspond to the actual wishes of the worker concerned.

According to the labour force surveys, as an average for the first three quarters of 2007 over one-fifth of workers were employed part time, representing an increase of almost 5 percentage points since 2000, despite the stagnation after 2006 coinciding with an apparent stabilisation of the proportion of working women. In the early 1990s, only one person in ten had a part-time job. The growth has occurred in all branches of activity, but in varying proportions, depending very much on the concentration of female employment in those branches. Thus, in firms belonging to the "other services" branch – where the great majority of the employees are women – more than one person in three works reduced hours. In particular, in firms belonging to the domestic services branch and the health and social work branch, 84 and 43 p.c. of jobs respectively were filled by part-time workers in the first three quarters of 2007. Conversely, this form of working is relatively uncommon in industry, and particularly in construction, branches of activity where the majority of workers are men. Part-time work remains an essentially female phenomenon, although it has spread to the male population. The proportion of female part-timers in fact increased from 35.1 p.c. in 2000 to 41 p.c., with an increase from 4.8 to 7.5 p.c. for men. The expansion is even more marked compared to the early 1990s, when the proportions of female and male part-timers were 28 and 2 p.c. respectively.

TABLE 18 LABOUR SUPPLY AND DEMAND

(annual averages; year-on-year changes in thousands of persons, unless otherwise stated)

	2003	2004	2005	2006	2007 e	*p.m. 2006, level* (1)
Population of working age (2)	30	30	44	63	56	*6,942*
Labour force	50	68	71	47	15	*4,922*
National employment	3	30	52	55	71	*4,334*
Frontier workers	1	2	1	3	2	*56*
Domestic employment	2	28	51	53	69	*4,278*
Self-employed	–4	0	8	8	14	*695*
Employees	6	28	43	45	55	*3,583*
Branches sensitive to the business cycle (3)	–21	8	23	32	46	*2,246*
General government and education	9	10	11	3	0	*758*
Other non-market services (4)	18	10	10	9	10	*578*
Unemployment (5)	47	38	20	–8	–56	*588*

Sources: DGSEI, NAI, NEO, NBB.

(1) Thousands of persons.

(2) Population aged from 15 to 64 years.

(3) The branches "agriculture, hunting, forestry and fishing", "industry", "construction", "trade, transport and communication" and "financial, real estate, renting and business activities".

(4) The branches "health and social work", "community, social and personal services" and "private households with employed persons".

(5) Unemployed job seekers, comprising totally unemployed persons claiming benefits except older unemployed persons not seeking work, and other job seekers registered on a compulsory or voluntary basis.

TABLE 19 RATIO OF PART-TIME WORK
(percentages of total employment)

	Ratio of part-time work (1)			*p.m. Share of women in total employees*
	2000	2006	2007	*2006 (2)*
By branch of activity (3)				
Industry	6.0	10.5	9.7	*23.7*
Construction	3.9	5.8	5.3	*7.3*
Trade, transport and communication	17.2	22.6	22.7	*40.3*
Financial, real estate and business activities	15.2	19.6	22.2	*44.7*
General government	20.0	22.8	22.3	*46.7*
Other services	32.5	36.7	36.1	*70.6*
Total	**17.5**	**22.3**	**22.2**	***43.9***
By sex				
Men	4.8	7.4	7.5	
Women	35.1	41.2	41.0	

Source: EC.
(1) Average of the first three quarters.
(2) Annual average.
(3) The figures for agriculture are not given because the labour force survey data are not sufficiently statistically representative.

Usual full-time working hours have remained constant since the beginning of the 1990s, at an average of almost 41 hours per week (including normal overtime). Conversely, part-time working hours – i.e. where the working time specified by contract is less than 100 p.c. of the standard contractual working time – have tended to increase, rising from 21 hours in the first half of the 1990s to 23½ hours in the first three quarters of 2007. The longer working time applies to both men and women. While in the case of full-time workers, men work on average 2 hours longer than women, the difference in the hours usually worked by female and male part-time workers is smaller, at less than one hour. The average part-time working hours vary between the branches of activity, but contracts for less than half time are generally the least common. On the basis of the NOSS statistics on paid employment, long part-time contracts – i.e. more than three-quarters of standard hours – are the most common in industry and general government. In construction, they concern around 40 p.c. of part-time jobs. In services, the commonest contracts are those for 50 to 75 p.c. of standard hours.

In line with the trend apparent for the working population as a whole, the standard of qualifications and the average age of part-time workers have also increased. Whereas in the early 1990s low-skilled persons accounted for the major share of part-time work, that proportion has since declined, dropping from 38.7 p.c. in 1992 to 28 p.c. in the first three quarters of 2007. Nowadays, one in three part-timers has higher education qualifications. Moreover, more older persons are opting to work reduced hours by taking advantage of measures to adjust working time in the run-up to retirement. A quarter of part-time jobs are currently filled by persons aged from 50 to 64 years, whereas the figure was only one in ten in 1992.

Employment rate and population of working age

In parallel with the steep rise in the number of jobs, the harmonised employment rate also increased sharply. It is estimated that, on average, 62 p.c. of the population of working age were in work in 2007, against 61 p.c. in 2006. In 2000, during the previous boom period, the employment rate was lower, at 60.5 p.c. Since 2000, the rise in the number of jobs has in fact considerably outpaced the increase in the population aged from 15 to 64 years.

The composition of that population has also changed considerably: there has been a sharp fall in the percentage of low-skilled persons in favour of more skilled persons, and there has been a shift from the 25 to 54 age group towards the 55 and over age group, indicating that the population of working age is growing older. Since the employment rate displays a structurally positive correlation with the educational level and declines significantly from the age of 55 years, changes in the composition of the population of working age – all other things being equal – exert an influence on the overall employment rate recorded. In the three regions, the upward effect due to the higher educational level in the period from 2000 to 2007 exceeded the downward effect due to the average age. For Belgium as a whole, the change in the composition of the population of working age accounts for the major part of the observed increase in the employment rate: that was particularly true in Wallonia, whereas in Flanders the impact was smaller. In contrast, in Brussels the employment rate declined slightly between 2000 and 2007, despite a substantial positive structural effect. Adjusted for the population structure, its employment rate is therefore tending to fall, in contrast to that in the other two regions.

As in 2006, the population of working age expanded considerably: the number of residents aged from 15 to 64 years has increased, on average, in the past two years by around 60,000 persons per annum, twice the increase seen at the beginning of the decade and far outpacing the rise in the labour force. The accelerating growth of the potential labour supply is due mainly to the increased immigration into Belgium. Between the beginning and end of 2006, the population grew by 73,000 persons, among whom 51,000 net incomers represented the balance of flows to and from other countries. This augmented the population of Brussels and that of Flanders by around 20,000 persons each, while net immigration was only half that figure in Wallonia, at 9,000 persons. In all, the number of non-Belgians increased by 56,000 – of whom 31,000 came from other EU countries – while net migration by Belgians remained negative in line with its structural trend. Among this new population, of whom the majority are aged between 20 and 34 years, the proportions of men and women are more or less the same.

The conditions for access to the Belgian labour market depend notably on the person's nationality and the type of activity to be pursued. To be employed on the payroll of a Belgian or foreign employer in Belgium, a person who is not a Belgian national has to obtain a work permit, unless he is from the European Economic Area. As a transitional measure, this permit is also required for citizens of the new EU Member States, except Malta and Cyprus. In the great majority of cases, the work permit in question is type B, valid for one year, renewable, and granted for a contract of employment with an employer who has previously obtained a work permit. This is not granted unless there is evidence that no Belgian or European candidates (from the EU15, during the transitional period) are available. In 2007, around 39,000 type B permits were issued, of which 31,400 in Flanders, 5,400 in Brussels and 2,300 in Wallonia. Almost 26,000 were granted to Polish and Romanian nationals, which is double the previous year's figure. This increase is due partly to the fact that, since

TABLE 20 BELGIUM'S POPULATION AND IMMIGRATION IN 2006
(thousands of persons)

	Brussels	Flanders	Wallonia	Belgium
Change between 1 January and 31 December	12	39	22	73
of which:				
Net migration	21	20	9	51
of which:				
Men	10	10	4	24
Women	11	10	5	26
Belgians	–1	–3	–2	–6
Non-Belgians	22	23	12	56
p.m. Population as at 31 December 2006	*1,031*	*6,117*	*3,436*	*10,585*

Source: DGSEI.

TABLE 21 HARMONISED EMPLOYMENT RATES IN BELGIUM AND IN THE EU

(annual averages, unless otherwise stated; percentages of the corresponding population)

	Population aged from 15 to 64 years			Women aged from 15 to 64 years			Population aged from 55 to 64 years		
	2000	2006	2007 (1)	2000	2006	2007 (1)	2000	2006	2007 (1)
Belgium	60.5	61.0	61.8	51.5	54.0	54.9	26.3	32.0	34.1
Brussels	55.0	53.4	54.6	48.9	46.6	48.3	34.5	36.9	39.9
Flanders	63.9	65.0	65.9	54.7	58.3	59.5	25.6	31.4	33.9
Wallonia	55.9	56.1	56.7	46.4	48.6	48.9	25.5	31.9	33.1
EU (2)	62.1	64.5	65.3	53.6	57.3	58.2	36.8	43.6	44.6
p.m. EU targets for 2010		*70*			*60*			*50*	

Sources: EC, DGSEI.
(1) Average for the first three quarters.
(2) For the year 2000, only second quarter data are available for the EU.

1 June 2006, workers from the new Member States have been issued with permits automatically and more quickly in the case of the critical occupations listed at regional level.

Foreigners may also come to work temporarily in Belgium whereas they normally work, or were recruited, in another country. The contractual relationship between the foreign employer and the seconded worker is maintained, and the worker comes under the social security system of the country of origin. However, it is Belgian legislation, notably that on working and pay conditions, that applies to workers seconded in this way for their work in Belgium. Since 1 April 2007, under the "LIMOSA" project, a declaration has to be submitted to the social security authorities not only for employees and trainees on secondment but also for foreign self-employed workers. On the basis of the information available for the first eleven months of the year, over 138,000 persons had been recorded in this way. However, as the LIMOSA project currently stands, it is not possible to eliminate double counting caused by the renewal of short-term contracts, which may give rise to multiple declarations. The declaring firms are mainly based in neighbouring countries (Netherlands, Germany and France, in descending order of importance) and in Poland, though that does not mean that workers seconded to Belgium are nationals of those countries.

Despite the steep rise in employment in 2007, the proportion of persons aged from 15 to 64 years pursuing a paid occupation has remained well below the European average in Belgium, and even further below the 70 p.c. target set for the EU as a whole for 2010. Yet that level is far exceeded in some countries, such as Denmark where almost 80 p.c. of the population of working age are in employment. In addition, between 2000 and 2007, the overall employment rate rose more slowly in Belgium than on average in the EU. Such a disparity is also evident between the three regions of the country. In fact, with almost two in three persons of working age in work, the employment rate in Flanders is not only about 10 percentage points higher than in the other two regions, it has also recorded the largest increase since the end of the last century.

The figures for Belgium are also below the EU average for women and older workers, for whom target employment rates have also been set at European level. The female employment rate, averaging 54.9 p.c. over the first three quarters of 2007, increased significantly faster than the rate for men, but is still below the European level except in Flanders, where it is now already very close to the EU target, set at 60 p.c. for 2010. In the other two regions, just under half of women work, and in Brussels the employment rate for this group is lower than it was at the start of the decade. Belgium has a particularly low employment rate for persons aged from 55 to 64 years. However, the increase in the employment rate for this age group has been much larger than for the other target groups, with a rise from 26.3 p.c. in 2000 to 34.1 p.c. in the first three quarters of 2007. The situation of persons aged 55 and over is relatively more favourable in Brussels, where around 40 p.c. of them were working in 2007, against only one-third in Flanders and Wallonia. The increase in the employment rate for older persons also reflects the rise in the average effective age of retirement from the labour market, which increased by nearly four years between 2001 and 2005, to 60.6 years.

The rise in the number of older workers is due to both demographic factors – cohort effect linked to the greater participation of women – and economic factors – the relative increase in tertiary sector employment – as well as the implementation of specific policies in recent years. Apart from the gradual raising of the statutory retirement age for women since July 1997, to bring it into line with that for men, these policies aim on the one hand to limit the scope for early retirement from the labour market (reform of the system applicable to older unemployed persons and the pre-pension scheme) and on the other hand to encourage the continued employment of persons approaching retirement, notably through targeted cuts in social charges for firms employing or recruiting older workers, income guarantees for the calculation of pension rights, or the right to "outplacement". Also, measures such as the career break scheme, replaced by the time credit scheme in the private sector in 2002, which enable employees to take a temporary career break, or to reduce their working time, while still receiving an allowance from the government, may help to extend the period in which those concerned pursue an occupation. In addition, from 2007 onwards, persons who continue working after the age of 62 years – or after a career of at least 44 years – are entitled to a bonus in the calculation of their pension.

The upgrading of skills is an important requirement for improving the employment prospects of older people. In general, the older age groups have a lower standard of initial education than the younger age groups and have less ready access to continuous training. The latter is important not only for job seekers but also for persons in employment, who have to endeavour to maintain or even enhance their employability. In this regard, personal initiatives are important, but the role of the firms is decisive. This has been stressed on multiple occasions by the social partners and by the government, particularly in the pact on solidarity between the generations. An assessment of in-service vocational training is presented in box 8. The participation rate of the population aged from 25 to 64 years in lifelong education and training (which covers all possible forms of training, whether or not linked to an occupational context) came to 7.5 p.c. in 2006 and is lagging behind the EU as a whole, where that rate stood at 9.6 p.c. At regional level, Brussels had the highest participation rate, namely 10.4 p.c. In contrast, in Wallonia only one in twenty adults attended training in 2006; in Flanders, the figure was 8.4 p.c.

Box 8 – In-service vocational training

In principle, the training policy of private sector firms in Belgium should take account of the target figures agreed between the social partners at central level. These targets concern the amount spent on training and the ratio of workers participating. The central agreement for the period 1999-2000 specified that the training budget of companies in the private sector as a whole should represent 1.9 p.c. of labour costs in 2004. Intermediate goals were set for 2000 and 2002, namely 1.4 and 1.6 p.c. At the 2003 employment conference, a target relating to worker participation was added: by 2010, 50 p.c. of workers should have access to training each year. These strategic objectives were included in the Generation Pact in 2005. In view of the delayed implementation of the agreements, however, it was specified that the 1.9 p.c. target should be achieved in 2006, and be subsequently revised upwards each year. The social partners were also called upon to define a growth path for expenditure on training, including at sectoral level. Finally, the sectors regarded as making insufficient effort will have to pay increased contributions to the "training leave" scheme.

Every year, the training effort can be assessed on the basis of the social balance sheets filed by firms. Thus, in terms of the training budget, the first intermediate goal had been achieved in 2000, since training accounted for 1.42 p.c. of staff costs, though admittedly that was in a period of buoyant economic activity. Since then, this indicator has declined steadily, reaching 1.13 p.c. in 2005. Unlike the financial indicator, the training participation rate has risen slightly, up from 35.1 p.c. in 2000 to 36 p.c. in 2005. For 2006, the changes measured on the basis of a reduced population of firms show some increase in both these indicators, with levels estimated at 1.2 and 36.4 p.c. respectively.

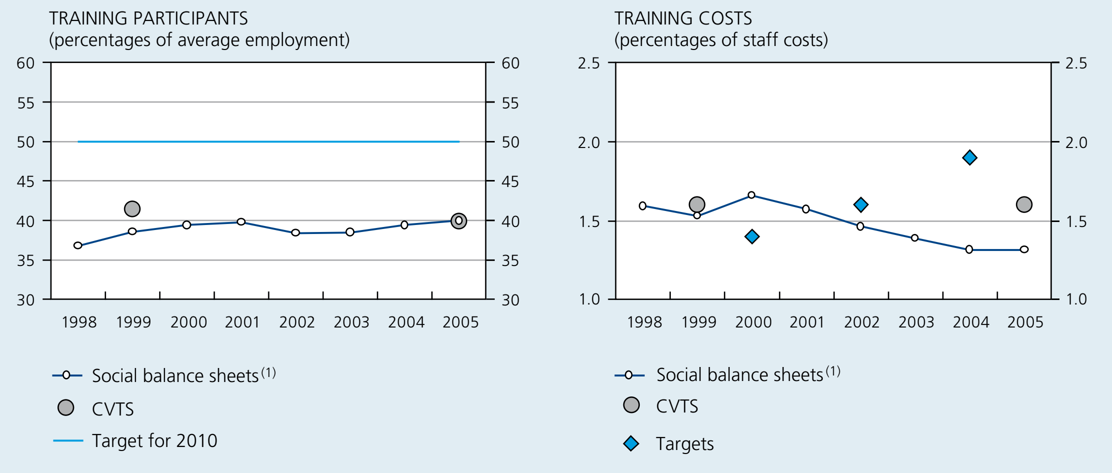
The EC's harmonised surveys on continuing in-service training (Continuing Vocational Training Survey – CVTS) permit periodic assessment – in 1993, 1999 and 2005 – of Belgium's position, and comparison with that of its European partners. The population of firms covered is smaller than that filing a social balance sheet, since the CVTS is confined to firms employing ten or more workers and pursuing activities in branches C to K of the NACE-Bel nomenclature(1). The survey is also based on the information obtained for a sample of 2,953 companies in 2005, while the corresponding population filing a social balance sheet totals almost 18,000.

According to the survey, the training participation rate of workers, in the order of 40 p.c., remains the same as in 1999. Belgium thus holds an intermediate position in relation to the neighbouring countries, since 30 and 34 p.c. of workers respectively had access to training in Germany and the Netherlands, while in France the figure was 46 p.c.

It is noteworthy that substantial differences of access to training according to the workers' age profile are recorded in many countries, particularly to the detriment of the groups which, in principle, are most in need of additional skills to augment their employability and/or their ability to cope with changes. Thus, it is generally workers aged from 25 to 54 years who had the widest access to training initiatives. In Belgium, the participation rate for young people under the age of 25 is 5 percentage points below the average, and the difference is even greater – almost 12 percentage points – for workers aged 55 and over.

In contrast to the results recorded on the basis of the social balance sheets, the financial indicator measured according to the CVTS does not show any decline from 1999 to 2005. In those two years it stood at 1.6 p.c. of staff costs. That stability should be compared to the provisional results recorded in neighbouring countries, which show a slight decline in Germany (from 1.5 to 1.4 p.c.) and a marked fall – though admittedly from a much higher initial level – in the Netherlands (from 2.8 to 2.2 p.c.) and in France (from 2.4 to 1.7 p.c.).

TRAINING TARGETS AND ACTUAL FIGURES ACCORDING TO THE SOCIAL BALANCE SHEETS AND THE CVTS SURVEY



Sources: DGSEI, NBB.
(1) Population of firms corresponding to the CVTS methodology.

(1) The branches are C: Mining and quarrying industry; D: Manufacturing industry; E: Electricity, gas and water supply; F: Construction; G: Wholesale and retail trade, repair of motor vehicles, motorcycles, and personal and household goods; H: Hotels and restaurants; I: Transport and communication; J: Financial intermediation, and K: Real estate, renting and business activities.

The lower level of the indicator based on the social balance sheets probably reflects incomplete recording of the training efforts by firms. In particular, the special contributions paid to social security or to sectoral funds appear to be only partly taken into account. The introduction of the new social balance sheet form, in which the table relating to training has been redesigned to clarify the various elements in the cost calculation, should remedy this problem in the case of accounts closed from 31 December 2008 onwards.

Unemployment

The strong expansion of employment during the year under review brought a sharp fall in unemployment. On average, there were 56,000 fewer unemployed job seekers than in the previous year ; this is the steepest fall ever recorded since the beginning of the 1980s. For comparison, at the time of the previous peak in the cycle, in 2000, unemployment had fallen by 33,000 persons. The harmonised unemployment rate thus dropped from 8.3 p.c. in 2006 to 7.6 p.c.

In 2007, unemployment declined on average by 36,000, 16,000 and 3,000 persons respectively in Flanders, Wallonia and Brussels. In relative terms, the fall was sharpest in Flanders : here, the number of unemployed job seekers dropped by 17 p.c., against 6 and 4 p.c. respectively in Wallonia and Brussels. At the end of 2007, the three regions respectively had around 171,000, 248,000 and 95,000 unemployed job seekers.

The decline in unemployment was fairly general, regardless of sex, age, educational level and duration of unemployment. Older people are a notable exception : the number of unemployed persons aged 55 and over increased in all three regions in 2007. However, this is a very small group, so that a slight absolute increase implies a substantial relative rise. In Brussels, there was also an increase in the number of persons out of work for over two years. Here the change in unemployment was most favourable to the short-term unemployed. In fact, the chances of joining or re-entering the labour market are

TABLE 22 UNEMPLOYED JOB SEEKERS IN 2007 [1]

(annual averages, thousands of persons ; in brackets, percentage changes compared to 2006)

	Brussels		Flanders		Wallonia		Belgium	
Total	**94**	**(–3.5)**	**180**	**(–16.8)**	**258**	**(–5.8)**	**532**	**(–9.5)**
Men	48	(–3.2)	84	(–16.6)	121	(–5.6)	253	(–9.2)
Women	46	(–3.9)	96	(–16.9)	137	(–6.0)	279	(–9.8)
Aged under 25 years	15	(–7.4)	37	(–22.2)	59	(–6.7)	110	(–12.6)
Aged from 25 to 54 years	74	(–3.8)	127	(–17.4)	185	(–7.2)	387	(–10.2)
Aged 55 years and over	5	(18.1)	16	(6.0)	15	(21.5)	35	(13.6)
Low skilled	14	(–5.3)	52	(–16.6)	66	(–5.6)	131	(–10.2)
Medium skilled	38	(–3.5)	102	(–17.3)	161	(–6.1)	302	(–9.9)
Highly skilled	12	(–4.9)	27	(–15.4)	30	(–4.4)	68	(–9.0)
For less than six months	21	(–9.9)	69	(–10.9)	64	(–4.6)	154	(–8.2)
Between six months and two years	30	(–6.8)	54	(–30.4)	79	(–7.1)	163	(–16.3)
For more than two years	43	(2.4)	58	(–7.3)	115	(–5.6)	216	(–4.6)

Source : NEO.

(1) The breakdown by educational level takes no account of the "other qualifications" category which is less important – except in Brussels – and comprises unemployed persons holding qualifications not recognised in Belgium and those whose level of education is not known. The "medium skilled" category also includes holders of an apprenticeship certificate.

TABLE 23 HARMONISED UNEMPLOYMENT RATES IN 2007

(average of the first three quarters, percentages of the corresponding labour force)

	Brussels	Flanders	Wallonia	Belgium
Total population aged from 15 to 64 years	17.5	4.5	10.6	7.6
Aged from 15 to 24 years	35.9	12.2	27.9	19.3
Aged from 25 to 54 years	16.6	3.7	9.3	6.7
Aged from 55 to 64 years	9.7	3.9	3.8	4.4
Low skilled	30.5	7.1	17.4	13.0
Medium skilled	18.6	4.7	11.5	7.7
Highly skilled	9.0	2.6	4.5	3.9
Belgians	16.5	4.1	10.1	6.9
Other EU nationals	12.0	6.6	11.0	9.8
Non-EU nationals	34.2	21.9	38.0	30.2

Source : DGSEI.

generally in inverse proportion to the duration of unemployment. This situation may be due to discouragement affecting job seekers and to the attitude of potential employers, who may feel that the long-term unemployed, having been out of contact with the labour market for a long while, have lost some of the skills needed to find and keep a job. In Brussels and Wallonia, persons who have been unemployed for over two years represented almost 45 p.c. of the total population of job seekers ; that proportion was much lower in Flanders, at 32 p.c. In the latter region, apart from a marked fall in the number of short-term unemployed, there was also a substantial decline in the numbers unemployed for between six months and two years.

Some categories of persons have greater difficulty in entering the labour market than others. That is indicated by their above-average unemployment rate. This applies to young people aged from 15 to 24, with an average of 19.3 p.c. unemployed in the first three quarters of 2007, more than twice the figure for the total population. The unemployment rate of non-EU nationals came to 30.2 p.c. over the same period, four times the ratio for Belgian nationals. The probability of entering the labour market displays a positive correlation with the level of education, as is evident from the fact that the proportion of unemployed job seekers among persons with a diploma of tertiary education is one-third of the figure for low-skilled persons.

The regional disparities in employment are reflected in the unemployment statistics. The unemployment rates are highest in Brussels, whichever labour force category is considered, except for the group of non-EU nationals, for whom the least favourable situation is in Wallonia. In Brussels, the differences are particularly marked in the case of young people and the low skilled, whose unemployment rate exceeds the national average by almost 20 percentage points. In Flanders, the differences are significantly smaller, in particular for persons below the age of 25 years and for non-EU nationals, though the latter have an unemployment rate of 21.9 p.c., which is five times the rate for Belgians. In Flanders and Wallonia, the proportion of non-European nationals in the population of working age is relatively small, at around 2 p.c., but in Brussels it is significantly higher at over 10 p.c. of persons aged between 15 and 64 years.

In that context, the regional services for public employment and training undertook to cooperate more closely. The cooperation agreement on interregional mobility concluded in 2005 thus led to a systematic exchange of job offers, provided that they came from a firm recruiting for operational headquarters located in a region other than that of the employment service, or if they concerned critical occupations. That cooperation also extends to other spheres, such as language learning and vocational training. These dimensions are complementary, as training enables job seekers to acquire new skills which match the needs of businesses, and helps to increase their mobility, since the higher wages paid for those skills more than compensate for the costs and inconvenience of accepting a job away from home. Geographical mobility on the labour market in fact has a positive correlation with people's educational level, that being an indicator of their level of pay. In September 2007, job fairs were held in Flanders, organised by the VDAB in collaboration with the public services responsible for employment and training in the other regions. The aim was to direct as many Brussels, Wallonian and German-speaking job seekers as possible to jobs for which there is a labour shortage in Flanders.

Flanders and Wallonia recently expanded the guidance facilities for young people who, on completing their studies, have difficulty in entering the labour market. The regional employment services sign up those of them with the lowest skills for an integration course, to provide them with proper guidance from the very first day that they are unemployed. In Flanders, in view of the experience gained from a special action plan launched in 2006 in thirteen towns and municipalities, it was decided that, from 1 January 2008, this scheme would apply to all job seekers aged under 25 years throughout the region. In Wallonia, young unemployed people are given guidance under the "job tonic" plan set up in July 2007. In Brussels, young job seekers have the opportunity, if they so wish, to participate immediately in such an integration course (the "occupational project contract"). In general, the transition from school to a job is particularly difficult for young people with low skills: that applies in particular to those who leave school early, i.e. without the equivalent of the certificate of secondary education. This group is quite substantial, since 14 p.c. of young people aged between 18 and 24 years were in that situation in 2006. Flanders recorded the least adverse performance with a ratio of 11 p.c., while in Wallonia and Brussels respectively, 17 and 22 p.c. of young people faced the problem of a lack of qualifications.

Conversely, in 2007, almost 60 p.c. of job seekers held certificates of higher secondary education, placing them in the medium skilled category. They make up a substantial labour reserve, capable of benefiting faster and more effectively from the guidance and training schemes set up by the public employment services to remedy the labour shortages.

Since July 2006, the programme to encourage active job seeking, implemented in July 2004, whereby assistance with the job search is combined with monitoring of fulfilment of the criteria for claiming unemployment benefit, applies to all persons under the age of 50 who are wholly unemployed claiming benefits. The guidance measures set up by the communities and regions are supplemented by regular monitoring interviews arranged by NEO. According to the statistics available as at 31 December 2007, of the 135,077 job seekers questioned in an initial interview, 43.4 p.c. were making an adequate effort to find work. That proportion differs slightly between the regions: it was 39.6 p.c. in Flanders, 46 p.c. in Wallonia, and 41.4 p.c. in Brussels. The steps taken by the others were deemed inadequate, so that a personal action plan was arranged. The percentage of persons immediately fulfilling the NEO criteria has been falling steadily since the programme's launch: at the end of the first year it was 70 p.c. This decline is due in part to the greater heterogeneity, for instance in terms of age, of the job seekers questioned as the programme was phased in. In all, since the system was introduced in July 2004, 11,620 persons have been penalised by loss of part of their entitlement to benefits following their second interview, namely 3,543 in Flanders, 6,291 in Wallonia and 1,786 in Brussels. Also, around 7,000 job seekers – 2,623, 3,023 and 1,411 respectively according to the region – were penalised for unjustified failure to attend the assessment interviews. Finally, 3,415 job seekers were disqualified from claiming unemployment benefits, namely 987 in Flanders, 1,908 in Wallonia and 520 in Brussels.

Labour shortages and inactivity

The expansion of employment and the decline of unemployment bore witness to a favourable labour market development in a context of sustained growth of economic activity. However, demand for labour has expanded to the point where shortages seem to have affected certain regions and occupations. The available statistics concerning the number of unfilled vacancies do not, however, permit an accurate and direct estimate of the scale of this phenomenon, since a vacancy may be counted more than once, both within the same region and for the country as a whole.

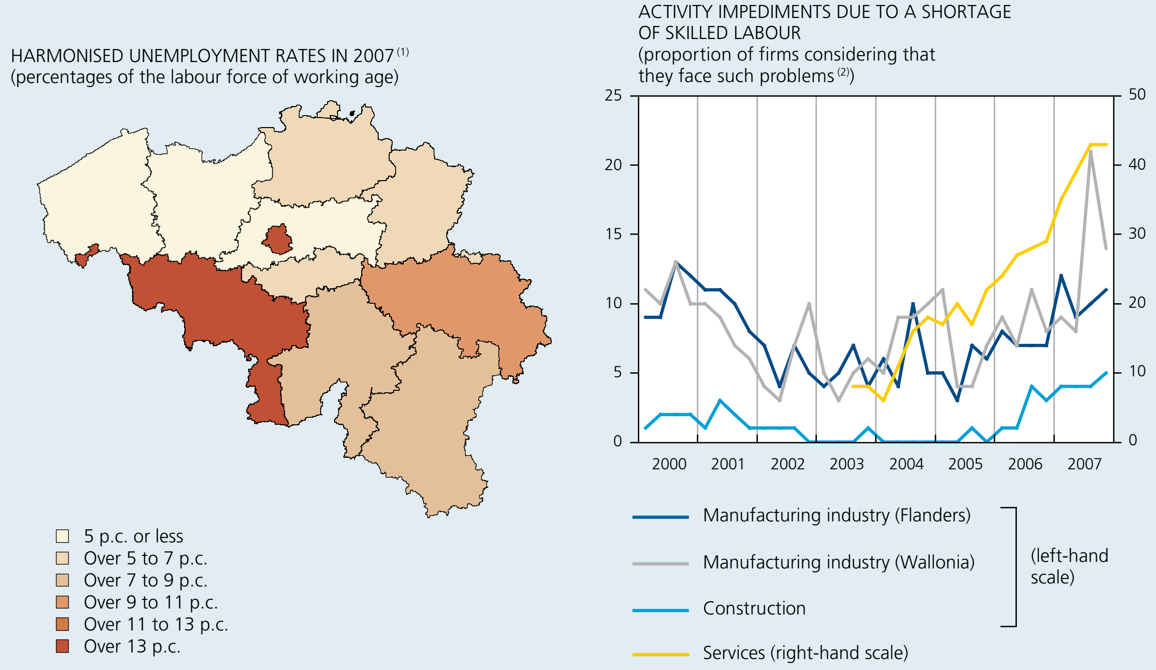
According to the findings of the labour force survey, there is an appreciable risk of tensions, essentially in Flanders and, more generally, in the case of highly skilled workers. Moreover, the results of the Bank's business surveys show that the shortage of skilled labour was increasingly acute in 2007 in manufacturing industry, construction and services. In a labour market where jobs are constantly being created or abolished, it is normal for some time to elapse before the supply of labour and the demand can be matched. Consequently, there is a minimum level of "frictional" unemployment which would exist even on a labour market with no regional or functional mismatches. For Belgium as a whole, the harmonised unemployment rate for highly skilled workers averaged around 4 p.c. in the first three quarters of 2007. An even lower level, in the order of 3 p.c., was actually recorded as the average for all job seekers in West Flanders and in Flemish Brabant, and the unemployment rate for highly skilled workers in Flanders was only 2.6 p.c. This reflects a situation of virtually full employment, and even a labour shortage, which could curb economic growth while also exerting upward pressure on wages.

The fact that the average unemployment rate is higher in Brussels and Wallonia does not mean that there is no risk of a shortage affecting certain functions and branches of activity. Thus, in manufacturing industry – which is the only branch of activity for which regional data are available, and then only for Flanders and Wallonia – it is mainly Wallonian firms that reported worsening problems in recruiting the necessary staff to expand their activities in the second half of 2007.

The problem of the limited labour supply is acute in Belgium. Like the employment rate, the activity rate is well below the EU average: during the first three quarters of 2007, around 67 p.c. of persons aged from 15 to 64 years had a job or were seeking one, against just over 70 p.c. on average in the EU. The difference is even greater if account is taken of inactive persons who would nevertheless be prepared to work. Although – unlike job seekers – they cannot be mobilised immediately, they could ultimately reinforce the labour supply. In Belgium, they represented around 3 p.c. of the population of working age. Thus, overall, seven out of ten Belgians between the ages of 15 and 64 years were working or wished to work. In other words, around 30 p.c. of the potentially active population is not prepared to work, against an average of less than 25 p.c. in the EU. On the scale of Belgium, this difference with respect to the EU represents a potential additional labour supply of some 400,000 persons. Although Brussels has the lowest employment rate in the three regions, it has proportionately the largest (potential) labour supply, with 72 p.c. of the population of working age, compared to 71 and 67 p.c. respectively in Flanders and Wallonia.

In order to remedy the imbalances already evident – which will become still more acute in the future, owing to population ageing that will ultimately reduce the size of the population of working age –, the effective mobilisation of a larger percentage of the potential labour supply seems essential. It is clear from comparison with the European average that Belgium has considerable scope here, regardless of sex, age, educational level and nationality. Only in

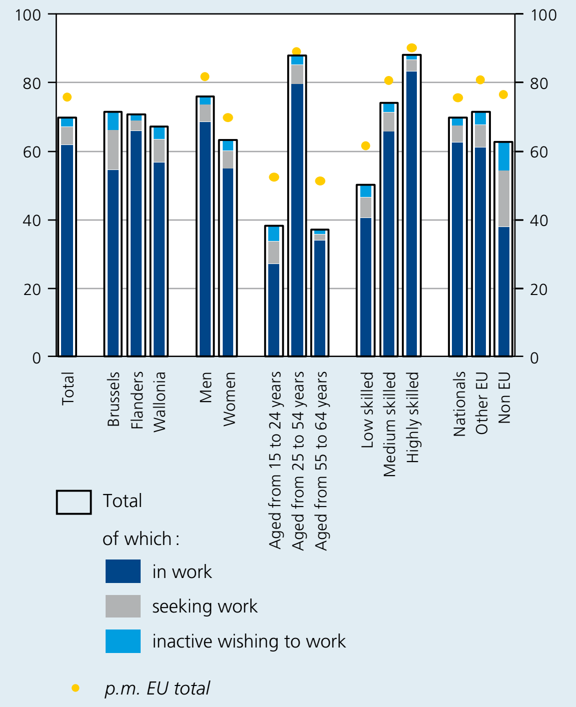
CHART 37 INDICATORS OF LABOUR MARKET SHORTAGES



Sources: DGSEI, NBB.
(1) Average for the first three quarters.
(2) Weighted according to the relative size of the firms, measured via turnover or employment.

CHART 38 EMPLOYMENT AND LABOUR RESERVE IN BELGIUM IN 2007

(average for the first three quarters, percentages of the corresponding population of working age)



Sources: EC, DGSEI.

the case of highly skilled workers and those aged from 25 to 54 years is the labour supply comparable to the EU average level.

Although a large proportion of young people, low-skilled persons and non-EU nationals, whose employment rate is particularly low, demonstrate a desire to work, there is a marked difference in relation to the EU as a whole. That difference is also great for persons aged 55 and over: in relative terms, a small number of them are working, and few of them wish to return to work. There are various reasons for not participating in the labour market, depending on the characteristics of the inactive persons, as explained in box 9.

Box 9 – Reasons for inactivity in Belgium

In Belgium, one-third of persons of working age were inactive in 2006, i.e. they did not have a job and were not actively seeking work, or were not available for work in the short term. In Brussels and Wallonia, the inactivity rate was 35.1 and 36.4 p.c. respectively; it was lower in Flanders, at 31.6 p.c. In the population aged between 15 and 24 years, two out of three young people were inactive; that proportion was the same for persons aged between 55 and 64. Conversely, the inactivity rate was only 15.5 p.c. for the 25 to 54 age group.

The reasons for not seeking work differ according to the age and sex of the persons in question. The results of analysing the reasons for inactivity for the total population aged between 15 and 64 years, on the basis of the labour force surveys, are therefore influenced by the large proportion of young people recorded as inactive who are still pursuing training and are not seeking employment for that reason. Also, among the older inactive persons not seeking employment, about half are retired or mention personal or family responsibilities.

Within the inactive population aged between 25 and 54 years, three times as many women as men are not seeking work. The reasons given vary according to the composition of the household. In almost half of cases, an adult with no children is not seeking work on grounds of sickness or disability. In the case of couples with one or more children, personal or family responsibilities are the main reason, especially if the child is under 15 years old: in that case, one in three adults mention child care as the reason. For half of those, that is so regardless of child care facilities, and for the other half it is because services are inaccessible or not available. In regard to child care facilities, Belgium scores relatively well according to European criteria on the subject, since the schools can cater for all children between the age of three years and the age of compulsory education, and there are crèche places for 30.5 p.c. of children under the age of three. But apart from the availability of places, the financial costs and the respective ways in which child care and work are organised may prevent the achievement of a good work-life balance. The reasons for not seeking work are more diverse in the case of an inactive person living in a childless household, but personal or family responsibilities and medical reasons are still the main explanation. In single parent families with at least one child under 15, family responsibilities – usually child care – and sickness or disability are the dominant reasons.

REASONS MENTIONED FOR NOT SEEKING WORK BY THE INACTIVE POPULATION AGED FROM 25 TO 54 YEARS IN 2006

(percentages of the total corresponding population)

	One adult, no children	Single parent family with at least one child under the age of 15	Single parent family with at least one child between the ages of 15 and 24	Couple (1) with no children	Couple (1) with at least one child under the age of 15	Couple (1) with at least one child between the ages of 15 and 24	Total
Personal or family responsibilities	7.3	29.7	– (2)	29.6	57.6	45.9	37.6
In training	9.8	13.1	– (2)	6.2	4.3	– (2)	6.2
Sickness or disability	44.5	28.7	35.4	26.8	15.0	15.0	24.1
Thinks no job is available	7.4	– (2)	– (2)	7.9	3.9	8.9	6.6
Other reasons	31.0	24.1	34.4	29.5	19.2	25.0	25.6
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
p.m. Percentages of the total	*12.8*	*5.2*	*2.2*	*34.9*	*32.2*	*12.7*	*100.0*

Source: EC.
(1) Could equally be two adults (without being a couple in the legal sense) or more.
(2) The figure is not given because the data in the labour force surveys are not sufficiently statistically representative.

4.2 Labour costs in the private sector

In 2007, private sector hourly labour costs increased by 2.9 p.c., as in 2006, since the slower rise in negotiated wages – both the real agreed adjustments and the automatic indexations – was offset by a larger contribution from net increases in salaries granted outside the central or sectoral agreements, referred to as "wage drift". The influence of employers' social contributions on the movement in labour costs was neutral.

The real wage increases agreed by joint committees came to only 0.2 p.c. in 2007, below the percentage recorded in the two preceding years. During the biennial cycle of wage agreements, the first year's increases are usually lower owing to the time required for the joint committees to conclude and implement the agreements.

Having averaged close to 2 p.c. in the two preceding years, the wage increase resulting from the automatic mechanism linking wages to consumer prices dropped to 1.6 p.c. in 2007. This easing reflects the movement in the health index, i.e. the national consumer price index excluding tobacco, alcohol, petrol and diesel, particularly owing to the marked deceleration in that index from May to September 2007. The strong increase in inflation in the ensuing months had no significant impact on wages in the year under review. Wages are not in fact adjusted immediately in line with the health index, since the procedures followed vary from one joint committee to another,

TABLE 24 LABOUR COSTS IN THE PRIVATE SECTOR

(calendar adjusted data; percentage changes compared to the previous year, unless otherwise stated)

	2003	2004	2005	2006	2007 e
Gross wages per hour worked	1.5	2.4	2.6	3.0	2.9
Collectively agreed wages (1)	1.8	2.3	2.5	2.3	1.9
Real agreed adjustments	0.4	1.0	0.4	0.5	0.2
Indexations	1.4	1.4	2.1	1.8	1.6
Wage drift (2)	–0.3	0.1	0.1	0.7	1.0
Employers' social contributions (3)	0.1	–0.4	–0.3	–0.2	0.0
Social security	–0.1	–0.1	–0.2	0.0	–0.1
of which: impact of reductions in contributions	–0.2	–0.5	–0.3	0.0	–0.1
Other contributions (4)	0.1	–0.3	–0.1	–0.2	0.1
Labour costs per hour worked	1.6	2.1	2.3	2.9	2.9
p.m. Including the effects of the reductions in payroll tax (5)	*1.6*	*2.1*	*2.2*	*2.7*	*2.7*

Sources: FPS Employment, Labour and Social Dialogue; General notes on the budget; NAI; NOSS; NBB.

(1) Wage increases fixed by joint committees.

(2) Increases and bonuses granted by enterprises over and above those under central and sectoral collective agreements, wage drift resulting from changes in the structure of employment and errors and omissions, contribution to the change in labour costs, percentage points.

(3) Contribution to the change in labour costs resulting from changes in the implicit contribution rates, percentage points.

(4) Actual social contributions which are not paid to the government, and imputed contributions.

(5) This concerns the part of the reductions in payroll tax granted to private sector firms. According to the national accounts methodology, the ESA 95, these should be recorded as a subsidy and not as a direct reduction in charges. They therefore cannot be taken into account in calculating labour costs.

but are all based on the change in a moving four-month average of the index. Nonetheless, that acceleration should contribute to significantly higher wage indexation in 2008, so that – for the period 2007-2008 – the inflation forecasts on which the wage agreements were based will be exceeded.

That effect could be tempered to some extent by the activation of all-in clauses which a number of joint committees have inserted in their sectoral agreements. According to information from the Federal Public Service Employment, Labour and Social Dialogue on the sectoral agreements concluded in 2007, only around a quarter of private sector workers are covered by a collective labour agreement (CLA) comprising an all-in clause, as in the previous agreement period. The use of such agreements is much more common in joint committees responsible for manual workers, since over two-fifths of them are covered, whereas the ratio is around one in twenty in the case of non-manual workers. Most all-in clauses make the size of the real agreed increases dependent on the actual wage indexations. If the latter exceed the figures based on the inflation forecasts produced at the time of the preparation of the wage agreement, the difference is deducted in whole or in part, depending on the case, from the increases granted in the second year – i.e. 2008 in the case of the agreements concluded in 2007 – or during the ensuing agreement period.

Like the indexation mechanisms, the all-in clauses vary greatly from one committee to another. They may take a number of forms. Most commonly, when the last real increase of the two-year period is granted, a check is done to verify whether the actual indexations have exceeded the forecasts issued at the time of the sectoral negotiations. If they have, the difference is deducted from the real increase, on the understanding that the latter cannot be negative. In other instances, the nominal sectoral norm is considered an absolute maximum, and a check is done on the occasion of each intermediate increase to see whether it has been exceeded. If the norm has been used up, no further real increase is granted and the indexation is only partly applied, if at all. These clauses were included, in particular, in the CLAs concluded by the joint committees for the construction sector, the food industry and garages.

In 2007, the slower pace of agreed wage adjustments was accompanied by an increased contribution from wage drift to the rise in hourly labour costs, namely 1 percentage point against 0.7 in 2006. This acceleration is due partly to a non-recurring accounting factor, namely the earlier date for submitting holiday pay declarations to the NOSS on termination of an employment contract. However, the increased pressure of wage drift on labour costs, already clearly apparent in 2006, may also be due to the tensions on the labour market.

Speedy labour cost adjustments in line with economic activity are possible via the agreements concluded at enterprise level, which supplement the sectoral agreements, in particular by the payment of allowances and bonuses not included in the agreements, or via extra pay for overtime work. Leaving these factors aside, the wage drift is also determined by changes to the structure of employment. These may have either a negative or a positive influence. For example, a downward effect results from the increased participation of women in the labour market, since they are less well paid, on average, than men, even after adjustments to take account of working time, branch of activity, age, seniority or job. Conversely, the increasing participation of older workers exerts upward pressure, since the labour cost of older people is higher owing to the application of scales related to age and/or seniority in many joint committees, primarily those concerning non-manual workers. The transposition into Belgian law of Directive 2000/78/EC establishing a general framework for equal treatment in employment and occupation should end discrimination based on age. Provisions on this matter were included in the anchorage points of the central agreement for 2007-2008. Thus, it was agreed that the social partners would take measures at the time of the sectoral negotiations, or at the beginning of 2009 at the latest, to satisfy that directive's criteria. In practice, the government made the mandatory character of the CLAs conditional upon the abolition of the systems of pay scales linked to age, or – failing abolition – objective justification specifying why that had not yet been done, and an undertaking to respect this new framework by the end of 2008.

The central agreement also stressed the importance of developing a results-related bonus system, to make the wage policy more flexible by introducing a larger variable pay component. Such a measure may influence the movement in labour costs, and more particularly the wage drift. Profit-sharing mechanisms already exist, but the social partners have found that these instruments are little used. For 2005, on the basis of partial data, the national accounts in fact only recorded a sum of 160 million euro paid out by way of profit sharing, or just 0.1 p.c. of the wage bill. The social partners therefore wanted to provide additional impetus here. To that end, in December 2007, in the National Labour Council, they concluded a collective agreement on the granting of a bonus to workers. This new scheme for financial rewards linked to corporate results came into effect on 1 January 2008. The bonus is granted subject to attainment of specific pre-set targets. These bonuses cannot be regarded as ordinary pay, and they therefore cannot be granted recurrently and automatically. The targets may concern a group of workers or the entire staff. They may be financial goals, but they may also, for example, relate to the number of industrial accidents or absenteeism. The bonuses cannot exceed a net maximum of 2,200 euros per worker per annum. A final deduction at source of 33 p.c. is calculated on this amount and paid to the NOSS. The employer can deduct the total cost of these bonuses from corporate income tax.

The influence of employers' social contributions on wages was neutral during the year under review. The reductions in social security contributions had a moderating effect of 0.1 percentage point. They increased from 4.7 billion euro in 2006 to over 5.1 billion in 2007, or 4 p.c. of the private sector wage bill. That increase was due mainly to measures in favour of target groups on the labour market, more particularly young people and older workers. The recruitment of low-skilled workers under the age of 30 years has been encouraged since 2006 by the introduction of a specific reduction, while for workers aged 50 years and over an additional reduction introduced under the generation pact came into effect in 2007.

Other forms of reduction in labour charges have recently gained in importance, namely reductions in payroll tax. These provisions, the effect of which is recorded in the national accounts as a subsidy and not as a direct reduction in labour costs, were initially intended to promote research and development, innovation and specific working arrangements such as shift work and night work, as well as overtime. This wage subsidy system was extended in 2007. Thus, since April the percentage reduction has been increased for overtime, and for shift work and night work, and since October all firms have been granted a wage subsidy, namely the structural reduction in charges of 0.15 p.c. of labour costs, introduced under the central agreement for 2007-2008. This takes the form of non-payment of part of the payroll tax equal to 0.25 p.c. of gross wages. In 2007, this new measure reduced the labour charges by 45 million euro. In all, the support to the private sector in the form of payroll tax cuts totalled 730 million euro in 2007, or 0.6 p.c. of the wage bill. If this form of reduction in charges had been taken into account in calculating labour costs per hour worked, that would have lowered the increase by 0.2 percentage point, as in 2006.

While the general reduction introduced under the central agreement benefits all firms, that is not the case for the reductions in payroll tax applicable to shift work and night work, which mainly benefit firms in the industrial branches. In 2006, almost half of shift workers and around one-third of night workers were employed in industry. Conversely, overtime and hence the associated reductions were more evenly distributed among the branches of activity.

TABLE 25 LABOUR CHARGE REDUCTIONS GRANTED TO EMPLOYERS

(totals, millions of euro)

	2003	2004	2005	2006	2007 e
Reductions in employers' social security contributions	3,451	4,063	4,544	4,731	5,067
of which:					
Structural reductions	2,944	3,420	3,822	3,898	4,005
Target groups	0	220	364	492	730
of which:					
Young workers	0	24	48	112	190
Older workers	0	98	105	116	236
p.m. Percentages of the private sector wage bill	*3.2*	*3.6*	*3.9*	*3.9*	*4.0*
Reductions in payroll tax (1)	8	25	110	409	730
of which:					
Scientific research and innovation	8	0	4	47	64
Shift work and night work	0	25	95	328	554
Overtime	0	0	11	23	32
General reduction	0	0	0	0	45
p.m. Percentages of the private sector wage bill	*0.0*	*0.0*	*0.1*	*0.3*	*0.6*

Sources: General notes on the budget, NAI, NOSS, NBB.
(1) Except the reductions granted to universities, colleges or other public institutions.

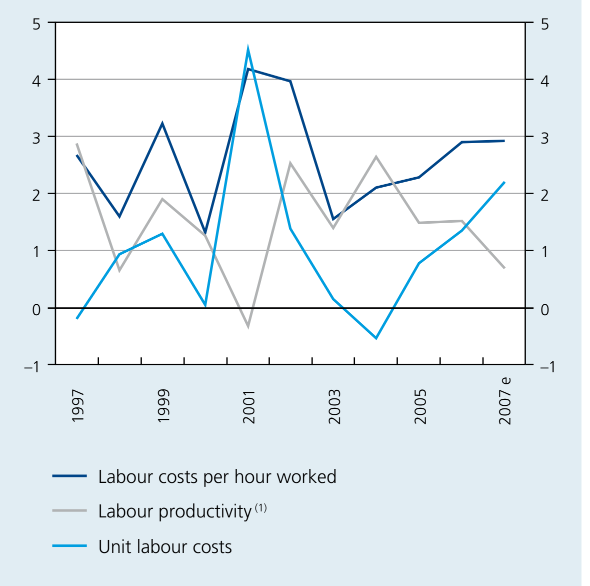
During the year under review, the other employers' social charges exerted slight upward pressure on labour costs amounting to 0.1 percentage point. Redundancy payments in connection with the Volkswagen Forest restructuring – treated as imputed contributions under the ESA 95 – in fact more than offset the general reduction in these charges, which comprise in particular other imputed social contributions and payments by employers for their staff under a supplementary pension scheme.

The stabilisation of the growth rate of labour costs per hour worked in the year under review was accompanied by a cyclical contraction in productivity gains, as is usual when economic activity slows down, since the rate of job creation takes time to respond. The rise in unit labour costs therefore accelerated to 2.2 p.c.

Although the wage negotiation mechanism is based on a single norm, defined under the central agreements concluded at national level, it nonetheless permits some differentiation between sectors in the movement in wages. In fact, while the rise in hourly labour costs in the private sector averaged 2.6 p.c. per annum over the period 1996-2006, it varied between 2 p.c. in the "real estate, renting and business services" branch and 3.5 p.c. in "transport and communication". Despite the moderate rise in hourly pay, unit labour costs recorded an

CHART 39 LABOUR COSTS AND LABOUR PRODUCTIVITY IN THE PRIVATE SECTOR

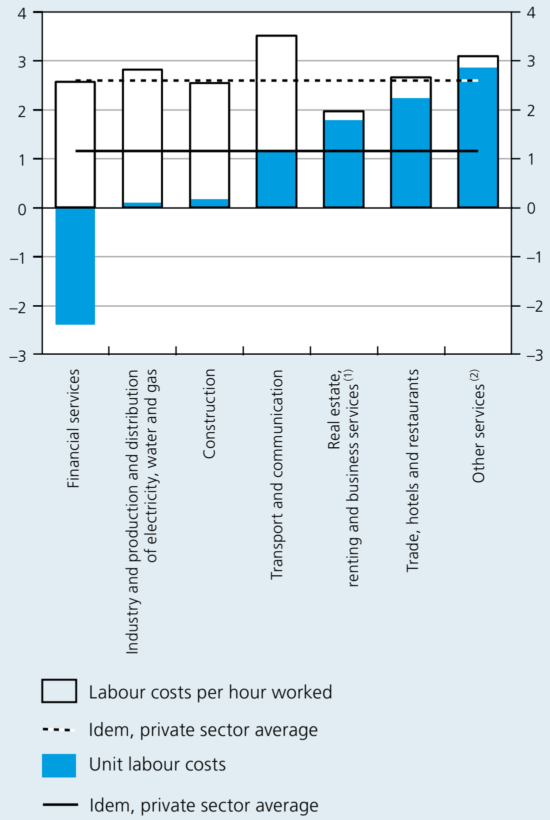
(calendar adjusted data, percentage changes compared to the previous year)



Sources: NAI, NBB.
(1) Value added in volume, per hour worked by employees and self-employed workers.

CHART 40 LABOUR COSTS IN THE BRANCHES OF ACTIVITY, 1996 TO 2006

(average of the annual percentage changes)



Sources: NAI, NBB.
(1) Excluding housing services in the calculation of value added.
(2) I.e. the "health and social work", "community, social and personal services" and "domestic services" branches.

above-average increase in "real estate, renting and business services", owing to the adverse movement in productivity. Certain branches, such as industry and transport and communication, which recorded an above-average rise in hourly labour costs, produced more substantial productivity gains, so that the increase in their unit labour costs was less than, or at most equal to, the average for the private sector. Conversely, this offsetting was not possible in either the "other services" branch or the "trade, hotels and restaurants" branch, where the faster rise in labour costs per hour worked was not associated with stronger productivity gains. Finally, in financial services, unit labour costs showed a marked fall, owing to the large productivity gains accumulated during the period under review, while hourly wages increased in line with the average for the private sector.

Despite this great diversity, the relative specialisation in a particular activity only partly explains the wage differentials between regions. Box 10 examines regional wage variations in the light of the individual data obtained from social balance sheets for 2005.

Box 10 – Staff costs per hour worked in the regions

The social balance sheets submitted by private sector firms provide information on staff costs and the volume of hours worked. However, the staff cost concept differs from the labour cost concept in the national accounts. In particular, it does not include payments to pensioners, who are no longer entered in the staff register, or certain costs recorded on a firm's balance sheet under exceptional expenses, for instance in the case of restructuring.

Altogether, in 2005 – the latest financial year for which the total population of firms [(1)] is available – one hour worked cost an average of 31 euro. The cost was lower in single-region firms, i.e. those which have their head office and/or their places of business in the same region, than in those with establishments in more than one region, namely 29 and 36.7 euro respectively.

(1) Population adjusted according to the methodological principles set out in Annex 1 to the article The social balance sheet 2006, Economic Review, NBB, December 2007.

The difference is due mainly to the type of activity and the size of the firms concerned. They specialise in very different fields: single-region firms are concentrated more in the secondary and non-market sectors, and multi-region firms in the market services sector. Some activities need more skilled personnel, are more exposed to national and/or international competition, offer more scope for productivity gains or achieve larger profit margins, and that could explain the differences in wages. The average size of firms is also a factor. Single-region firms employed an average of 17 workers, whereas multi-region firms had an average workforce of 456 persons. The bargaining power of employers and workers varies according to the firm's size, and economies of scale are only possible beyond a certain threshold. Finally, conditions on the local labour market, more particularly any shortages in certain labour categories, also influence pay conditions.

STRUCTURE OF REGIONAL EMPLOYMENT BY BRANCH OF ACTIVITY IN 2005

(percentages of the total, unless otherwise stated)

	Single-region firms					Multi-region firms		Total
	Brussels	Flanders	Wallonia	Total	*p.m. Average size* [1]	Total	*p.m. Average size* [1]	
Agriculture	0.1	0.8	0.7	0.7	*7*	0.0	*0*	0.5
Industry	12.5	31.8	28.1	28.6	*36*	20.2	*608*	26.4
Construction	5.0	9.8	11.8	9.8	*11*	1.7	*220*	7.6
Trade, transport and communication	29.8	28.5	25.2	27.8	*11*	44.6	*403*	32.3
Financial, real estate and business services	36.3	11.2	9.2	13.6	*12*	26.9	*549*	17.1
Other services [2]	16.4	17.9	25.1	19.5	*51*	6.7	*359*	16.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	***17***	**100.0**	***456***	**100.0**
p.m. Number of firms	*9,115*	*46,994*	*20,093*	*76,202*	–	*1,016*	–	*77,218*
Workforce of those firms (thousands of employees)	*148.0*	*823.0*	*323.4*	*1,294.4*	–	*463.7*	–	*1,758.1*

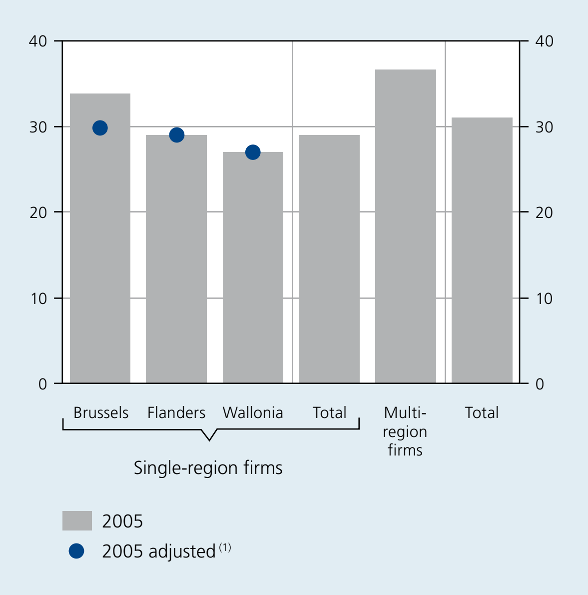
Source: NBB (social balance sheets).
(1) Average number of employees per firm.
(2) I.e. the "health and social work" and "community, social and personal services" branches.

Single-region firms exhibit a relatively more homogenous structure in terms of activity and size. Marked differences in wage conditions are however observed between regions. Staff costs per hour worked came to 27 euro in Wallonia, 29 euro in Flanders and 33.8 euro in Brussels.

Closer examination of firms' specialisation reveals definite characteristics specific to the three regions. In an attempt to measure their impact, staff costs per hour worked calculated at a more detailed level were given a uniform weighting, corresponding to the structure of activity of single-region firms as a whole. However, that adjustment has no significant effect except for single-region firms based in Brussels – proportionately more specialised in business, financial and insurance services – where in 2005 it reduced hourly costs from 33.8 to 29.8 euro. In the other two regions, the adjustment has no notable impact overall. A similar exercise to identify the influence of firms' size also provides no evidence of any significant effect. The wage differentials between single-region firms based in Flanders and Wallonia are therefore due only marginally to differences in the structure of activity or the size of those firms, but reflect a range of specific characteristics concerning in particular profitability, productivity, and the age and skills of the staff.

STAFF COSTS PER HOUR WORKED : INFLUENCE OF THE STRUCTURE OF ACTIVITY ON REGIONAL RESULTS

(euro)



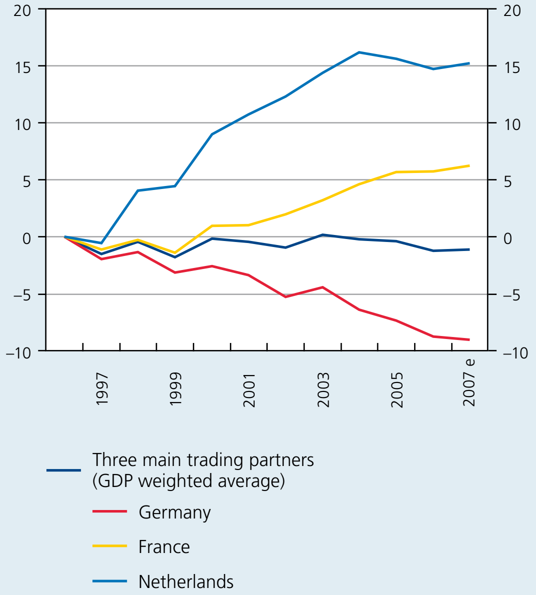
Source : NBB (social balance sheets).

(1) Weighting according to the breakdown, per NACE-Bel 2-digit division of activity, of the hours worked in all single-region firms.

For a small, open economy, analysis of the movement in labour costs would be incomplete without an assessment of the impact of that movement on the competitiveness of Belgian firms in relation to rival foreign firms. The 1996 law on the promotion of employment and the safeguarding of competitiveness refers for that purpose to the average rise in hourly labour costs in the three main trading partners, namely Germany, France and the Netherlands. On the basis of the national data concerning the movement in labour costs per employee and the labour force survey figures for the changes in working time, the Secretariat of the Central Economic Council (CEC), which is responsible for that assessment, states in its latest technical report, published on 6 November 2007, that the average increase in hourly labour costs is estimated at 2.5 p.c. in the neighbouring countries in the year under review. For Belgium, while in this Report the Bank estimates the rise in hourly labour costs at 2.9 p.c., the Secretariat's estimate was only 2.4 p.c., or slightly less than the increase recorded in the three neighbouring countries. This means that Belgium's wage handicap, measured by the cumulative difference in hourly labour cost increases in relation to the three neighbouring countries since 1996, has diminished somewhat, according to the Secretariat, to 1.1 percentage point. That relative stability is a considerable advantage in relation to the Netherlands, and to a lesser extent France, while the handicap in relation to Germany has further increased. On the basis of the Bank's estimates, the cost-competitiveness handicap which emerged in 2004 and gradually increased thereafter worsened again in 2007, to a total of 1.6 percentage points.

CHART 41 LABOUR COSTS PER HOUR WORKED IN THE PRIVATE SECTOR: DIFFERENTIAL IN RELATION TO BELGIUM ACCORDING TO THE CEC [(1)]

(percentage points, differences in relation to the index for Belgium, 1996 = 100)



Source : CEC.
(1) CEC data on labour costs per employee and working time.

Prices

5.

5.1 Summary

In Belgium, inflation measured by the harmonised index of consumer prices (HICP) and calculated on an annual basis declined from 2.3 p.c. in 2006 to 1.8 p.c. Thus, Belgium recorded one of the lowest inflation rates in the monetary union, where the average rate was 2.1 p.c. in 2007. However, this relatively slow pace of price rises masks divergences in both the monthly profile and the movement in the various components of the HICP.

In the first eight months of the year, inflation thus dropped from 1.7 p.c. in January to 1.2 p.c. in August. In contrast, the closing months of 2007 brought a very sharp acceleration, with a peak at 3.1 p.c. in December. This "V"-shaped profile is due largely to developments concerning the energy component, while food prices rose steeply all through the year and even quickened pace in the second six months. Conversely, the pace of price rises for non-energy industrial goods and services remained moderate.

As in other advanced countries, consumer prices in Belgium encountered, on the one hand, the upward pressure exerted by the very strong fluctuations in the prices of crude oil and food commodities on the international markets, and on the other hand, the attenuating effect of stronger international competition and continuing wage moderation. In the recent past, it had already been apparent that the globalisation process influences inflation in both directions, and is therefore accompanied by significant changes in relative prices, while the net impact on inflation tends to be limited. The relative importance of these two factors may nonetheless vary over time: in the second half of the year under review, the pressure exerted by the first of these was very clearly reinforced. In Belgium, as in the other euro area countries, rising inflation was, however, tempered by the appreciation of

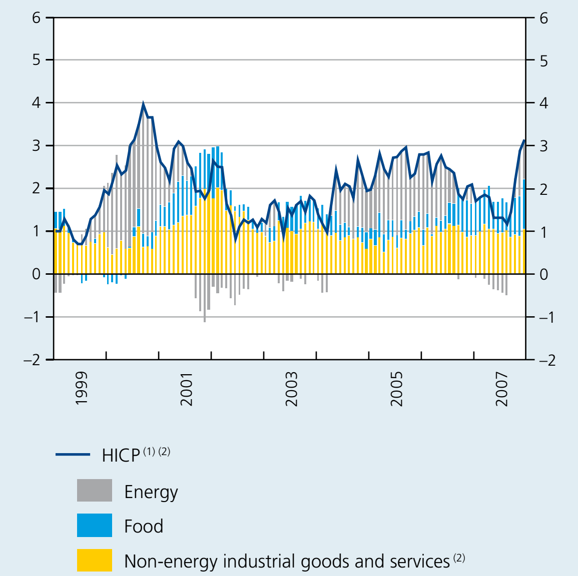
TABLE 26 HARMONISED INDEX OF CONSUMER PRICES FOR BELGIUM
(percentage changes compared to the previous year)

	Total							*p.m. Health index* [3]
		Energy	Unprocessed food [1]	Underlying trend in inflation [2]				
					Processed food	Non-energy industrial goods	Services	
2001	2.4	1.4	6.9	2.1	2.2	2.0	2.0	*2.7*
2002	1.6	–3.6	3.2	2.1	1.5	1.7	2.6	*1.8*
2003	1.5	0.2	1.7	1.7	2.8	1.0	1.9	*1.5*
2004	1.9	6.6	0.9	1.4	2.2	0.3	2.1	*1.6*
2005	2.5	12.7	1.7	1.4	2.0	0.3	2.1	*2.2*
2006	2.3	7.3	3.3	1.6	2.1	0.9	2.1	*1.8*
2007	1.8	0.2	3.0	1.9	4.7	0.9	1.9	*1.8*

Sources: EC, DGSEI, NBB.
(1) Fruit, vegetables, meat and fish.
(2) Measured by the HICP excluding unprocessed food and energy.
(3) National consumer price index, excluding products considered harmful to health, namely tobacco, alcohol, petrol and diesel.

CHART 42 INFLATION IN BELGIUM

(contribution to inflation, percentage points, unless otherwise stated)



Sources : EC, NBB.
(1) Percentage changes compared to the corresponding month of the previous year.
(2) Excluding the estimated effect, in January and July 2000, of the fact that prices discounted in sales have been taken into account in the HICP since 2000.

the euro. The repercussions of exchange rate movements are considerable and are evident almost immediately in the case of energy, whereas their impact on the other HICP components is relatively limited and takes time to emerge.

In Belgium, the easing of inflation in the first half year and its sharp acceleration at the end of the year were further intensified by the specific movement in consumer prices of gas. The increase in excise duty on tobacco and petrol and the introduction of an environmental levy contributed some 0.15 percentage point to inflation.

5.2 Direct impact of higher commodity prices

Energy

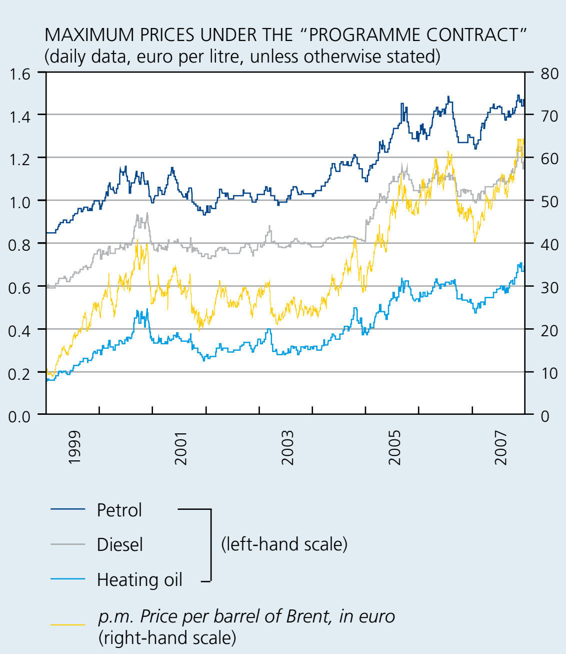
In 2007, energy products exerted hardly any pressure on inflation, on average, in sharp contrast to the three preceding years when very steep increases had been recorded for these products. However, that average conceals very divergent developments throughout the year : energy prices were lower than in the previous year until September, whereas substantial increases were seen at the end of the year.

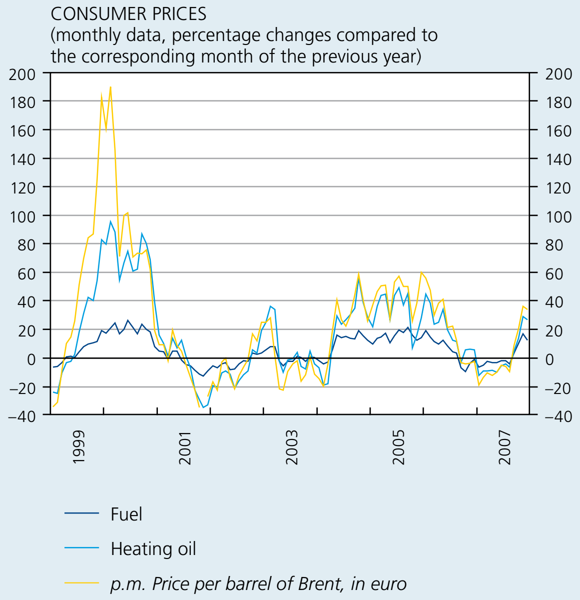
The movement in fuel prices is determined mainly by the crude oil price expressed in euro, the refining, transport and distribution margins, and any changes in the taxes on these products. In 2006, owing to the rising price of crude oil, the maximum fuel prices set by the "programme contract" had reached record levels by the end of the summer ; however, they then declined sharply in the final four months. Therefore, although the crude oil price increased throughout the year – a movement which was nonetheless somewhat attenuated by the appreciation of the euro against the US dollar – fuel prices during much of 2007 were below the level recorded in the corresponding period of 2006. That was no longer the case from September, when the maximum prices of diesel, petrol and heating oil alike equalled the record levels recorded in the previous year, and even exceeded them subsequently. Those prices were thus considerably higher than their end-of-2006 level. At the close of the year under review, motor fuel prices were 12.3 p.c. higher than a year earlier, while heating oil had gone up by 26.6 p.c. This last product is more sensitive to fluctuations in crude oil prices because, unlike petrol and diesel, it attracts only low flat-rate duties.

In practice, consumer prices are lower than the maximum prices set by the "programme contract", since the petroleum product distributors grant discounts. In 2007, the average consumer prices of petrol, diesel and heating oil included in the HICP were thus lower than the official maximum prices by 6.3, 5.8 and 1.4 euro cents per litre respectively, amounts comparable to the discounts granted in 2006. In other words, these discounts no longer curbed the rate of price rises for these products, as they had between 2002 and 2006, a period of constant year-on-year increases.

In accordance with the law of 10 June 2006 on biofuels, from 1 October 2007 the federal government increased by around 3 euro cents per litre the excise duty on petrol not blended with renewable fuels. Since the selling price of renewable fuels – i.e. the "bio" element of biofuels – is considerably higher than that of purely fossil fuels, a differential rate of excise duty is the only way of enabling the former to compete with the latter on an equal footing. In November 2006, the excise duty on unblended diesel had already been increased by 1 euro cent per litre for that purpose. Moreover, under the programme law of 11 July 2005, the proportion of esterified biodiesel added to blended diesel increased from 3.37 to 4.29 p.c., and then to 5 p.c. The price of unblended diesel therefore had to

CHART 43 CONSUMER PRICES OF PETROLEUM PRODUCTS





Sources : EC, Thomson Financial Datastream, NBB.

be increased slightly via a further adjustment to the excise duty. However, this last measure had only a negligible impact on diesel prices.

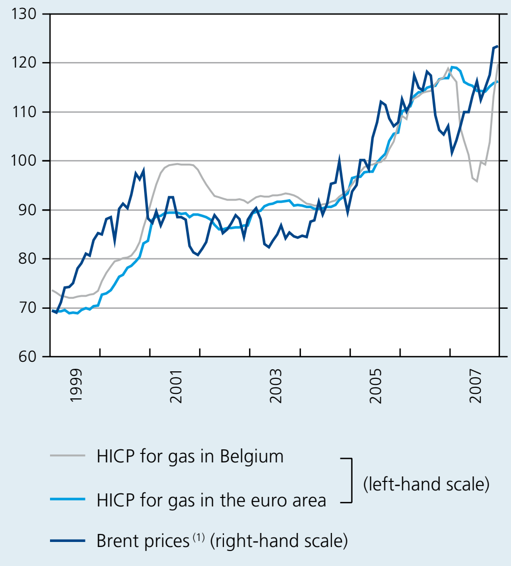
In addition, the government decided to reactivate the reverse ratchet system. Under this device, which was introduced in May 2005, each increase in VAT revenues generated by a price increase under the "programme contract" is totally offset by a cut in excise duties, so long as the prices set by the "programme contract" exceed the thresholds of 1.10 euro per litre for diesel and 1.50 euro for petrol. This mechanism had already reduced the excise duties on diesel by around 5 euro cents per litre between July 2005 and August 2006, thus bringing them close to the minimum of 30.2 euro cents per litre set by the EC. They were further reduced by around 1.5 euro cents per litre on 5 December 2007, so that the minimum duty level has actually been reached for blended diesel. Leaving aside their impact on the budget, such measures have the disadvantage of weakening the potential signal given by these prices to encourage a reduction in energy consumption. Moreover, since the activation threshold was never exceeded in the case of petrol, the reverse ratchet system increased the differential between the prices of diesel and petrol.

Other factors specific to Belgium also had a considerable influence on the movement in consumer prices of energy. More particularly, this concerns the direct and indirect consequences of the liberalisation, on 1 January 2007, of the gas and electricity markets for the whole of Belgium: on that date, the opening up of the residential markets in Wallonia and Brussels completed the process of liberalisation initiated in Flanders in July 2003. The movement was particularly marked in the case of gas, with a sharp fall from the first months of the year. Gas prices in Belgium in fact fell much more steeply than in the euro area as a whole, before rising again in the final months of 2007. Apart from a small reduction in the energy levy and the downward influence of the probably stronger price competition following liberalisation, this profile mainly reflects the indirect consequences of the liberalisation, which affected all three regions of the country.

First, the formula for one of the parameters which gas suppliers use to index their tariffs was modified. Gas prices in fact depend largely on the movement in energy prices on the international markets. Thus, gas tariffs are traditionally adjusted partly according to the movement – with a several-month time lag – in the international petroleum product prices quoted in euro, which themselves are closely linked to the prices per barrel of Brent.

CHART 44 CONSUMER PRICES FOR GAS AND PRICES OF BRENT CRUDE

(indices 2005 = 100, unless otherwise stated)



Sources : EC, Thomson Financial Datastream, NBB.
(1) Brent prices in euro.

In view of the time taken to make this adjustment, the transmission of Brent prices therefore initially exerted a downward effect on gas prices in Belgium, at the beginning of 2007, before steadily driving them higher from the middle of the year. However, this profile became more marked following liberalisation. In fact, since the beginning of the year under review, the reference prices of natural gas in Zeebrugge (called Zeebrugge Hub) have been a second factor determining the indexation of gas tariffs, alongside heating oil prices. Almost all the suppliers active on the Belgian market opted to use these two determinants, but in proportions which may vary according to the methods used to fix the indexation of their tariffs. In 2007, the two determinants declined and then began rising again almost simultaneously, thus further accentuating the movements during the year. In addition, the upward movement at the end of the year was even more strongly reinforced following the October change in the indexation formula mentioned above on the part of the main supplier of gas to households. The effects of that adjustment were fully evident in the HICP from November.

Furthermore, the liberalisation of the gas and electricity markets brought improvements in the method of recording prices, both in order to adapt to the new structure of these markets and to comply with the common rules laid down by Eurostat for calculating the HICP, particularly the rule whereby prices should be recorded as close as possible to the time when consumption of the product begins. As a result, since January, the price index now reflects the movement in the monthly prices, whereas previously it reflected the movement in the annual bills as deemed to be sent to households, which in practice was equivalent to an average of the prices for the twelve preceding months. Another consequence of this methodological adjustment is that, as households generally pay a fixed monthly amount by way of intermediate instalments, there may be some divergence between households' assessments of changes in the prices invoiced and the movement in the gas and electricity price index. In fact, it is not until households receive their annual statement that they are really able to assess the average movement in prices, provided that they are also able to distinguish between the part of the bill attributable to price changes and the part relating to fluctuations in consumption, due for example to more favourable or more adverse weather conditions. This difficulty of assessing price movements is also suggested by the recent survey conducted for Flanders by the regional regulator, VREG. This problem could engender a structural difference between perceived and measured inflation, and therefore needs to be specifically monitored.

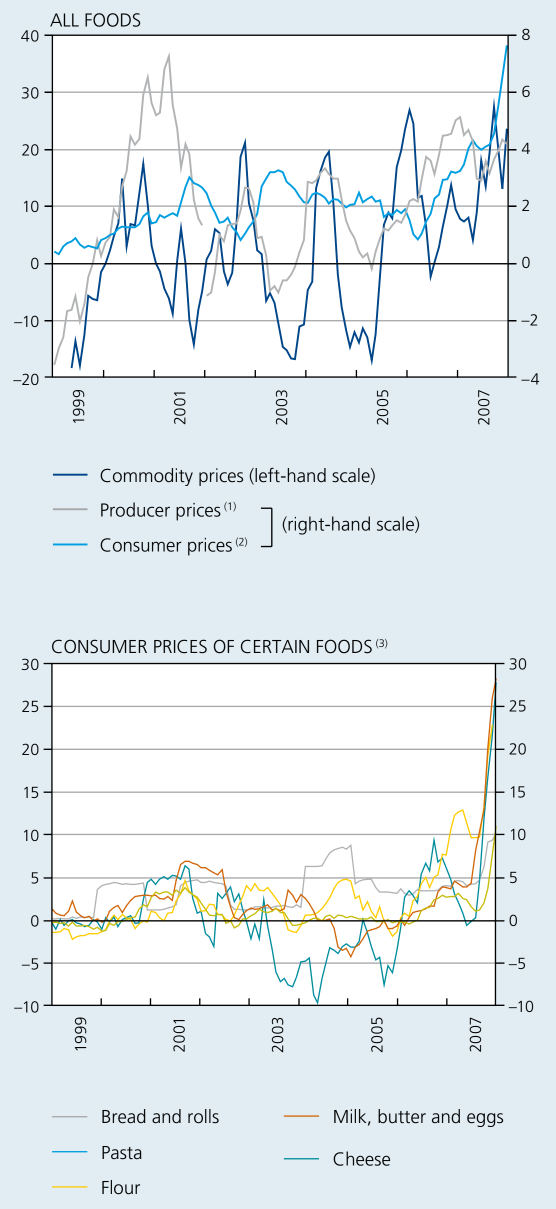
Food

During the year under review, food prices went up by 4 p.c. While prices of unprocessed foods, namely vegetables, fruit, meat and fish, rose at a rate close to that seen in 2006, namely 3 p.c. compared to 3.3 p.c., in contrast, processed food prices increased much more sharply, rising by an average of 4.7 p.c. compared to 2.1 p.c. in 2006. Furthermore, the increase in these prices accelerated in the second half of the year to 6.6 p.c. in the final quarter of 2007. The rise in food commodity prices and the impact of the increased cost of energy are the reasons for this unusually high inflation.

There has been an upward trend in food commodity prices since the beginning of 2002. Owing to tension between supply and demand, the price rises have steadily accelerated on the international markets since mid 2006. In the closing months of 2007, market conditions were even tighter, triggering a further marked rise in food commodity prices (for more detailed information on the underlying causes, see box 1 in chapter 1 on the international environment). Thus, the HWWI food commodity index, expressed in US dollars, increased by 24.8 p.c. in 2007, against an average of 8.5 p.c. in the period 2002-2006. In the last quarter of 2007, a rise of 33.5 p.c. was even recorded against the corresponding period of the previous year. The biggest increases concerned cereals, oils and fats. FAO figures show that dairy products, which are not included in the HWWI index, went up by almost 80 p.c. on the international markets during 2007. However, owing to the persistent depreciation of the dollar, these increases were attenuated by around 9 percentage points, on average, for 2007 when expressed in euro.

CHART 45 **TRANSMISSION OF THE INCREASE IN THE PRICE OF FOOD COMMODITIES**

(percentage changes compared to the corresponding month in the previous year)



Sources: EC, HWWI, DGSEI, NBB.

(1) Owing to a change in the methodology of the producer price index for the domestic market, there is a break in the series between the old index (base 1980 = 100) and the new index (base 2000 = 100) with effect from 1 January 2002.

(2) Processed food prices according to the HICP.

(3) HICP.

In the case of consumer prices, the strongest increases were also recorded for dairy products, eggs and cereals: thus, compared to the end of the previous year, the price of milk was around 30 p.c. higher in December 2007, and egg and butter prices had risen by around 25 p.c., while flour had gone up by 32 p.c., pasta by 28 p.c. and bread by almost 10 p.c. However, the rise in consumer prices of foods was less marked than the increase in commodity prices, since the latter represent only a small part of the consumer price, which also depends on the cost of processing, transport and distribution.

Thus, according to the United States Department of Agriculture (USDA), the price of the unprocessed agricultural product leaving the farm is about 19 p.c. of the price which the consumer pays for a food product. The price of the agricultural product itself obviously includes non-agricultural inputs, such as fertilisers, which also account for part of the increase in the cost of agricultural products owing to their high energy intensity. That proportion calculated by the USDA is of the same order of magnitude for Germany, for which the German Federal Research Centre for Agriculture (Bundesforschungsanstalt für Landwirtschaft (FAL)) calculated that the farmer receives around 25 p.c. of the consumer price. The two studies indicate that there are wide disparities between the various products. Thus, cereals account for a very small percentage of the bread price, partly because energy represents a relatively large share of the production costs. For meat, the agricultural value represents 25 to 50 p.c. of the consumer price. For dairy products, the figure is close

TABLE 27 **SHARE OF THE AGRICULTURAL VALUE IN THE CONSUMER PRICE OF FOODS**

(percentages)

	EU	Germany	United States
Bread	4	4	6
Meat		26	
Beef			45
Pork	50 – 70		33
Poultry	50 – 70		43
Dairy products		37	34
Eggs		67	36
Oils and fats			21
Potatoes		16	16
Sugar		38	20
Average		*25*	*19*

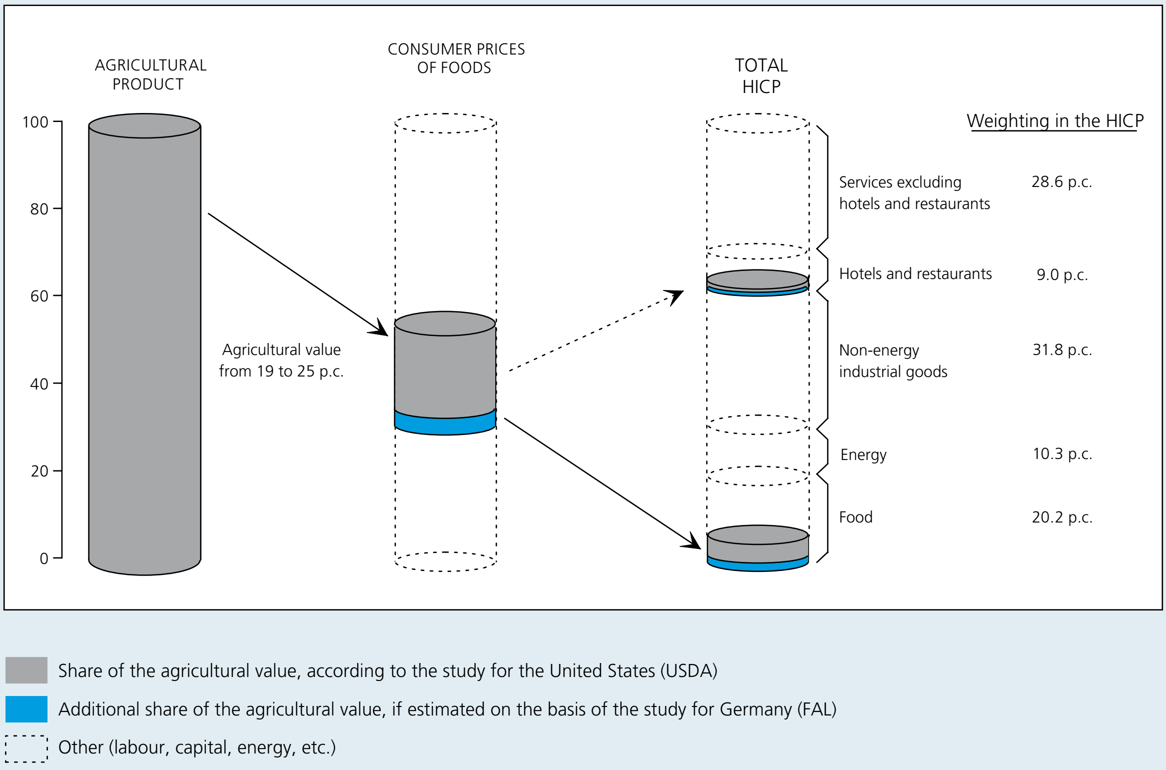
Sources: CE, FAL, USDA.

to 35 p.c. Conversely, the farm product price represents a higher percentage of the consumer price of eggs. The EC has published similar conclusions for the EU as a whole, but for a smaller number of products.

The effect of the rise in food commodity prices on the HICP should be smaller still, since food products represent only around 20 p.c. of that index. Moreover, foods hardly ever constitute an intermediate input for the production of other goods and services, so that there are very few indirect repercussions. However, the hotel and restaurant sector is an exception. Yet according to an analysis of the input-output tables which reflect the structure of the Belgian economy, food products have a weight of only 9.4 p.c. in the hotel and restaurant sector, which itself only represents 9 p.c. of the HICP, so that even through this channel, the higher cost of food commodities has only a limited potential impact on the general level of prices.

In view of these findings, the scale of the price rises recorded for food products and, particularly, the speed with which increases in the prices of food commodities and basic products were passed on during the year under review, are striking. A study conducted within the framework of the Eurosystem Inflation Persistence Network (IPN) found that, for food products, over 20 p.c. of producer prices change each month, compared to around 15 p.c. for consumer prices. These results are based on the microeconomic data banks which the Directorate General of Statistics and Economic Information of the FPS Economy, SMEs, Self-employed and Energy uses to compile the index of producer prices and the index of consumer prices. As far as possible, they exclude price fluctuations resulting from temporary reductions – which may be substantial, especially at the level of consumer prices. As a result, while food prices are adjusted less frequently than the prices of petroleum products, which – as indicated earlier – respond very promptly to movements in the crude oil price, they still change much more often than the prices of non-energy industrial goods. There is therefore generally a certain time lag before the movement in food commodity prices is reflected in producer prices, and before the latter in turn affect consumer prices. This second finding is in line with the observation that the frequency of price changes for food products tends to be higher for producer prices than for consumer

CHART 46 TENTATIVE ESTIMATE OF THE SHARE OF FOOD COMMODITIES IN THE HICP

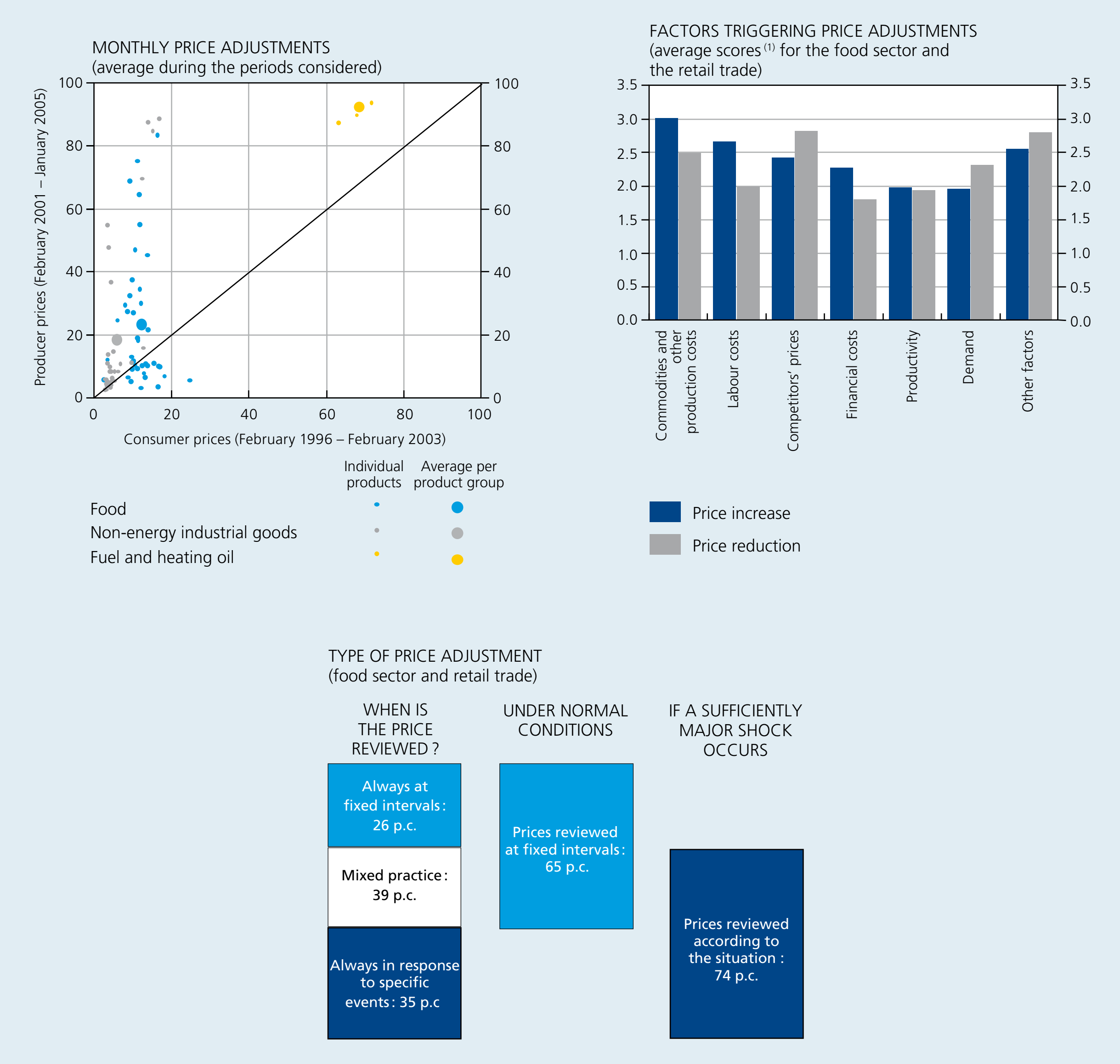


Sources: EC, FAL, USDA, NBB.

prices. During the year under review, the rise in commodity prices was passed on sooner than usual. Moreover, equally unusually, the timing of the transmission to producer and consumer prices more or less coincided.

This faster transmission is due to certain specific characteristics of the food price shock. Thus, it is evident, from the ad hoc survey which the Bank conducted in 2004 within the framework of the IPN on the pricing practices of firms, that prices react asymmetrically to shocks. Cost factors are more important for price increases than for reductions, while the movement in demand and competitors' prices is more important for price cuts than for increases. Price rises are in fact relatively easy to justify by referring to cost increases, which are often universally apparent. This observation confirms the findings recorded in the final months of 2007 : price rises were very clearly announced and motivated by the increase in costs. The above survey also showed that the price adjustment may suddenly deviate from its normal pattern of changes at fixed intervals and respond to specific events if a sufficiently large shock occurs. The current rise in the cost of certain food commodities can indeed be regarded as a substantial shock, particularly as its impact – in view of the

CHART 47 PRICE ADJUSTMENT CHARACTERISTICS



Sources : DGSEI, NBB.

(1) Firms were asked to indicate the importance of a series of factors triggering price increases and reductions respectively ; they were offered a choice between the following options : "1 = not important", "2 = not very important", "3 = important" and "4 = very important".

high level of prices at global level – was no longer moderated by the common agricultural policy (for more details, see box 11). For food products, there is some anecdotal evidence of the transition, during the year under review, from a system of reviewing prices at fixed intervals to a system of reviews according to the situation. Thus, the agricultural sector normally sells the bulk of its output at pre-agreed contract prices. During 2007, however, many contracts were cancelled, especially for milk, and large price increases were negotiated. The commodity price shock thus led to some synchronisation in the adjustment of prices by individual firms, facilitating the rise in prices: firms did not need to be so concerned about their relative position on prices, and hence their competitive position.

Box 11 – Does the increase in food prices necessitate further adjustments to the EU's common agricultural policy ?

During 2007, world market prices of many agricultural products, such as cereals, milk powder and butter, increased strongly. Until recently the EU's common agricultural policy (CAP) largely protected prices on the European market against this type of fluctuations, as the guaranteed price on the internal market exceeded the world market price. However, owing to the increase in world market prices in 2007 and the cuts in guaranteed prices on the internal market resulting from the 2003 CAP reform (cf. below), the price rises on the global markets had a greater impact on the European market than in the past. This in fact attenuated various distortions of the pricing mechanism. Nonetheless, the current rise in world market prices for food raises more general questions concerning the effects of the CAP and the possible need for further reforms.

The CAP was devised in the 1950s. The war years had taken their toll on European agriculture, which was no longer capable of satisfying the food requirements of the population. The need for a common agricultural policy was therefore enshrined in Article 33 of the Treaty establishing the European Community. The aims of that policy were: (i) to increase agricultural productivity, (ii) to ensure a fair standard of living for persons engaged in agriculture, (iii) to stabilise markets, (iv) to assure the availability of supplies, and (v) to ensure that supplies reach consumers at reasonable prices.

Initially, the CAP supported the incomes of farmers by guaranteeing them a price on the internal market which was in many cases much higher than the world market price. To that end, a system of intervention buying, import levies and export subsidies had been developed. This system encouraged excess production – the "butter mountain" and the "milk lake" became legendary – and implied an immense cost to the budget. Another notorious drawback of the CAP is that it hampered the development of agriculture in other regions of the world where this sector did not receive such substantial structural aid, particularly in the developing economies.

In 1980, the CAP accounted for almost 70 p.c. of the total EU budget. It came under ever-increasing criticism, and over the years the price support was reduced somewhat, and new measures were introduced, such as production quotas and compulsory set-aside, to inhibit the overproduction. In 2003, the European agriculture ministers agreed on a more fundamental reform of the CAP to satisfy the requirements of the international trade agreements, to continue cutting the CAP budget and to make the agricultural sector more competitive. For that purpose, a whole array of support measures linked to production were replaced by a single payment per farm, regardless of the type of production, and it was agreed that the guaranteed prices for certain products, such as milk powder and butter, would be gradually reduced. For other products, such as sugar, that also applied subsequently in the ongoing CAP reforms.

As a result of these measures, support for the agricultural sector is now far less closely linked to production, and it therefore causes less price distortion than in the past. In practice, the steep rise in world market prices recently further reinforced that trend. Moreover, the budgetary cost of the CAP has been greatly reduced; in 2007, it was already down to 43 p.c. of the total EU budget, and by 2013 the CAP's share of the budget is set to fall to 36 p.c. of the total. Nevertheless, the CAP still generates market distortion, although to a lesser extent than previously, and it still causes a price differential between the internal market price and the world market price for certain agricultural products such as milk, butter, meat and sugar. Measures aimed at limiting supply no longer seem appropriate, given the strong increase in demand for food products.

In the context of the recent price movements, the EC tried, in the final months of the year under review, to relieve the pressure on prices by temporarily relaxing some of the CAP instruments designed to limit supply. Thus, the Council of agriculture ministers decided, in particular, to abolish the compulsory set-aside rate of 10 p.c. for the 2007 autumn sowings and those scheduled for spring 2008. In addition, import duties applicable to almost all cereals except oats were suspended for the current marketing season – ending on 30 June 2008 – unless there is radical change in the market situation before that date, which might justify their reintroduction.

At the end of the year, the Commission also launched numerous ideas for continuing to reduce aid to agriculture and enhancing its effectiveness. Moreover, in view of the high prices of agricultural products, the Commission felt it appropriate to speed up the progressive abolition of price support and the existing quotas, and to make permanent the temporary abolition of the compulsory set-aside rate. However, no specific proposals will be submitted to the Council of agriculture ministers until some time in 2008.

The continued CAP reforms may improve the allocation of resources and result in cheaper prices for the European consumer. The impact of the cheaper prices on purchasing power is progressive in that it has a greater effect on low-income households, because food products represent a larger share of their consumption basket. However, reforming the CAP is not enough to ensure that consumers actually benefit from more advantageous conditions : it is also necessary to ensure that those lower prices are actually passed on in the subsequent stages in the processing of agricultural products, and that they are reflected in wholesale and retail prices.

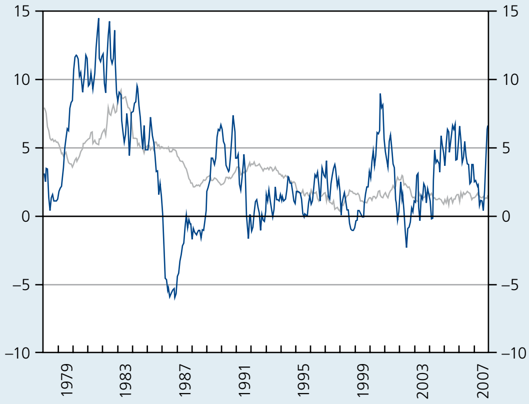
5.3 Non-energy industrial goods, services and second-round effects

In contrast to the picture for energy and food, inflation originating from services and non-energy industrial goods remained low in 2007, at 1.4 p.c. The main effect of the increase in commodity prices was thus to initiate significant changes in relative prices, but the net effect on inflation has been rather limited so far. Taking a historical view, the scale of the relative price movements seen not only in 2007 but also during the period from 2004 to 2006 was not exceptional. However, the recent situation differs from the past in that the rising prices of energy and food have not triggered a more widespread inflationary tendency, prompting questions about the factors behind the absence of contagion or second-round effects.

Part of the reason is that the higher cost of commodities is only one aspect of globalisation. In fact, the development in the emerging economies of cheaper products exported to the rest of the world has coincided with stronger demand for commodities – which have therefore risen in price – and keener competition, which has tended to restrain the price increases of labour-intensive products. In addition, the Eurosystem's monetary policy is designed to avoid second-round effects, while the first-round effects of higher commodity prices are more difficult to neutralise, given the time lags for the transmission of monetary policy. That is precisely why the Governing Council defined price stability – an increase in the HICP of less than, but close to 2 p.c. – as a medium-term objective. The absence of second-round effects in the euro area as a whole helps to prevent the emergence of such effects in Belgium, given the very high degree of openness to the other Member States of the euro area. Finally, the movement in wages in Belgium has so far been moderate, despite the indexation mechanism. All the same, most international institutions, such as the IMF, the OECD and the ECB, advocate the elimination of any system of indexing wages to prices. There is in any case less justification for indexation than in the past, as monetary policy is effectively delivering low inflation rates. Under such conditions, there is in fact little difference between negotiations concerning nominal wages, which incorporate inflation expectations compatible with the definition of price stability, and negotiations concerning real wages which are subsequently indexed to actual inflation but adjusted to mitigate the impact of unexpected events, as happens in Belgium, in view of the changes made to the method of setting wages since the 1990s.

CHART 48 CONSUMER PRICE INDEX

(percentage changes compared to the corresponding month of the previous year)



Sources : EC, NBB.

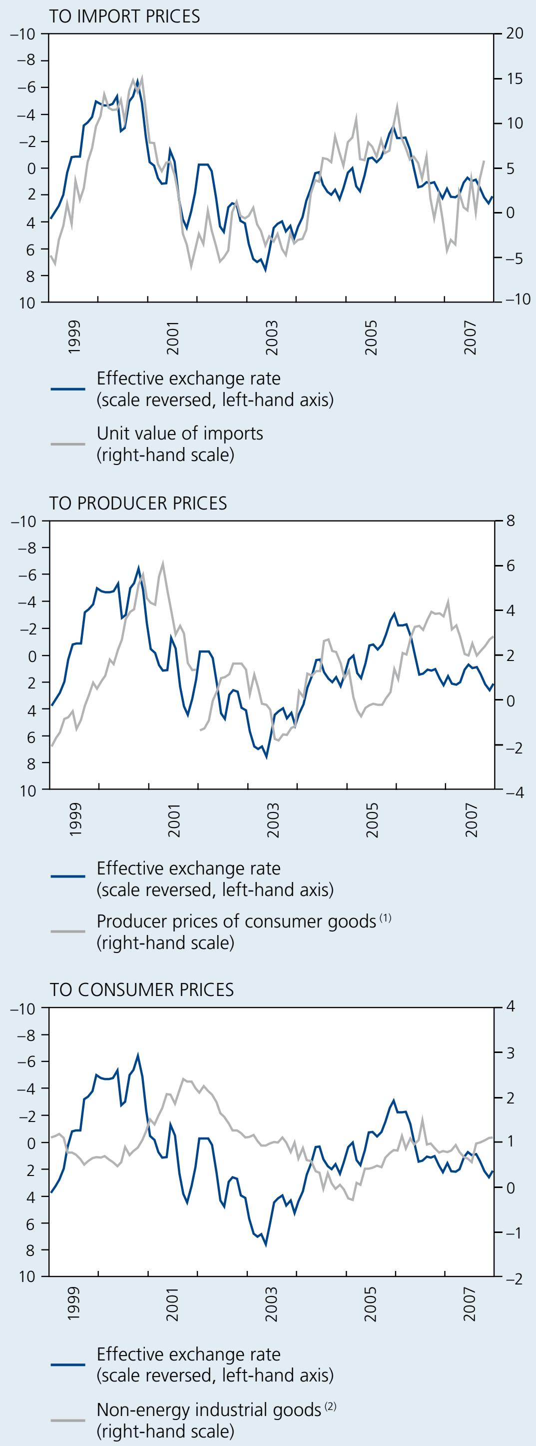
Non-energy industrial goods and services

In 2007, the rate of increase in the prices of non-energy industrial goods remained steady at 0.9 p.c., or 0.8 p.c. excluding the impact of the introduction, in July 2007, of a levy on certain disposable products. Moreover, it was in the case of non-energy industrial goods that the largest price reductions were recorded, particularly for technological products. Non-energy industrial goods are in fact the HICP component where the downward influence of globalisation is generally fairly marked via stronger competition and cheap imports.

The appreciation of the euro also tempered the externally generated pressure on prices of non-energy industrial goods. However, unlike energy products, where the transmission of exchange rate fluctuations to consumer prices is particularly rapid if not immediate, the transmission is considerably slower, and attenuated, in the case of other products. At the import stage, exchange rate fluctuations and import price movements are fairly closely synchronised, but producer prices take time to respond to exchange rate fluctuations, and their response is more limited. The scale of the initial variations is moderated somewhat by the production and processing process, which requires the use of other inputs – i.e. other intermediate products, wages, equipment, etc. Moreover, that process takes time. But the time lag in the transmission of exchange rate movements is probably due to pricing policies, rather than production times. Most firms in fact tend

CHART 49 TRANSMISSION OF EXCHANGE RATE FLUCTUATIONS

(percentage changes compared to the corresponding month of the previous year)



Sources : EC, DGSEI, NBB.

(1) Following a change in the methodology of the producer price index for the domestic market, the series is affected by a break between the old index (base 1980 = 100) and the new index (base 2000 = 100) which took effect on 1 January 2002.

(2) Excluding the estimated effect, in January and July 2000, of the fact that prices discounted in sales have been taken into account in the HICP since 2000.

to adjust their prices only at quite specific intervals, unless an exceptional movement in costs justifies a change, either because the movement is abnormally large or because changes in costs initially perceived as temporary eventually become permanent. In addition, firms tend to react asymmetrically to exchange rate fluctuations, and may pass on cost changes in prices to a lesser extent in the case of an appreciation – as has been the case since mid 2006 for the exchange rate of the single currency against the currencies of the main trading partners – than in the case of a depreciation. The scale of the transmission is even smaller since account has to be taken of value added, and hence of costs yet to be added before the final consumption stage, be they transport or distribution costs. The time lag is also extended by this fact, especially if suppliers are bound to their distributors by medium- or long-term contracts, particularly in regard to prices. The weak and slow transmission of exchange rate impulses to consumer prices is confirmed by a recent EC study for the euro area as a whole: it seems that, in the short term, barely 1 p.c. of the exchange rate fluctuations are thus reflected in producer and consumer prices, while in the longer term that figure climbs to 23 p.c. for producer prices, though it remains below 19 p.c. for consumer prices.

Domestic inflationary pressure also remained modest in 2007. Thus, service prices increased by only 1.9 p.c., the smallest rise since 2000 (except for 2003, when service prices included the downward effect of the abolition of the radio & television licence fee in Flanders and Brussels). Although certain specific factors contributed to this relatively low rate, such as the sharp fall in communication costs for mobile telephony, the movement in labour costs, which are a traditionally important determinant of service prices, has been moderate in recent years, and has not so far exhibited any signs of second-round effects.

Movement in the health index and implications of wage indexation

Despite moderate inflation for non-energy industrial goods and services, the strong acceleration in inflation at the end of 2007, driven by prices of energy and food, raises questions regarding the risk of second-round effects. Beyond the "first-round" effects on consumer prices, i.e. the direct and indirect effects via the transmission to consumer prices of the production costs of firms, second-round effects occur if the scale of the initial shocks is accentuated by a price-wage spiral. This is caused by pay increases granted to workers to offset the reduction in their real income resulting from first-round effects. Such second-round effects are generally facilitated by the presence of an automatic wage indexation system. Although such a system exists in Belgium, its operation is governed by rules which mitigate these undesirable effects and make it more compatible with the operation of EMU.

A first factor which limits, though only partly, the possibility of second-round effects is the health index, adopted in 1994 as the reference index for linking incomes to inflation. The health index in fact excludes from the national CPI the products deemed harmful to health, namely tobacco, alcohol, petrol and diesel. This index therefore excludes motor fuels and thus tempers the impact on wages of a jump in petroleum product prices. Nevertheless, the introduction of the health index has not provided total protection against the second-round effects of an oil shock, as the index still includes heating oil and gas, the prices of which are sensitive to changes in oil prices. Electricity prices, which are also included in this index, are similarly influenced by what happens to the prices of other forms of energy. In practice, it is evident from the cumulative movement in the health index over the period 1999-2007 that its increase has been 2 percentage points lower than that of the overall harmonised index, the former rising by a total of 17.3 p.c. against 19.3 p.c. for the latter. The health index has only neutralised about three-fifths of the increase in the cost of energy, since an index excluding all energy products would have recorded only a 16 p.c. cumulative increase in that time. The health index also acts as a buffer in the case of an increase in indirect taxes on products excluded from its scope, but conversely, it does not cushion other shocks, such as those resulting from the increase in the cost of food commodities.

Comparison of the two sub-periods featuring a rise in crude oil prices, namely the years 1999-2003 and 2004-2007, reveals that on both occasions the health index acted as a buffer, as its increase was 0.6 and 1.3 percentage points respectively below overall inflation. While energy products included in the health index exerted upward pressure amounting to 1.1 percentage points during the second of these sub-periods, their influence had been negligible during the first one.

Another factor limiting the risk of second-round effects consists in the changes made to the wage-setting system by the law of 1996 on the promotion of employment and the safeguarding of competitiveness. In order to determine the margin available for real wage increases, the social partners take account of the expected movement in inflation when negotiating the norm for the nominal increase for the two years covered by a central agreement in accordance with the said law. In view of

TABLE 28 INFLATION AND THE HEALTH INDEX
(cumulative percentage changes)

	1997-1998	1999-2003	2004-2007	1999-2007
Overall inflation (HICP)	2.4	9.7	8.8	19.3
Health index	2.6	9.1	7.5	17.3
Health index excluding energy (1)	2.8	9.0	6.4	16.0

Sources: EC, DGSEI, NBB.
(1) All components linked to the movement in energy prices are excluded, including those of internal origin.

the system of automatic indexation, the ex post rise in nominal wages may nonetheless deviate from the increase initially planned if actual inflation differs from expected inflation. In practice, however, as explained in more detail in chapter 4 on the labour market, it is evident that in recent years a number of sectors have opted for all-in agreements, one aim of which is to be able to reduce the negotiated real increase in wages if indexation exceeds the rate foreseen when the collective agreements were concluded at sectoral level. Such a system allows cushioning of the surprise effect of inflation exceeding the rate anticipated at the time of the negotiations, but only partly in the case of large forecasting errors. It thus limits the risk of second-round effects during the period for which the agreement was signed. In contrast, when a new negotiation cycle begins, that protection disappears and it is down to the negotiators to take that risk into account. It should also be noted that if the actual index increase falls short of the expected figure, the effect of all-in agreements – depending on the case – may be that the nominal pay increase initially planned is actually granted, and that the ex post increase in real wages exceeds the figure agreed on conclusion of the negotiations. All-in agreements therefore imply that the negotiations in fact concern nominal wages. The 1996 law also stipulates that any derailment of the wage increase in Belgium compared to the three neighbouring countries must in any case be taken into account when the social partners determine the new margin for wage increases when negotiating the subsequent agreement.

In view of the substantial acceleration in the health index at the end of 2007 – its year-on-year rise came to 2.6 p.c. in December – and the resulting level effect for the next year, the impact of indexation on wage increases in 2008 is very likely to be well in excess of the effect anticipated at the time of the central and sectoral negotiations. In fact, when the sectoral negotiations took place in the spring of 2007, the inflation forecasts – including those published by the Bank – were much more favourable than those appearing subsequently. Ex post indexation in excess of the level initially anticipated implies faster nominal wage growth and, via that channel, the risk of less favourable prospects for future inflation and the competitiveness of Belgian firms.

However, the difference between the movement in the health index and overall inflation, which is precisely one of the mechanisms limiting the risk of second-round effects in the event of increases in energy prices or indirect taxes on products excluded from the index, also implies some loss of relative purchasing power, since purchasing power increases less quickly than in a – hypothetical – situation where, for example, the oil price has not increased. Nevertheless, that loss of relative purchasing power is justified from a macroeconomic angle, since the deterioration in the terms of trade resulting from the higher cost of oil implies a relative impoverishment of the domestic economy as a whole, which has to be borne by all the country's economic agents. It was precisely the refusal to accept the principle of this allocation of losses of purchasing power following the original oil shocks, when firms and the government were made to bear the burden, that had disastrous consequences for the Belgian economy in the 1970s and the early 1980s, consequences which could only be rectified subsequently by a long and painful recovery process. Moreover, the loss of purchasing power which households suffer as a result of the increased oil price is only relative in the current context, since their disposable income continues to rise in absolute terms, mainly as a result of job creation but also because real hourly wages have maintained their upward trend.

However, from a social angle it is necessary to bear in mind that losses of purchasing power in real terms may accumulate under certain circumstances, particularly for persons dependent on a replacement income, for whom indexation is the only source of an increase. Moreover, the specific inflation confronting certain population groups, owing to a consumption structure which diverges from the average, may also accentuate that loss of purchasing power under certain conditions (for more details, see box 12). To remedy that, the appropriate approach is to implement specific social policies as necessary.

Box 12 – Perceived and actual Inflation

In the context of a marked rise in the prices of food and energy, the question of the representativeness of the consumer price index acquires particular importance. In fact, the index takes account of the consumption structure of an average household, based on total private consumption according to the household budget survey. Therefore, by definition, the consumption structure of each individual household is never exactly the same as the average. If one type of household has a consumption structure which is very different from the average, there is a danger that the consumer price index might become less representative and be responsible for losses or gains of purchasing power in relation to the average. Where the structure of expenditure is concerned, it is evident indeed that, within each income group, consumers have specific spending habits. Thus, expenditure on food, housing (including heating, water and electricity) and health represent a larger share of the outgoings of less well-off households. Conversely, expenditure on clothing, transport and leisure is higher in relative terms among better-off households. These discrepancies may give rise to subjective differences in inflation perceptions according to income levels, and to objective differences in the inflation specific to each income group.

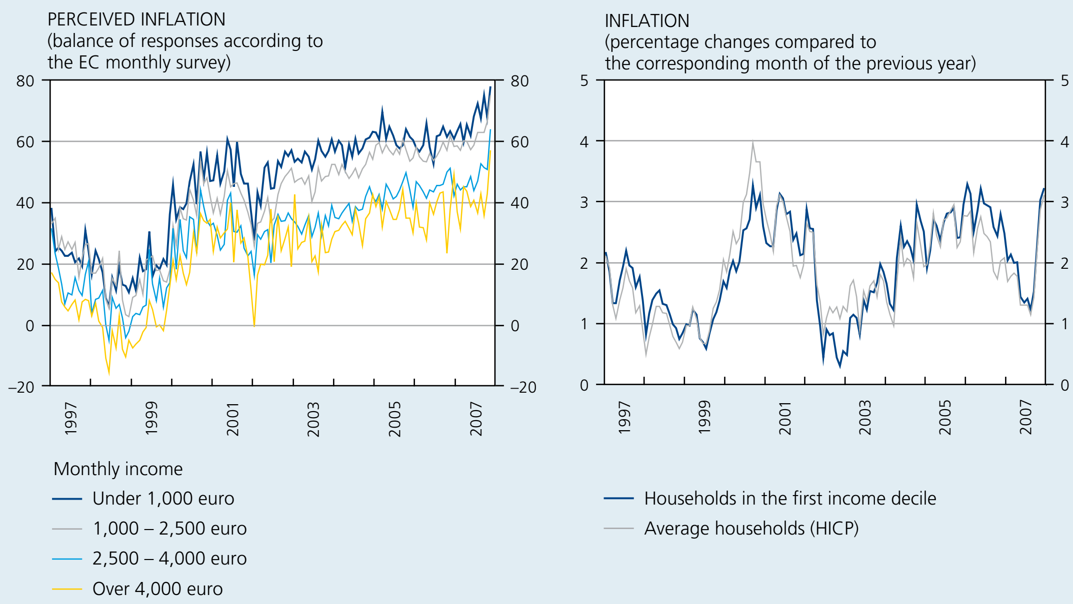
In regard to inflation perceptions, the results obtained from the EC consumer survey can be broken down according to the socio-economic characteristics of the respondents. Individuals with a higher standard of education, high incomes and a corresponding occupation (self-employed or employees), working full time, being males and belonging to the youngest age groups, have on average a lower inflation perception than the lowest income groups, low-skilled persons, manual workers, persons working part-time, the unemployed, the elderly and women. However, it seems that these differences of perception tend to be permanent. For example, while the introduction of the euro in January 2002 clearly caused a break in the link between actual and perceived inflation, it had little influence on the differences of perception per income group, although in Belgium the perception gap between the lowest and highest income groups did widen slightly after the changeover to the euro. The EC consumer survey data therefore indicate that, in 2002, there was a more or less identical increase in the inflation perception of all groups, and a gradual but slow increase persisted without any marked variations according to income. During the last quarter of 2007, the rise was accentuated owing to fears aroused by the increasing cost of energy and food commodities. This movement also appeared to be relatively uniform.

A key question is whether these persistent divergences in perception are actually based on objective differences in inflation, giving rise to systematic purchasing power losses or gains. To find that out, it would be necessary to have indicators of inflation specific to the various classes of consumers in Belgium. However, no official indicator of that type has been published. Nevertheless, since the household budget surveys – on which the structure of the consumer price index (CPI) weightings is based – permit identification of consumers according to their income group, it is possible to calculate CPIs specific to each of those groups. As an approximation, series were calculated by adapting the weightings used for the national CPI (index with base 1996 and the new index with base 2004) in line with the differences observed in the 2004 household budget survey between households as a whole and each of the various household categories. The calculations were performed at a fairly detailed level for 115 products or product groups. Since there is no record of prices specific to each income group, it was necessary to work on the assumption that the various groups faced the same price movement for each individual product. This is a relatively limiting assumption, since – for some types of expenditure – there is a strong likelihood that the movement in prices confronting the most disadvantaged households, for example, differs from the average. Thus, it is evident from the Brussels Rental Observatory data that the rents of the most disadvantaged tenants had risen faster than the average in 2006. Whether or not households shop in discount supermarkets, for example, may also give rise to a different price movement since, as these outlets operate on smaller margins, the changes in suppliers' prices are probably passed on more quickly in the advertised prices, leading to greater price volatility, even if the average price level is lower than in other outlets. However, in the absence of exhaustive data, it is not possible to take account of these specific characteristics in the analysis presented in this box.

This analysis reveals slight differentials in the inflation rates for the various household categories ; in the short term, depending on the circumstances, these may give rise to a less favourable movement in the purchasing power of the poorest families. All other things being equal, it is in fact evident that, between 2004 and 2006, those in the first income decile (the 10 p.c. of households with the lowest incomes) suffered a loss of purchasing power in relation to the average household. In 2007, that loss did not worsen in the initial months of the year, but a further deterioration set in from September, owing to the rise in prices of energy and food. In all, over the period 2004-2007, the cumulative difference comes to around 1 percentage point. Viewed over a longer period (for example, from 1996 to 2007), the erosion of the purchasing power of households in the first decile is, however, largely counterbalanced by the gains recorded from 2002 to 2003, due particularly to the abolition of the radio & television licence fee in Flanders and Brussels, and the reduction in that fee in Wallonia. In the long term, the variations are fairly small overall in Belgium : inflation is not systematically higher for low incomes than for high incomes. The absence of significant differences between income groups is also confirmed by a study by Bodart and Hindriks (2006) (1).

It is worth remembering that the aim of the consumer price index is to measure the movement in consumer prices for households in general. By ensuring medium term price stability, defined according to the aggregate consumer price index, monetary policy protects average purchasing power, from a macroeconomic point of view. While the detailed data from the consumer price index and the household budget survey draw attention to social inequalities

INFLATION : REALITY AND PERCEPTION ACCORDING TO LEVEL OF INCOME IN BELGIUM



Sources : EC, DGSEI, NBB.

(1) Bodart C. and J. Hindriks (2006), *Les Belges sont-ils tous égaux face à l'inflation ?*, Regards économiques, UCL (IRES), no. 46.

in specific circumstances – despite the limitations of these indicators being used for a purpose for which they were not designed –, it is nevertheless true that targeted and appropriate social policies can, if necessary, address these social aspects. However, such a finding does not cast doubt on the representativeness of the consumer price index from a macroeconomic angle, which is its primary role. This legitimacy is, moreover, reinforced by the updating every two years from 2008 of the sample of products covered by the national index, and hence by the health index.

5.4 Inflation gap between Belgium and the euro area

As the authority responsible for the common monetary policy, the Eurosystem ensures the maintenance of price stability in the euro area as a whole, disregarding inflation differentials which may arise between member countries. The Eurosystem does not in fact have any instrument for influencing such differentials. It is therefore up to those Member States with price movements significantly different from the euro area average to identify undesirable inflation differentials and to take the necessary action. Such an analysis is crucial for a small open economy like Belgium, since any positive inflation gap is reflected in a real appreciation in relation to the rest of the euro area and consequently, as a general rule, in a loss of competitiveness. Despite the symmetrical nature, within the euro area, of the shocks affecting the commodity markets, their impact on the Belgian economy differed to some extent from that seen for the monetary union as a whole.

Overall, the inflation profile in Belgium is broadly comparable to that for the euro area as a whole. The negative inflation differential which appeared in 2007 is due to a smaller rise in prices for both energy products and non-energy industrial goods and services. The impact of these factors was only partly negated by food prices, which increased more steeply than in the euro area from the last quarter of 2006.

Regarding energy prices, the divergences seen are due essentially to the specific characteristics of the Belgian economy whereby, in the short term, fluctuations in oil prices – either up or down – have a more significant impact on inflation in Belgium than in the euro area. This greater short-term sensitivity of the Belgian HICP to fluctuations in the price of crude oil is due first of all to the heavier weight of energy products in the consumption basket used to calculate the HICP for Belgium. It is reinforced by a lower level of excise duties on petroleum products. Because of their flat-rate character, excise duties in fact tend to cushion the effect of oil price fluctuations. Moreover, for the reasons mentioned earlier, gas prices fell more sharply in Belgium than in the euro area in 2007, before increasing again at the end of the year.

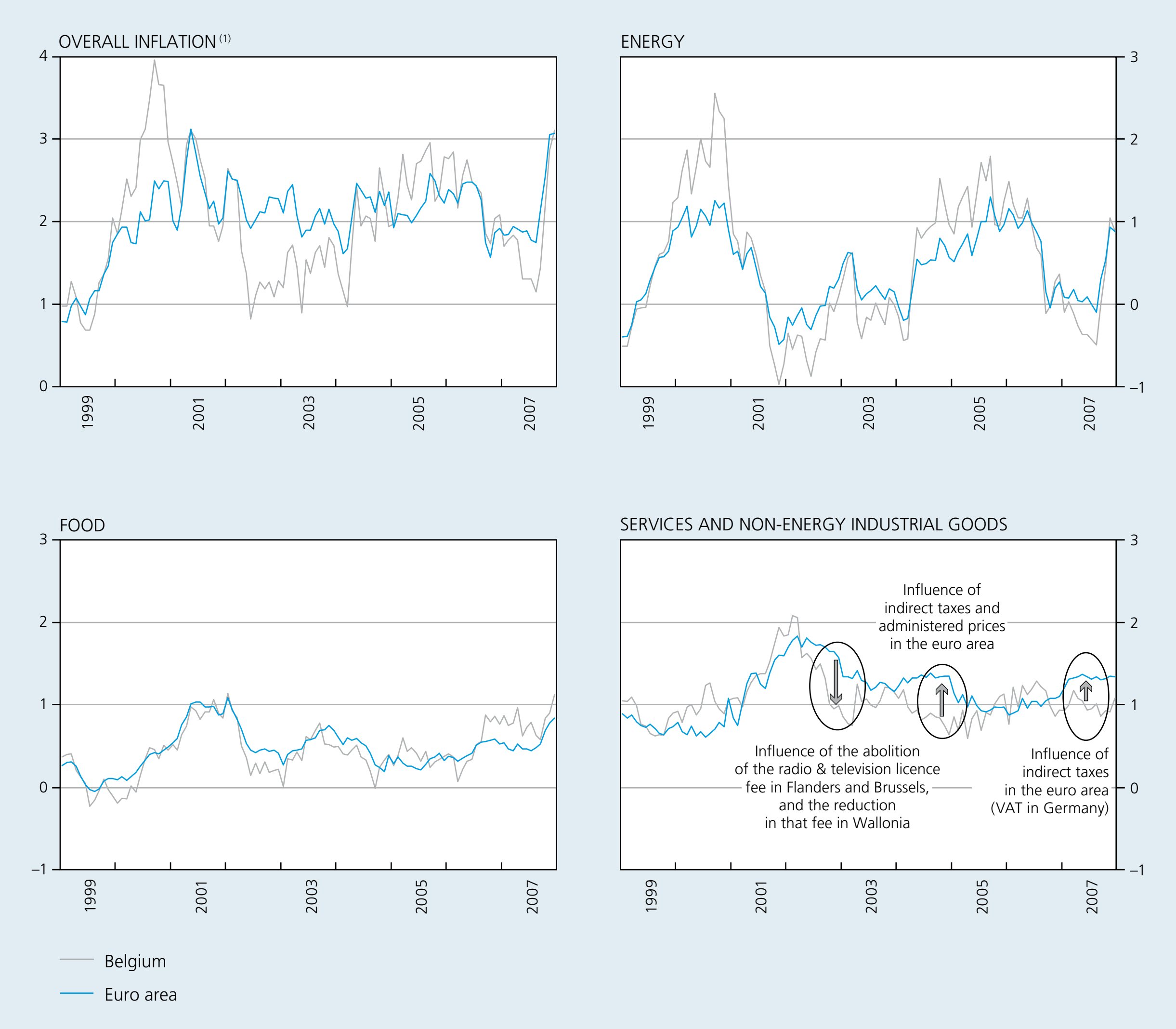
Furthermore, the differential recorded in 2007 in the case of services and non-energy industrial goods is largely attributable to an acceleration in inflation for these products in the euro area, following the increase in VAT in Germany in January 2007. Conversely, in Belgium the impact of indirect taxes was limited for these product categories during the year under review. The impact of indirect taxes and administered prices also used to be the main source of inflation divergences in the past. That was particularly true in 2002-2003, owing to the abolition of the radio & television licence fee in Flanders and Brussels and its reduction in Wallonia, and in 2004, when administrative price changes had pushed up inflation in the euro area.

Overall, there therefore appears to be no reason to think that inflation in Belgium differs fundamentally and systematically from that in the euro area. It seems to be purely temporary factors that cause Belgian inflation to deviate from the euro area average. That situation is due mainly to the implementation of economic policies compatible with the current operation of EMU.

Household inflation perceptions have remained relatively high in Belgium since 2006, while overall inflation tended to slacken pace up to mid 2007, thus mirroring the profile of energy prices. Households apparently failed to take account of these price reductions in their perception, probably because the level of energy prices remained historically high and because their perception may be unaffected by monthly price movements for products such as gas and electricity, which are invoiced annually. In principle, it was conceivable that the sudden jump in inflation, in October and November 2007, would not have a correspondingly large impact on perception, since in fact it partly compensated for falls recorded earlier in the year which households may not have taken into account in their opinions on price movements. In practice, however,

CHART 50 INFLATION IN BELGIUM AND IN THE EURO AREA

(contribution to inflation, unless otherwise stated)



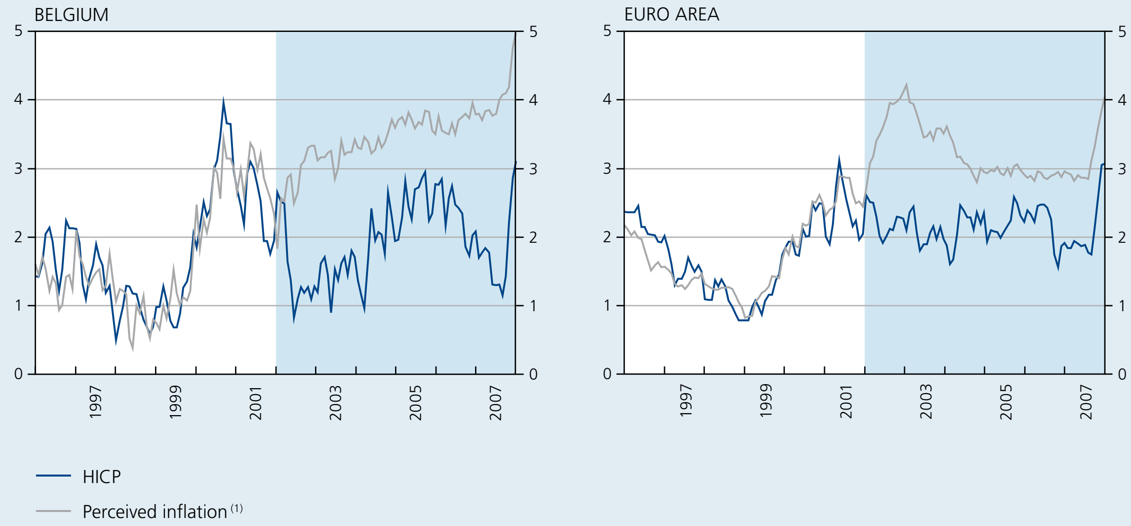
Sources : EC, NBB.
(1) Percentage changes compared to the corresponding month of the previous year.

there was a strong acceleration in perceived inflation in the final quarter. The same applies in the euro area where that perception showed a marked deterioration from October 2007, but in both cases this movement does not appear disproportionate to the acceleration in measured inflation, connected with price increases recorded for both energy and food products.

The perception gap which arose at the time of the euro changeover therefore did not diminish during the year under review, either in Belgium or in the euro area as a whole. In the latter, however, that gap did narrow in 2003 and 2004, mainly as a result of the movement in inflation perceptions in Germany and the Netherlands. Together with Austria, France and Spain, Belgium is one of the countries where this gap is very persistent.

CHART 51 INFLATION : REALITY AND PERCEPTION [1]

(percentage changes compared to the corresponding month of the previous year)



Sources : EC, NBB.

(1) Balance of responses to the EC survey, converted into an inflation indicator comparable to the HICP using the standardisation procedure described in Aucremanne L., M. Collin and T. Stragier (2007), *Assessing the gap between observed and perceived inflation in the euro area: is the credibility of the HICP at stake ?*, NBB, Working Paper 112.

Public finances

6.

6.1 Revenue, expenditure and overall balance

In the year under review, the general government accounts closed with a very small deficit. The target of a budget surplus of 0.3 p.c. of GDP, set in the December 2006 stability programme, was therefore not achieved, although actual economic growth (2.7 p.c.) was almost 0.5 percentage point higher than the figure expected (2.2 p.c.) when that programme was drawn up. This disappointing performance is due partly to the non-execution of certain non-recurring measures which had been announced in the budget, such as further property sales and pension fund take-overs.

In the statement made on 21 December 2007 to the Chamber of Representatives, the government announced that it aimed to absorb the budget deficit expected if the policy remained unchanged for 2008, and intended to ensure that the general government overall balance returned as soon as possible to the path specified in the stability programme. Taking account of the continuing high level of the public debt and the future impact of population ageing, a rapid return to that path is in fact essential to ensure sustainable public finances, as shown by box 13.

Revenue

In 2007, the fiscal and parafiscal revenues of general government declined by 0.2 percentage point to 43.8 p.c. of GDP. Non-fiscal and non-parafiscal revenues remained stable, at 4.8 p.c. of GDP. The easing of the fiscal and parafiscal burden is due to the disappearance of the effect of a number of non-recurrent measures which had greatly inflated the taxes on corporate profits and those levied on goods and services in 2006. In addition, permanent

TABLE 29 TARGETS FOR THE FINANCING REQUIREMENT (–) OR CAPACITY OF BELGIAN GENERAL GOVERNMENT (1)

(percentages of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Stability programme and successive updates									
November 2002	0.0	**0.0**	0.3	0.5					
November 2003		0.2	**0.0**	0.0	0.0	0.3			
December 2004			0.0	**0.0**	0.0	0.3	0.6		
December 2005				0.0	**0.0**	0.3	0.5	0.7	
December 2006					0.0	**0.3**	0.5	0.7	0.9
p.m. Actual figures									
According to the view taken by Eurostat (2)	*0.0*	*0.0*	*0.0*	*–2.3*	*0.4*	*–0.1 e*			
According to the view taken by the NAI (2)	*0.0*	*0.0*	*0.0*	*0.1*	*0.3*	*–0.2 e*			

Sources: EC, FPS Finance, NAI, NBB.

(1) According to the methodology used in the framework of the excessive deficit procedure (EDP). That methodology differs from that of the ESA 95 which was adapted in 2001 to exclude from the calculation of the overall balance the net interest gains on certain financial transactions, such as swaps and forward rate agreements (FRAs). The EDP methodology is also used in the other tables and charts in this chapter.

(2) According to the view taken by the NAI, the Railway Infrastructure Fund (RIF), set up in the context of the BNRC restructuring on 1 January 2005, comes under the non-financial corporations sector. According to Eurostat, that Fund forms part of the general government sector and the assumption of BNRC debt should be recorded as a capital transfer from that sector to the non-financial corporations sector. Unless otherwise stated, the Eurostat view is adopted in the other tables and charts in this chapter.

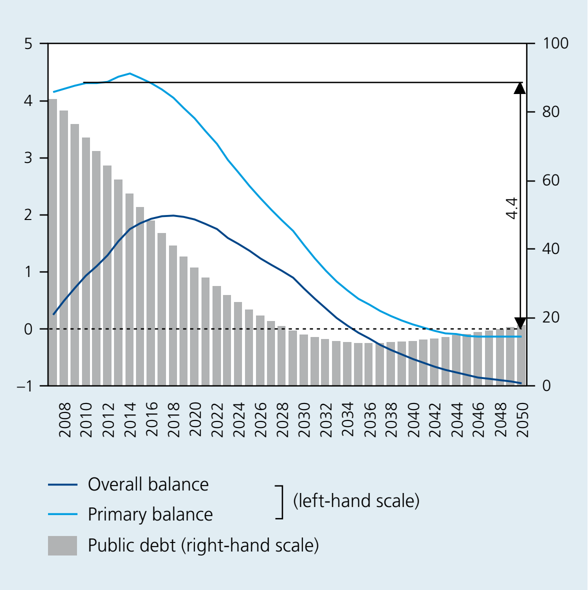
Box 13 – Budget path advocated by the High Council of Finance

The High Council of Finance is a leading advisory body in Belgium. Its "Public Sector Borrowing Requirement" section analyses fiscal policy and makes recommendations on the subject. In the past, the Section's opinions have generally underpinned the medium-term budget programmes and the corresponding agreements concluded by the federal government and the communities and regions.

The Section produced a new report in March 2007, for the first time since 2004. That report was based on the conclusions of the Study Committee on Ageing concerning the budgetary impact of demographic developments. According to that Committee's latest estimate, public spending on pensions and health care will increase by around 8 percentage points of GDP between 2006 and 2050. However, since unemployment benefits and expenditure relating to family allowances, incapacity and pre-pensions should diminish, the net increase in public spending associated with demographic changes during that period is estimated at 6.2 percentage points of GDP.

BUDGET PATH RECOMMENDED BY THE HIGH COUNCIL OF FINANCE

(percentages of GDP)



Source : HCF.

Two key considerations guided the Section in its choice of the path to be recommended to the government for the movement in the overall budget balance. First, that path must be sustainable, in that the public debt must tend in the long term towards a low and stable level. Second, it must ensure as far as possible the intertemporal neutrality of fiscal policy, which implies that the burden of any budget adjustments necessary to ensure that sustainability must not be passed on to future generations.

In formulating its recommendation, the Section disregarded two extreme scenarios : one with full pre-financing and one with simple maintenance of a balanced budget. Full pre-financing in 2010 of all the budgetary costs of population ageing estimated up to 2050 would have demanded a substantial budgetary effort – of at least 2 p.c. of GDP –, the whole of which would have to be made during the federal legislative period from 2007-2011. In the Section's view, such an effort would have disrupted the continuity of fiscal policy and risked leaving too few resources for pursuing an active employment policy and supporting growth potential, whereas those objectives are also part of the global strategy needed to cope with the consequences of population ageing. In a scenario based solely on the constant maintenance of a balance in public finances, the pressure on the budget caused by ageing would eventually have necessitated a considerable increase in compulsory levies or a drastic reduction in public spending. That scenario was not considered desirable either, since it did not respect the principle of intertemporal neutrality.

According to the path recommended by the Section, which assumed a structural budget surplus of 0.3 p.c. of GDP in 2007, the overall balance of general government should increase by 0.2 percentage point of GDP per annum to reach 1.3 p.c. of GDP in 2012. That scenario is in line with the budget targets set in Belgium's December 2006 stability programme. Furthermore, since 2005 those targets have been included in the law of 5 September 2001 guaranteeing a continuous reduction in the public debt and creating an Ageing Fund. However, the Section pointed out that this medium-term path should be regarded as the minimum effort. The budget surplus should continue its expansion after 2012, rising to around 2 p.c. of GDP during the period 2017-2019. After that, it should gradually diminish, reverting to a balanced budget in 2035 and being converted to a deficit of just under 1 p.c. of GDP in 2050.

According to this scenario, the budgetary costs of ageing in the period 2010-2050 would be largely, but not entirely, prefinanced. In fact, four-fifths of the increase in public expenditure associated with demographic changes during that period, or 4.4 p.c. of GDP, could be offset by the fall in interest charges due to the reduction of the public debt combined with the steady reduction of the budget surplus and, finally, its conversion to a modest deficit. Under the technical assumption of unchanged fiscal and parafiscal pressure, the remaining fifth could only be financed if the rate of expansion of public spending unconnected with demographic changes is limited after 2010 to a level well below the volume growth of GDP.

fiscal and parafiscal measures also had a negative impact on revenues. The reduction in revenues occurred almost exclusively at federal level. In the other sub-sectors, revenues, excluding cross-transfers between levels of government, did not change as a percentage of GDP.

Expressed as a percentage of GDP, levies on earned incomes remained practically unchanged during the year under review, in contrast to their steady decline since 2003. This relative stability was due to a reduction in revenues generated by personal income tax and an increase in the amount raised via social contributions. The share of GDP represented by earned incomes – compensation of employees and gross mixed incomes, excluding imputed contributions – increased by 0.1 point in 2007, whereas it had been falling steadily since 2002.

The personal income tax reform approved in 2001 continued to exert slight negative pressure on the assessments in 2007, estimated at 133 million euro. The whole of the impact of that reform is now incorporated in the revenues. Moreover, the federal government extended the standard allowance for professional expenses by raising the percentages and ceilings applicable, cutting the tax yield by 77 million. In addition, the Flemish region granted a standard reduction in payroll tax of a maximum of 125 euro per annum to its residents, limited in 2007 to those earning no more than 22,250 euro. The cost of this measure came to 107 million euro.

In contrast to the tax burden, the parafiscal pressure on labour increased slightly during the year under review. The rise in employers' contributions was restrained by the introduction of two new structural reductions in contributions approved in the context of the generation pact. The entry into force on 1 July 2006 of a reduction in employers'

TABLE 30 REVENUE OF GENERAL GOVERNMENT [1]
(percentages of GDP)

	2003	2004 [2]	2005	2006	2007 e [2]
Fiscal and parafiscal revenue	44.2	44.4	44.3	44.0	43.8
Levies weighing chiefly on earned income	26.8	26.3	25.9	25.2	25.3
Personal income tax [3]	12.3	12.0	11.9	11.4	11.3
Social contributions [4]	14.6	14.3	14.0	13.9	14.0
Taxes on company profits [5]	2.9	3.2	3.4	3.7	3.7
Levies on other incomes and on assets [6]	3.5	3.6	3.7	3.6	3.6
Taxes on goods and services	11.0	11.3	11.3	11.4	11.2
of which:					
VAT	6.6	6.8	6.9	7.1	7.2
Excise duties	2.3	2.4	2.4	2.2	2.2
Non-fiscal and non-parafiscal revenue [7]	6.9	4.7	5.1	4.8	4.8
Total revenue	51.1	49.1	49.4	48.8	48.6
p.m. Entity I [8]	*43.2*	*41.4*	*41.6*	*41.0*	*40.7*
Federal government [8]	*28.8*	*27.2*	*27.7*	*27.3*	*27.0*
of which: transfers to the communities and regions [9]	*9.9*	*9.7*	*9.8*	*9.7*	*9.7*
Social security [8]	*14.5*	*14.3*	*14.0*	*13.8*	*13.9*
Entity II [8]	*7.9*	*7.7*	*7.8*	*7.8*	*7.9*
Communities and regions [8]	*4.3*	*4.3*	*4.4*	*4.4*	*4.5*
Local authorities [8]	*3.7*	*3.4*	*3.4*	*3.4*	*3.4*

Sources: NAI, NBB.
(1) In accordance with the ESA 95, total revenue of general government does not include the proceeds of fiscal revenue which the government transfers to the EU.
(2) In 2004, fiscal and parafiscal revenue was augmented by around 0.1 p.c. of GDP as a result of the shift between VAT and GNI resources following the EU financing reform. The reform of the method of paying pensions to former BNRC Group staff had a positive impact of 0.05 p.c. of GDP on the parafiscal levies in 2007. These factors increased both revenue and expenditure without any significant effect on the overall balance.
(3) Mainly withholding tax on earned income, advance payments, assessments and the proceeds of additional percentages on personal income tax.
(4) Total social contributions, including the special social security contribution and the contributions of persons not in work.
(5) Mainly advance payments, assessments and withholding tax on corporate income from movable property.
(6) Mainly withholding tax on income from movable property of individuals, withholding tax on income from immovable property (including the proceeds of additional percentages), inheritance taxes and registration fees.
(7) Income from property, imputed social contributions, current transfers and capital transfers from other sectors, plus sales of goods and services produced.
(8) The revenue of the general government sub-sectors does not include the transfers which they receive from other sub-sectors.
(9) This consists essentially of personal income tax and VAT revenues which are transferred under the Special Finance Act.

contributions for young workers on low incomes, and on 1 April 2007 of a further reduction in employers' contributions for workers aged fifty and over, curbed the rise in revenues by 125 and 118 million euro respectively. Also, the favourable business climate of recent years enabled companies to reduce their contributions to the Business Closure Fund. These reductions in charges were offset by the fact that, since 1 January 2007, the advance holiday allowance paid by the employer on termination of employment contracts is immediately liable to social contributions; this generated non-recurrent additional revenues of 233 million euro. The social contributions were also augmented by a change in the method of financing pensions for former BNRC Group staff. Since 2007 these pensions have been paid by the federal government pensions service, whereas they used to be paid by BNRC itself. Social contributions for BNRC Group employees are therefore paid to the government from now on. In practice, a reduction in the federal government grant to the BNRC Group ensured that this change was neutral for the budget.

Taxes on corporate profits expanded at a rate slightly below that of nominal GDP growth. This was due mainly to the more limited impact of non-recurrent measures. Revenues were no longer boosted as in 2006 by the structural acceleration in the collection of corporation tax, which had an impact amounting to 900 million euro. The disappearance of this factor was only partly offset by the exceptional income generated by the possibility for companies to distribute or invest at a reduced rate of tax certain tax-exempt reserves recorded on their balance sheet; this raised an estimated 245 million euro for the Treasury. The structural measures concerning corporation

TABLE 31 MAIN FISCAL AND PARAFISCAL MEASURES [1]

(millions of euro, changes compared to the previous year)

	2005	2006	2007
Structural fiscal measures	–25	–1,244	–575
Federal government and social security	–10	–1,123	–376
Personal income tax	–486	–1,336	–352
Personal income tax reform	–464	–1,245	–133
Other	–22	–91	–220
Taxes on corporate profits [2]	89	–149	–45
Levies on other incomes and on assets	–56	516	30
Taxes on goods and services	442	–155	–9
Communities and regions [3]	–50	–50	–187
Local authorities	35	–71	–11
Structural parafiscal measures	–420	–464	–219
Employers' contributions	–371	–112	–409
Employees' contributions	–49	–352	–6
BNRC Group social contributions	0	0	197
Non-recurrent measures	–38	764	–1,330
Impact of securitisation operations	439	–106	–783
Corporation tax assessments	0	900	–900
Tax-exempt reserves	0	0	245
Social contributions due at the end of an employment contract	0	0	233
Other [4]	–477	–30	–125
Total	**–484**	**–944**	**–2,124**
p.m. Percentages of GDP	*–0.2*	*–0.3*	*–0.6*

Sources: budget documents, NBB.

(1) This generally concerns the assumed impact of the measures according to the budget documents. It may differ from the actual impact. No account is taken of measures to control tax evasion and promote more efficient collection.

(2) The impact of the tax allowance for venture capital applicable since 2006 is not included in this table, in view of the uncertainty over its budget implications.

(3) In 2005 and 2006, water charges in the Flemish Region were abolished following the changes to the financing of Aquafin.

(4) In 2007, this mainly concerns the termination of the financing of the Heating Oil Fund by Electrabel and Distrigaz and the disappearance of the revenues which had been raised in 2006 from the revaluation of the diamond sector's stocks.

tax were more or less neutral. While the measure effective from 1 April 2007 whereby the tax allowance for new company cars depends on their CO2 emissions did generate additional revenue, its effect was fully offset by the increase in the percentage – linked to the yield on linear bonds – used to calculate the venture capital allowance, better known as the notional interest deduction.

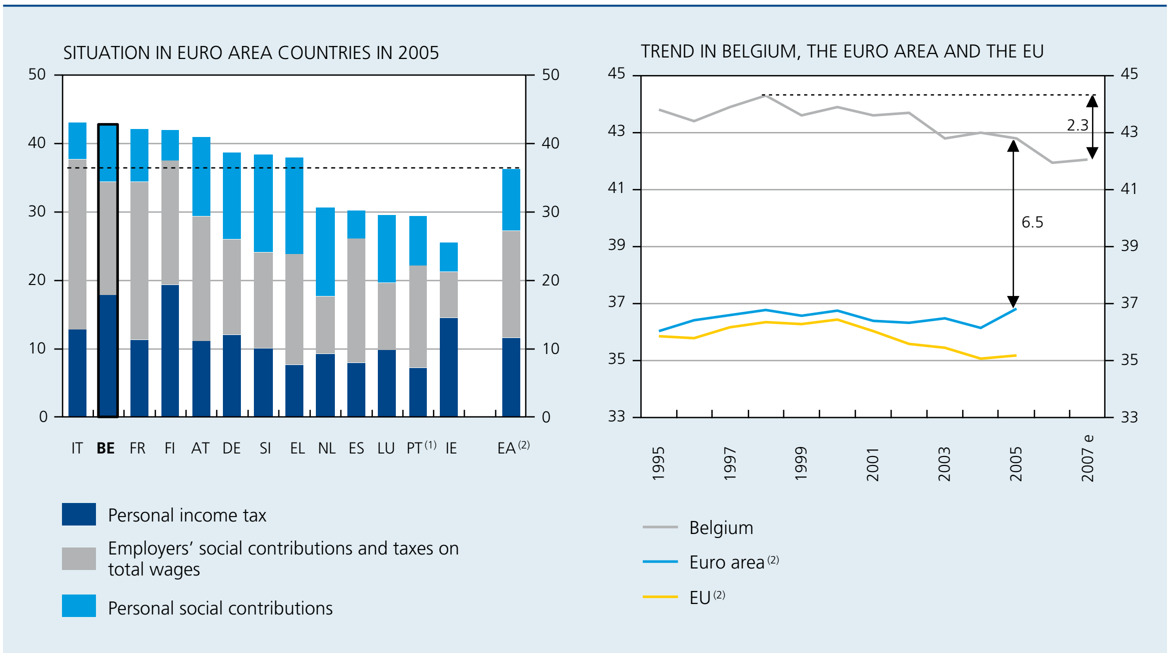
Levies on other incomes and on assets remained practically steady as a percentage of GDP. The increase in the tax on subscriptions to collective investment funds was the source of additional revenue, but the abolition of inheritance tax on their own home in the case of married couples in the Flemish Region and the reduction in the standard tax payable by heads of households in the Brussels Capital Region depressed revenues.

Taxes on goods and services were down sharply, by 0.2 percentage point of GDP, mainly owing to the disappearance of the impact of the measures which temporarily boosted revenues in 2006, one of them being an operation to securitise tax arrears. In that regard, it should be noted that, on 25 June 2007, Eurostat adopted a decision whereby this type of operation can no longer be recorded as revenue with effect from 2007. The securitisation operations which the federal government conducted in 2005 and 2006 are therefore still taken into account, as are the refunds which they entail, particularly in the year under review. Moreover, revenues were no longer augmented as in 2006 by the 100 million euro paid by Electrabel and Distrigaz to finance the Heating Oil Fund. Conversely, measures with a structural impact on indirect tax revenues were neutralised. While the operation of the reverse ratchet system on diesel and the gradual abolition of the excise compensatory levy on diesel cars had a negative impact on revenues, that impact was largely counterbalanced by the increase in excise duty on tobacco and, to a lesser extent, by the introduction on 1 July 2007 of an ecotax on certain specific products, such as a aluminium or plastic packaging film, disposable bags and disposable cutlery.

Box 14 – Fiscal and parafiscal levies on labour in Belgium

Belgium is among the group of European countries with the highest levies on labour. In fact, the latest figures published by the EC indicate that, in 2005, the implicit rate of levies on earned incomes – i.e. all levies on earned incomes expressed as a percentage of the wage bill as calculated according to the national accounts – was no less than 6.5 percentage points higher in Belgium than the unweighted average for the euro area. That rate of levy was relatively comparable to the figure for Italy, France and Finland, but higher – often actually much higher – than in the other countries. That is due mainly to personal income tax, where the implicit tax rate was 6.3 points higher than the unweighted average for the euro area. In Belgium, the implicit rate of personal social security contributions was 0.6 percentage point below the unweighted average for the euro area, while the rate of employers' contributions was 0.9 point higher.

IMPLICIT RATE OF LEVIES ON EARNED INCOMES
(percentages of labour costs)



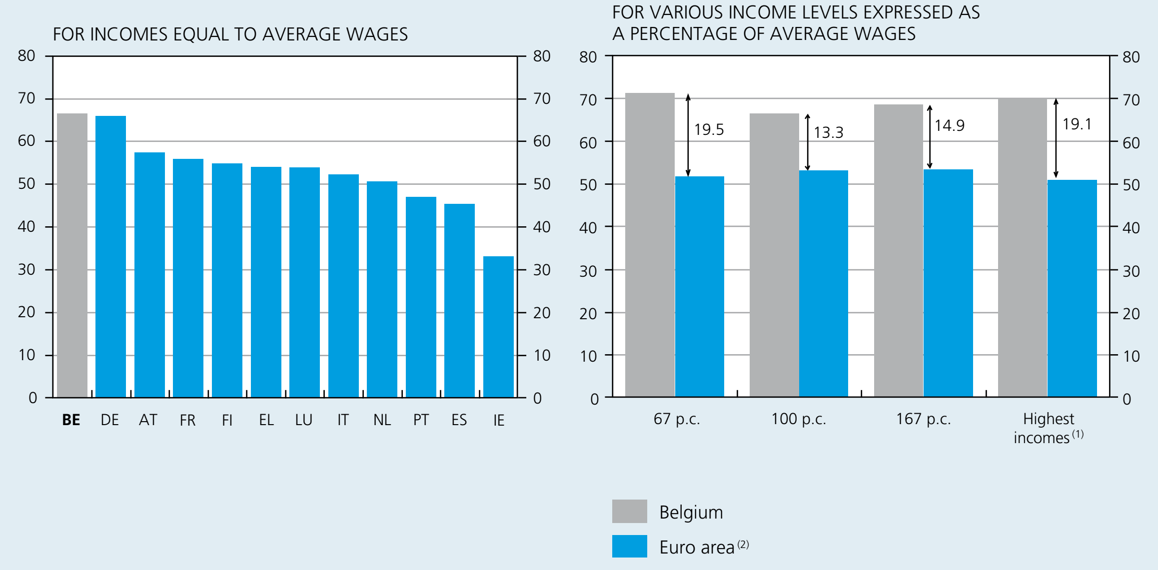
Sources: EC, NBB.
(1) 2004.
(2) Unweighted average.

While these substantial levies on earned incomes provide funding for social protection in particular, they undeniably have a demotivating influence on the labour supply and on demand for labour. To remedy that state of affairs, the Belgian government has been trying for some years to lower the levies on labour by making use – in view of the budget restrictions – of other sources of taxation. Since the turn of the century, the implicit rate of levies on earned incomes has fallen steadily. That is due mainly to the personal income tax reform approved in 2001, which had an impact on the budget between 2002 and 2007. Large reductions in social contributions were also granted. The structural reduction in employers' contributions was stepped up sharply in 2000, and then further amplified in 2004 and 2005. New cuts in employers' social contributions were granted for certain target groups on the labour market, such as workers under the age of thirty on low incomes or those aged fifty and over. In addition, the work bonus reduced the personal social security contributions of low wage earners and certain workers affected by corporate restructuring. All these factors contributed to the decline in the implicit rate of levies on earned incomes to 42 p.c. in Belgium in 2007, which was 2.3 percentage points lower than the peak reached in 1998. Belgium thus succeeded in reducing the discrepancy in relation to the average for the euro area countries, even though it remains very large.

Apart from the average level of the implicit burden on labour, the marginal tax rate also has a very important influence on labour supply and demand : in fact, it determines the net amount that taxpayers gain from doing more work. In Belgium, fiscal and parafiscal levies make up around two-thirds of an increase in labour costs, regardless of the individual income level. OECD data reveal that the Belgian marginal rates are 13 to 20 percentage points higher than the euro area average, depending on the income level.

MARGINAL RATES OF FISCAL AND PARAFISCAL LEVIES ON AN UNMARRIED WORKER WITH NO DEPENDENT CHILDREN

(percentages of labour costs, January 2006)



Sources : OECD, NBB.
(1) These are the rates applicable to amounts in the top income tranche, for which the threshold varies between countries.
(2) Unweighted average, excluding Slovenia.

The level of the marginal rates depends both on the personal income tax rates and the social contribution rates. In the latter case, many countries have a maximum income level beyond which the levy becomes zero, but that is not the case in Belgium. This difference is part of the reason why the marginal rate on the highest incomes is almost 20 percentage points higher than the euro area average. It is also worth noting that in Belgium the marginal rate is higher for an income level corresponding to 67 p.c. of the average wage than for other income levels, even though the marginal rates of personal income tax increase with the level of income. That is because the rate of the special social security contribution is higher for this income level. The targeted measures to encourage the employment of low-skilled or low wage earners may also imply substantial increases in the marginal rates once incomes reach the threshold from which they cease to apply.

Primary expenditure

The primary expenditure of general government, i.e. excluding interest charges, was higher than in 2006, rising from 44.5 to 44.9 p.c. of GDP, after having peaked at 47.5 p.c. in 2005. However, these fluctuations are not representative of the structural trend in this expenditure, since they are greatly distorted by a range of factors whose influence needs to be eliminated in order to obtain a more accurate idea of the underlying trend. These elements include temporary factors, operations which inflate both revenue and expenditure while being neutral in their effect on the budget, the influence of the business cycle on expenditure and, finally, differences between the movement in inflation and the impact on wages or social benefits of the indexation to consumer prices.

In 2007, the impact of temporary or fiscally neutral factors contributed 1.2 percentage points to the volume growth of primary expenditure, while in the previous year they had moderated the growth rate by 5.9 points, taking account of the fact that, in 2005, expenditure had been expanded by the assumption of the BNRC debt at a figure corresponding to 2.5 p.c. of GDP.

Non-recurrent operations specifically connected with the year under review were effected mainly by the federal government, and consisted primarily of tax refunds totalling almost 500 million euro – 210 million to insurance companies following a court ruling, 99 million to a bank and 177 million to an energy company – and the cancellation of developing country debts totalling around one hundred million euro. In addition, Flanders again paid exceptional subsidies to the water supply companies and to Aquafin, amounting to around 150 million euro more than in 2006. Conversely, in contrast to the six preceding years, there were no major transactions concerning the sale of buildings or land. Although, as explained earlier, the move was fiscally neutral, the fact that the federal government has taken on the payment of pensions for former BNRC Group employees had an influence of almost 200 million euro on primary expenditure.

TABLE 32 PRIMARY EXPENDITURE OF GENERAL GOVERNMENT

(deflated by the HICP, percentage changes compared to the previous year, unless otherwise stated)

	2003	2004	2005	2006	2007 e	Average 1996-2007 e
Level recorded (1)	45.8	44.4	47.5	44.5	44.9	44.1
Real growth recorded	5.1	0.3	8.7	–4.0	3.5	2.5
Influence of non-recurrent or fiscally neutral factors (2)	1.7	–2.2	6.9	–5.9	1.2	0.2
Influence of cyclical factors (2)	0.3	0.2	0.1	–0.1	–0.3	0.0
Indexation effect (2) (3)	–0.1	–0.4	–0.1	–0.5	–0.2	–0.1
Real growth adjusted for cyclical and non-recurrent or fiscally neutral factors and the indexation effect	3.2	2.7	1.9	2.4	2.8	2.5

Sources: EC, NAI, NBB.
(1) Percentages of GDP.
(2) Contribution to real recorded growth of primary expenditure.
(3) Effect caused by the difference between the actual indexation of public sector wages and social security benefits and the rise in the HICP.

The growth rate of primary expenditure is also subject to cyclical fluctuations as a result of the movement in unemployment benefits, which follow the business cycle with a certain time lag. Thus, the upturn in activity since 2004 initially reduced the upward influence of these benefits on expenditure, and later actually contributed to the moderation of the real expenditure growth in 2006. In 2007, that moderating effect was reinforced by the continuing sustained expansion of activity, and reached 0.3 percentage point. Unemployment expenditure, which had already fallen by 2.9 p.c. in real terms in 2006, in fact declined further by 5.6 p.c. in 2007.

The indexation mechanism for social benefits and civil service pay is a third external factor which influences the real movement in primary expenditure. Thus, social benefits and wages, which account for over 60 p.c. of the government's primary expenditure, are linked to the movement in the health index of consumer prices. In 2007, however, the difference between the movement in that index and the HICP, used to deflate expenditure, was smaller than the previous year. The indexation mechanism therefore helped to restrain the expansion of expenditure in real terms by only 0.2 percentage point, in contrast to 2006 when its curbing effect totalled 0.5 percentage point, essentially owing to the introduction of the new national CPI and the health index of consumer prices (for more details, see box 12 in the 2006 Report).

After adjustment for the effect of these various factors, primary expenditure expanded by 2.8 p.c. in 2007, exceeding not only its average growth rate since 1996, but also the trend growth of GDP.

The movement in the adjusted primary expenditure of general government was relatively homogeneous in the various constituent sub-sectors, excluding the local authorities. While the expenditure of the local authorities was lower than in 2006, that of the other levels of government accelerated by between 3.2 and 3.7 p.c., far outpacing trend economic growth.

In 2007, the adjusted primary expenditure of the federal government grew by 3.2 p.c. in real terms, against 1.8 p.c. the previous year. This rise was due to the increase in most expenditure categories. Thus, purchases of goods and services, which had fallen in 2006 owing to particularly strict application of the departmental expenditure anchoring mechanism – namely the monthly monitoring of the rate of expenditure in order to keep it below the budget – increased substantially in 2007, both because of payments passed on from 2006 and because the anchoring was less stringent at the end of the year. The reductions in the withholding tax on earned incomes, recorded as business subsidies in accordance with the ESA 95, increased substantially. These reductions target certain categories of workers and are designed to encourage the employment of researchers, shift working, innovations and – via the more favourable tax treatment of overtime pay – flexibility of labour. Since 1 October 2007 they have been supplemented by a general reduction in the withholding tax on earned incomes. These subsidies contributed around 300 million euro – or 1.1 percentage points – to the increase in federal expenditure.

TABLE 33 ADJUSTED PRIMARY EXPENDITURE BY GENERAL GOVERNMENT SUB-SECTOR (1) (2)

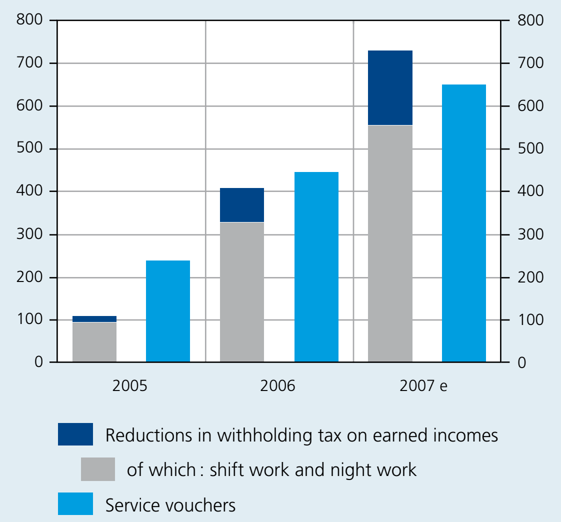
(deflated by the HICP, percentage changes compared to the previous year)

	2003	2004	2005	2006	2007 e	Average 1996-2007 e
Federal government	1.9	3.2	1.8	1.8	3.2	2.1
Social security	4.0	2.8	1.5	1.6	3.5	2.4
p.m. Entity I	*3.4*	*2.9*	*1.6*	*1.7*	*3.4*	*2.3*
Communities and regions	2.5	3.8	0.8	3.5	3.7	2.7
Local authorities	3.6	0.2	4.7	4.0	–1.1	2.9
p.m. Entity II	*2.9*	*2.4*	*2.3*	*3.7*	*1.7*	*2.8*

Sources: NAI, NBB.
(1) The expenditure of the general government sub-sectors does not include mutual transfers.
(2) Real growth adjusted for the influence of cyclical and non-recurrent or fiscally neutral factors, and for indexation effects.

CHART 52 SUBSIDIES GRANTED TO ENTERPRISES: SERVICE VOUCHERS AND REDUCTIONS IN WITHHOLDING TAX ON EARNED INCOMES

(millions of euro)



Sources: budget documents, NAI, NBB.

The volume growth of the adjusted social security expenditure accelerated sharply in 2007 to 3.5 p.c. The main reason was that health care spending expanded strongly again, by 4.7 p.c., after having declined in 2006. Owing to its significant size – at over one-third of total social spending – and volatility, health care expenditure generally has a decisive influence on the movement in social security spending. The calculation of a moving average, which attenuates the impact of fluctuations caused by shifts, accounting delays or short-term measures, indicates that the real growth of health care expenditure has resumed an upward trend.

Practically all other social spending categories also recorded real – adjusted – growth which exceeded the 2006 figure. In part, that acceleration is due to social measures which were more extensive in 2007 than in the three preceding years. In fact, new measures took effect in favour of pensions, amounting to some 200 million euro. This mainly concerns the adjustment of the oldest pensions in line with prosperity, the aim being to counteract the spontaneous decline in the relative wealth of the oldest pensioners, increases in the pensions of self-employed persons, particularly their minimum guaranteed pensions, and other more limited measures adopted under the generation pact. The few measures in favour of other categories of replacement incomes which took effect in 2007 had only a limited impact on the budget.

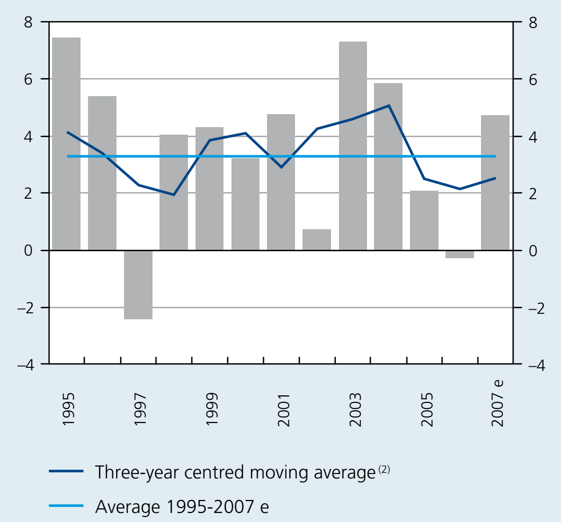
Finally, the subsidies paid to businesses by social security recorded a further sharp increase, principally as a result of activities under the service voucher scheme. Despite the one euro cut in the government subsidy per service voucher used, the total budget allocated to this scheme increased by more than 200 million euro, to 650 million. That figure disregards the tax allowances which users of these vouchers are also granted.

Following relatively strong growth in 2006, the volume of the adjusted primary expenditure of the communities and regions strengthened further in 2007, to 3.7 p.c. This expansion was due in particular to a return to positive investment growth, following a decline in the two preceding years. The budgetary scope available in Flanders, in particular, was another factor.

The movement in the real primary expenditure of local authorities is greatly influenced by the impact of the electoral cycle on their investment. Thus, the latter generally expands most strongly in the run-up to the local elections, as in 2005 and 2006. In contrast, it falls sharply in post-election years. These changes of tempo are reflected in the total local primary expenditure, which declined by 1.1 p.c. in 2007.

CHART 53 PUBLIC HEALTH CARE EXPENDITURE (1)

(deflated by the HICP, percentage changes compared to the previous year)



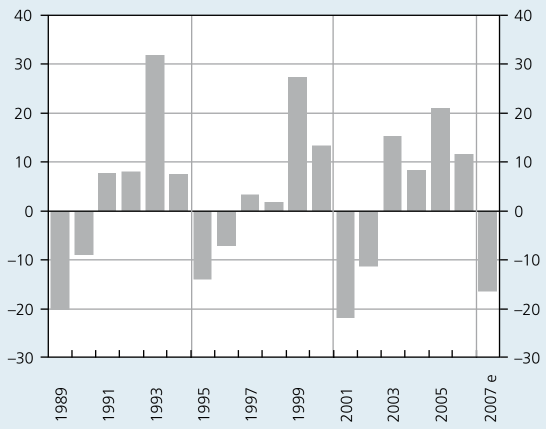
Sources: NAI, NBB.

(1) Public spending on health care, excluding sickness and invalidity benefits, benefits for the disabled, transfers to institutions caring for the disabled, and spending on long-term care insurance.

(2) For 2008, the real growth figure was assumed to be equal to the average for 1995 to 2007.

CHART 54 INFLUENCE OF THE ELECTORAL CYCLE ON GROSS FIXED CAPITAL FORMATION OF LOCAL AUTHORITIES (1) (2)

(percentage changes in volume compared to the previous year, excluding property sales)



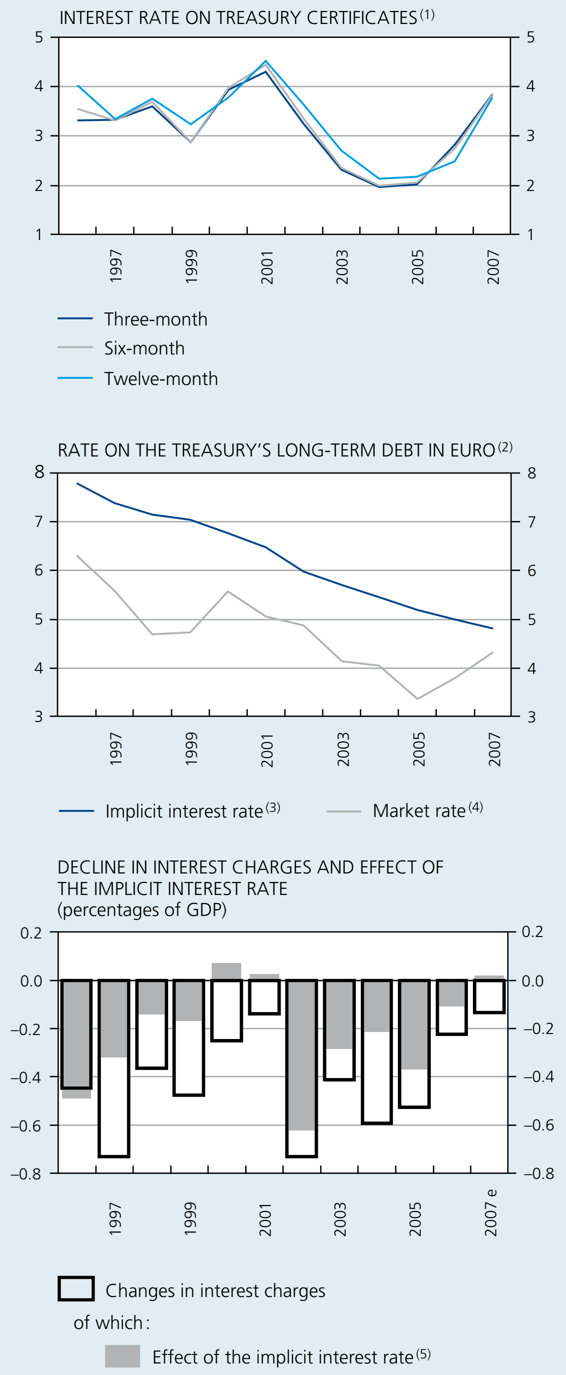
Sources : NAI, NBB.
(1) The vertical grey lines indicate the end of the local authority legislative terms.
(2) Deflated by the prices of gross fixed capital formation of general government.

Interest charges of general government

Since reaching a peak in 1990, the interest charges of general government have declined at an annual average rate of 0.5 percentage point of GDP. That is due to the combined effect of the systematic reduction in the debt ratio from the record high attained in 1993, and the fall in the implicit interest rate on the public debt, from 10 p.c. in 1990 to 4.7 p.c. in 2007.

Since 2006, the rate of the decline in interest charges has slowed sharply, so that the annual fall represented only 0.1 percentage point of GDP for the year under review. The main reason lies in the movement in the implicit interest rate which, for the first time since 2002, ceased to decline and actually edged upwards very slightly. This break in the trend is due to the rise in short-term interest rates which began in 2006. Thus, the average interest rate on twelve-month Treasury certificates climbed from 2.5 p.c. in 2006 to 3.8 p.c. in 2007. That increase reflects the tightening of monetary policy which has seen the interest rate of the Eurosystem's main refinancing operations increase steadily from 2 p.c. at the end of 2005 to 4 p.c. from June in the year under review.

CHART 55 BREAKDOWN OF THE CHANGE IN INTEREST CHARGES



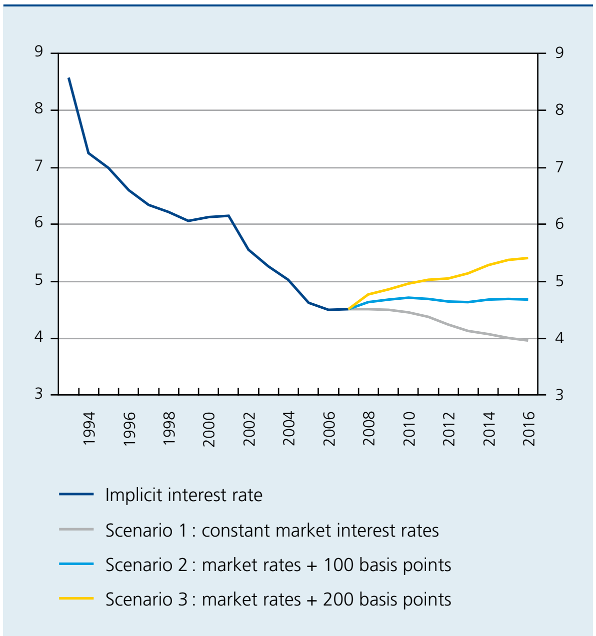
Sources : EC, FPS Finance, NAI, NBB.
(1) Implicit average rate on Treasury certificates.
(2) Excluding the loans issued before 1 January 1999 in currencies other than the Belgian franc and excluding variable-rate linear bonds on which the rate fluctuates in the same way as short-term rates.
(3) Ratio between interest charges (including issue premiums) and the average monthly outstanding amount of the debt.
(4) Average interest rate on ten-year public loans.
(5) Ratio between interest charges in the current year and debt at the end of the previous year. An adjustment was made in assessing the implicit rate in 2005, to take account of the impact of the inclusion of the RIF in the general government sector from 1 January 2005.

However, short-term debt instruments represent only a very small percentage of the total debt. The impact of the rise in short-term interest rates was thus cushioned by favourable movements affecting the long-term debt. In fact, long-term liabilities continued to be refinanced at lower rates : the differential between the interest rate on long-term security issues and that paid on securities maturing during the year remained favourable, despite the rise of around 50 basis points in ten-year interest rates for the second consecutive year. In the absence of any significant change in the implicit interest rate, the decline in interest charges in 2007 overall is due exclusively to the steady reduction of the public debt as a percentage of GDP.

As from 2008, the gradual expiration of old long-term bond series issued at high interest rates will come to an end so that, at constant market interest rates, the decline in the implicit rate on the total debt is unlikely to be as noticeable as in the past two decades. An increase in market interest rates would actually drive up the implicit rate, as is evident from the various sensitivity tests in chart 56.

CHART 56 IMPLICIT RATE ON THE PUBLIC DEBT (1) (2)

(percentages)



Sources : FPS Finance, NAI, NBB.

(1) Ratio between interest charges in the current year and debt at the end of the previous year. An adjustment was made in assessing the implicit rate in 2005, to take account of the impact of the reorganisation of the BNRC on the interest charges and debt of general government.

(2) The three illustrative scenarios were calculated on the basis of the technical assumption of a stable debt level in euro and an unchanged debt structure, and in relation to average market interest rates in 2007 which were used as the benchmark.

Overall balance of general government sub-sectors

The movement in the budget balance of general government is the outcome of developments which vary between sub-sectors. The very small deficit recorded during the year under review resulted from a deficit in Entity I, which comprises the federal government and social security, and a surplus in Entity II, which comprises the communities and regions plus the local authorities.

The federal government, which had recorded a small surplus in 2006, saw its balance deteriorate into a deficit of 0.9 p.c. of GDP, despite a reduction in interest charges amounting to 0.1 percentage point. The fall of 1.1 points in its primary balance is due in particular to the disappearance of a number of non-recurrent measures and the increase in transfers to other sub-sectors. Federal government expenditure also increased slightly as a percentage of GDP.

Social security succeeded in increasing its surplus to 0.5 p.c. of GDP, representing an improvement of 0.2 percentage point compared to the previous year. Its revenue grew by 0.2 percentage point following the increase in amounts collected in the form of social contributions and transfers from the federal government by way of "alternative funding", which is based on transferring to social security a share of the tax revenues collected by the Treasury. Social security expenditure fell by 0.1 percentage point of GDP, notably because of the favourable movement in unemployment expenditure, which is closely linked to the business cycle. Conversely, health care spending increased faster than GDP.

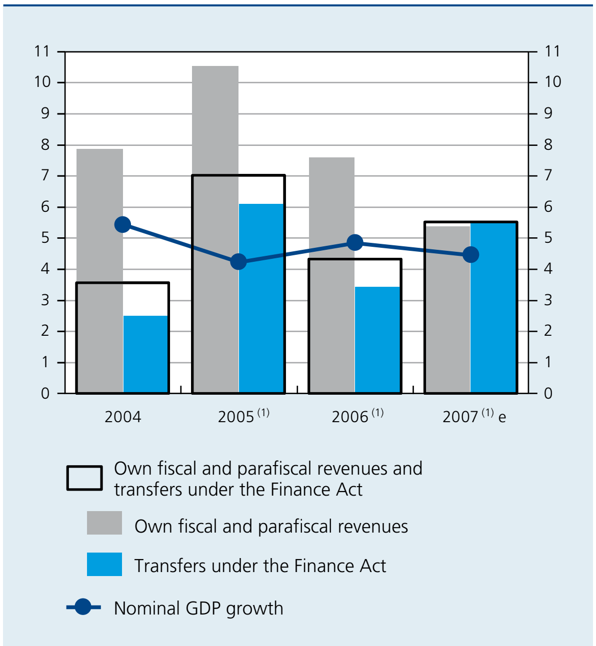
The surplus of the communities and regions edged upwards to 0.3 p.c. of GDP, since their revenues increased faster than their expenditures. Regional taxes recorded a smaller rise than in the previous year, mainly owing to the personal income tax cut granted by the Flemish Region. However, that reduction was offset by the strong rise in the share of personal income tax and VAT allocated to them by the federal government under the Finance Act. Since 2007, the resources granted to the communities in the form of VAT revenues had been adjusted not only in line with the consumer price index, but also by 91 p.c. of real GDP growth. In addition, from 2007 to 2011, VAT revenues increase by a flat amount of 25 million euro each year. However, the main reason for the strong rise in the financial resources transferred to the federated entities lies in the adjustment of the final settlement for 2006, following the recalculation of the resources to be allocated to the communities and regions on the basis of the final parameters to be applied under the said Finance Act. The reason for the positive balance resulting from that

TABLE 34 OVERALL BALANCE OF GENERAL GOVERNMENT, AND PER SUB-SECTOR
(percentages of GDP)

	2003	2004	2005	2006	2007 e
Primary balance	5.3	4.7	1.9	4.3	3.7
Entity I	4.9	4.3	1.5	4.1	3.2
Federal government	5.3	4.3	1.6	3.9	2.8
Social security	–0.3	0.1	0.0	0.3	0.5
Entity II	0.4	0.5	0.5	0.2	0.5
Communities and regions	0.3	0.4	0.4	0.3	0.4
Local authorities	0.2	0.1	0.1	–0.1	0.2
Interest charges	5.3	4.7	4.2	4.0	3.8
Overall balance	0.0	0.0	–2.3	0.4	–0.1
Entity I	0.1	–0.1	–2.4	0.4	–0.4
Federal government	0.3	–0.1	–2.4	0.1	–0.9
Social security	–0.3	0.1	0.0	0.3	0.5
Entity II	–0.1	0.1	0.1	0.0	0.3
Communities and regions	0.0	0.2	0.3	0.2	0.3
Local authorities	–0.1	–0.2	–0.1	–0.2	0.0

Sources: EC, NAI, NBB.

CHART 57 REVENUES OF THE COMMUNITIES AND REGIONS
(percentage changes compared to the previous year)



Sources: NAI, NBB.
(1) The data have been adjusted to take account of the change in Aquafin's funding, which is no longer based on the revenues generated by water charges but on the fees paid by the Flemish Region water supply companies.

settlement is that, in 2006, the expansion of economic activity, which largely determines the volume of these resources, far exceeded the figure predicted at the beginning of that year.

The local authority accounts ended in balance. The improvement in the balance compared to the previous year was due to a decline in their expenditure amounting to 0.2 percentage point of GDP, while their revenues hardly changed as a percentage of GDP. This reduction in their expenditure compared to 2006 is in line with the usual pattern following a local election year.

6.2 – Cyclically adjusted and structural budget balances

Analysis of the fiscal policy stance cannot be based exclusively on the apparent movement in budget aggregates. It is necessary to make an adjustment for the effect of the economy's automatic stabilisers and the impact of temporary factors. For this purpose, the ESCB uses an adjustment method which reveals the level of, and changes in, the general government structural financing balance.

This concept should be treated with due caution since, for the recent period, the data are subject to sometimes substantial revisions. That is a weakness inherent in all known methods of ascertaining the structural state of the economy or of one of its components. Nonetheless, experience has shown that the uncertainty mainly concerns the level. It is therefore primarily the movement in the structural indicators that should be examined.

Indicators constructed according to the methodology used by the ESCB show that the deterioration in the overall balance during the year under review cannot be attributed to the economic cycle, since that produced an improvement in the balance amounting to 0.4 percentage point of GDP. Activity growth far exceeded its trend rate, and this was reinforced by composition effects favourable to public finances. In fact, the expansion of some of the revenue and expenditure components which, such as earned incomes and private consumption, have a marked influence on the general government account, exceeded their trend growth rate by an even larger margin.

Nonetheless, the favourable cyclical effect on the budget balances was more than offset by the reversal of the influence of non-recurrent factors, which took a negative turn totalling 0.9 percentage point of GDP : while these factors had improved the general government account by 0.7 p.c. of GDP in 2006, they caused it to deteriorate by more than 0.1 p.c. It is true that the measure making it temporarily more advantageous for companies to pay out or invest certain tax-exempt reserves at a reduced rate of tax, and the bringing forward of the date for collecting social contributions on holiday pay at the end of an employment contract, had a favourable impact on the general government balance. However, that appears to have been insufficient to counterbalance the negative effects of the exceptional tax refunds paid pursuant to court rulings and arrangements agreed by the tax authorities with companies, on the one hand, and the revenue loss due to the securitisation of tax arrears effected in earlier years, on the other hand.

When the stability and growth pact was reformed in 2005, the structural budget balances became more important for the assessment of fiscal policy under the European surveillance procedures. The reform pact in fact stipulates that the budget outcomes must be adjusted for cyclical and temporary factors when they are compared with the medium-term objective set for public finances, and with the budget path required to achieve it. Under the European budgetary rules, the method of cyclical adjustment differs from that used by the ESCB : this method, applied by the EC, is based on the concept of potential, rather than trend, GDP and excludes on an annual basis the composition effects of economic growth ; moreover, the non-recurrent measures taken into account are not necessarily the same in the two adjustment methods. Despite these differences of methodology, the EC's assessment of the structural financing balance is only slightly different from the Bank's estimate : the EC also considers that the year under review will have ended with a structural deficit of 0.2 p.c. of GDP. Both estimates therefore indicate that the medium-term objective, which

TABLE 35 **MOVEMENT IN THE STRUCTURAL (1) BUDGETARY POLICY**

(change compared to the previous year, percentage points of GDP, unless otherwise stated)

	1999-2003	2004	2005	2006	2007 e
Recorded overall balance	0.8	0.0	–2.3	2.6	–0.5
Cyclical component (2)	0.1	0.0	–0.5	0.4	0.4
Non-recurrent factors	1.4	–0.4	–2.8	2.7	–0.9
Structural overall balance	–0.8	0.4	1.0	–0.5	0.0
p.m. Level of the structural overall balance (3)					
According to the NBB methodology		*–0.6*	*0.4*	*–0.1*	*–0.1*
According to the EC methodology		*–0.8*	*0.0*	*–0.3*	*–0.2*
Interest charges	–2.0	–0.6	–0.5	–0.2	–0.1
Structural primary balance	–2.8	–0.2	0.5	–0.7	–0.2

Sources : EC, NAI, NBB.

(1) Adjusted for cyclical and non-recurrent factors. According to the methodology described in Kremer J., C. Rodrigues Braz, T. Brosens, G. Langenus, S. Momigliano and M. Spolander (2006), *A disaggregated framework for the analysis of structural developments in public finances*, ECB, Working paper 579. This methodology is described in box 15 in the NBB's 2006 Report (Part 1), pp. 116-118.

(2) According to the methodology described in Bouthevillain C., Ph. Cour-Thimann, G. van den Dool, P. Hernández de Cos, G. Langenus, M. Mohr, S. Momigliano and M. Tujula (2001), *Cyclically adjusted budget balances : an alternative approach*, ECB, Working paper 77. A less technical explanation of this methodology is presented in box 6 entitled *Cyclically adjusted budget balances : method of calculation used by the ESCB* in the NBB's 2003 Report (Part 1), pp. 83-84.

(3) Percentages of GDP.

for Belgium corresponds to a structural surplus of 0.5 p.c. of GDP, has still not been achieved. The recommendation made in the reformed pact, namely to improve the structural balance by 0.5 percentage point of GDP per annum until that objective has been achieved, was not satisfied either, especially as advantage could have been taken of the favourable business climate to exceed that target, as advocated by the pact.

Since interest charges continued to fall, the slight deterioration in the structural balance, at least according to the Bank's assessment, is due solely to the decline in the structural primary surplus.

6.3 Debt of general government

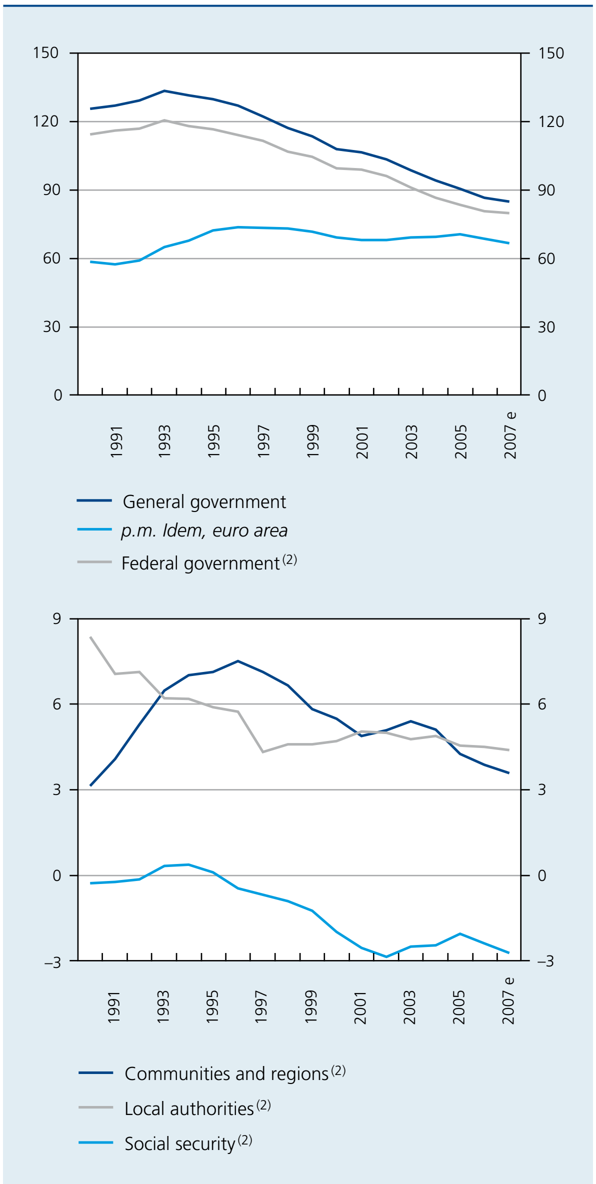
In 2007, the consolidated gross debt of general government amounted to 85.1 p.c. of GDP. That represents a decline of 3.1 percentage points of GDP compared to the previous year, falling slightly short of the average for the reductions recorded since 1993, when the debt had peaked at 133.5 p.c. of GDP.

This renewed fall is due mainly to nominal GDP growth, which forms the basis for measuring the public debt. Expressed in euro, there was a relatively marginal increase in the debt, taking account of the small budget deficit in the year under review. Moreover, the risk of a snowball effect was averted because, as in 2006, the implicit interest rate was lower than the growth rate of nominal GDP.

Since its peak in 1993, the general government debt has declined by over one-third as a percentage of GDP. The federal government's share of the debt has declined more or less proportionately, to represent 79.9 p.c. of GDP in 2007. The debt of the communities and regions had risen to 7.5 p.c. in 1996, but has since declined, falling to 3.6 p.c. of GDP in 2007. The consolidated gross debt of the local authorities declined from 8.4 p.c. of GDP in 1990 to 4.3 p.c. in 1997. Following that sharp fall, their debt continued hovering around that level, and stood at 4.4 p.c. in 2007. Since the mid 1990s, the gross debt of social security has fallen in both absolute and relative terms in relation to the public debt in general. It became zero in 2001, having been taken over by the federal government. Over the same period, social security accumulated assets on the federal authority and the other government sub-sectors, so that it has recorded a net credit position since 1996. In 2007, that position expanded further to 2.7 p.c. of GDP.

CHART 58 CONTRIBUTION OF THE GENERAL GOVERNMENT SUB-SECTORS TO THE CONSOLIDATED GROSS PUBLIC DEBT (1)

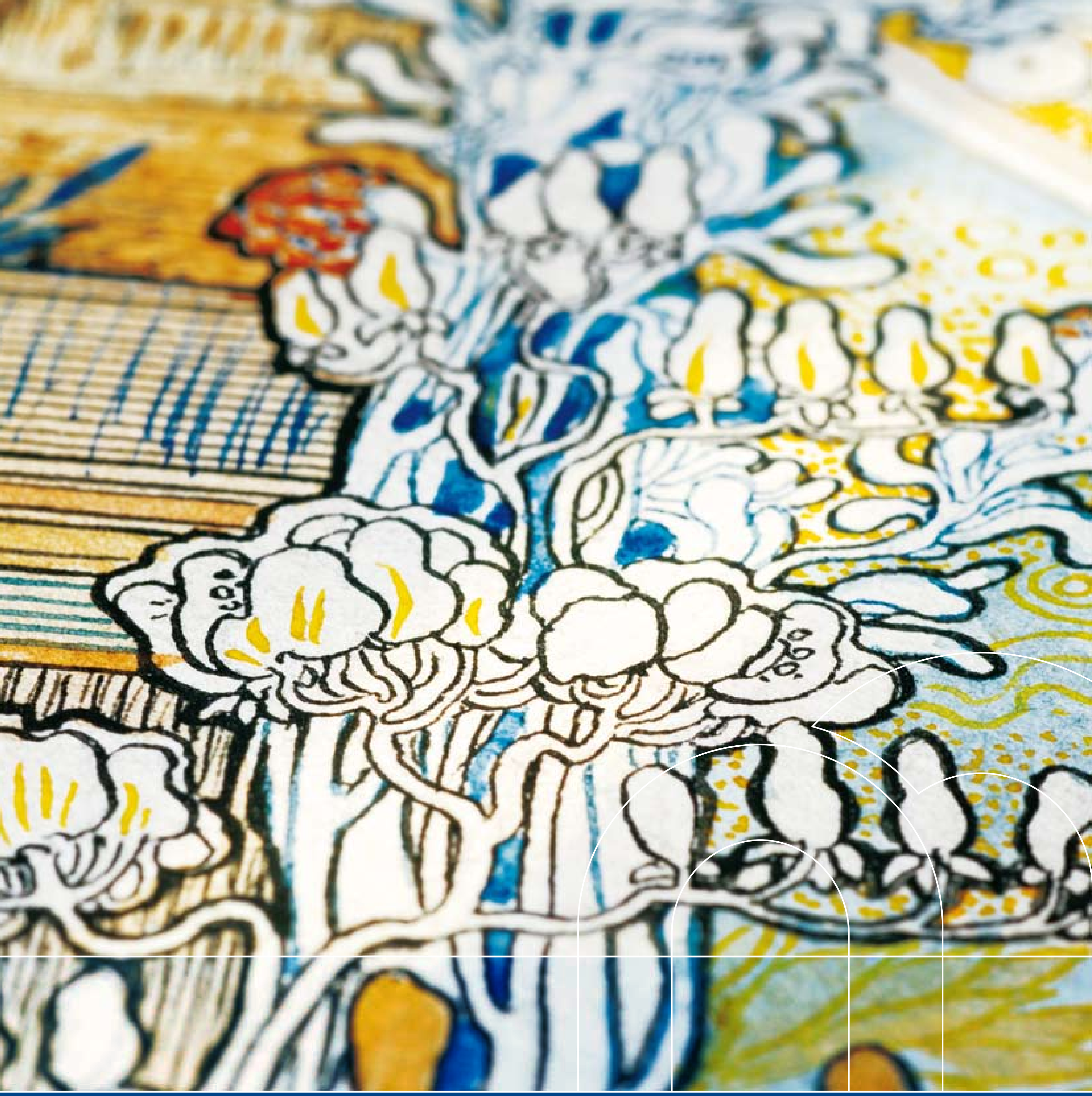
(percentages of GDP)



Sources: EC, NBB.

(1) Debt concept as defined in Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.

(2) Consolidated gross debt of the sub-sector, less the part of the debt of the other government sub-sectors which it holds.



Financial accounts and financial markets

7.

7.1 Structure of finance and investments in the Belgian economy

Households, which held net financial assets estimated at around 670 billion euro at the end of 2006, constitute the Belgian economy's only net creditor sector. They therefore finance, directly or indirectly, the other resident sectors and the rest of the world. As at 31 December 2006, non-financial corporations formed the largest debtor sector: although they held more financial assets than households, their financial liabilities were even larger, exceeding their assets at around 307 billion. The net debt of general government came to almost 238 billion euro at the end of 2006. As a result of the statistical conventions governing the compilation of the financial accounts, the financial corporations sector presented a financial position which was more or less in balance.

At the end of 2006, net lending to the rest of the world came to almost 119 billion euro. This positive net external position recorded by Belgium is largely due to the accumulation of previous current surpluses. It is attributable to households and financial corporations whose net financial assets in relation to the rest of the world stood at 144.3 and 227.1 billion respectively at the end of 2006. Conversely, non-financial corporations and general government recorded net financial liabilities in relation to other countries, totalling 119.8 and 132.8 billion respectively. Belgium's traditionally positive net external position had declined sharply in the early 1980s as a result of the marked deterioration in Belgium's external accounts. After the restoration of the current account surplus on the balance of payments, it expanded again to 62 p.c. of GDP in 1999. Following the bursting of the financial bubble, which led to a slump in net asset prices, it declined to 36 p.c. of GDP in 2002, and remained stable thereafter.

A comparison with other European countries, particularly the neighbouring countries, reveals the large size of Belgium's positive net external position. In 2006, only Switzerland, Norway and the Netherlands had higher levels of net financial assets. Germany and France also held net financial assets in relation to the rest of the

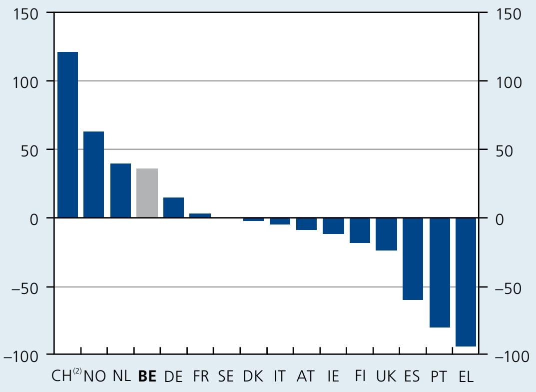
TABLE 36 FINANCIAL ASSETS AND LIABILITIES BY SECTOR
(outstanding amount at the end of 2006, billions of euro)

	Financial assets					Total financial liabilities
	Households	Non-financial corporations	General government	Financial corporations (1)	Rest of the world	
Financial liabilities						
Households	–	–	6.9	145.4	–	152.3
Non-financial corporations	130.4	507.7	18.9	123.2	483.4	1,263.7
General government	13.8	7.4	33.7	128.9	135.5	319.2
Financial corporations (1)	533.4	77.5	19.6	389.5	721.1	1,741.0
Rest of the world	144.3	363.6	2.7	948.2	–	1,458.8
Total financial assets	822.0	956.3	81.8	1,735.1	1,339.9	4,935.1
Net financial assets	669.7	–307.4	–237.5	–5.9	–118.9	

Source: NBB.
(1) Financial corporations mainly comprise the NBB, credit institutions and institutional investors. In the financial accounts, the NBB and credit institutions are treated as pure financial intermediaries, whose financial assets equal their financial liabilities.

CHART 59 BELGIUM'S NET EXTERNAL POSITION IN RELATION TO OTHER EUROPEAN COUNTRIES (1)

(percentages of GDP; data at the end of 2006, unless otherwise stated)



Source: EC.
(1) No data available for Luxembourg.
(2) End of 2005 for Switzerland.

world, while the other countries had a net debtor position. Spain, Portugal and Greece recorded the largest net debts.

During the first nine months of the year under review, the formation of financial assets by Belgian households once again exceeded the new liabilities which they incurred. Over that period, the net financial assets of households thus increased by 9.1 billion euro, leaving aside the effect of stock market or exchange rate fluctuations on the value of their financial assets or liabilities. At the same time, non-financial corporations, referred to from now on as corporations or companies, recorded a net financial surplus of almost 0.5 billion euro, again enabling them to reduce slightly the level of their net liabilities. In contrast, the financial transactions of general government recorded a net deficit of 4.7 billion euro over the period considered, as is usual at that stage in the year.

TABLE 37 STRUCTURE OF THE FINANCIAL ASSETS AND LIABILITIES OF THE RESIDENT NON-FINANCIAL SECTORS

(billions of euro)

	Households		Non-financial corporations		General government	
	Outstanding amount at the end of 2006	Flows of the first nine months of 2007	Outstanding amount at the end of 2006	Flows of the first nine months of 2007	Outstanding amount at the end of 2006	Flows of the first nine months of 2007
Financial assets (1)	822.0	17.0	956.3	53.6	81.8	9.5
of which:						
Notes, coins and deposits	232.9	4.8	101.5	7.4	4.9	7.7
Fixed-income securities	75.2	–0.9	13.5	0.6	13.9	2.1
UCI units	137.2	0.3	0.1	0.0	1.4	2.8
Shares and other equity	197.5	1.0	492.5	24.9	22.3	0.2
Insurance technical reserves	189.9	9.8	6.7	–0.2	–	–
Loans	–	–	362.8	7.9	22.5	–1.4
Financial liabilities	152.3	8.0	1,263.7	53.1	319.2	14.2
of which:						
Notes, coins and deposits	–	–	–	–	1.0	0.1
Fixed-income securities	–	–	32.8	0.9	257.8	17.8
Shares and other equity	–	–	812.8	28.3	–	–
Loans	143.8	9.3	407.2	26.3	48.1	–0.3
Financial balance	669.7	9.1	–307.4	0.5	–237.5	–4.7

Source: NBB.
(1) Apart from the main categories of financial instruments presented in the table and various minor assets not specifically named, this item also covers errors and omissions in Belgium's financial account with the rest of the world, traditionally treated as unrecorded capital movements. When the cumulative flows of these errors and omissions are negative, the sum of the outstanding amounts of the main categories of instruments included in the table may exceed the total amount of the financial assets.

7.2 Households

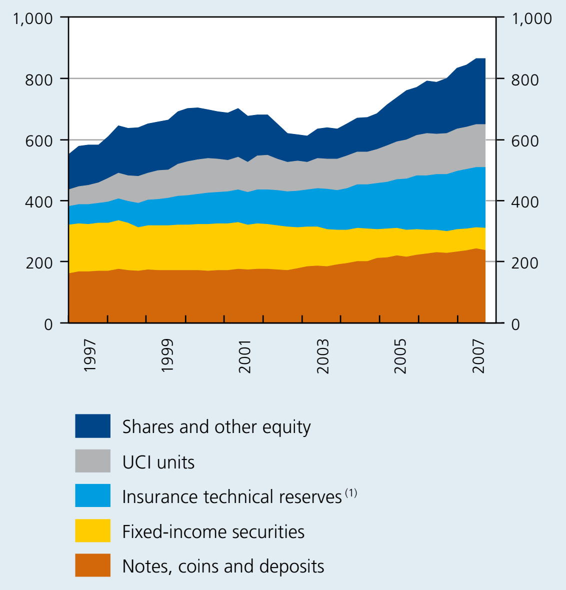
Formation of financial assets

Households formed financial assets totalling 17 billion euro during the first nine months of last year, compared to 10.3 billion in the corresponding period of 2006. Combined with valuation effects, these transactions boosted the outstanding total of household financial assets to 855 billion euro as at 30 September in the year under review. Notes, coins and deposits, which continued to make up a significant part of the household portfolio, represented 27.7 p.c. of that amount, or 237 billion. On that same date, shares and other equity accounted for 25.3 p.c. of the financial assets of households (216 billion). However, that percentage – which depends mainly on the prices of listed shares – probably declined subsequently, in view of the stock market fall in the fourth quarter of 2007. The outstanding total of investments in units of undertakings for collective investment (UCIs), the value of which is affected by prices of both bonds and equities, represented 15.9 p.c. (136 billion) of the financial assets of households. The proportion of their assets held directly in the form of fixed-income securities has declined steadily over the past five years, being affected mainly by the extensive disinvestment from bonds, and now amounts to only 8.7 p.c. (74 billion). This fall benefited the reserves formed with insurance companies and pension funds. That category, which records sustained growth regardless of the economic cycle, accounted for 23.4 p.c. of the financial assets of households as at 30 September last year, or 200 billion euro.

Regarding transactions effected over the first nine months of 2007, households invested more in medium- or long-term assets (10.6 billion) than in short-term assets (4.3 billion). This preference was reflected in the ranking of household investment instruments, with insurance technical reserves again dominating.

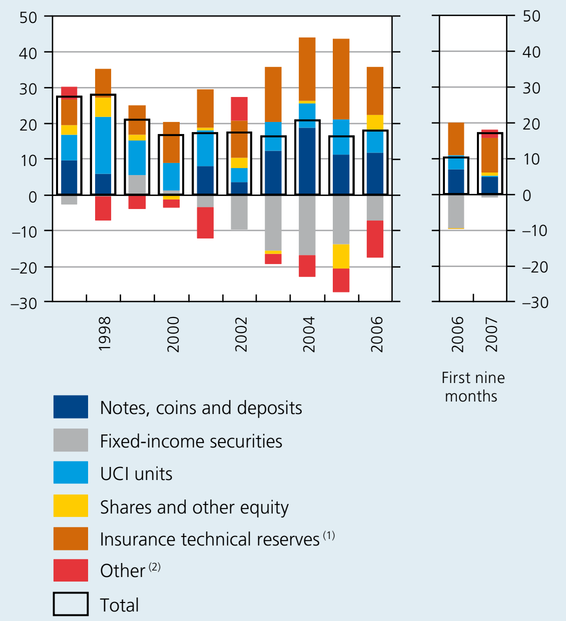
The level of interest rates offered on savings accounts held with the big banks, which still largely dominate this market segment, increased only slightly in the year under review. This rather unattractive return seems to have encouraged many households to put their savings into other instruments. These include term deposits which, though less liquid, are just as secure as regulated savings

CHART 60 FINANCIAL ASSETS HELD BY HOUSEHOLDS
(end-of-quarter data, billions of euro)



Source : NBB.
(1) This item essentially comprises the net claims of households on life insurance technical reserves and pension funds.

CHART 61 FORMATION OF FINANCIAL ASSETS BY HOUSEHOLDS
(billions of euro)



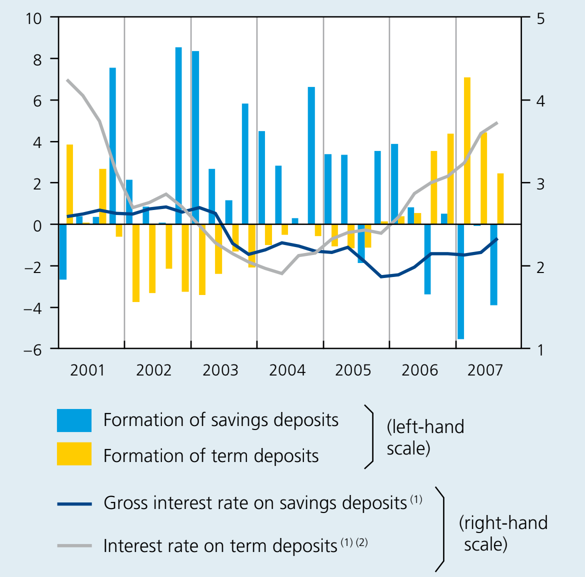
Source : NBB.
(1) This item essentially comprises the net claims of households on life insurance technical reserves and pension funds.
(2) This item comprises, so far as they could be recorded, financial derivatives and miscellaneous assets on financial institutions, including in particular interest accrued but not paid and the part attributed to households of the errors and omissions on Belgium's financial account with the rest of the world.

deposits. Since the beginning of 2005, term deposits in particular have offered interest rates which are higher, on average, than those applicable to regulated savings, even after deduction of the withholding tax – which applies immediately to all interest paid. They thus benefited directly from the continuing increase in the Eurosystem's key interest rates. In that context, term deposits recorded an inflow of 13.9 billion euro during the first nine months of 2007, while savings deposits – on which the remuneration is less sensitive to movements in money market interest rates – contracted by 9.5 billion over the same period. In the end, only the banks offering better terms in order to gain market shares saw an expansion in savings deposits. As at 30 September in the year under review, regulated savings deposits and term deposits held by households represented 140.8 and 42.7 billion euro respectively.

The reduction in savings deposits also seems to have benefited fixed-income securities. Net sales of this type of instrument, which had come to 9.5 billion euro during the first nine months of 2006, fell sharply to 0.9 billion in the corresponding period of last year. In other words, purchases and subscriptions more or less equalled sales and redemptions, a situation not seen since the year 2000. The very steep increase in interest rates in the first part of the year under review was undeniably a factor here,

CHART 62 **REGULATED SAVINGS DEPOSITS AND TERM DEPOSITS OF HOUSEHOLDS**

(billions of euro, unless otherwise stated)



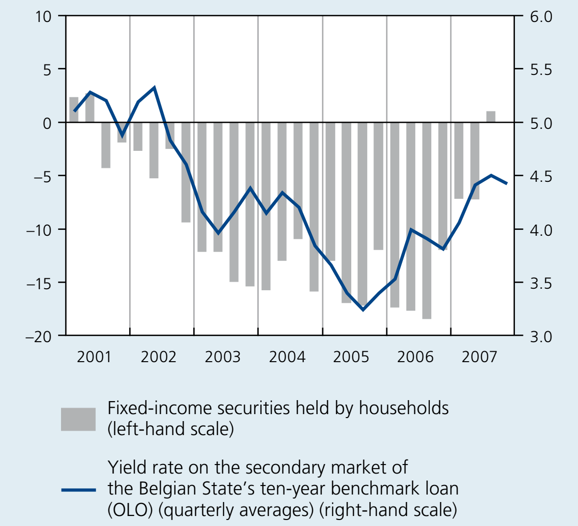
Source : NBB.

(1) Implicit interest rate as indicated by the profit and loss accounts of credit institutions ; quarterly averages.

(2) Less the 15 p.c. withholding tax on income from movable property.

CHART 63 **FIXED-INCOME SECURITIES HELD BY HOUSEHOLDS AND LONG-TERM YIELD RATES**

(percentage changes compared to the corresponding quarter of the previous year, except for yields)



Source : NBB.

offering an incentive to subscribe to new bond issues. However, in the second half of the year, the quest for quality investments, prompted by the uncertainty surrounding the implications of the credit crisis, tempered somewhat the rise in interest rates on the market in government bonds, regarded as a safe haven. Conversely, the yields offered on riskier bonds continued rising in response to the waning demand for this type of product.

Households acquired more shares and other equity than they sold, the difference amounting to 1 billion euro during the first nine months of 2007. Over the corresponding period of the previous year, net sales of unlisted shares had negated the positive contribution of amounts invested in listed shares. Conversely, in 2007, these two categories absorbed positive, although very small, inflows. The slowdown in investments in listed shares took place in an economic climate dominated by growing uncertainty, after several years of rising stock markets. The upturn in unlisted shares is attributable to various factors, which are explained in section 7.3.

Households also considerably reduced the amount of their investments in UCI units : net acquisitions of this type of assets came to 0.3 billion euro during the first nine months of the year under review, compared to 3.9 billion during the corresponding period of 2006. Bond funds, in particular, recorded more redemptions than subscriptions.

The prospect – since confirmed – of an extension, with effect from 1 January 2008, of the basis of assessment of the withholding tax, to include all capital gains realised – and not only the interest component – on the bond element of capitalisation UCIs with a European passport, investing at least 40 p.c. in fixed-income securities, curbed the inflow of household investments into this type of product. In fact, a poll commissioned in 2007 by the daily papers, L'Écho and De Tijd, indicates that for one in two Belgians, the tax regime is a decisive factor in the choice of an investment product.

Despite some uncertainty regarding tax, the array of funds offered to households continues to expand. Thus, according to the Belgian Asset Managers Association (BEAMA), as at 30 September 2007, UCIs focusing on sustainable and responsible investments (SRI) represented 4.1 p.c. of the total fund market in Belgium. The term SRI refers to funds in which the part of the portfolio held in shares and bonds is comprehensively screened according to various non-financial criteria concerning social, ecological, societal and ethical aspects. In addition, these investments must represent at least 90 p.c. of the assets under management. Sustainable and responsible funds, which represented barely 1 p.c. of the UCI market at the beginning of 2004, have recorded particularly strong growth in the past few years.

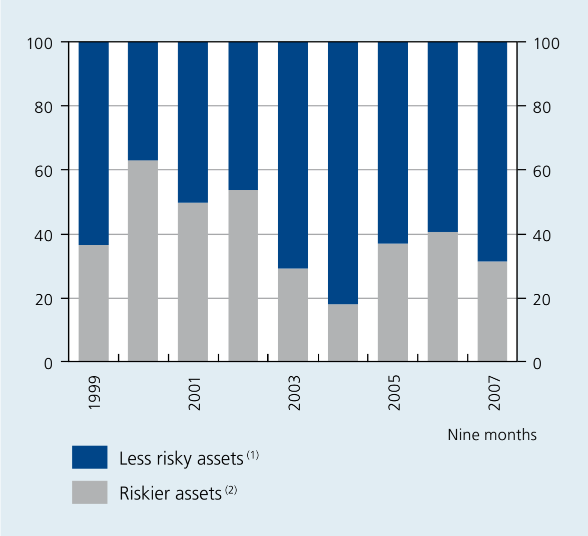
Quoted index funds, also known as trackers or exchange-traded funds (ETF), are making similarly rapid strides. These funds, which can be traded as readily as shares on the stock market, confine themselves to faithfully reflecting a particular stock market index in order to mirror its movement exactly. The number of such funds quoted on Euronext increased from 160 at the end of 2006 to 228 a year later.

The formation of reserves with insurance companies and pension funds absorbed a large part of household savings, amounting to 9.8 billion euro in the first nine months of 2007, against 9.1 billion over the corresponding period of the previous year, when some loss of momentum was seen following the introduction of a 1.1 p.c. tax on premiums paid for individual life insurance policies.

Apart from the tax rules applicable, there are two criteria which primarily determine portfolio choices: the expected gross yield and the level of risk which the saver considers acceptable. In that regard, the breakdown of investment flows between riskier and less risky assets reveals the influence of stock market shocks on the composition of the financial assets of households. For example, the proportion of riskier assets peaked at 63 p.c. in 2000, before plummeting once the technology stocks bubble burst, and dropping to just 18 p.c. in 2004. That ratio subsequently climbed back rapidly as households were probably encouraged by the steady rise in stock market prices up to the beginning of the year under review. These developments show the extent to which past performance influences investment decisions. Last year, households showed a renewed preference for assets regarded as more secure: during the first nine months of 2007, riskier investments represented only 31 p.c. of their financial asset formation. Households may have learnt from the previous stock market crisis, and decided to cash in part of their profits without waiting for the markets to overheat. The turbulence on the financial markets from the summer and its impact on stock markets probably reinforced this risk aversion exhibited by households.

CHART 64 FORMATION OF FINANCIAL ASSETS ACCORDING TO THE RISK INCURRED

(percentages of total flows)



Source: NBB.

(1) This category comprises notes, coins and deposits, fixed-income securities, UCI units with capital protection and insurance technical reserves other than class 23. It therefore covers all instruments which, provided they are held to maturity and the debtor honours his commitments, guarantee a positive or zero nominal yield in their reference currency. This distinction is therefore arbitrary since, in the absence of information, it ignores the risk inherent in the currency or the investment counterparty.

(2) This category comprises financial instruments which do not offer the guarantee described above, namely shares and other equity, UCI units without capital protection, and class 23 insurance technical reserves.

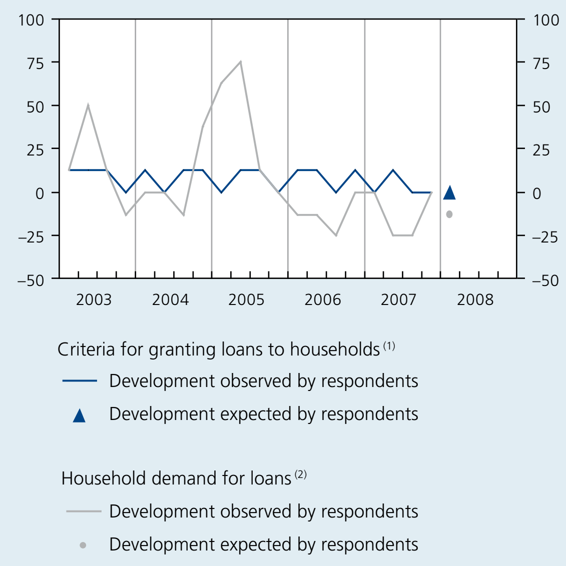
In addition, savers need to be properly informed of the risks incurred in subscribing to a particular financial product. In that regard, the entry into force of the legislation transposing into Belgian law the European Directive on markets in financial instruments (MiFID), on 1 November 2007, introduces several provisions which should ensure better information for private investors. The most notable innovation concerns the obligation on all financial institutions to ensure that their customers have the knowledge, experience and appropriate profile, before they recommend a risky investment product to them.

New financial liabilities

During the first nine months of 2007, Belgian households contracted new financial liabilities totalling 8 billion euro, compared to 8.3 billion during the corresponding period of the previous year. The level of net subscriptions to mortgage loans equalled these new liabilities: loans granted amounted to 8 billion more than loans repaid, a balance which only slightly exceeded that recorded during the corresponding period of 2006. This relatively stable picture is due to the weakening of demand for home loans, since the lender institutions eased their credit conditions.

Echoing the rising prices on the residential property market, the average amount of loans granted increased again. However, the rise was modest compared to the growth rates seen in the past six years. Also, the average loan term increased further during the year under review, as a result of the strong expansion of very long-term loans offered by a growing number of banking institutions.

CHART 65 RESULTS OF THE EUROSYSTEM'S BANK LENDING SURVEY: MORTGAGE LOAN SUPPLY AND DEMAND IN BELGIUM



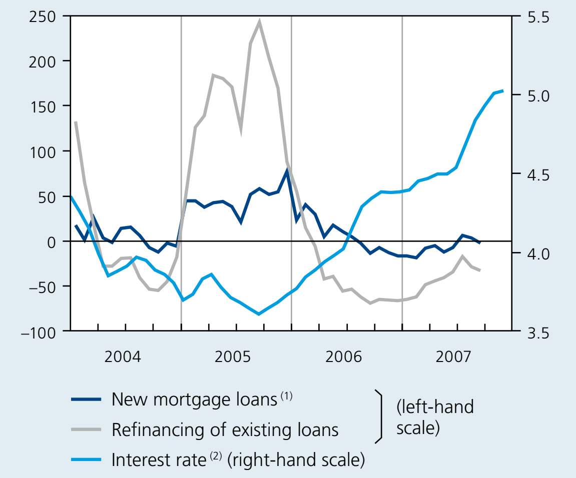
Source: NBB.

(1) Net percentages of weighted replies by credit institutions to the Eurosystem's bank lending survey indicating the degree to which lending criteria were eased or tightened (–).

(2) Net percentages of weighted replies by credit institutions to the Eurosystem's bank lending survey indicating the degree of increase or decrease (–) in demand for credit.

CHART 66 NEW MORTGAGE LOANS TO HOUSEHOLDS, REFINANCING AND INTEREST RATES

(percentage changes compared to the amounts lent in the corresponding month of the previous year, except for interest rates)



Sources: PLU, NBB.

(1) Excluding the refinancing of existing loans.

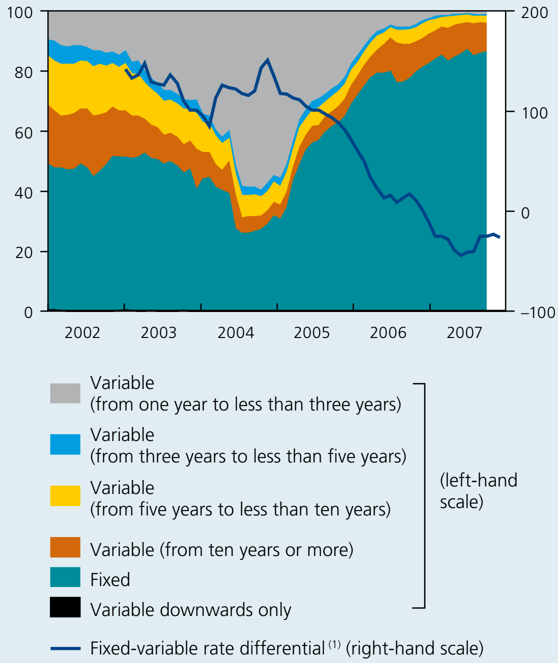
(2) Average of the rates charged on the main categories of mortgage loans, weighted by the amounts of new loans contracted in each of those categories.

These two factors, which are closely linked, partly compensated for the effect on new lending of the rising interest rates seen since mid 2005. However, in view of the renewed rise in the average interest rate charged on mortgage loans, recorded in the second half of 2007, it is likely that lending declined more sharply at the end of the year. In any case, the refinancing of existing loans, particularly sensitive to interest rate movements, showed a steep fall in 2007, for the second consecutive year.

For the past two years, the reduction in the differential between fixed and variable interest rates has encouraged borrowers' preference for fixed-rate loans: this formula accounted for 87 p.c. of the contracts signed in September of the year under review. However, variable-rate formulas, which periodically pass on market interest rate movements in the interest charged, were concluded on a massive scale between 2000 and 2005 and therefore still represented a substantial percentage of current loans. However, the rise in interest rates does not seem to be threatening households' ability to meet their monthly payments. At the end of December 2007, the Central Individual Credit Register recorded 24,364 loans with unpaid arrears, or barely 1.1 p.c. of the total number of loans recorded. At the end of 2003, that figure had stood at 1.8 p.c.

CHART 67 RATE DIFFERENTIAL[1] AND BREAKDOWN OF NEW MORTGAGE CONTRACTS BY TYPE OF INTEREST RATE [2]

(monthly data, percentages of the total, except for the rate differential)



Sources : PLU, NBB.
(1) Difference in basis points between the interest rate on new loans granted to households with an initial fixed-rate period of over ten years and the interest rate on new loans with an initial fixed-rate period of one year.
(2) The entries in brackets refer to the initial fixed-rate period.

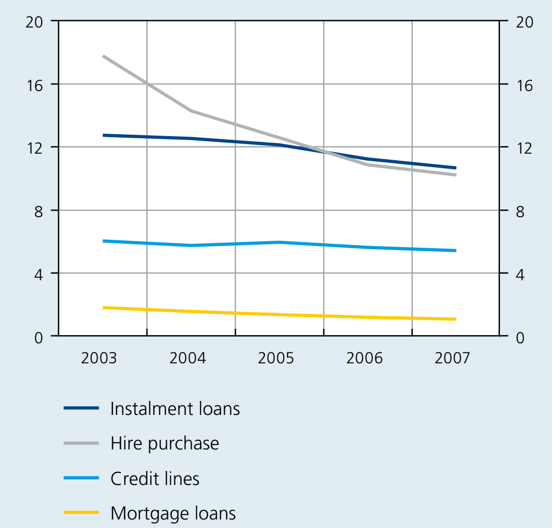
It is true that the legislature has introduced safeguards to facilitate repayments whatever the circumstances. Thus, the upward or downward movement in the interest rate in relation to its initial level must be subject to contractually agreed limits. In all cases, the increase in the initial rate cannot exceed a legal maximum of 1 percentage point in the second year and 2 percentage points in the third year, if the initial fixed-rate period is less than three years. The legislature has also adopted the yield on government bonds as the benchmark for the periodic adjustment of variable-rate loans. Since those yields are far less volatile than interbank interest rates, mortgage rates were sheltered from the turmoil affecting the money market in 2007. That is particularly true as the minimum fixed-rate period is one year in the case of variable rates in Belgium. Finally, mortgage companies are required to consult the information recorded at the Central Individual Credit Register in order to check the potential borrower's solvency before granting a loan. This system, intended to prevent excessive debt, seems more justifiable than ever in view of the consequences of the crisis resulting from the unrestrained granting of mortgage loans to low-solvent American households.

The Central Individual Credit Register also collects data on consumer credit contracts. This segment, too, has shown a fall in the number of defaulting non-regularised contracts. As at 31 December 2007, the number came to 387,051 compared to 388,719 a year earlier. That fall is all the more significant since the total number of current contracts has risen steadily, despite the increase in interest rates. In relation to total current loans, the number of defaulting loans as at 31 December 2007 was 10.7 p.c. for instalment loans, 10.2 p.c. for hire purchase and 5.4 p.c. for credit lines. Although these ratios are well above the default rates recorded on mortgage loans, they have nevertheless displayed a downward trend in recent years. The fact that, since 2003, the Central Individual Credit Register has recorded all credit contracts, rather than only those in default, may have played a role in this reduction.

On 1 December in the year under review, the movement in interest rates triggered a further rise in the maximum APR (annual percentage rate) permitted for each type of consumer credit. This was the second time that a royal decree which took effect on 1 February 2007 was applied ; that decree introduced a mechanism for the automatic adjustment of these maximum rates in line with

CHART 68 NUMBER OF NON-REGULARISED DEFAULTING LOANS AS A RATIO OF TOTAL CURRENT LOANS

(data as at 31 December, percentages)



Source : NBB.

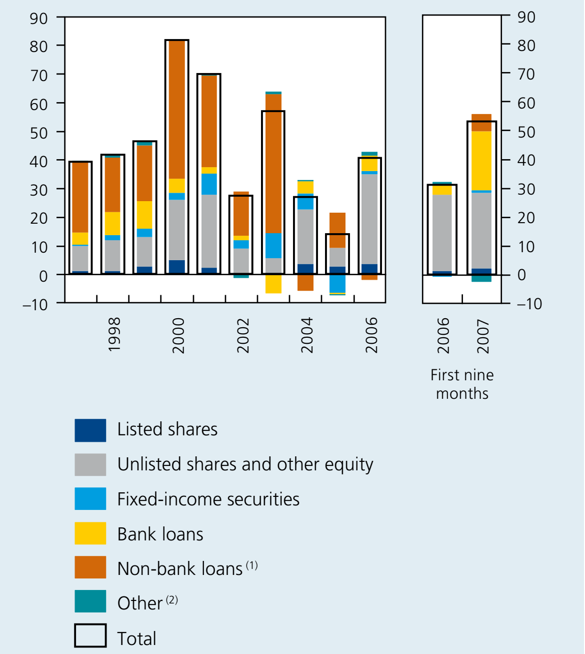
the movement in the benchmark indices reflecting the cost of credit for the lender institutions (for more details, see box 16 on this subject in the 2006 Report).

7.3 Non-financial corporations

During the first nine months of 2007, companies contracted new financial liabilities totalling 53.1 billion euro, well in excess of the 31.2 billion recorded in the corresponding period of 2006. Viewed over the longer term, new corporate financing needs were very substantial during the first three quarters of 2007. These resources were used to finance the strong growth of the tangible investments of non-financial corporations, as their gross fixed capital formation came to 39.7 billion euro in 2007, an increase at current prices of 6.3 p.c. against 2006. Also, in line with the traditional pattern in Belgium, the growth of new financial liabilities was accompanied by substantial corporate financial asset formation, totalling around 53.6 billion. A significant proportion of these transactions are international, reflecting the transit function of the coordination centres based in Belgium. Also, in the third quarter, a company takeover inside the Suez group led to the formation of assets in the form of unlisted shares totalling 18.2 billion.

CHART 69 NEW FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS: BREAKDOWN BY INSTRUMENT

(billions of euro)



Source: NBB.

(1) Mainly loans granted by Belgian and foreign non-financial corporations, also referred to as inter-company loans.

(2) Includes technical reserves of non-autonomous pension funds and transitory items.

As in the previous year, issues of unlisted shares and other equity were the primary source of corporate financing, totalling around 26.1 billion euro during the first nine months of 2007. Recourse to the stock market via the issue of listed shares increased, recording cumulative flows of 2.2 billion euro. Marking the end of a long period of weak growth in this segment, firms made extensive use of bank credit to meet their financing needs: during the first nine months of 2007, they contracted new bank loans amounting to over 20 billion euro, almost three-quarters of them being granted by Belgian banks. Net issues of fixed-income securities came to just under 1 billion euro, while net redemptions of an equivalent sum had been recorded in the corresponding period of 2006. Finally, financing via non-bank lending, essentially intercompany loans, which had been decelerating sharply for several years, came to 5.9 billion euro last year.

Financial conditions

Belgian firms faced a widespread increase in the cost of external financing sources in 2007. Having begun at the end of 2005, the rise in interest rates on the various categories of corporate loans persisted throughout last year, as a result of successive increases in the Eurosystem's key interest rates and, from the summer, the tensions on the financial markets generated by the crisis on the sub-prime mortgage market in the United States. The average interest rate weighted according to the respective flows of the various categories of corporate loans – excluding overdrafts – granted by Belgian banks increased by 52 basis points between December 2006 and November 2007. However, that is a much smaller increase than in 2006, when that same index had risen by 137 basis points, in a context of admittedly much stricter tightening of monetary policy.

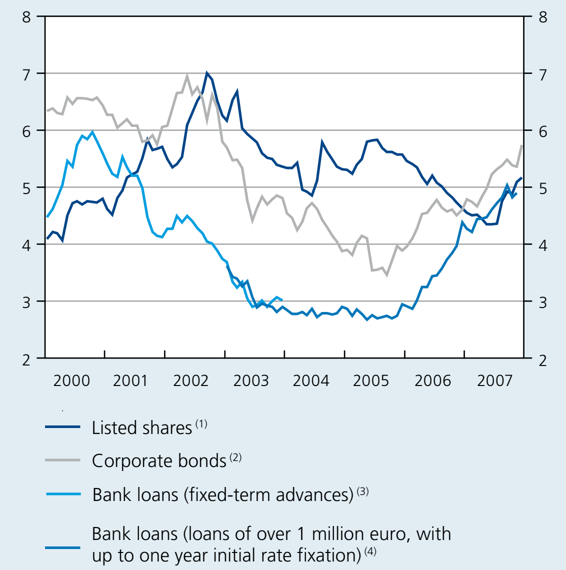
The transmission of the successive increases in the key rates to the debit interest rates charged by Belgian banks was more or less complete in the case of short-term loans, defined here as loans with an initial fixed-rate period of up to one year. Between September 2005 and July 2007, the short-term rates applied to firms increased by 186 and 197 basis points respectively, depending on whether the value of the loan was less or more than 1 million euro, while the three-month interbank market rates, which are used as a benchmark, increased by 208 basis points. Interest rates on longer-term loans showed a smaller proportionate rise over the same period: thus, loans with a value of under 1 million on which the interest rate is fixed for a period of over five years saw only an 86 basis point rise. That reflects the smaller increase in long-term risk-free rates and the longer transmission times in the case of long maturity bank loans. The keener competition between banks, which is driving down their margins, was another contributory factor. Consequently, the differential between the long- and short-term rates offered by Belgian banks, which had become negative in October 2006, increased almost continuously in the year under review.

The eruption of the subprime crisis in the summer immediately sparked fears of a potential tightening of credit standards. Yet from July to November 2007, there was only a modest increase in the short-term rates charged by Belgian banks, despite the severe money market tension. Longer-term rates remained practically unchanged, and therefore did not benefit from the slight fall in the risk-free long-term rate.

The nominal cost of debt in the form of the issuance of securities by non-financial corporations continued to rise in 2007, but remained below the peaks attained in previous years, and particularly in 2002. The spreads in relation to the corresponding risk-free interest rates widened greatly from the third quarter, as a result of the general repricing of risk resulting from the financial market turbulence triggered by the subprime crisis. The borrower categories with the weakest profiles were the most affected. Thus, the spread between the yield on a euro-denominated corporate bond with a BBB rating and a maturity of five to seven years and the yield on public debt securities with a comparable maturity widened by 90 basis points between June and December 2007. A higher quality bond with an AAA rating saw its spread widen by only 22 basis points over the same period.

CHART 70 EXTERNAL FINANCING COSTS OF NON-FINANCIAL CORPORATIONS IN BELGIUM

(percentages)



Sources : Thomson Financial Datastream, NBB.
(1) Estimated on the basis of a dividend discount model, monthly averages.
(2) Yield on a euro-denominated bond with a BBB rating and a maturity of five to seven years, monthly averages.
(3) Data from the monthly RIR survey.
(4) Data from the monthly MIR survey, for new loans contracted.

The cost of raising finance by issuing listed shares declined up to July, owing to the favourable movement in stock market prices, which in turn resulted largely from the good results achieved and expected by Belgian companies listed on the Stock Exchange. As detailed in box 19 of the 2005 Report, the cost entailed in share issues as discussed here was estimated on the basis of a dividend discount model : the cost goes up in response to an increase in dividends (actually paid and / or expected) and goes down when stock markets rise. Thus, the abrupt correction suffered by the leading stock markets in August, following the turbulence caused by the eruption of the subprime crisis, sparked a strong rise in equity financing costs, but that rise slowed down in the closing months of the year. On average, taking 2007 as a whole, the cost of this financing method nonetheless remained more attractive than it was in 2006 and during the major part of the current decade.

To sum up, the past year brought a proportionately larger increase in the cost of debt financing – be it in the form of bank lending or bond issues – than in the cost of equity financing. Chart 70 is not intended for comparison of the respective levels of the various sources of funding, but for analysis of their pattern over time. On the one hand, the level of the cost of equity financing depends very much on the assumption regarding real long-term dividend growth. Also, the distortions introduced by taxation are disregarded. In that connection, the entry into effect on 1 January 2006 of the legislation on the risk capital tax allowance, better known as the notional interest deduction, helped to reduce the real cost of equity financing by harmonising the tax treatment of equity capital and debt financing.

Bank lending

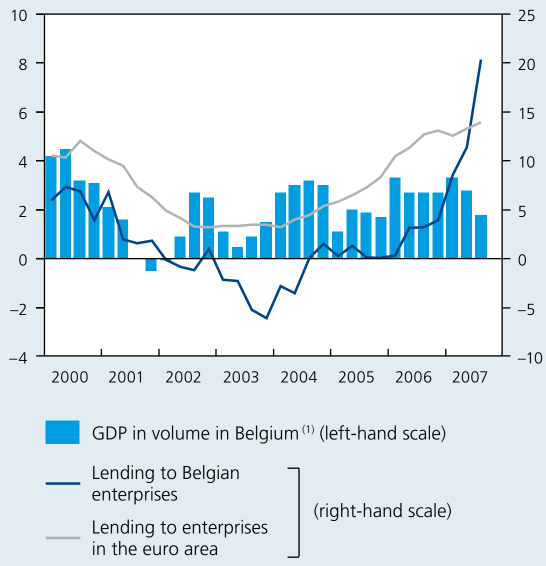
During the first nine months of 2007, bank lending to enterprises raised strongly, by 20.4 billion euro, compared to 3.4 billion for the corresponding period of 2006.

This was a dramatic increase, since the volumes granted in the first three quarters of last year are well in excess of those attained over twelve months in the most dynamic years, e.g. in the late 1990s. The reason lays in the maintenance of brisk economic growth, including the continuing rapid expansion of gross fixed capital formation by enterprises. It is also possible that some catching up took place in 2006 and 2007, after a protracted period of weak growth in bank lending to firms, and even a decline from 2002 to 2004.

In this period, firms in the euro area – and especially the largest of them – had exhibited a desire to consolidate their balance sheet, particularly via a substantial reduction in their debts. In Belgium, gross fixed capital formation by enterprises had been especially meagre from 2001 to 2003 owing to the cyclical uncertainty and continuing excess production capacity. Thus, the weakness of demand from Belgian firms during that period was the main reason why lending lagged well behind the levels in the euro area as a whole, as the policy adopted by Belgian banks was not more restrictive than that of other banks in the euro area.

CHART 71 LENDING BY MONETARY FINANCIAL INSTITUTIONS IN THE EURO AREA AND CYCLICAL DEVELOPMENTS IN BELGIUM

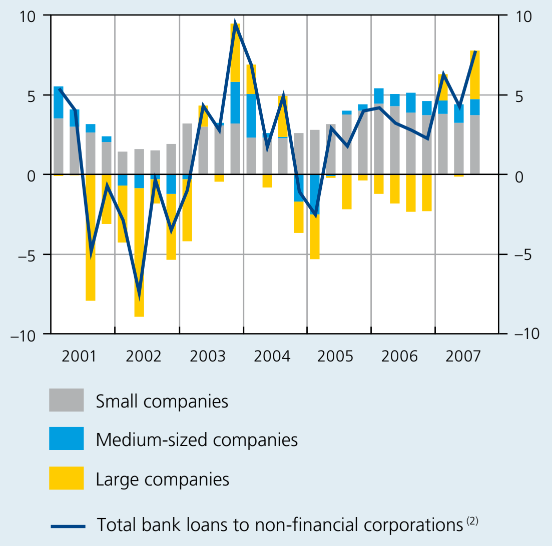
(percentage changes compared to the corresponding quarter of the previous year)



Sources: ECB, NBB.
(1) Gross quarterly data.

CHART 72 LOANS GRANTED BY BELGIAN CREDIT INSTITUTIONS TO NON-FINANCIAL CORPORATIONS, BY SIZE OF COMPANY [1], ACCORDING TO THE CENTRAL CREDIT REGISTER

(contribution to the change in bank lending to non-financial corporations, percentage points, unless otherwise stated)



Source: NBB.
(1) Companies which filed their annual accounts in the abbreviated format are deemed to be small enterprises. Those which filed full-format accounts are regarded as large or medium-sized depending on whether or not their turnover exceeded 37.2 million euro for two consecutive years.
(2) End-of-quarter data adjusted for exchange rate fluctuations and sectoral reclassifications; percentage changes compared to the corresponding quarter of the previous year.

The data from the Central Credit Register operated by the Bank permit a breakdown of the lending developments by size of firm. However, the Central Register data are not entirely comparable to the data from the financial accounts discussed elsewhere, in particular because their coverage is limited to lending by Belgian banks and an individual value of over 25,000 euro.

According to the Central Register data, firms as a whole, whatever their size, made a positive contribution to the general growth of bank lending in 2007. That contrasts with the picture in the previous year when large firms had made a negative contribution to bank lending. In the third quarter of 2007, the year-on-year growth of outstanding bank loans came to 7.9 p.c. for small companies, 4.9 p.c. for medium-sized companies and 9.3 p.c. for large companies.

The successive bank lending surveys conducted in 2007 confirm a marked strengthening of demand for bank loans, which was more pronounced in the case of large companies (for more details, see box 15). While the dynamism of mergers and acquisitions was a major factor at the beginning of the year, the Belgian banks state that, during the last year, they experienced a revival in demand for lending for all types of investment, particularly investments in fixed capital.

Companies seeking credit encountered an abundant supply. In fact, despite the context of steadily increasing bank interest rates, the qualitative surveys indicate that, initially, the Belgian banks did not tighten their credit standards, keeping them unchanged overall until the second quarter of 2007. This can be ascribed primarily to the favourable business climate and excellent corporate financial health. The increase in asset prices may also have had a positive impact on the net value of companies or on the value of the collateral which they can provide, improving their access to bank financing.

The survey conducted by the Belgian Knowledge Centre for SME financing (BeCeFi) on a representative sample of Belgian SMEs in the second quarter of 2007 also indicated easier access to credit, compared to the previous year. Thus, only 10.1 p.c. of respondents stated that they faced great, or even huge, problems in financing their projects, compared to 13 p.c. a year earlier, and the proportion of respondents encountering few or very few problems in that connection dropped to 29.5 p.c. in 2007, against 40.4 p.c. in 2006.

Conversely, the Bank's survey of corporate investment in manufacturing industry conducted later that year, in November, indicated a marked deterioration in the assessments of the companies questioned concerning conditions for accessing bank credit: whereas in 2006, 35 p.c. of the companies polled still considered that current conditions for access to new loans or credit lines were favourable, only 22 p.c. took that view in 2007. The tougher conditions seem to have applied to all lending criteria (interest rates, volumes granted, collateral required and other charges).

From the third quarter, Belgian banks in fact proceeded to tighten their lending criteria in the wake of the turbulence caused on the financial markets by the subprime crisis in the United States, and the much more cautious risk assessment which ensued, particularly in the case of liquidity risk and credit risk (for more details, see box 15).

Box 15 – Bank lending to Belgian enterprises: supply and demand

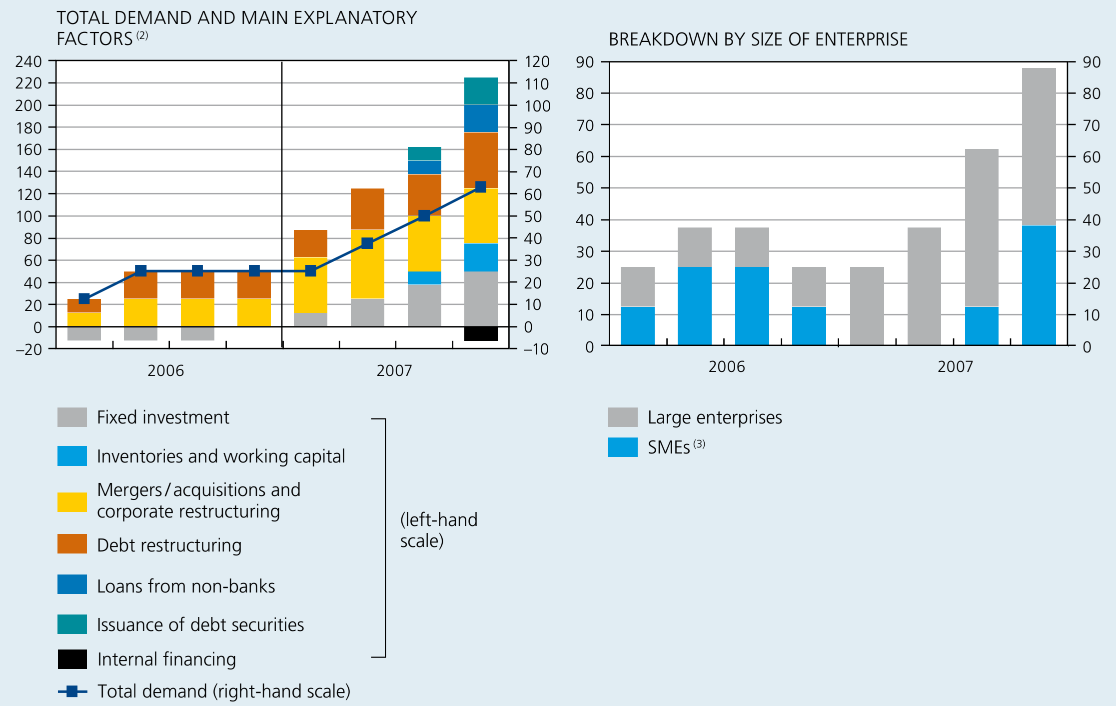
According to the financial accounts, flows of bank lending to Belgian enterprises accelerated sharply in 2006 and 2007, after a fairly long period of very weak growth from 2001 to 2005. This box explores the respective movements in credit supply and demand over the past two years on the basis of the detailed responses by a number of Belgian credit institutions to the bank lending survey. It then examines how the financial turmoil caused by the subprime crisis in the United States may have affected credit standards, by considering the specific questions in the last two surveys.

The Eurosystem's quarterly bank lending survey is a qualitative survey which collects the opinions of the leading credit institutions in the euro area regarding recent and future developments in lending criteria in the euro area, and in demand for loans. The Belgian sample comprises four banks whose lending to the private sector represents around 70 p.c. of the credit granted by all Belgian credit institutions together. In order to measure more accurately the effects of the financial turmoil caused by the subprime crisis, a series of specific questions concerning the financial market tensions and their possible effects on credit standards was added in the October 2007 and January 2008 surveys.

The values presented in the first two sets of charts below correspond to cumulative "net percentages". The concept of a net percentage is defined as the percentage difference in the responses of the banks questioned indicating a movement in a particular direction (in this case, an increase in demand for loans or a relaxation of credit standards) and those indicating a development in the opposite direction (weakening of demand or tightening of credit standards). The responses are weighted according to their distance from the "neutral" response: thus, the mention of a "considerable" increase (decrease) in demand is given twice as high a weighting as the mention of a "slight" increase (decrease). The responses are cumulated from the first quarter of 2006, making it easy to offer

DEMAND FOR BANK LOANS BY ENTERPRISES

(balance of responses [1] in cumulative net percentages from the 1st quarter of 2006)



Source : NBB.

(1) The balance of responses is expressed as the percentage difference in the responses of the banks questioned indicating an increase in demand for loans and those indicating a decrease (–).

(2) Only factors accounting for demand and explicitly mentioned by the banks in the period 2006-2007 are included here. Other factors, such as recourse to share issuance, are also suggested in the question, but the banks considered that they had no impact on demand for loans in the period analysed.

(3) The distinction between SMEs and large enterprises is based on annual turnover : a large enterprise has a net annual turnover in excess of 50 million euro.

a visual representation of the movements in relation to the period as a whole. However, since the responses are cumulated, the data should be interpreted with caution : in particular, any errors occurring in each survey may be compounded over the whole period under review, increasing the risk of bias in the results.

While in 2006 the expansion of loans to enterprises had been greatly influenced by loans granted to SMEs, it was large enterprises that made the most significant contribution in 2007. The financing of mergers and acquisitions and debt restructuring remained important factors generating stronger demand during the year under review. Compared to the wave of mergers in the late 1990s, a large proportion of which had been financed by share exchanges, the takeovers recorded in recent years have mainly been paid for in cash or via borrowing (particularly by LBOs). The positive contribution to total demand generated by fixed capital investment increased throughout 2007. Finally, the financing of inventories and working capital generated additional demand for credit in the second half of 2007.

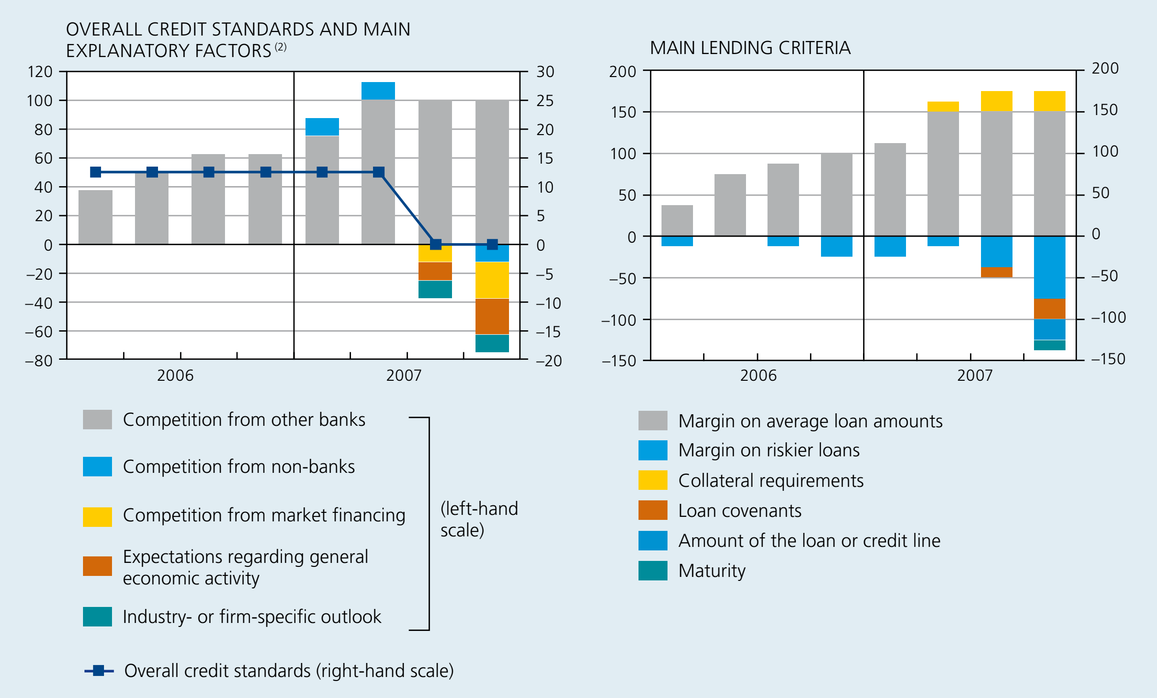
Apart from positive factors stimulating demand for loans, firms may also make greater use of the banks because they are experiencing difficulty in finding funds via other channels. Thus, in the second part of the year, the problems encountered in raising funds on the corporate debt market, probably as a result of the tension on the international credit markets, and the reduction in lending by non-bank institutions contributed to the rise in demand for bank loans. In the fourth quarter, the continuing positive growth of demand for credit was slightly depressed by greater use of internal resources on the part of enterprises.

Faced with a strong increase in demand, the Belgian banks maintained relatively favourable financing conditions. While the increase in money market and capital market interest rates was reflected to a reasonable extent in average rates, the Belgian banks seem to have sacrificed part of their margins in order to keep their overall conditions more or less unchanged up to and including the second quarter of 2007. They also state that they relaxed their collateral requirements. The fiercer competition between banks and with non-bank institutions explains why the banks adopted a fairly mild approach to borrowers overall. Nevertheless, borrowers with a high risk profile suffered more from the increase in interest rates, even before the eruption of the subprime crisis. The implementation on 1 January 2007 of the Directive on the capital adequacy of credit institutions, in order to ensure compatibility with the new Basel Committee Capital Accord, known as Basel II, which imposes different capital requirements according to the risk profile of the debtor, is undoubtedly a factor in this development.

Credit standards were adjusted in the second half of the year, in the wake of the financial crisis triggered on the subprime mortgage segment in the United States and its spill-over to many credit markets across the world. In the third quarter, the Belgian banks questioned indicated a tightening of credit standards, although it was relatively minor, followed by a status quo in the fourth quarter. They predicted a further modest tightening in the

SUPPLY OF BANK LOANS TO ENTERPRISES

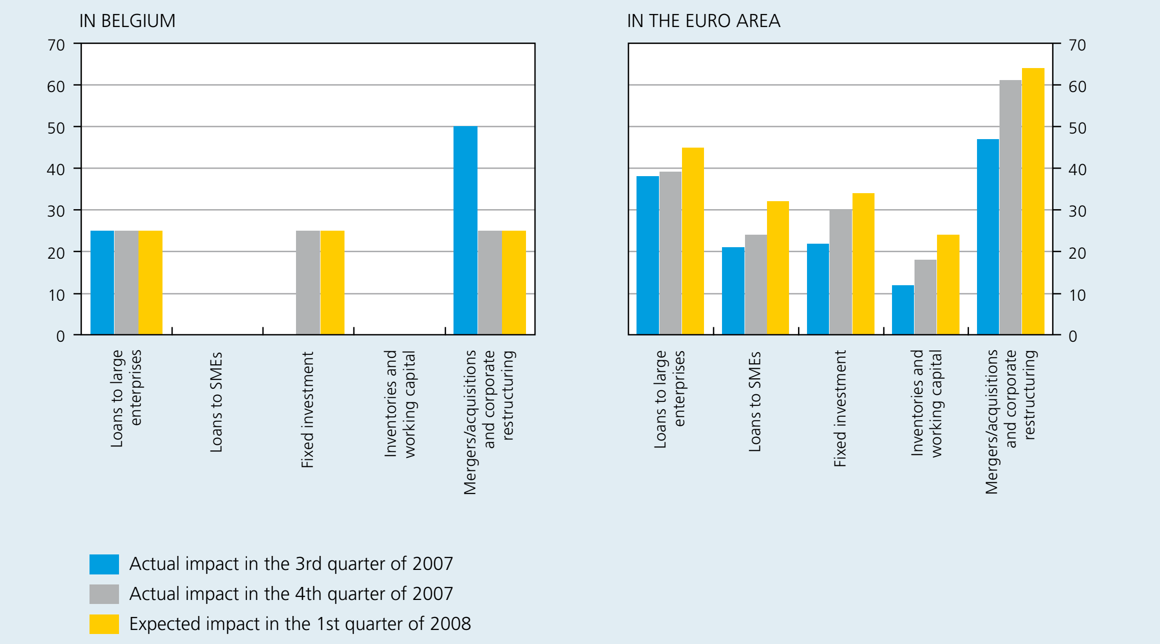
(balance of responses [1] in cumulative net percentages from the 1st quarter of 2006)



Source: NBB.
(1) The balance of responses is expressed as the percentage difference in the responses of the banks questioned indicating an easing of credit standards and those indicating a tightening (–).
(2) Only factors accounting for credit standards and explicitly mentioned by the banks in the period 2006-2007 are included here. Other factors, such as the cost of resources or balance sheet management constraints, are also suggested in the question, but the banks considered that they had no impact on credit standards in the period analysed.

ACTUAL OR EXPECTED IMPACT OF THE FINANCIAL TURBULENCE CAUSED BY THE SUBPRIME CRISIS ON CORPORATE CREDIT STANDARDS

(percentages of banks reporting a moderate or significant tightening of credit standards, breakdown by size of borrower and purpose of the loan)



Sources : ECB, NBB.

first quarter of 2008. In addition to a fairly marked increase in margins on the riskiest loans, the Belgian banks stated that they had reviewed their lending conditions other than interest rates, indicating that they had slightly reduced the volume or maturity of the loans or amended the loan covenants.

The short-term effects on corporate credit standards of the financial turbulence associated with the subprime crisis, measured in the third and fourth quarters of 2007, seemed less pronounced in Belgium than in the euro area. Compared to the aggregate results for the euro area, the Belgian banks reported a smaller rise in their financing costs, and it was therefore mainly the deterioration in their perception of the risks associated with both general economic activity and the outlook for the various sectors or firms that prompted a moderate tightening of their credit standards. The easing of competition from non-banks or from market financing was also a factor.

In both Belgium and the euro area, the impact of the crisis varied according to the size of borrower, with lending to large enterprises being proportionately more affected than that to SMEs. Also, the Belgian banks did not report any actual or expected restrictive effect originating from the financial turbulence and affecting lending to SMEs, though they did not rule out the possibility of a slight tightening in regard to the latter if the economic outlook continued to deteriorate in 2008. The euro area banks adjusted their SME credit standards from the start, and the tightening of conditions applied to SMEs has tended to become more marked as time goes by.

Initially, loans connected with mergers and acquisitions were the main ones affected by the tightening of financial conditions. But as the financial turbulence persisted, the banks indicated a tightening of their policy on all loans, including those relating to fixed capital investments.

Fixed-income securities

Belgian firms issued fixed-income securities totalling 0.9 billion euro in the first nine months of 2007. That total figure, which is rather low in historical terms, conceals varying developments between short-term and long-term securities. Thus, net issues of short-term securities in the form of commercial paper totalled 3.7 billion euro; they originated mainly from coordination centres of large multinational groups with high ratings. The principal subscribers to these relatively liquid issues were Belgian and foreign institutional investors. Conversely, there were net redemptions of long-term securities last year.

Shares

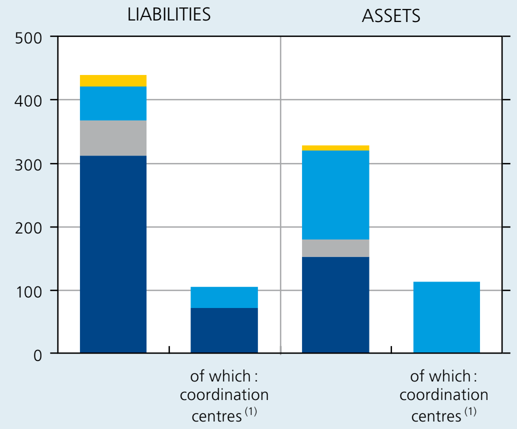
During the first nine months of 2007, issues of unlisted shares and other equity amounted to 26.1 billion euro. Disregarding Electrabel's takeover of Suez-Tractebel at a price of 18.2 billion euro, which has no influence on the net issue volume but affects only the counterparty sectors, around 60 p.c. of these issues were subscribed by foreign investors. The bulk of these flows consisted of direct investments originating from non-banks located in other countries, associated or having participating links with their Belgian counterparts. The coordination centres established in Belgium thus received 2.7 billion euro from other countries.

These entities, which historically enjoyed a favourable tax regime, generally act as the internal banker for a multinational group. Group companies acquire interests in their coordination centre and receive dividends from it which are almost entirely tax-exempt. When they need new funds, they borrow from the centre at interest, which is a tax-deductible expense. Consequently, the presence in Belgium of coordination centres attached to foreign groups is the source of significant capital inflows and outflows, though the amounts tend to balance one another overall, thus limiting their impact on the net external position of Belgian firms. Inflows consist mainly of capital injections, while outflows more often take the form of intercompany loans.

Thus, as at 31 December 2006, the participating interests and other claims which foreign enterprises held on coordination centres totalled an estimated 105.1 billion, or around 24 p.c. of the total non-bank liabilities of Belgian firms vis-à-vis the rest of the world. The coordination centres held claims on foreign corporations amounting to 113.2 billion euro, which represented 35 p.c. of the total non-bank assets of Belgian firms in the rest of the world.

CHART 73 ROLE OF THE COORDINATION CENTRES IN THE NON-BANK ASSETS AND LIABILITIES OF BELGIAN FIRMS IN OTHER COUNTRIES

(outstanding amounts at the end of 2006, billions of euro)



Source : NBB.
(1) The coordination centres' data are estimated on the basis of the Bank's direct investment survey.

Criticised by the Ecofin Council from the late 1990s as a harmful fiscal measure, and deemed incompatible with the rules on State aid by the EC in 2003, the coordination centre regime is being phased out, and the last licences are due to expire by no later than 2010. The notional interest deduction applicable since 1 January 2006 ensures a transition to an attractive tax regime enabling any resident enterprise to reduce its effective tax bill by increasing its equity capital.

From its inception in 2006, this measure generated strong enthusiasm for share issues among Belgian corporations, particularly the largest of them. Even after adjustment for issues by the coordination centres themselves, the volumes of unlisted shares issued by Belgian corporations in 2007 were very high in historical terms, as had already been the case in 2006. Smaller firms seem to intend to take advantage of the recent tax measure by allocating more of their profits to the reserves.

Listed share issues totalled 2.2 billion during the first nine months of 2007, an increase against the corresponding period of 2006 (1.3 billion euro). Apart from the tax incentive of the notional interest deduction, last year brought a more favourable movement in the cost of equity financing as opposed to debt financing.

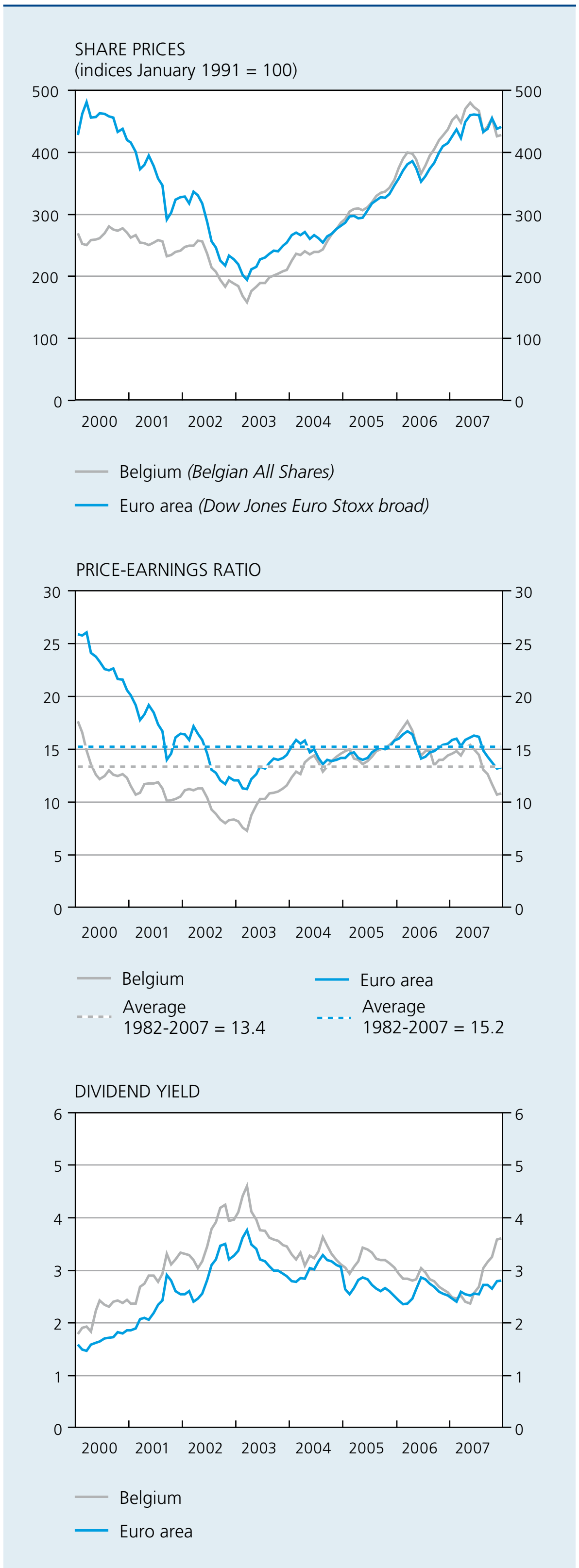
The rise in stock market prices faltered in 2007, in both Belgium and the euro area. While the broad index of Belgian stocks increased by an average of 16.2 p.c. over the year as a whole, it ended the year 2007 down by 2.1 p.c. against year-end 2006, while its euro area counterpart recorded a 6.4 p.c. rise over the same period. Up to the end of May, however, the European stock markets did well, underpinned by corporate results which exceeded the analysts' estimates, and by the ebullience generated by speculation and announcement of mergers and acquisitions. Only one brief downturn was recorded between the end of February and the beginning of March, following the turbulence originating from the Chinese market. But at the onset of the subprime crisis, stock markets became more volatile and prices collapsed. Substantial losses were then incurred owing to the waning appetite for risk on the part of international investors. The Belgian index, which includes a large proportion of financial corporations, was hit harder than its euro area counterpart. Nonetheless, the continuing positive sentiment of market analysts regarding corporate results in the medium term, and the decline in long-term bond yields, which act as a discount rate for future corporate profits, curbed the fall in prices up to the end of 2007.

Until the summer of 2007, the price-earnings ratio of Belgian corporations continued to hover around a level slightly above its long-term average, maintaining the trend seen since the end of 2004. Since the financial turmoil mainly inhibited demand for risky instruments such as equities, without directly affecting corporate growth fundamentals, the price-earnings ratio plummeted, dropping to 10.8 by the end of the year, 2.6 percentage points below the average calculated over the last twenty-five years. A similar development, but on a smaller scale, occurred in the case of euro area shares, which ended the year 2007 with a price-earnings ratio of 13.3, 1.9 percentage points below their historical average. Over the year 2007, on average, Belgian shares offered a dividend yield which exceeded that on shares in the euro area. The remuneration received by shareholders, measured as the ratio of dividends to profits, was almost the same in Belgium and the euro area, at 38 and 39 p.c. respectively.

Belgian companies were launched onto the stock market in rapid succession throughout the year under review. In total, taking all the Euronext Brussels markets together, eighteen introductions were recorded in 2007; taking account of the delisted companies, and including financial corporations, that brought the number of Belgian

CHART 74 STOCK MARKET PRICES, PRICE-EARNINGS RATIO AND DIVIDEND YIELD IN BELGIUM AND IN THE EURO AREA

(monthly averages)



Sources : Thomson Financial Datastream, Euronext Brussels.

companies issuing listed shares to 163 at 31 December 2007. Nine companies were launched on the regulated market of Euronext Brussels : the one attracting the most media attention was certainly Nyrstar, which raised 2 billion euro on that occasion. Six much smaller companies made their debut on the Free Market – the unregulated segment of the Brussels Stock Exchange – raising an average of 1.7 million per initial public offering. Finally, three Belgian companies were launched on Alternext – a segment specialising in listing medium-sized companies – where they raised an average of 12.6 million. The average size of the newly listed companies and of the capital raised by the launch demonstrates the complementary character of the three markets mentioned above, which focus on firms with specific needs.

Two developments which could facilitate future access to the stock market for Belgian companies are worth mentioning. First, it is now possible for firms planning a stock market flotation to announce the initial public offering without having to wait for the CBFA to approve their prospectus. The extension of the period between the recruitment of potential investors and the official launch of the offer is an additional advantage, ensuring that the offer will be placed.

Also, the link-up between the New York Stock Exchange (NYSE) and Euronext on 4 April 2007 created NYSE Euronext, which thus combines twelve markets (six cash markets and six derivatives markets), and can therefore offer its participants a wide range of readily available products, thanks to its market liquidity and depth. For the time being, the stock markets on the two continents are operating as separate entities, and there is no common trading platform or interconnection between Euronext and NYSE. Companies cannot be systematically quoted on a common list, since the merger took place between two regions with different legal and regulatory frameworks. Nonetheless, the plan is to create cross-border products and services and international quotation in numerous currencies covering a number of time zones. The enhanced visibility of Belgian firms in this context should enable them to raise funds on a larger scale, as is already evident from the Fortis capital increase in the fourth quarter of 2007. At close on 13.4 billion euro, this was by far the largest transaction ever conducted on the primary share market in Brussels.

7.4 General government

During the first nine months of the year under review, the financial accounts of general government deteriorated. Their deficit thus increased from 3.8 billion euro in the corresponding period of 2006 to 4.7 billion. This deterioration is reflected mainly in the movement in the financial liabilities, which increased by 14.2 billion euro, against 3.5 billion in 2006. However, taking account of the issue

TABLE 38 FINANCIAL ASSETS AND LIABILITIES OF GENERAL GOVERNMENT
(billions of euro)

	2002	2003	2004	2005 (2)	2006	2007	First nine months 2006	First nine months 2007
Formation of financial assets (1)	4.4	–4.1	4.0	2.7	1.5	n.	–0.3	9.5
New financial liabilities	5.7	–4.7	3.9	2.5	0.8	n.	3.5	14.2
Securities denominated in euro	5.8	–2.0	–1.6	2.4	–1.2	n.	2.1	17.8
of which:								
Treasury	5.4	–0.9	–1.6	3.1	–0.8	12.6	1.5	19.5
At up to one year	–0.5	–0.3	–0.2	0.8	0.1	4.1	3.4	9.2
At over one year	5.9	–0.6	–1.4	2.3	–0.9	8.4	–1.9	10.4
Other liabilities denominated in euro (1)	1.1	–1.3	6.9	0.8	2.1	n.	0.4	–3.6
Treasury liabilities denominated in foreign currencies	–1.2	–1.3	–1.4	–0.7	–0.2	–0.5	1.0	0.0
Financial balance	–1.2	0.6	0.1	0.2	0.7	n.	–3.8	–4.7

Source : NBB.
(1) Including “Ageing Fund Treasury Bonds”.
(2) Data compiled in accordance with the NAI’s point of view whereby the RIF is treated as a non-financial corporation, rather than as a public authority in accordance with the Eurostat view. In 2005, both the formation of financial assets and the new financial liabilities were influenced by operations connected with the assumption of BNRC debt by the RIF. Those operations consist in the refinancing by the State of part of the debt totalling 1.9 billion euro, and the registration of a claim of an equivalent amount on the RIF. Consequently, the financial balance was unaffected.

by the Treasury of loans intended essentially to finance redemptions in the near future, the financial assets rose strongly by 9.5 billion euro, whereas they had hardly changed in 2006.

New Treasury issues

Net issues of euro-denominated securities by the Treasury represented the bulk of the new financial liabilities of general government: these issues reached a cumulative total of 19.5 billion euro at the end of September 2007, against 1.5 billion a year earlier.

In the medium- and long-term segment, the Treasury issued two new benchmark loans via a consortium. At the beginning of the year, the Treasury as usual placed a new ten-year benchmark loan, followed in April by a five-year benchmark loan. In addition, a new four-year bond was also issued in June, via a consortium, for a total of 3 billion euro. Unusually, this new linear bond (OLO) offers a floating rate, linked to the three-month Euribor.

During the year, the existing OLO lines were topped up by four tenders. Regarding the long term, the fifteen-year benchmark loan, issued in 2006, was offered again, as was a security maturing in 2028. These lines attracted interest from institutional investors, who subscribed almost 4.3 billion euro.

Altogether, the Treasury issued linear bonds for a total of 27.9 billion euro in 2007, against 20.8 billion in 2006.

In October, in view of the increased market volatility and in order to avoid total dependence on OLO financing, the Treasury, which also faced a certain refinancing risk, issued a structured product called LOBO (lender's option borrower's option) for a total of 1 billion euro, placed with institutional investors. The special feature of this product, maturing in thirty years, is that – subject to certain conditions – both lenders and borrower can demand early redemption or adjust the yield. In principle, for the Treasury the LOBO entails lower financing costs than a traditional OLO, at least during the initial years. By issuing this product it was possible to take advantage of exceptional market circumstances in 2007. In the future, the use of structured products cannot be ruled out, though they still hold a secondary position among Treasury issues.

Issues of State notes, a public debt instrument intended for private investors, are normally smaller in scale. In 2007, the Treasury borrowed 0.5 billion euro via this instrument, compared to 0.7 billion in the previous year. These were State notes with a term of three, five or eight years. March saw the issue of the last State notes in material form – in this case five-year notes. From now on, since the June 2007 issue, State notes are represented solely by registered entries in the Public Debt Ledger or by dematerialised securities, exclusively in the form of account entries.

Management of the Treasury debt

As in 2006, in the year under review the Treasury's budget operations ended with a deficit, thus increasing the gross balance to be financed. Medium- and long-term issues were insufficient to cover it, so that the short-term debt increased.

The Treasury devoted a larger volume than in 2006 to the redemption or repayment of loans maturing during the year under review. Similarly, there was an increase in the volume of redemptions of securities maturing in 2008 or later.

TABLE 39 FINANCING REQUIREMENTS AND RESOURCES OF THE FEDERAL STATE
(billions of euro)

	2006	2007
Gross balance to be financed	25.7	29.6
Gross financing requirements	23.2	24.5
Budget deficit or surplus (–) (1)	3.5	3.6
Medium- and long-term debt maturing during the year	19.7	20.9
In euro	19.6	20.9
In foreign currencies	0.1	0.0
Redemptions and exchanges (securities maturing the next year or later)	2.5	4.9
Other financing requirements	0.1	0.2
Funding resources (2)	21.5	29.4
Medium- and long-term issues in euro	21.5	29.4
Linear bonds (OLOs) (3)	20.8	28.9
State notes	0.7	0.5
Medium- and long-term issues in foreign currencies	0.0	0.0
Net change in the short-term debt in foreign currencies	–0.1	–0.5
Net change in the short-term debt in euro and in financial assets	4.3	0.6

Source: FPS Finance.
(1) Excluding transfers to the Ageing Fund. The budget balance is calculated on a cash basis and, among other things, takes account of financial transactions which are not included in the overall balance of general government which, in accordance with the ESA 95, is calculated on a transaction basis.
(2) Excluding issues of "Ageing Fund Treasury Bonds".
(3) Including structured products.

Efficient management of the public debt entails control of the risks associated with borrowing transactions; it also has to ensure the liquidity of the securities issued. To increase liquidity, the Treasury has for some years concluded contracts with primary dealers and recognised dealers who are responsible for promoting Belgian public debt securities and encouraging activity on both the primary and secondary markets (for more details, see box 16).

Thus, the activities of the primary dealers and the recognised dealers ensure a wide diversity of holders of Belgian public debt, fostering ample liquidity for the securities. At the end of September 2007, the proportion of OLOs held by foreigners reached 54.3 p.c., while in the case of Treasury certificates, foreign holdership came to 81.6 p.c. for the same period. This situation reflects the strong foreign demand generated by the relative scarcity of short-term euro-denominated public securities which were accorded a good rating by the rating agencies.

Box 16 – Primary dealers and recognised dealers

The group of primary dealers was established at the time of the reform of the market in government securities in January 1991. They are financial intermediaries which have agreed with the Treasury, by contractual conditions, to stimulate activity on the primary market in OLOs and Treasury certificates, to encourage OLO stripping, to ensure the liquidity of these instruments on the secondary market and to promote the Belgian debt financing instruments. The primary dealers must participate regularly and to a significant extent – with a market share averaging at least 2 p.c. of the total competitive bids – in tenders for OLOs and Treasury certificates. They must also make a substantial contribution to the liquidity of the secondary off-exchange market in OLOs, stripped securities and Treasury certificates. Here, too, a market share of at least 2 p.c. of the total purchases and sales notified by primary dealers as a whole is stipulated. On this over-the-counter market, the primary dealers perform the role of market makers by quoting firm rates or buying and selling prices.

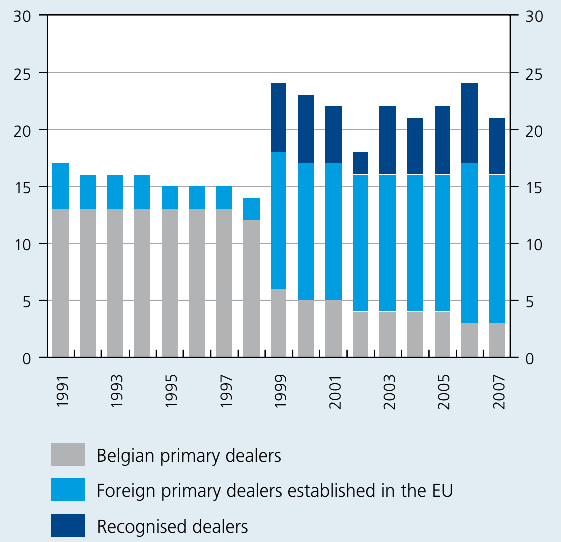
The group of recognised dealers has the specific task of promoting the placement of Treasuries, particularly on markets where demand for Belgian Treasury securities is weak or non-existent, or on markets where the placement potential has not been fully exploited. Their obligations in regard to promoting Treasuries involve, in particular, publishing economic research and market analyses, and organising meetings with investors. They are also required to be active on both the primary and the secondary markets in public debt securities but, unlike the primary dealers, they do not have to achieve a minimum market share.

In return for their commitments, the primary dealers have certain exclusive rights, such as the right to submit non-competitive bids following the tenders for government securities. They are also the Treasury's preferential counterparties in its financial management operations. Primary dealers and recognised dealers are the only intermediaries allowed to take part in tenders for government securities, to request the stripping and reconstitution of OLOs, to participate in the buy-backs organised by the Treasury and to use a repo facility offered by the Treasury. By means of this facility, which is – however – also available to other market makers, the Treasury conducts a repo operation to deliver securities which are in short supply when a delivery problem arises on the inter-dealer broker system.

Their number is not fixed. The Minister of Finance can withdraw that status from any primary dealer or recognised dealer who is in serious breach of his obligations, or grant that status to other financial intermediaries, just as every primary dealer or recognised dealer is free to decide to renounce that status, subject to a period of notice. The number of primary dealers has fluctuated, mainly on account of mergers in the financial world and the changeover to the euro.

The changeover to the single currency was a huge challenge for the Belgian Treasury. Previously, public debt securities were indispensable assets on the financial markets in Belgian franc. After 1 January 1999, that was no longer the case since, from then on, Treasury securities were in competition with other euro-denominated public

NUMBER OF PRIMARY AND RECOGNISED DEALERS



Source : FPS Finance.

securities. As Belgian residents have been able, since that date, to subscribe to those securities without incurring any exchange rate risk, it was vital for the Treasury to convince foreign investors to buy its securities. To that end, it made fundamental changes in the structure of its market counterparties : seven new primary dealers and six recognised dealers, all of foreign origin, were appointed in 1999. The number of Belgian primary dealers declined as a result of mergers and the transfer of the activities of foreign primary dealers from their Belgian subsidiary to their European headquarters (London, Paris, Frankfurt, Amsterdam). In 2007, sixteen primary dealers and five recognised dealers were active. The group is very diverse : the leading European and Anglo-Saxon institutions, and even a Japanese merchant bank (in each case via a subsidiary in the EU) form the essential complement to the three Belgian primary dealers to ensure a global network for trading and investing in Belgian government securities.

The financial risks associated with the issue of Belgian public debt securities are the currency risk, the refinancing risk, the interest rate risk and the credit risk.

The currency risk has practically disappeared, as the percentage of the debt denominated in foreign currencies has become minimal in recent years. By the end of 2007, the foreign currency debt represented only 0.33 p.c. of the total debt, against 0.52 p.c. at the end of 2006.

Four indicators are used to monitor the refinancing risk and the interest rate risk. Since 2005, those indicators have been calculated on the basis of a six-month average in order to smooth out sudden movements in the indicators which are not triggered by an increase in the risk.

The Treasury defines the refinancing risk as the possibility that the costs and interest charges will be higher than expected owing to excessive financing requirements in a short period of time. For this risk, the maximum amount to be refinanced within twelve months is 22.5 p.c. of the portfolio, and 60 p.c. within five years. In the second half of 2007, the amount to be refinanced within twelve months often approached its limit owing to increased financing by Treasury certificates, following larger than expected deficits, and to substantial maturities in 2008. At the end of 2007, the amount to be refinanced within twelve months had actually slightly exceeded the limit and stood at 22.7 p.c. of the portfolio. Conversely, at the five-year horizon for which the indicator came to 51.9 p.c., there was no refinancing problem.

Refinancing operations also imply an interest rate risk since the cost of new refinancing depends on future market movements. The interest rate risk is limited by the use of derivatives such as interest rate swaps or forward rate agreements. According to the Treasury's definition, the interest rate risk indicates the percentage of the portfolio subject to an interest rate review during a particular period. The limit for the twelve-month risk is set at 25 p.c. of the euro-denominated debt. It is 65 p.c. for the five-year risk. On average, during the year under review, the twelve-month interest rate risk was 20.5 p.c. and the five-year risk was 55.4 p.c.

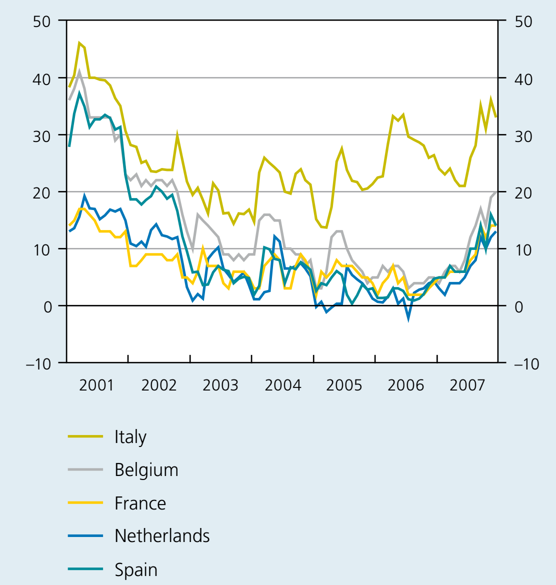
Finally, the credit risk is determined by the loss which the Treasury would incur if one or more of its counterparties defaulted on its contractual payment obligations. To limit that risk, the Treasury deals only with counterparties with a minimum credit rating of "A". In practice, however, most of them have an "AA" rating, which helps to reduce the credit risk. In addition, since 2006, the Treasury has concluded credit support agreements with the primary dealers. Under these agreements, in widespread use on the financial markets, the counterparties exchange mutual pledges, generally in the form of cash or securities, equal to the net amount of the credit risk. This measure enables the Treasury to reduce the credit risk on its derivatives substantially, cutting it by over 60 p.c. at the end of 2006.

The spread between the yield on the Belgian government's ten-year benchmark loan and that of the German *Bund* with a similar maturity increased significantly to reach a peak of 26 basis points on 4 December. The loans of other euro area Member States, such as France, Spain, the Netherlands and Italy, also saw their spread deteriorate in relation to the *Bund* during the last six months. That deterioration can be ascribed to the effects of the financial turbulence emanating from the US market in sub-prime mortgage loans. In fact, in the face of this tension, investors switched to highly liquid, risk-free investments. In the euro area, German government bonds, which present the lowest credit risk and the highest liquidity, are increasingly preferred as a safe haven. The strong demand from investors for these instruments drove up their price and therefore reduced their yield, thus increasing the spreads in relation to the loans of other Member States. In addition, the political crisis in Belgium during the second half of the year was another factor widening the spread between the Belgian benchmark loans and the *Bund*, especially towards the end of the year.

As an average, over 2007 as a whole, the spread between the Belgian benchmark ten-year loan and German bonds with the same term stood at 11 basis points, compared to 5 in 2006. The yield differential in relation to the *Bund* was also higher than in the previous year for the benchmark loans of the Netherlands (7 basis points on average, against 2 in 2006), France (9 basis points, against 4) and Spain (9 basis points, against 2). In contrast, for Italian loans it remained practically unchanged (averaging 27 basis points compared to 28).

CHART 75 YIELD DIFFERENTIALS ON TEN-YEAR GOVERNMENT BONDS (1) IN RELATION TO THE GERMAN *BUND*

(monthly averages, basis points)



Source : ECB

(1) For Belgium, secondary market yield on government benchmark loans (OLOs).

Financial stability

8.

8.1 Recent developments on international financial markets

In the second half of 2007, the international financial system encountered severe turbulence, heralding an abrupt end to several years of limited volatility, low credit and liquidity risk premiums, and generally favourable market conditions for financial institutions. The deterioration of the American housing market and the resulting proliferation of defaults in the subprime mortgage segment were the main factors triggering the serious upheaval and corrections experienced by major segments of the money and credit markets.

As explained in chapter 1 on the international environment, there was a particularly strong boom in house prices and mortgage lending in the United States up to mid 2006, as in many other countries. One of the factors contributing to the vigour of the American market was the rapid expansion of mortgage lending to risky borrowers who had previously had very little access to the market. These new borrowers have inadequate incomes or do not provide proof of their income, they have a history of defaulting, or do not have sufficient resources themselves to finance part of their intended house purchase. While the proportion of home-owning households increased as a result of development of this market segment, that was made possible only by a steady easing of the credit standards applied by banks and other financial institutions. Thus, loans were granted at very low initial rates which were, however, subject to review after a number of years, while the loan-to-value and debt-income ratios increased sharply. So long as property prices continued rising, this easing of subprime mortgage standards did not result in loan losses for the lenders concerned. In fact, the owners were able to mobilise the capital gains generated by the property boom to obtain new loans, enabling them to keep up the repayments on the principal and interest of the initial loan. However, when the rise in property prices came to a halt, defaults on variable rate mortgages escalated. For the most recent vintages (2005 and 2006), this phenomenon was much more pronounced than at the time of the previous downturn on the subprime mortgage market in 1999 and 2000.

In the United States, at the end of 2006, subprime mortgages represented over one-fifth of the 10,000 billion dollars in outstanding mortgage loans, including "Alt A" loans granted to borrowers for whom complete references are not available but whose creditworthiness is better than that of subprime borrowers. In stark contrast to the "savings and loans" crisis which had affected the US banking system in the late 1980s, most of these potential problem loans are no longer recorded on the balance sheet of the banks, but were securitised and sold on the markets in the form of mortgage-backed securities (MBS) and home equity loan asset-backed securities (HEL ABS). In recent years, securitisation has very rapidly gained ground in the American and global financial systems, since major credit institutions have steadily replaced their traditional activity model – based on a vertically integrated system combining loan origination and loan holding – with a more market-oriented banking model in which those operations are fragmented and the loans originally granted by one institution are sold on to other investors.

In the conventional model, the banks retain the loans and hence the risks on their balance sheet until maturity, thus taking charge of the whole operation, namely analysing the borrower's solvency, granting and financing the loan, collecting the interest and capital, monitoring the borrower's situation and, if appropriate, restructuring the borrower's debt. The development, during the 1970s and 1980s, of the securitisation technique, whereby all or part of a loan portfolio is converted into marketable securities such as MBS, gradually eroded this conventional model.

The use of securitisation means that new loans granted, or a portfolio of mortgage loans recorded on a credit institution's balance sheet, can be mobilised to create new fixed-income securities which are then placed on the market and acquired by investors. To shelter investors from the potential failure of the financial institution originating the loans, that process entails the creation of a separate legal entity in the form of a special purpose vehicle (SPV). This SPV buys the loan portfolio from the original lender and, in order to raise funding, issues fixed-income securities. The cash flows generated by the loans are used to pay the investors who bought those securities.

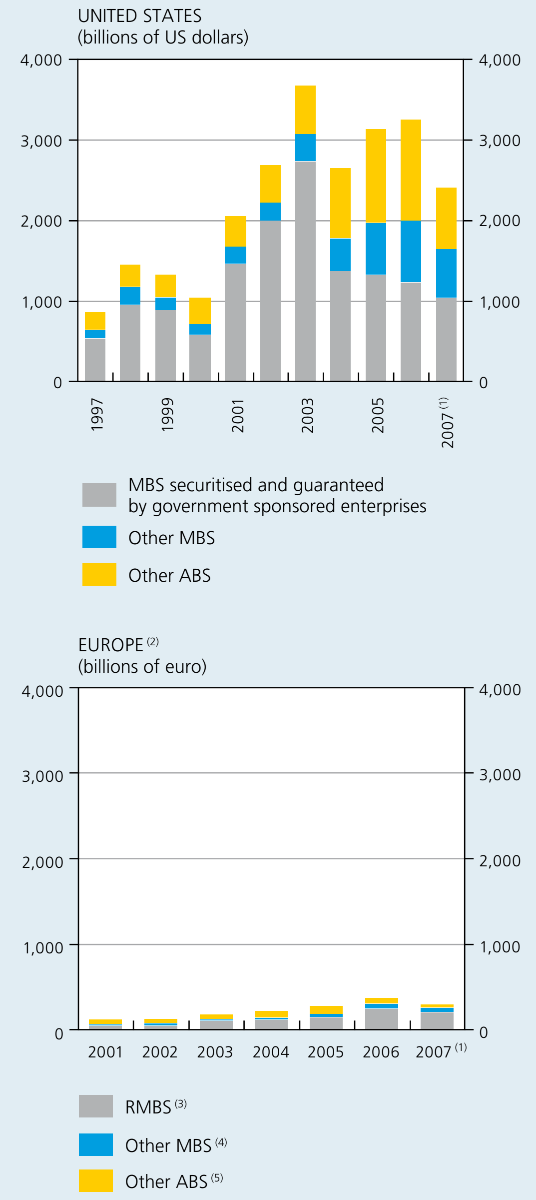
The loans are therefore ultimately financed by the purchasers of the securities issued by the SPV. Those investors also assume the credit, interest rate and market risks associated with the operation. In addition, securitisation implies the involvement of a number of specialist players, including servicers, rating agencies, investment banks, asset managers, the company managing the SPV and the bond insurers.

In the United States and Europe, the volume of issues of MBS and other asset-backed securities (ABS) has soared in recent years. American gross issues were thus in the region of 3,000 billion dollars per annum from 2002 to 2006, against an average of 1,350 billion in the preceding five years. The MBS issued by the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac – which offer investors a guarantee against the risk of default on payment of the interest and the principal – traditionally represented the bulk of these new issues. However, since a ceiling was imposed on the portfolios of those institutions in 2003, following the discovery of flaws in their accounting, their annual issue volume has dropped below 1,400 billion dollars. Entities other than these government agencies have filled part of the gap, their annual MBS issues more than doubling between 2003 and 2006. This expansion was accompanied by an increase in the volume of mortgage loans not meeting the government agency eligibility criteria, either because the amount borrowed is too large ("jumbo" loans) or because the borrower's solvency is inadequate ("subprime" loans). At the end of 2006, the outstanding amount of ABS in the United States, namely 8,600 billion dollars, comprised 80 p.c. MBS, of which 1,300 billion were backed by subprime or Alt A mortgage loans.

In Europe, the securitisation market is far less developed. It is true that there are covered bonds (Pfandbriefe) representing an outstanding total of 2,000 billion euro, and they are also backed by loans, mainly to the public sector and on the mortgage market. However, these products are not generally considered part of the securitisation market proper, but rather as a form of guaranteed claims issued by financial intermediaries, since the loans continue to be recorded on the balance sheet of the issuing institution. Excluding this large category of securities, the securitisation market appears to be much smaller in Europe than in the United States, even though there has been a significant increase in gross issues of MBS and ABS in recent years, from less than 150 billion euro in 2001 to over 350 billion in 2006. As in the United States, the securitised assets have often taken the form of MBS. They have been issued more particularly on the Spanish, Italian and Dutch markets.

During the first six months of 2007, the volume of issues continued to rise, both in Europe and in the United States, but that trend was clearly reversed in the third quarter, following the turbulence which hit the MBS and ABS markets at that time. Overall, the volume of new ABS issues declined in the first nine months of 2007 in the United States (compared to the same period of 2006), but

CHART 76 GROSS ISSUES OF ASSET-BACKED SECURITIES



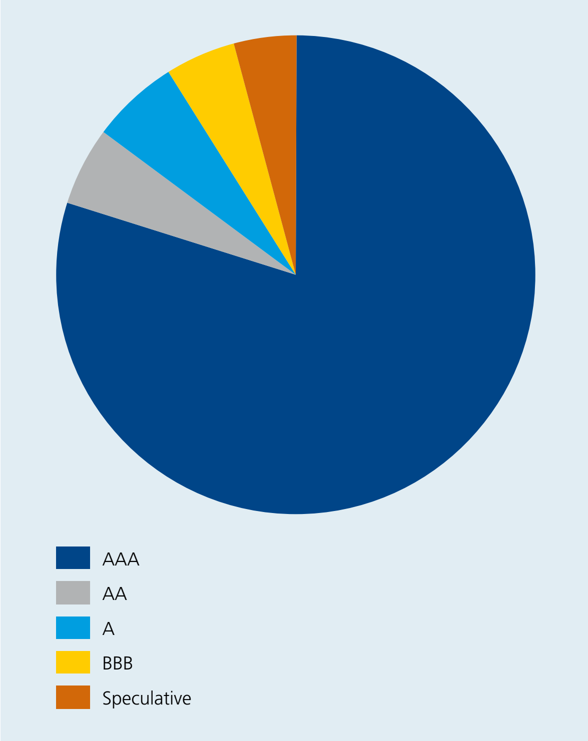
Sources: European Securitisation Forum, SIFMA.
(1) First nine months.
(2) EU, Russia and Turkey.
(3) Residential mortgage-backed securities.
(4) Other mortgage-backed securities.
(5) Excluding collateralised debt obligations (CDO).

continued to expand slightly in Europe, where the total amount outstanding on the market came to 1,050 billion euro at the end of September 2007.

The data supplied by the European Securitisation Forum can be used to break down the outstanding total of ABS and MBS in Europe according to the rating of the securities issued. One of the key characteristics of structured finance instruments is that a substantial volume can be issued with a high rating despite the intrinsically lower creditworthiness of the individual loans or claims included in the asset pool of the SPV structuring the operation. This credit risk "transformation" can be achieved by various credit enhancement techniques (for more details, see box 17). One of the main ones is the issue by the SPV of securities structured into tranches, which are ranked in relation to one another according to the exposure to losses in the underlying assets. Since the subordinate tranches (with a lower rating) have to take all the losses incurred on the underlying assets before a higher tranche is affected, such a structure can be used to create securities which have a low risk of default on the interest and the capital, and which therefore enjoy a better rating.

CHART 77 BREAKDOWN OF THE OUTSTANDING TOTAL OF ASSET-BACKED SECURITIES [1] IN EUROPE ACCORDING TO RATING, AT THE END OF SEPTEMBER 2007

(percentages of the total)



Source : European Securitisation Forum.
(1) Including 273 billion euro in collateralised debt obligations (CDO).

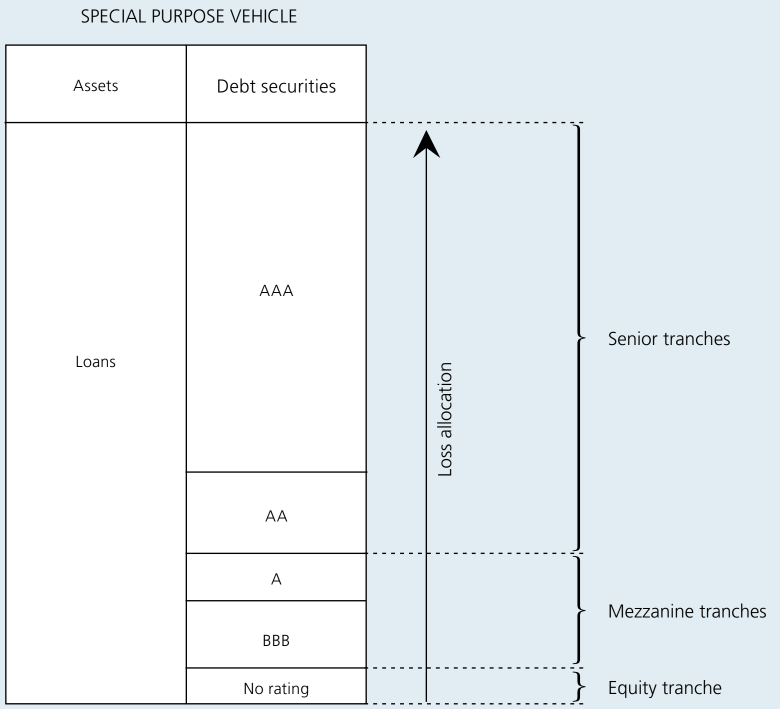
Box 17 – Use of credit enhancement techniques for structured finance instruments

Many banks, insurance companies, pension funds and investment funds face restrictions – owing to the regulations applicable, the capital requirements, or simply the internal limits which they impose on portfolio investments – on their scope for holding debt instruments which do not qualify for the optimum ratings. This gives rise to market segmentation, according a premium to the assets with the best ratings in comparison with riskier assets, and opening the way to arbitrage between credit risk categories. This arbitrage premium is exploited by structured finance instruments which use various credit enhancement techniques in order to offer investors securities which meet their requirements in terms of the level of risk, without necessarily being backed by a pool of assets with the same creditworthiness.

One of these credit enhancement techniques is over-collateralisation, whereby the institution arranging the securitisation sells assets for an amount higher than the face value of the securities issued. That reserve can be used to absorb any losses incurred on the asset pool. The positive interest rate differential between the average yield on the asset pool and the contractual payments to holders of the securities (excess spread) may also be paid into such a reserve.

Another credit enhancement technique consists in structuring the securities issued to investors into tranches and assigning a ranking to them. Use of this technique is typical of structured finance instruments and distinguishes them from securitisations taking the form of a simple transfer (pass-through securitisations) in which the cash flows generated by the underlying assets are simply allocated pro rata among the investors without any distinction between them. The principle underlying structured finance instruments is illustrated by the chart, which outlines the balance sheet of a special purpose vehicle (SPV) whose investors are divided into various levels (or tranches) associated with different risk-return characteristics. All tranches except the one with the highest risk are accorded a rating reflecting the risk of losses in the event of non-payment, at maturity, of all or part of the interest and principal to which the holders are contractually entitled.

STYLISED BALANCE SHEET OF A SPECIAL PURPOSE VEHICLE



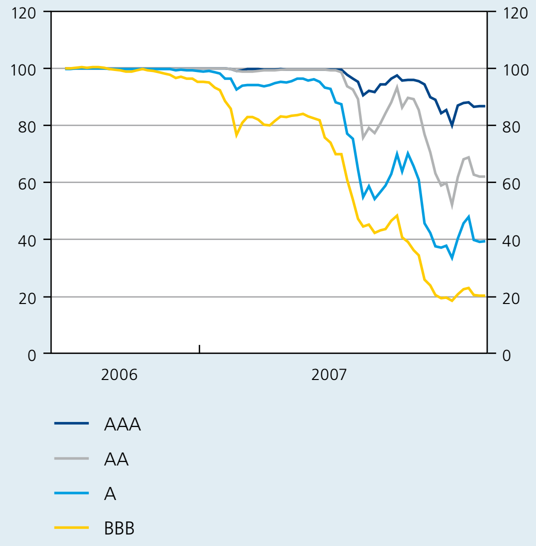
This ranking of the holders of the securities creates a cascade structure permitting allocation of the losses among the various tranches, in inverse order of their rank. Thus, the tranche bearing the highest risk will absorb the first losses incurred on the underlying assets until it is exhausted. Additional losses will then be covered successively by the tranches with an intermediate ranking, beginning with BBB in the example, and ending with the tranche accorded the highest rating (AAA). This arrangement makes it possible to issue securities with a very low risk of losses due to non-payment of the interest or principal. However, it should be stressed that the AAA rating does not imply the total absence of any credit risk. Such a risk could thus arise in the event of numerous simultaneous defaults on the underlying assets, as the holders of the tranches with the highest ratings are still exposed, in particular, to the risk of correlated defaults (correlation risk). Moreover, an excellent credit rating does not rule out the possibility of losses associated with risks other than the credit risk, such as market risks resulting from adverse interest rate movements, or insufficient liquidity on the secondary securities markets.

One last credit enhancement technique consists in institutions with a very high rating providing guarantees for the structure. This constitutes, in particular, the basic activity of bond insurers, also known as monoline insurers, who rely on their high rating (very often AAA) to enhance the credit quality of many bonds issued by local authorities in the United States, or asset-backed securities.

During the first half of 2007, the prices of the AAA and AA tranches of securities backed by subprime mortgages were hardly affected by the escalating defaults on loans granted in 2005 and 2006, as the relative size of the intermediate tranches of structured finance instruments – which had suffered a sharp fall in prices – was deemed sufficient to absorb the additional losses. Towards the end of the second quarter, the increasing problems on the US residential property market prompted a review of the assumptions underlying the valuation of all securities backed by subprime mortgages, particularly the assumptions concerning default correlation. That review also affected the market value of the security tranches with the highest rating. In June and July, the downgrading by the main rating agencies of many tranches of securities backed by subprime mortgages, including some tranches rated AAA, exacerbated investors' doubts about the real value of those tranches, especially as further rating cuts were looming, and the announcement of changes in the methodologies used by the agencies caused the markets to lose confidence in the rating models. More fundamentally, many investors reconsidered the significance which they attach to the rating in their investment decisions. They became aware that the rating accorded to a financial asset offers an assessment of the credit risk only, and does not imply any judgment about the possibility of realising that asset on a liquid market in all circumstances.

CHART 78 PRICE INDICES OF SECURITIES BACKED BY SUBPRIME HOME EQUITY MORTGAGES IN THE UNITED STATES, ACCORDING TO TRANCHE RATINGS [1]

(index ABX.HE 2006-2, face value = 100, weekly data)



Source : JP Morgan Chase.
(1) Indices established at the beginning of the second half of 2006.

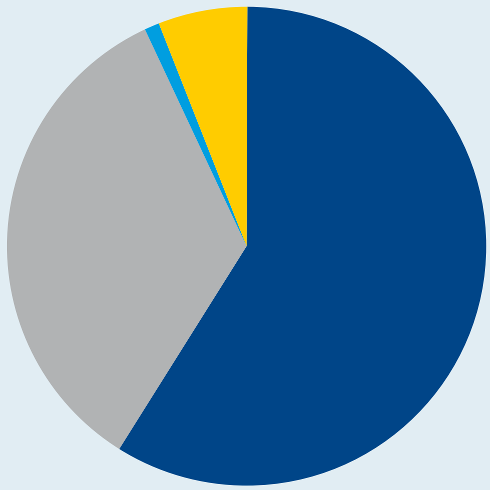
The consequences of these falls in the value of securities backed by subprime mortgages were amplified by the leverage effect in the case of investors who had borrowed heavily to increase the return on their positions. This applied, for example, to hedge funds which had obtained finance from professional counterparties – particularly investment banks acting as their prime broker – amounting to a certain percentage of the value of the securities pledged. In these financing arrangements, the percentage of the value of the securities exceeding the amount of the finance obtained is used as a margin to cover any credit losses or falls in the market value of the securities pledged.

At the end of June, two hedge funds sponsored by the American investment bank, Bear Stearns, collapsed as a result of their massive investment in MBS and other structured finance instruments backed by subprime mortgages which nevertheless had a high rating. The prime brokers' attempts to sell the seized collateral then revealed large discrepancies between the theoretical value of these instruments, calculated on the basis of models, and the actual price which they could fetch on the market. This episode demonstrated the fallacy of the assumption that the high rating of the structured finance instruments would guarantee their liquidity, despite the complex structure and tailor-made nature of the majority of these instruments. This led to the tightening of financing conditions for such products, in the form of additional margin requirements.

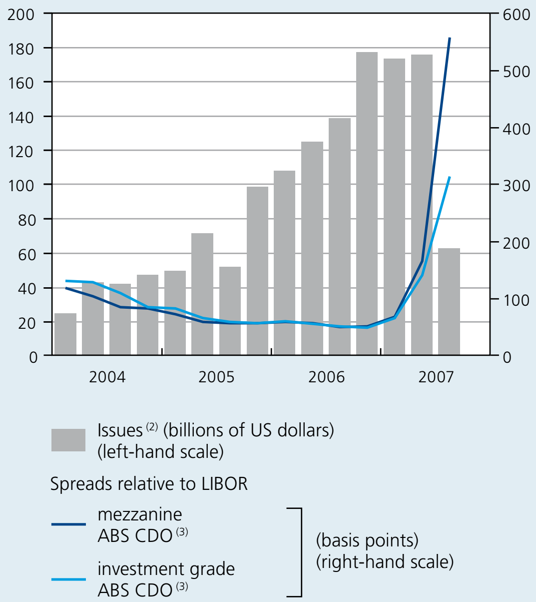
CHART 79 MARKETS IN COLLATERALISED DEBT OBLIGATIONS (CDO) AND COLLATERALISED LOAN OBLIGATIONS (CLO) IN THE UNITED STATES AND EUROPE (1)

(percentages of the total, unless otherwise stated)

BREAKDOWN OF ISSUES IN 2006 BY UNDERLYING ASSET CATEGORY



QUARTERLY DATA



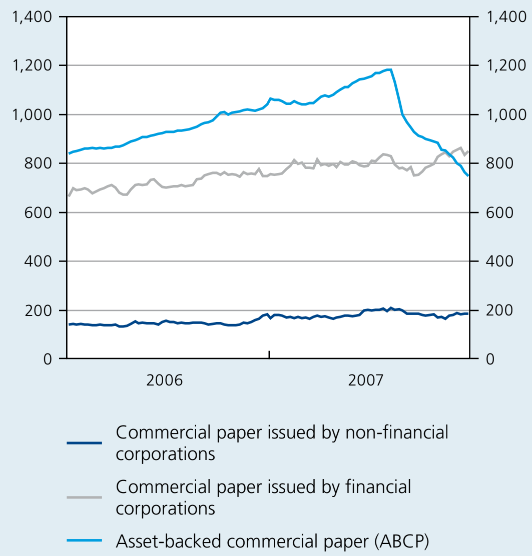
Sources : JP Morgan Chase, SIFMA.
(1) EU, Russia and Turkey.
(2) Comprises CDO and CLO issues.
(3) For CDO tranches with an AA rating.

The problems encountered by the two *Bear Stearns* hedge funds and the subsequent unwinding of similar investments in structured finance instruments with a high rating contributed to the drying up of both the primary and the secondary markets. In July, investors lost interest in these instruments in a context of uncertainty over their exact characteristics and their real value. That was particularly true of the most complex products, such as collateralised debt obligations which in turn consist of tranches of asset-backed securities (ABS CDO). These structures, which represented almost 60 p.c. of the total volume of collateralised debt obligations (CDO) issued in 2006, played a key role on the primary market in structured finance instruments, by providing the finance for the intermediate (mezzanine) tranches of ABS or MBS. Issues of these securities, which were very substantial up to the second quarter of 2007, plummeted in the third quarter, while the spreads in relation to the interbank interest rate widened dramatically.

Enthusiasm for new issues of collateralised loan obligations (CLO) also waned. These bonds had been a major source of funds on the high-yield corporate bond market, contributing to the spate of leveraged buy-outs by venture capital companies. Credit institutions which had subscribed to loans of this type before the summer, with the intention of selling them subsequently, therefore faced the risk of having to keep these claims for much

CHART 80 OUTSTANDING COMMERCIAL PAPER IN THE UNITED STATES

(billions of US dollars, weekly data)



Source : Federal Reserve

longer than planned with the potential consequence of unexpected balance sheet expansion and unanticipated use of their financial resources and own funds.

The negative sentiment towards ABS was particularly noticeable on the market in asset backed commercial paper (ABCP), as is evident from the contraction of dollar-denominated ABCP, down from almost 1,200 to 748 billion dollars between the end of July and December 2007. With the addition of euro-denominated ABCP, the outstanding total had peaked at almost 1,500 billion dollars. This market had been widely used as a financing channel by ABCP conduits and structured investment vehicles (SIVs). These ad hoc structures had invested heavily in ABS, with outstanding assets totalling 1,600 billion dollars at the end of the first half of 2007.

Box 18 – ABCP conduits and structured investment vehicles

An essential component of the asset-backed securities (ABS) market, asset-backed commercial paper conduits (ABCP conduits) and structured investment vehicles (SIVs) – with an outstanding total in the region of 1,200 and 400 billion US dollars respectively at the end of July 2007 – played a major role in the summer 2007 liquidity crisis.

ABCP conduits are ad hoc structures which issue asset-backed commercial paper and are usually sponsored by large banks which record them off the balance sheet. These ABCP issues are used to finance various asset categories, such as trade receivables, consumer credit, car loans, collateralised debt obligations (CDO), asset-backed securities (ABS) and mortgage-backed securities (MBS). On average, these assets have a longer term than the financing obtained. This maturity transformation entails a liquidity risk, since it obliges the ABCP issuer to refinance its long-term assets by constantly issuing new commercial paper in order to meet the redemption obligations. However, the underlying liquidity risk can be attenuated by obtaining a liquidity line from other financial institutions, essentially banks. It can also be mitigated by issuing commercial paper comprising a maturity extension clause in case the issuer is temporarily unable to obtain on the market the funds needed to redeem the commercial paper at maturity. ABCP subscribers are generally very risk-averse money market investors, seeking a secure return in the short term by investing in assets with a high rating.

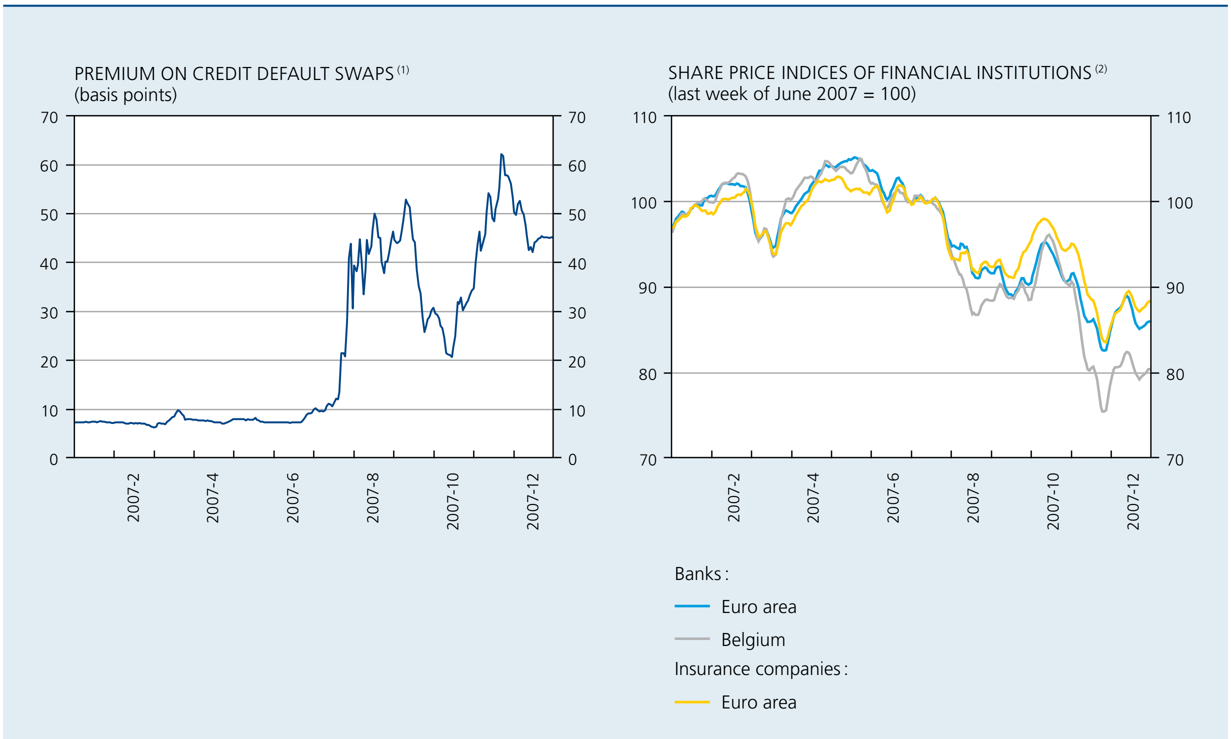
SIVs are also off-balance-sheet vehicles. They invest in a broad range of structured and unstructured securities with a high rating, including debt instruments issued by financial institutions. Although SIVs also obtain their finance via ABCP, they are different from ABCP conduits in that they have only partial emergency liquidity lines, and their liabilities also comprise medium-term debt securities and capital notes (equity). These entities make substantial use of leverage, and are generally governed by contractual liquidity clauses which force them to sell assets speedily in order to obtain the funds needed to meet their redemption obligations.

ABCP conduits and SIVs were created in order to finance a wide range of assets – such as portfolios of mortgage claims, MBS warehoused by financial institutions, or other long-term claims. These assets generally have a very high credit rating (AAA), but also a longer maturity than that of the securities which they are backing. Since they are thus exposed to a mismatch between the maturity of the assets and liabilities, these entities are particularly vulnerable to a reduction in the liquidity of their assets on the secondary market, and the risk that ABCP maturing cannot be refinanced. When the mistrust of MBS and other structured credit products began to impair investors' willingness to renew their ABCP, the ABCP conduits had to draw on credit lines which they had obtained from the banks in order to make up the funds which they could no longer raise on the market. At the end of July, a medium-sized German bank, IKB, had to announce that it was no longer able to honour the off-balance-sheet credit lines that it had opened for its ABCP vehicle. Although the necessary liquidity was eventually provided by IKB's main shareholder, the financial institution KFW, this episode unleashed a chain reaction which triggered a serious liquidity crisis in August.

Once IKB's situation came to light, the pressure on the markets in structured finance instruments and ABCP intensified. A good many larger banks then became worried about the possibility of having to cope with massive use of the credit lines which they had granted to entities specialising in ABCP, at the very moment when the impasse on the primary securitisation market was causing an accumulation, on their balance sheet, of customer loans which they had originally intended to sell on to other investors. These fears prompted the banks to hoard their liquidity and made them much more reticent in reinvesting their funds on the money market, including lending to other banks. The widespread quest for liquidity placed heavy pressure on the interbank overnight and forward markets. Debit interest rates increased sharply, and liquidity declined, necessitating exceptional intervention by the central banks, including the Eurosystem. These injections of liquidity were crucial to enable the financial institutions to cope with the sudden shocks, in the face of the general deterioration in refinancing conditions and unexpected growth of their balance sheet total.

It is true that the leading financial intermediaries entered this period of turbulence with high levels of profitability and large solvency margins, which should enable them to withstand unexpected losses. However, the widespread uncertainty regarding the exposure of individual institutions to the markets hardest hit by this turbulence, and the fears concerning the total amount of the losses which the global financial system would have to absorb, seriously heightened the perception of counterparty risk within the financial system. That was reflected, in particular, in the higher premiums charged on the credit derivatives market to cover the risk of the failure of financial institutions. In Europe, the premiums on credit default swaps (CDS) referencing financial intermediaries increased from less than 10 basis points in the first half of the year to over 50 basis points in August and early September, when liquidity was at its most constrained. They then declined, pointing to stabilisation on the money markets. The larger than expected interest rate cut by the US Federal Reserve in mid September revived confidence in the financial system, suggesting that the operation of the markets was gradually returning to normal. But in the second half of October, financial

CHART 81 MARKET INDICATORS FOR EURO AREA FINANCIAL INSTITUTIONS
(daily data)



Source : Thomson Financial Datastream
(1) Premium on iTraxx Financials.
(2) Market indices defined by Thomson Financial Datastream (return indices); moving averages of data for the last five working days (i.e. one week).

conditions deteriorated again when some major investment banks in the United States and Europe announced substantial impairments on investments in MBS, CDO and leveraged loans, on top of those already recorded in the results for the third quarter of 2007. Some of those banks also announced that they had made supplementary provisions for bad debts in the consumer credit segment. In response, credit risk premiums on financial institutions began rising again, and the temporary recovery in the stock market valuation of financial intermediaries was wiped out by the renewed fall in the share prices of banks and insurance companies.

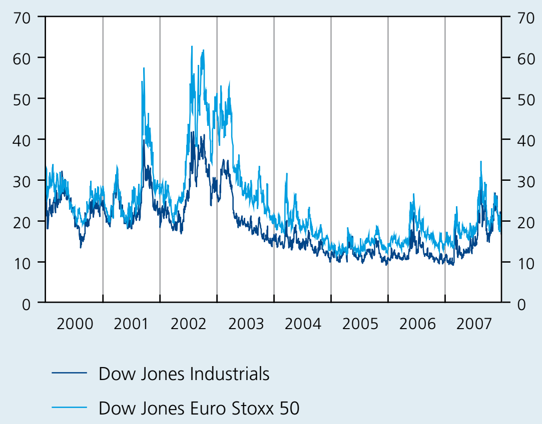
These corrections also concerned the large Belgian *bancassurance* groups. Being closely integrated into the global system, these were affected by the financial turmoil which they had to face from their own specific situation. Thus, one of the big Belgian banks had to finalise a major acquisition during the most acute phase of the recent tension, while another Belgian group has a large subsidiary which acts as monoline insurer of securitised assets.

The monoline insurers, initially set up to guarantee repayment of the principal and payment of the interest to investors in US municipal bonds, extended their activities to include ABS during the 1980s, and CDO in the 1990s. Owing to their involvement on these two markets, the monoline insurers recently recorded a marked rise in the premiums on their CDS.

The renewed tension affecting the financial system in the late autumn not only hastened the decline in ABCP totals outstanding, but also led to a more general reappraisal of risk premiums on almost all asset markets. This review took place in a context of growing concern over the economic outlook in the United States and throughout the world, and fears that the persistent upheaval on the capital markets might have negative repercussions on the volume and cost of credit for the non-financial sectors of the economy. On the stock markets, the implicit volatility thus increased again in the fourth quarter of 2007, indicating growing doubts about the future performance of financial and non-financial corporations. These sentiments were in stark contrast to the confidence that had prevailed in the preceding quarters, when a protracted period of sustained profits growth had driven up stock market prices to peak levels during 2007.

The more general reappraisal of risks towards the end of the period under review was also very evident on the corporate credit market. Measured against risk-free assets, the interest rate spreads on corporate bonds, which had reached a historically low level in the first half of 2007, increased sharply. Thus, on the dollar market in high-yield

CHART 82 IMPLICIT VOLATILITY OF STOCK MARKET INDICES
(percentages, daily data)



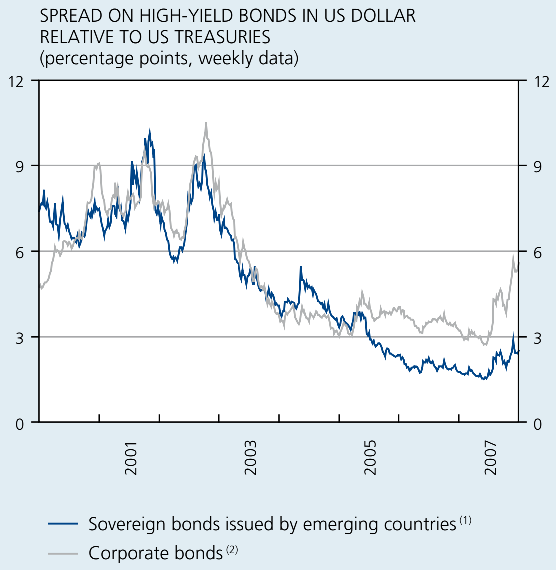
Source : Thomson Financial Datastream.

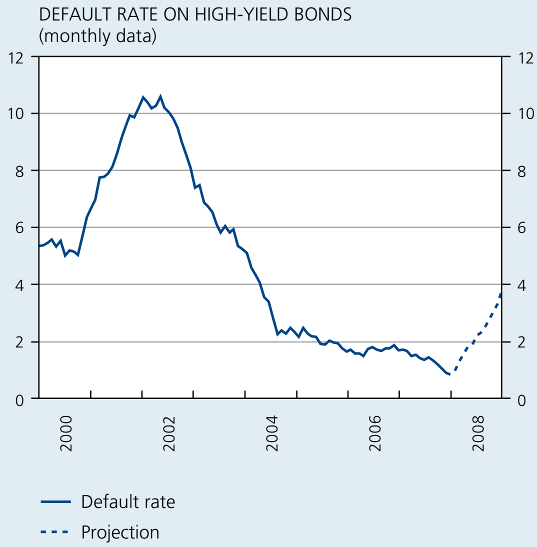
corporate bonds, the spread in relation to US Treasury bonds increased from under 300 basis points in June to over 550 points in December. This occurred despite a further decline, in the fourth quarter, in the default rate on speculative corporate bonds, which dropped to its lowest level since 1981, namely 0.9 p.c. However, that default rate is a "delayed" indicator of corporate credit quality, since the twelve-month projections suggest a gradual return to the long-term average of 4.8 p.c.

Conversely, on the emerging bond markets which had proved particularly sensitive to the investors' loss of confidence during earlier periods of financial tension, the risk recalibration was much more modest. That reflects the marked structural improvement in the macroeconomic and financial fundamentals of many emerging countries. However, some of them still make extensive use of external financing, which leaves them vulnerable, in the same way as private borrowers, to the potential repercussions on lending conditions if the financial turbulence persists beyond the year under review.

CHART 83 INTEREST RATE SPREAD AND DEFAULT RATE ON HIGH-YIELD BONDS

(percentages)





Sources : JP Morgan Chase, Merill Lynch, Moody's, Thomson Financial Datastream.
(1) EMBIG index; spread relative to interest rate on US Treasuries with a corresponding maturity.
(2) Corporate bonds denominated in US dollar with a rating lower than BBB/Baa3; spread relative to the interest rate on ten-year US Treasuries.

8.2 – Belgian banking sector

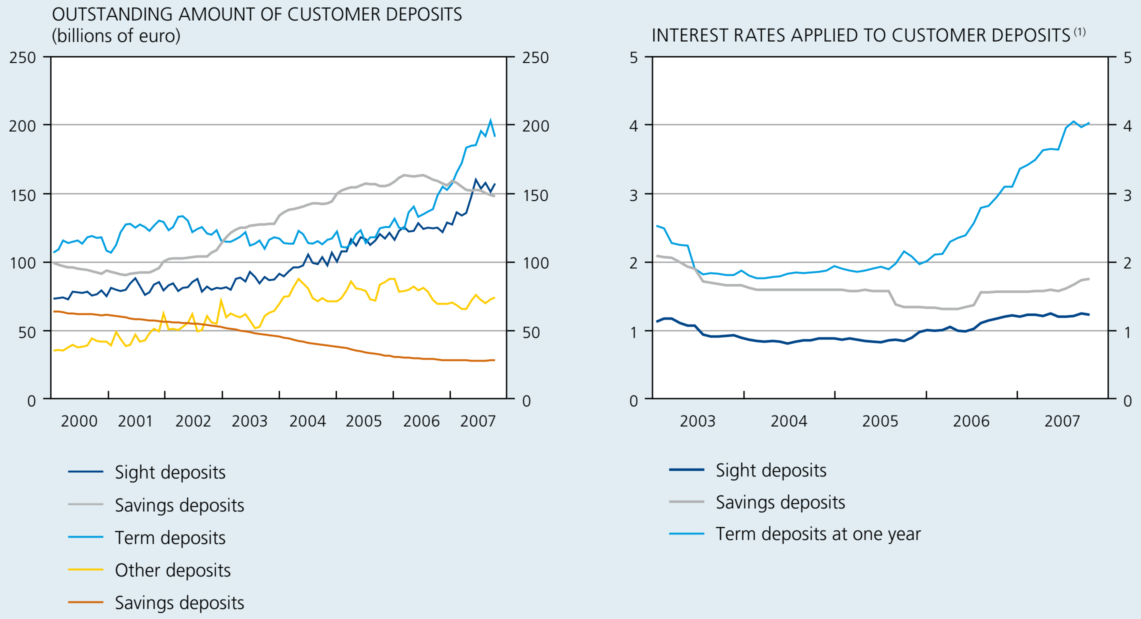
During the third quarter of 2007, like their counterparts in the United States and in other European countries, Belgian credit institutions faced a sudden tightening of liquidity on the unsecured interbank loan market and on certain other important segments of the money markets. However, the Belgian banking sector's dependence on these financing channels, particularly affected by the recent financial turbulence, was tempered somewhat both by the size of customer deposits and by the holding of a large portfolio of securities which can be used as collateral for borrowings.

Traditionally, Belgian credit institutions have always been able to limit their net use of the interbank market by using their non-bank deposits to finance the major part of their retail and corporate loans, which often have a fairly long maturity and low liquidity on the secondary markets. Thus, at the end of June 2007, these deposits represented 98 p.c. of the loans granted to customers, following correction of the outstanding total of these two items on the balance sheet to neutralise the effect of (reverse) repo transactions. Moreover, Belgian credit institutions do not rely extensively on securitisation operations to refinance their traditional intermediation activities. That is evident from the small amount of European asset-backed securities constituted on Belgian counterparties. At the end of September 2007, that figure came to only 7.3 billion euro and represented less than 0.5 p.c. of the total liabilities of Belgian credit institutions. Although that finding must be qualified by taking account of the securitisation operations conducted by foreign subsidiaries of the large Belgian credit institutions, particularly in the Netherlands and France, the amounts involved were still relatively limited.

The financial market turmoil does not seem to have had any significant impact on non-bank deposits, over half of which are collected in Belgium, although the composition of those deposits has changed slightly in recent quarters. As stated in chapter 7 on the financial accounts, the shifts detected are due essentially to the sharp rise in interest rates offered on term deposits as opposed to the rates offered on savings deposits. Consequently, the outstanding amount of this last deposit category, which had risen from less than 100 billion euro in 2001 to over 150 billion during 2005, recently declined, while at the end of September 2007 the outstanding total of term deposits was 29 p.c. higher than a year previously. Furthermore, the relative importance of savings notes as a source of finance for the banks maintained a structural decline,

CHART 84 OUTSTANDING AMOUNTS OF CUSTOMER DEPOSITS AND INTEREST RATES APPLIED BY BELGIAN CREDIT INSTITUTIONS

(monthly data on an unconsolidated basis)



Sources : CBFA, NBB.
(1) Data from the monthly MIR survey in the case of new deposits.

falling to less than 5 p.c. of total customer deposits, compared to almost 25 p.c. ten years ago, although the downward trend in the outstanding amount of those securities apparent for several years did come to a halt.

The other compensatory factor enabling Belgian credit institutions to withstand the tension on the financial markets lies in the quantity of securities held in the portfolio and capable of being used to obtain secured loans on the interbank or wholesale market. At the end of September 2007, the outstanding total of securities held by the Belgian banking sector came to 367 billion euro and represented almost one quarter of the total assets. Debt securities made up 83 p.c. of that portfolio.

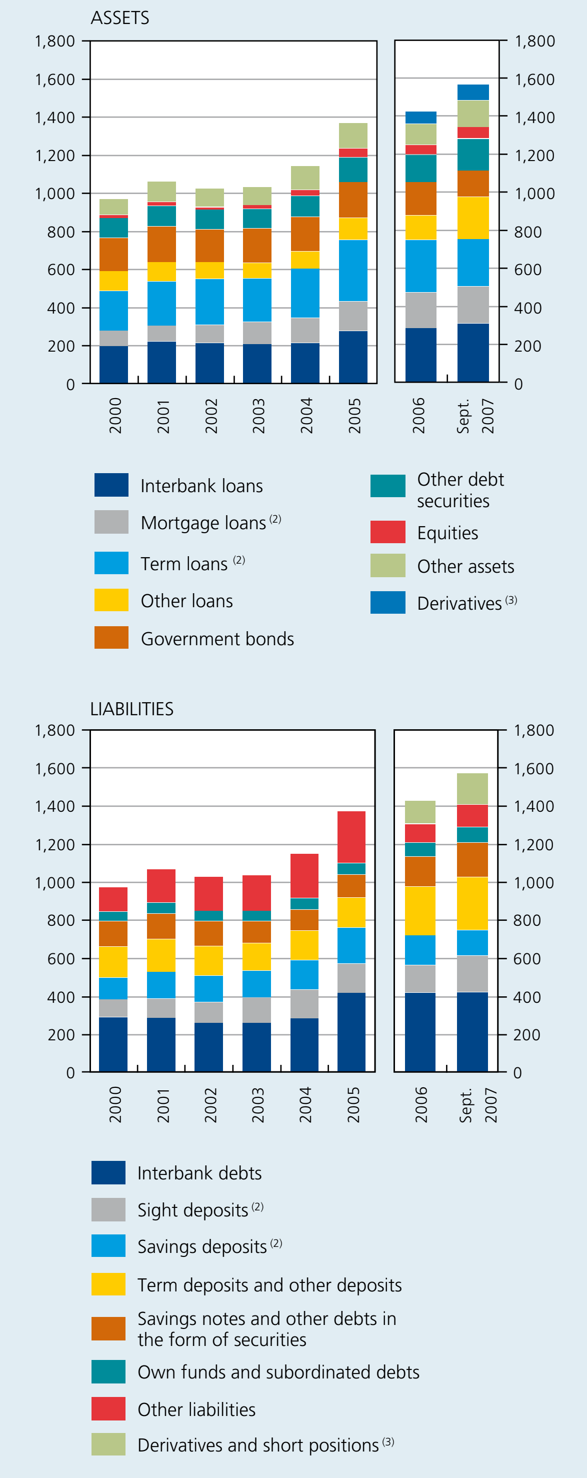
On the secured interbank market, the amounts borrowed by a counterparty are covered by pledged tradable securities, which reduces the credit risk inherent in the transaction. The prudential data supplied by Belgian credit institutions provide only partial information on the extent of this form of financing. In fact, while the prudential schemes give details of repurchase (repo) transactions in securities, whereby the banks exchange securities for cash for a specified period, they do not mention loans of securities against cash, which are similar instruments from an economic point of view, and are also effected on a large scale by Belgian credit institutions. At the end of September 2007, the outstanding total of repurchase transactions recorded on the liabilities side of the balance sheet of Belgian credit institutions came to 176 billion euro, of which 117 billion was recorded against other credit institutions. These repo transactions in securities represented 28 p.c. of all interbank borrowings.

While these various sources of funding helped to shield the credit institutions from the substantial shocks affecting market liquidity in the second half of 2007, they were also used to finance a very varied asset portfolio.

At the end of September 2007, loans to other credit institutions and customers represented 62 p.c. of the total banking sector assets, a proportion which has been relatively stable since 2000. The loan portfolio has therefore expanded at much the same rate as the balance sheet total, which has recorded sustained growth since 2003. This general increase is due partly to the fact that, since the entry into force of the IAS/IFRS international accounting standards in 2006, derivatives have been recorded on the balance sheet at their market value. The introduction of these new standards also caused various other methodological breaks in the time series, which were explained in detail in box 18 in the 2006 Report and which prevent

CHART 85 ASSETS AND LIABILITIES OF BELGIAN CREDIT INSTITUTIONS [1]

(end-of-period data in billions of euro, on a consolidated basis)



Sources: CBFA, NBB.

(1) Data compiled in accordance with the Belgian accounting standards until 2005 (Belgian GAAP) and according to the IAS/IFRS from 2006.

(2) Comprising only loans and deposits recorded at amortised cost.

(3) Derivatives recorded at their market value.

comparison over time of the prudential data relating to the consolidated balance sheet of credit institutions. However, the data obtained from the non-consolidated accounts, which are still compiled on the basis of the Belgian generally accepted accounting principles (Belgian GAAP), also indicate a sizeable increase in the balance sheet total of Belgian credit institutions.

This marked expansion of bank assets is only partly a reflection of internal activity growth. It is also due to acquisitions, by Belgian banks, of foreign credit institutions. These acquisitions were concentrated mainly in central Europe and Turkey. The recent takeover of part of ABN AMRO by Fortis, not yet incorporated in the data, will generate an additional increase in the balance sheet total of the Belgian banking sector. At the end of September 2007, the sector's total assets came to 1,568 billion euro, against 1,422 billion at the end of 2006 and 1,033 billion at the end of 2003.

The loan portfolio, with an outstanding total of 974.1 billion euro, is highly diversified in both sectoral and geographical terms. Credit institutions and corporations are the two main counterparty sectors, representing fairly similar shares of around one-third of the total. Although the amount of outstanding loans to individuals is slightly less, the latter account for over a quarter of all the loans granted by Belgian credit institutions. The explanation for the low volume of lending to central government is that the credit institutions' exposure to that sector mainly takes the form of securities.

Although interbank loans are a channel for potential contagion between credit institutions, that risk is nonetheless tempered by the use of financial guarantees. One of the techniques used by credit institutions for that purpose consists in effecting reverse repurchase transactions of securities which are in fact the corollary to the repurchase transactions recorded on the liabilities side of the balance sheet. At the end of September 2007, these transactions made up 45 p.c. of interbank loans, a figure which – for reasons similar to those put forward earlier in regard to the liabilities – only partly reflect the proportion of total interbank loans represented by secured transactions.

Belgian credit institutions also record a large volume of reverse repurchase operations vis-à-vis non-bank counterparties. Since central governments and retail clients do not, in principle, engage in such transactions, they are attributable to non-banks and other corporations. At the end of September 2007, one-fifth of all loans granted to these two debtor categories took the form of reverse repos. The non-banks serving as counterparties in these transactions include London Clearing House, one of the

TABLE 40 BREAKDOWN OF THE LOAN PORTFOLIO OF BELGIAN CREDIT INSTITUTIONS BY SECTOR AND BY RESIDENCY OF THE COUNTERPARTY (1)

(data as at the end of September 2007, on a consolidated basis; percentages of the total, unless otherwise stated)

	Billions of euro	Total	Breakdown by residency		
			Belgium	Other euro area countries	Rest of the world
Central governments	15.5	1.6	0.9	0.2	0.5
Credit institutions	307.7	31.6	1.4	14.4	15.8
Corporations	308.6	31.7	10.2	8.7	12.8
Retail	261.7	26.9	14.4	10.5	2.0
Non-banks	80.6	8.3	4.1	1.4	2.8
Total	**974.1**	**100.0**	**31.0**	**35.2**	**33.8**

Sources: CBFA, NBB.
(1) The total includes 49.6 billion in loans classed as assets held for trading.

large clearing houses involved in triparty repos, but also hedge funds, since the loans granted to this category of financial intermediaries are usually in secured form.

The geographical breakdown of the loans reveals that Belgian residents, those of other euro area countries and the rest of the world each represent around one-third of the loans granted by Belgian credit institutions. If one looks at the geographical division of the loans for the three main types of counterparties individually, this distribution is more skewed.

It is interbank loans that present the highest degree of internationalisation and which form the main component of the relatively large share of non-residents in total lending. Half of all interbank loans are granted to credit institutions outside the euro area. Belgian residents also represent a minority of the loans granted to corporations, since they account for only one-third of the outstanding total of those loans.

Loans to households by Belgian credit institutions are less international, since over half of the outstanding total is located in Belgium, compared to 39 p.c. in other euro area countries and 7 p.c. in the rest of the world. Almost three-quarters of those loans consist of residential mortgage loans, while consumer credit and term loans represent virtually all of the remainder. Outside their domestic market, Belgian banks are also active on the mortgage markets in the Netherlands, and to a lesser extent in Ireland, and in Central and Eastern Europe. In those countries, Belgian credit institutions may face certain specific risk factors different from those on the national market. For instance, in Ireland there is the potential overheating of the residential property sector, in the Netherlands, mortgage loans are granted on terms which are generally much more flexible than in Belgium, while in the Central and East European countries, there is the strong expansion of mortgage lending in foreign currencies without the borrower being required to hedge the currency risk.

The results of the stress tests conducted at the end of June 2007 by the four leading Belgian credit institutions indicated that their loan portfolio was still concentrated on assets with a fairly low risk of default, and that – in the event of actual default – the losses would be limited. The good risk profile of the loan portfolio of Belgian banks was also reflected in a low percentage of impaired loans, down from 1.4 p.c. at the end of December 2006 to 1.3 p.c. at the end of September 2007. On that same date, the ratio of provisions for those claims was just over 39 p.c.

During the period under review, Belgian credit institutions had to recognise only a limited amount of new impairments for credit losses. The net credit risk provisions recorded in the profit and loss account remained at a historically low level during the first nine months of 2007, representing an amount equivalent, in annualised terms, to 5 basis points of the total outstanding loans. However, it seems rather unlikely that this level can be maintained in the coming quarters if the recent tightening of credit standards persists, and if the apprehension over even a gradual downturn in the economic and credit cycles materialises.

TABLE 41 BREAKDOWN OF THE PORTFOLIO OF DEBT SECURITIES OF BELGIAN CREDIT INSTITUTIONS BY COUNTERPARTY SECTOR AND BY IAS/IFRS ACCOUNTING CATEGORY

(data as at the end of September 2007, on a consolidated basis, percentages of the total)

	Total	Held to maturity	Held for trading	Available for sale	Designated at fair value through profit and loss
Central governments	44.9	4.4	6.0	31.6	2.9
Credit institutions	26.0	0.2	4.1	20.4	1.2
Corporations	23.0	0.2	7.8	14.3	0.7
Other	6.1	0.0	1.4	4.6	0.1
Total	**100.0**	**4.8**	**19.4**	**70.9**	**5.0**

Sources: CBFA, NBB.

Apart from loans, the other major category of financial assets held by the Belgian banking sector comprises debt securities, which totalled 305 billion euro at the end of September 2007. Just under half of these securities were issued by central governments and just over a quarter by credit institutions. The remainder consists of bonds issued by corporations and other debt instruments, including mortgage-backed securities (MBS), asset-backed securities (ABS) and other structured finance instruments. It should be pointed out that the Belgian credit institutions' exposure to the latter is concentrated in the tranches with AAA and AA ratings, and that the proportion of asset-backed securities based on subprime mortgages is only modest.

Since only 4.8 p.c. of debt securities are reported according to the IAS/IFRS rules as held to maturity investments, the portfolio is very largely recorded on the balance sheet at fair value. This 'fair value' concept is broader than the 'market value' concept. Although, according to the IAS/IFRS rules, the price quoted on an active market is in fact considered to be the best basis for calculating the fair value, and should preferably be used if it exists, that indicator is not exclusive. In the absence of an active market, the fair value concept may embrace other valuation techniques referring, for example, to the valuation of similar financial instruments.

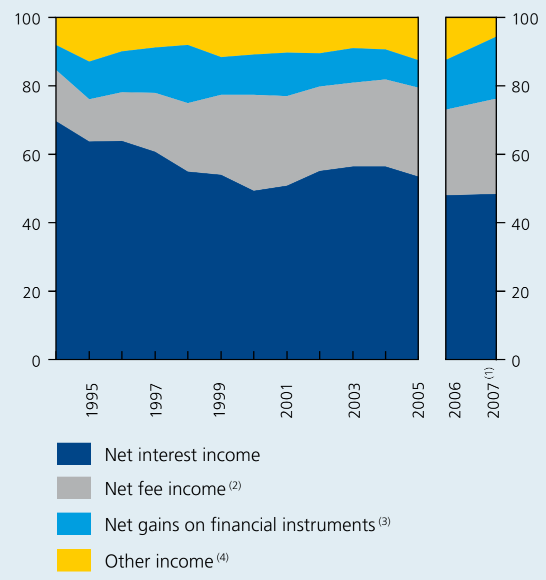
While the gains and losses realised on the sale of a debt instrument are automatically recorded in the profit and loss account, the accounting treatment of unrealised value changes depends on the accounting category to which the instruments concerned belong. Thus, unrealised value changes in the case of securities classed as assets available for sale, which represent 70.9 p.c. of the debt instruments held by the Belgian banking sector, are booked directly in equity, without passing through the profit and loss account. However, there is one important exception to this rule. If the reduction in the fair value of a debt instrument is considered to be permanent, it must give rise to an impairment of the security, and the impairment must be reported in the profit and loss account. In the case of securities classed either as held for trading or as assets designated at fair value through the profit and loss account – i.e. assets which the banks irrevocably decided to record at fair value at the time of entering them in the accounts – which, on 30 September 2007, represented 19.4 and 5 p.c. respectively of the debt securities portfolio of the Belgian banking sector, the value changes must always be reported in the profit and loss account.

Despite the value reductions which the Belgian banks recorded on certain securities linked to subprime mortgages in the third quarter, during the first nine months of 2007 they reported 3.63 billion euro in net realised or unrealised gains on securities or other financial instruments in the profit and loss account, representing a 16 p.c. increase against the corresponding period of 2006. With a contribution of 2.23 billion euro, the net gains on assets or liabilities classed in the accounts as held for trading – a category which comprises the bulk of the positions in derivatives, including those used for hedging – showed a 2 p.c. increase against 2006. The other net realised or unrealised gains were 49 p.c. higher at 1.4 billion euro.

The favourable market conditions prevailing in 2006 and in the first half of 2007, and the replacement of Belgian GAAP by the international IAS/IFRS rules – leading to a large increase in the proportion of the balance sheet to be recorded at fair value – account for much of the recent increase in the banking income generated by gains on

CHART 86 BREAKDOWN OF BANKING INCOME OF BELGIAN CREDIT INSTITUTIONS

(consolidated end-of-period data, percentages of the total)



Sources : CBFA, NBB
(1) First nine months.
(2) Excluding fees paid to bank agents, recorded as staff costs.
(3) Sum of all realised and unrealised gains reported through the profit and loss account. The relatively higher proportion since 2006 is attributable partly to the switch to the IAS/IFRS, which increased the amount of the unrealised gains in the profit and loss account.
(4) Other income consists of dividend income, revaluations for exchange rate differences, profits or losses on assets other than those available for sale which are no longer recorded, and other sources of net operating income.

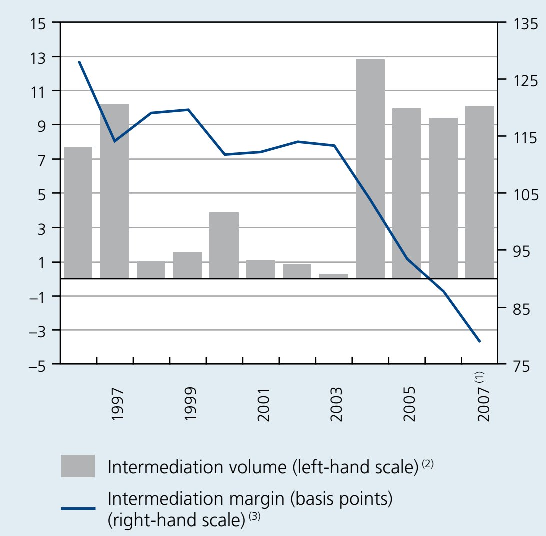
financial instruments. These new valuation rules can obviously also have the opposite, downward, effect on the results, in a context of highly volatile financial markets and an abrupt correction to the value of certain assets, as seen in the second half of the year under review.

Net fee income as a percentage of banking income has increased significantly in recent years. That increase is due in part to the stronger demand from households for savings products which do not appear on a bank's balance sheet, such as UCIs or life insurance policies. It also reflects the fact that corporations are making greater use of financing by direct borrowing on the financial market, offering credit institutions opportunities for income in the form of commissions for advice or a firm underwriting commitment. While fee income made up only 15 p.c. of banking income in 1994, that figure increased to 27.9 p.c. in the first nine months of 2007. During the first three quarters, net fee income was 21.9 p.c. higher than in the corresponding period of 2006. Asset management and private banking services – geared essentially to private customers – were the activities which made the main contribution to this overall increase. Fees relating to trading in securities remained stable, while those generated by clearing and settlement activities increased by 15 p.c.

Despite the substantial growth of net fee income, net interest income is still the main revenue source for Belgian credit institutions. In recent years, it has been boosted by the marked rise in the volume of deposits and loans, offsetting the significant reduction in the intermediation margin. In fact, the differential between the average yield received on interest-bearing assets and the average cost of remuneration of the liabilities declined from 113 basis points in 2003 to less than 80 basis points in 2007. This recent contraction of the intermediation margin is due partly to the shift, within customer deposits, from savings deposits to the comparatively more costly term deposits. Between 2003 and 2007, it was also attributable to the marked flattening of the yield curve in euro which, by reducing the spread between short-term and long-term interest rates, depressed the income obtained from the maturity transformation activities of Belgian credit institutions. Divergent movements in the price and volume components of net interest income also reflect, in part, the strong expansion of low-margin activities, such as (reverse) repurchase operations.

CHART 87 DETERMINANTS OF THE NET INTEREST INCOME OF BELGIAN CREDIT INSTITUTIONS

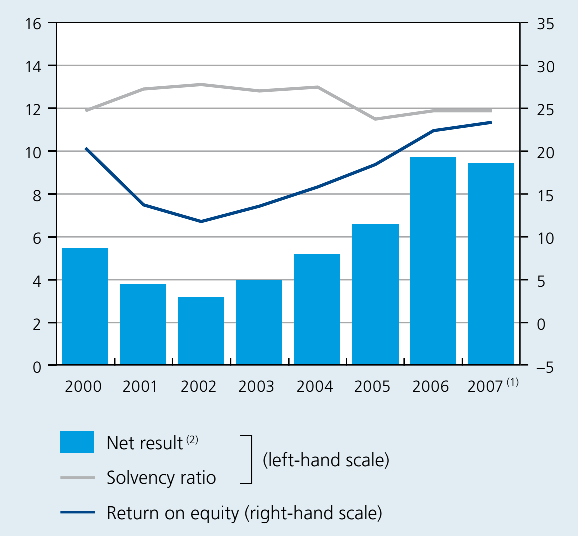
(unconsolidated data)



Sources : CBFA, NBB.
(1) Annual percentages calculated on the basis of the data for the first nine months.
(2) Average of the annual growth rates of the interest-bearing assets and liabilities, percentages.
(3) The intermediation margin corresponds to the difference between the average implicit rates charged and paid on the outstanding amount of the interest-bearing assets and liabilities respectively.

CHART 88 PROFITABILITY AND SOLVENCY OF BELGIAN CREDIT INSTITUTIONS

(consolidated data, percentages, unless otherwise stated)



Sources : CBFA, NBB.
(1) Annualised data based on the data for the first nine months.
(2) Billions of euro.

The ability to generate profits and maintain a good level of solvency are two key factors enabling the banks to withstand the deterioration of the environment in which they operate. During the first nine months of 2007, the overall profitability of the Belgian banking sector remained high. The result came to 9.5 billion euro on an annualised basis, so that the return on equity (23.4 p.c.) slightly exceeded the historically high level attained in 2006 (22.4 p.c.). The solvency ratio of Belgian credit institutions – which expresses the ratio between the regulatory own funds and the weighted volume of risks – stood at 11.9 p.c. at the end of September 2007, well above the 8 p.c. required by the regulations. 2007 was in fact the last year in which this solvency ratio could still be calculated according to the Basel I rules. From 2008, all Belgian banks must measure their solvency on the basis of the new Basel II rules. These refine the calculation of the regulatory capital requirements by making them much more sensitive to the banks' actual risk exposure.

8.3 Belgian insurance sector

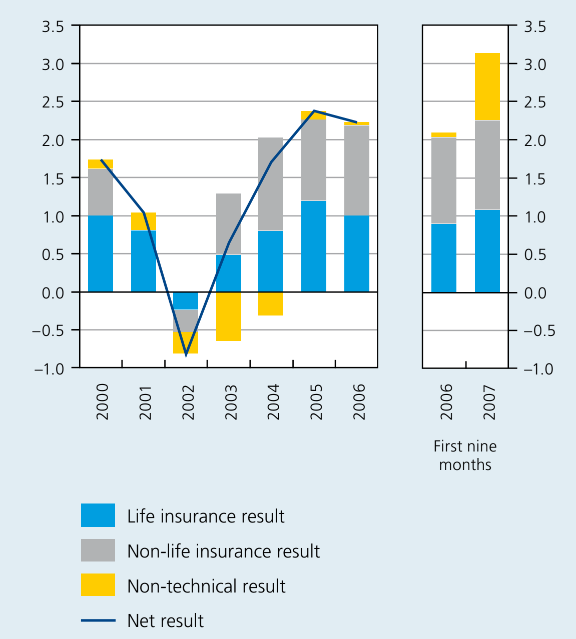
The profitability of the Belgian insurance sector improved significantly during the first nine months of 2007, compared to the corresponding period of 2006, bolstered by a strong rise in the income from investments that is recorded in the non-technical result and a 21 p.c. increase in the net result on life insurance activities. Over the year as a whole, the insurance companies should thus consolidate the recovery which set in after 2002, when the adverse stock market climate and high insurance and operating costs expressed as a percentage of premium income were reflected in a loss of 0.8 billion euro for the sector as a whole.

The significant contribution of life insurance activities to the growth of the net profit needs to be qualified somewhat to take account of the shifts in premiums collected between 2005 and 2006. These were due to the introduction on 1 January 2006 of a tax of 1.1 p.c. on premiums paid for individual life insurance contracts. Since households had anticipated this tax by paying additional premiums in the final months of 2005, and then reduced their payments in 2006, the net results for 2005 and 2006 were first artificially driven up and then depressed, compared to the picture which would have been expected in the absence of the new tax measure.

However, this factor alone is not enough to explain the increase in life insurance premium income, which is estimated at around 10 p.c. for the year under review as a whole. Taking account of the reduction in premiums

CHART 89 MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT OF BELGIAN INSURANCE COMPANIES

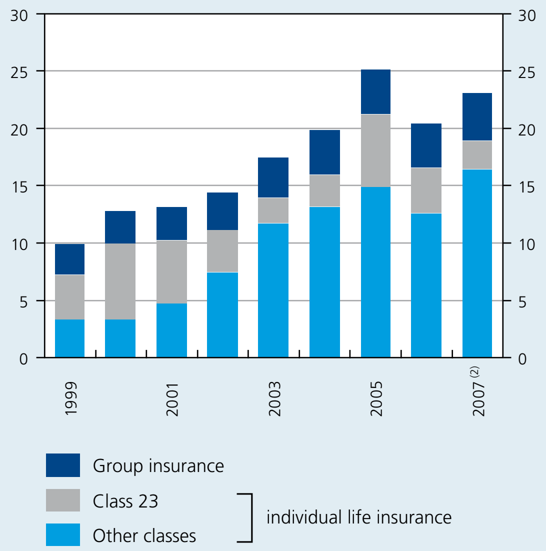
(billions of euro)



Sources : CBFA, NBB.

CHART 90 LIFE INSURANCE PREMIUMS (1)

(billions of euro)



Sources : Assuralia, CBFA, NBB.
(1) Premiums collected on direct insurance operations in Belgium.
(2) The 2007 figures are based on the October estimate by Assuralia.

for unit-linked products (class 23), this growth was due to the rise in premiums collected on policies relating to other types of contract, by far the most important being class 21, in both the individual and the group life insurance segment.

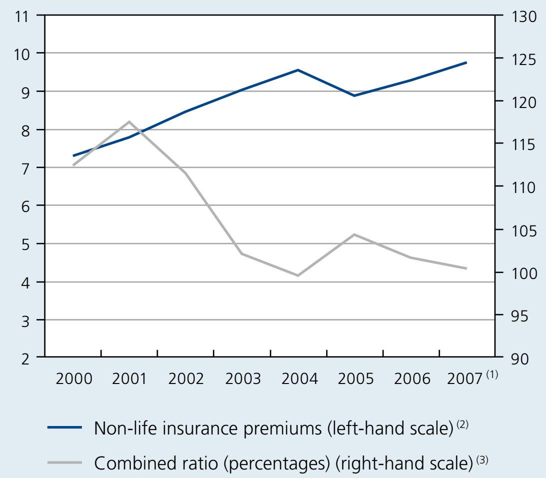
The profitability of class 21 insurance contracts had been impaired some years ago by the marked fall in the yield which insurance companies obtained on their investment portfolio, whereas those companies guaranteed policyholders a minimum yield which – owing to pressure of competition – was generally fixed at the legal maximum of 4.75 p.c. In 2002, the margin between the yield the companies obtained and that guaranteed to policyholders actually became negative, as a result of the adverse movement in global stock market prices and a decline in long-term interest rates to levels below that 4.75 p.c. mark. Since then, the sector has gradually improved its life insurance result, forming reserves for planned payments on the old insurance contracts offering high guaranteed yields, and offering new insurance contracts with policy clauses and yields better suited to current and expected financial market conditions. Combined with the positive impact on investment incomes of rising stock markets, these developments have helped to restore the life insurance result since 2002.

In non-life insurance, the result also increased considerably during this period, as illustrated by the movement in the combined ratio which expresses insurance and operating costs as a percentage of net premium income. After having exceeded 110 p.c. during the period 2000-2002, this reverse measure of the profitability of insurance activities proper (excluding investment income) dropped to 102 p.c. on average over the period 2003-2007. This significant improvement in the combined ratio from 2003 onwards is due to higher premiums, better cost control and more rigorous management of the risks covered in insurance branches recording a deficit.

Despite the recent improvement in life and non-life insurance results, the sector remains sensitive to financial market developments, and particularly interest rate movements. That applies principally in the life segment, where contracts and liabilities have relatively long maturities compared to the non-life segment, reflected in a higher volume of provisions and portfolio investments. For the same reasons, financial income expressed as a percentage of premiums received is also higher in life insurance than in non-life insurance.

CHART 91 NON-LIFE INSURANCE PREMIUMS AND COMBINED RATIO

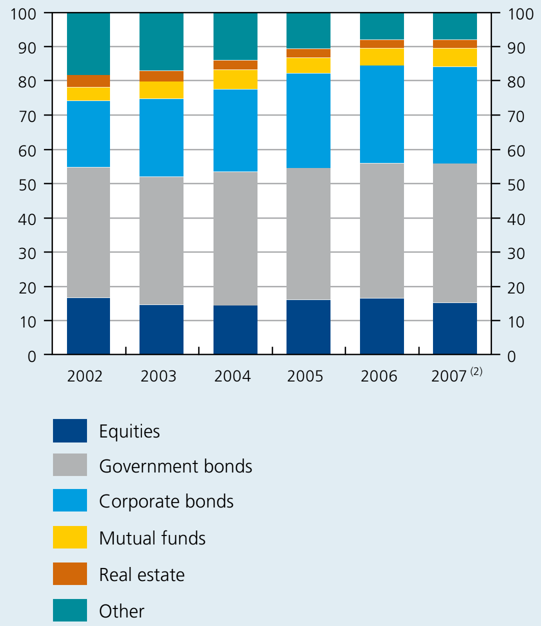
(billions of euro, unless otherwise stated)



Sources : Assuralia, CBFA, NBB.
(1) Projections based on the October estimate by Assuralia in the case of non-life insurance premiums, and on the basis of the data for the first nine months for the combined ratio.
(2) Premiums collected on direct insurance operations in Belgium.
(3) The combined ratio expresses the sum of insurance and operating costs as a ratio of net premium income.

CHART 92 INVESTMENT PORTFOLIO OF BELGIAN INSURANCE COMPANIES (1)

(percentages of the total)



Sources : CBFA, NBB.
(1) Excluding investments linked to class 23 contracts.
(2) End-of-September figures.

Belgian insurance companies active in both the life and non-life branches traditionally invest a significant part of their portfolio in bonds. At the end of September 2007, these represented 69.1 p.c. of the total portfolio, with equities and UCIs respectively accounting for only 15 and 5.4 p.c. In recent years, in order to increase the return on their investments, insurance companies have boosted the share of corporate bonds, so that at the end of September 2007 they represented 41 p.c. of the total bonds compared to 34 p.c. in 2002. Since the bonds selected generally have very high ratings, this diversification does not appear to have caused a significant decline in the overall credit quality of the investment portfolio of insurance companies.

Nonetheless, in order to enhance the risk-adjusted return on their portfolio, companies also invested in structured products, such as asset-backed securities or collateralised debt obligations, hedge funds, venture capital, or financial assets linked to commodities. Although the percentage of these asset categories has so far remained small, such diversification is gradually exposing companies to new types of risks.

In general, exposure to interest rate fluctuations is one of the main risks facing insurance companies in the management of their investments, since the average maturity of the sector's financial assets does not match that of the liabilities. The scale and even the direction of this gap differ between the life and non-life segments, as is evident from the stress tests conducted in 2007 by the main companies in the sector, at the request of the NBB and the CBFA. On the one hand, the average maturity difference between the investment portfolios and the technical provisions is generally smaller for non-life than for life insurance, so that the former has a lower exposure to interest rate risk. On the other hand, the average duration of the investment portfolios generally exceeds the duration of the corresponding contracts in the case of non-life insurance, while the opposite is true in life insurance.

The risks associated with the financial investments of insurance companies will be more explicitly taken into account in the forthcoming Solvency II Directive, which enters into force in 2012. Largely based on the new Basel II rules applicable to banks, this Directive also provides for a three-pillar system. This combines the quantitative rules for calculating the capital requirements, more qualitative requirements concerning risk control – the prudential authorities having the option of imposing supplementary capital requirements – and finally, obligations regarding the disclosure of information, designed to strengthen market discipline. The quantitative rules under the first pillar take account of a much wider range of risks, enable companies to use their own risk management models to calculate the capital required, and incorporate the impact on solvency of fair value accounting in the case of both the financial investments, on the assets side, and the technical provisions, on the liabilities side.

TABLE 42 IMPACT OF AN INTEREST RATE SHOCK ON THE NET ASSET VALUE OF BELGIAN INSURANCE COMPANIES (1)

(data as at the end of June 2007, percentage of the available regulatory capital)

	Total	Life insurance	Non-life insurance
Upward shift	0.1	6.6	–3.9
Downward shift	–6.7	–19.3	3.7

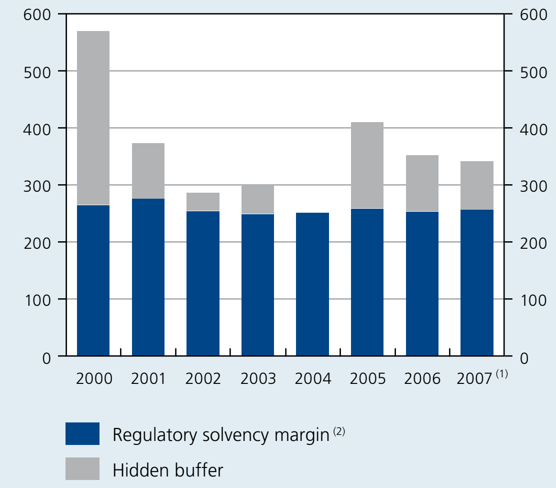
Sources: CBFA, NBB, insurance company calculations.
(1) Impact of a parallel shift in the yield curve of 200 basis points, calculated on the basis of internal models and the assumptions of the main institutions of the sector.

This last clause will correct a serious distortion in the current model of calculating regulatory capital, namely the absence of any adjustment to the rate for discounting the technical provisions in the event of market interest rate fluctuations. According to the system currently in force, which is still based on a fixed discount rate, the Belgian insurance sector far exceeded the regulatory solvency requirements at the end of September 2007. Since 2000, the sum of the explicit and implicit solvency margins has in fact constantly exceeded the minimum margin by at least 150 p.c.

The explicit component includes the own funds, subordinated debts and certain other balance sheet items, such as the fund for future allocations, which corresponds to the positive balance of the technical life insurance result for which, on the closing date for the financial year, the decision on the allocation between shareholders and policyholders is still pending. Apart from these explicit components, the insurance companies may also, subject to CBFA approval, include other specific elements in their regulatory solvency margin, the principal one comprising part of the unrealised gains on investment portfolios. This last possibility is linked to the current method of valuing insurance company assets. In fact, according to the accounting rules currently in force, most of the unrealised gains are not incorporated in the book value of the investment portfolios of insurance companies, and therefore do not cause any change in the capital. However, with the approval of the CBFA, part of these unrealised gains may be included in the implicit solvency margin. The fraction not included can be regarded as a hidden buffer; it diminished slightly between the end of 2006 and September 2007, as a direct result of the increase in long-term interest rates during those nine months.

CHART 93 AVAILABLE SOLVENCY MARGIN OF BELGIAN INSURANCE COMPANIES

(percentages of the minimum required margin)



Sources: CBFA, NBB.

(1) Figures as at the end of September.

(2) This margin is composed of an explicit margin – including the own funds, subordinated debts and certain other balance sheet items – and an implicit margin which, subject to the approval of the CBFA, comprises certain other specific elements, the principal one being a part of the unrealised gains on investment portfolios.

Annexes

Statistical annex

TABLE I GDP AND MAIN CATEGORIES OF EXPENDITURE, BY VOLUME

(percentage changes compared to the previous year, calendar adjusted data)

	2000	2001	2002	2003	2004	2005	2006	2007 e
Household final consumption expenditure	3.9	1.0	0.7	0.7	1.4	1.4	2.1	2.5
Housing	1.3	–4.4	–0.9	3.6	10.0	10.1	7.4	5.2
Gross fixed capital formation by enterprises	4.6	3.4	–3.0	–1.8	7.4	4.6	3.9	5.1
Expenditure of general government	2.9	1.2	2.7	2.1	1.8	0.7	–0.2	2.4
Final consumption	2.9	2.4	2.9	2.1	1.8	–0.2	0.0	2.1
Gross fixed capital formation	2.6	–11.6	0.7	1.3	1.9	13.0	–3.2	5.4
p.m. Total gross fixed capital formation (1)	*3.7*	*0.3*	*–2.3*	*–0.3*	*7.5*	*6.7*	*4.2*	*5.2*
Change in stocks (2)	0.2	–0.9	0.4	0.0	0.1	0.4	0.8	0.0
Total domestic expenditure	3.8	0.2	1.0	0.8	2.7	2.5	2.8	2.9
Exports of goods and services	8.7	0.9	0.8	2.9	6.3	4.1	2.6	4.6
Total final expenditure	5.9	0.5	0.9	1.8	4.4	3.3	2.7	3.7
Imports of goods and services	8.7	0.2	0.2	2.8	6.5	4.9	2.5	5.0
p.m. Net exports of goods and services (2)	*0.3*	*0.6*	*0.5*	*0.2*	*0.2*	*–0.4*	*0.2*	*–0.2*
GDP	3.9	0.7	1.4	1.0	2.8	2.0	2.9	2.7

Sources: NAI, NBB.

(1) Housing, gross fixed capital formation by enterprises and gross fixed capital formation by general government.

(2) Contribution to the change in GDP.

TABLE II GNI AND MAIN CATEGORIES OF EXPENDITURE, BY VOLUME

(percentage changes compared to the previous year, data not adjusted for calendar effects)

	2000	2001	2002	2003	2004	2005	2006	2007 e
Household final consumption expenditure	3.8	1.1	0.8	0.8	1.4	1.3	2.0	2.4
Housing	1.0	–4.3	–0.7	3.8	9.8	9.9	7.6	5.1
Gross fixed capital formation by enterprises	5.9	3.3	–3.1	–1.7	6.9	4.7	3.9	5.2
Expenditure of general government	2.9	1.2	2.7	2.0	1.9	0.7	–0.1	2.4
Final consumption	2.9	2.4	2.9	2.1	1.8	–0.2	0.0	2.1
Gross fixed capital formation	2.4	–11.4	0.6	1.5	1.9	13.0	–3.2	5.3
p.m. Total gross fixed capital formation (1)	*4.5*	*0.2*	*–2.3*	*–0.2*	*7.1*	*6.7*	*4.2*	*5.1*
Change in stocks (2)	0.1	–0.9	0.1	0.0	0.2	0.0	0.9	0.4
Total domestic expenditure	3.8	0.3	0.7	0.9	2.8	2.1	3.0	3.3
Exports of goods and services	8.4	0.9	1.2	2.9	6.5	3.6	2.6	4.7
Total final expenditure	5.8	0.5	0.9	1.8	4.5	2.8	2.8	4.0
Imports of goods and services	8.8	0.2	0.2	2.9	6.6	4.2	2.7	5.4
p.m. Net exports of goods and services (2)	*0.1*	*0.5*	*0.8*	*0.1*	*0.3*	*–0.3*	*0.0*	*–0.4*
GDP	3.7	0.8	1.5	1.0	3.0	1.7	2.8	2.7
Trade surplus or deficit (–) resulting from the change in the terms of trade (3)	–1.4	0.1	0.5	–0.4	–0.3	–0.2	–0.4	0.4
Net primary incomes received from the rest of the world (3)	0.4	–0.7	–0.2	0.1	–0.5	–0.3	0.7	0.1
GNI	2.6	0.2	1.7	0.7	2.1	1.1	3.1	3.1

Sources: NAI, NBB.
(1) Housing, gross fixed capital formation by enterprises and gross fixed capital formation by general government.
(2) Contribution to the change in GDP.
(3) Contribution to the change in GNI.

TABLE III **DEFLATORS OF GNI AND THE MAIN CATEGORIES OF EXPENDITURE**

(percentage changes compared to the previous year, data not adjusted for calendar effects)

	2000	2001	2002	2003	2004	2005	2006	2007 e
Household final consumption expenditure	3.5	2.3	1.3	1.7	2.5	2.8	2.5	2.0
Housing	2.7	4.2	4.5	1.2	4.7	3.3	5.3	3.9
Gross fixed capital formation by enterprises	1.9	–0.5	–2.2	0.5	2.0	0.5	1.6	0.9
Expenditure of general government	1.9	2.5	3.7	2.6	2.4	4.1	2.8	2.3
Final consumption	1.7	2.6	3.9	2.7	2.6	4.3	3.0	2.3
Gross fixed capital formation	3.5	0.6	0.5	0.8	0.7	1.0	3.1	1.6
p.m. Total gross fixed capital formation (1)	*2.2*	*0.6*	*–0.5*	*0.7*	*2.6*	*1.3*	*2.7*	*1.8*
Total domestic expenditure (2)	2.8	2.0	1.5	1.7	2.6	2.8	2.7	2.0
Exports of goods and services	9.5	2.1	–0.5	–2.2	2.4	4.1	3.4	3.1
Total final expenditure (2)	5.9	2.1	0.6	–0.1	2.5	3.4	3.0	2.6
Imports of goods and services	11.8	2.0	–1.2	–2.0	2.8	4.4	4.0	2.7
p.m. Terms of trade	*–2.0*	*0.1*	*0.7*	*–0.2*	*–0.4*	*–0.3*	*–0.5*	*0.4*
GDP	1.8	2.0	1.9	1.6	2.4	2.5	2.0	1.7
GNI	3.3	1.9	1.4	2.0	2.7	2.7	2.4	1.3

Sources: NAI, NBB.
(1) Housing, gross fixed capital formation by enterprises and gross fixed capital formation by general government.
(2) Excluding changes in stocks.

TABLE IV GNI AND THE MAIN CATEGORIES OF EXPENDITURE AT CURRENT PRICES

(millions of euro, data not adjusted for calendar effects)

	2000	2001	2002	2003	2004	2005	2006	2007 e
Household final consumption expenditure	135,726	140,300	143,227	146,763	152,641	158,949	166,254	173,674
Housing	11,433	11,392	11,818	12,409	14,270	16,199	18,346	20,041
Gross fixed capital formation by enterprises	36,080	37,076	35,126	34,700	37,827	39,816	42,015	44,571
Expenditure of general government	58,613	60,777	64,749	67,760	70,684	74,065	76,098	79,647
Final consumption	53,678	56,378	60,303	63,212	66,014	68,732	70,774	73,955
Gross fixed capital formation	4,934	4,399	4,446	4,549	4,671	5,333	5,324	5,692
p.m. Total gross fixed capital formation (1)	*52,447*	*52,867*	*51,389*	*51,657*	*56,767*	*61,348*	*65,685*	*70,304*
Change in stocks	2,508	180	62	810	1,874	1,726	3,828	2,801
Total domestic expenditure	244,359	249,724	254,981	262,442	277,295	290,754	306,541	320,735
Exports of goods and services	213,080	219,555	220,969	222,528	242,670	261,630	277,641	299,845
Total final expenditure	457,439	469,279	475,950	484,970	519,966	552,384	584,182	620,579
Imports of goods and services	205,698	210,396	208,298	210,244	230,276	250,418	267,560	289,802
p.m. Net exports of goods and services	*7,382*	*9,159*	*12,672*	*12,284*	*12,395*	*11,211*	*10,081*	*10,043*
GDP	251,741	258,883	267,652	274,726	289,690	301,966	316,622	330,777
Net primary incomes received from the rest of the world	5,694	3,922	3,384	3,804	2,596	1,677	3,869	4,158
GNI	257,435	262,806	271,036	278,530	292,286	303,643	320,491	334,935

Sources: NAI, NBB.

(1) Housing, gross fixed capital formation by enterprises and gross fixed capital formation by general government.

TABLE V VALUE ADDED OF THE VARIOUS BRANCHES OF ACTIVITY, BY VOLUME

(percentage changes compared to the previous year, data not adjusted for calendar effects)

	2000	2001	2002	2003	2004	2005	2006	*p.m. Percentages of the 2006 GDP*
Agriculture, hunting, forestry and fisheries	4.2	–5.5	4.3	–7.6	5.3	–5.4	–5.8	*0.8*
Industry	4.8	0.0	–0.8	–1.2	2.9	–0.2	3.5	*17.3*
Mineral-extracting industry	1.2	–11.5	–5.1	0.1	3.2	7.0	4.7	*0.1*
Electricity, gas, water	7.0	–1.7	–1.9	–0.8	–1.5	–3.2	10.2	*1.9*
Manufacturing industry	4.6	0.3	–0.7	–1.3	3.6	0.2	2.7	*15.3*
of which:								
Non-metallic minerals	–0.5	3.6	–1.3	–3.4	0.1	–1.8	4.9	*0.8*
Iron, steel and non-ferrous metals	3.8	1.8	0.4	–2.4	4.4	–7.6	5.2	*2.4*
Metal-working industry	11.8	–1.4	–4.4	–2.7	1.1	3.5	3.8	*3.3*
Paper, printing, publishing	2.3	1.8	–1.7	1.7	5.1	0.8	1.2	*1.1*
Chemicals and rubber	6.3	0.4	2.2	–0.4	6.2	–0.9	2.0	*3.6*
Textiles, clothing and footwear	–8.2	–0.3	–1.5	–8.9	0.6	–5.6	–0.4	*0.6*
Food, beverages, tobacco	–5.2	2.2	1.9	2.2	2.8	1.4	3.8	*2.1*
Construction	5.8	1.0	–1.5	0.9	3.5	3.8	8.5	*4.5*
Market services	3.2	2.2	2.3	2.2	2.3	2.7	2.6	*54.4*
Trade and repairs	–1.5	3.7	4.3	4.9	3.6	–4.2	1.0	*11.5*
Financial services	3.3	–0.7	10.2	–5.7	8.3	3.3	3.6	*5.3*
Real estate, renting and business services	4.8	2.5	0.9	3.1	1.4	6.6	4.9	*20.4*
Transport and communications	4.3	3.2	0.5	2.1	–0.3	3.8	0.4	*7.3*
Health and social work	4.8	3.0	1.2	1.9	1.4	2.0	1.0	*6.1*
Hotels and restaurants and miscellaneous services to households	4.1	–2.0	–1.2	1.4	1.4	2.2	1.5	*3.8*
Non-market services	2.4	0.5	1.6	1.3	1.0	0.6	0.9	*12.1*
Value added of branches, at basic prices	3.6	1.3	1.4	1.2	2.4	1.8	2.8	*89.0*
Taxes net of subsidies on products (1)	0.5	–0.4	0.3	–0.1	0.9	0.1	0.4	*11.0*
GDP	3.7	0.8	1.5	1.0	3.0	1.7	2.8	*100.0*

Source: NAI.
(1) Contribution to the change in GDP.

TABLE VI LABOUR MARKET

(annual averages, thousands of units)

	2000	2001	2002	2003	2004	2005	2006	2007 e
Population of working age [1]	6,724	6,743	6,774	6,805	6,835	6,879	6,942	6,998
Labour force	4,616	4,670	4,686	4,735	4,803	4,875	4,922	4,937
National employment	4,142	4,200	4,194	4,197	4,227	4,279	4,334	4,405
Frontier workers (balance)	50	50	50	51	53	53	56	58
Domestic employment	4,091	4,150	4,144	4,146	4,174	4,225	4,278	4,347
Self-employed	695	690	684	679	680	687	695	709
Employees	3,396	3,460	3,461	3,467	3,495	3,538	3,583	3,638
Branches sensitive to the business cycle [2]	2,187	2,227	2,204	2,183	2,191	2,214	2,246	2,292
Public administration and education	705	713	725	735	744	755	758	758
Other non market services [3]	504	519	532	550	559	569	578	588
Unemployment [4]	474	470	492	538	577	596	588	532

Sources: DGSEI, NAI, NEMO, NBB.

(1) Persons aged 15 to 64.

(2) The branches “agriculture, hunting, forestry and fisheries”, “industry”, “construction”, “trade, transport and communication” and “financial, real estate, renting and business services”.

(3) The branches “health and social work”, “community, social and personal services” and “domestic services”.

(4) Unemployed job-seekers, consisting of wholly unemployed persons receiving benefits, excluding older unemployed persons not seeking work, and other compulsorily or voluntarily registered job-seekers.

TABLE VII UNEMPLOYMENT RATE

(percentages of the corresponding labour force aged 15 to 64[1], annual averages)

								Average of the first three quarters	
	2000	2001	2002	2003	2004	2005	2006	2006	2007
Total	7.1	6.6	7.6	8.2	8.4	8.5	8.3	8.4	7.6
According to sex									
Women	8.7	7.5	8.7	8.9	9.6	9.6	9.4	9.4	8.7
Men	5.8	6.0	6.7	7.7	7.5	7.7	7.4	7.6	6.8
According to age									
15 to 24	17.4	16.9	17.7	21.7	21.1	21.5	20.5	20.7	19.3
25 to 54	6.1	5.6	6.6	7.1	7.4	7.4	7.2	7.4	6.7
55 to 64	3.0	3.1	3.9	2.8	3.8	4.5	4.8	4.9	4.4
According to educational level									
Lower secondary education or less	11.1	10.0	11.7	12.4	13.3	14.1	14.0	13.8	13.0
Upper secondary education	6.8	6.7	7.3	8.4	8.5	8.5	8.2	8.3	7.7
Higher education	3.3	3.5	4.1	4.4	4.7	4.4	4.6	4.7	3.9
According to region									
Brussels	14.0	13.0	14.7	15.8	15.9	16.5	17.7	17.7	17.5
Flanders	4.3	4.0	4.9	5.7	5.4	5.5	5.0	5.2	4.5
Wallonia	10.3	9.9	10.6	10.9	12.1	11.9	11.8	11.8	10.6

Sources: EC; DGSEI.

(1) These unemployment rates are calculated on the basis of the harmonised data taken from the labour force survey.

TABLE VIII HARMONISED INDEX OF CONSUMER PRICES

(percentage changes compared to the corresponding period of the previous year)

	Total	Energy	Unprocessed food [1]	Underlying trend in inflation [2]	Processed food	Non-energy industrial goods	Services	*p.m. National consumer price index*	*p.m. Health index* [3]
2000	2.7	16.3	0.2	1.1	1.3	0.0	2.3	*2.5*	*1.9*
2001	2.4	1.4	6.9	2.1	2.2	2.0	2.0	*2.5*	*2.7*
2002	1.6	–3.6	3.2	2.1	1.5	1.7	2.6	*1.6*	*1.8*
2003	1.5	0.2	1.7	1.7	2.8	1.0	1.9	*1.6*	*1.5*
2004	1.9	6.6	0.9	1.4	2.2	0.3	2.1	*2.1*	*1.6*
2005	2.5	12.7	1.7	1.4	2.0	0.3	2.1	*2.8*	*2.2*
2006	2.3	7.3	3.3	1.6	2.1	0.9	2.1	*1.8*	*1.8*
2007	1.8	0.2	3.0	1.9	4.7	0.9	1.9	*1.8*	*1.8*
2007 January	1.7	–0.9	5.9	1.6	3.2	0.8	1.8	*1.7*	*2.0*
February	1.8	0.3	4.3	1.7	3.5	0.8	2.0	*1.8*	*2.1*
March	1.8	–1.1	3.7	2.0	4.0	0.9	2.3	*1.8*	*1.9*
April	1.8	–2.5	5.6	2.0	4.3	0.8	2.2	*1.8*	*1.9*
May	1.3	–3.4	1.7	1.9	4.1	0.7	2.2	*1.3*	*1.3*
June	1.3	–3.5	3.2	1.7	4.0	0.6	2.0	*1.3*	*1.3*
July	1.3	–3.9	3.6	1.8	4.1	0.6	2.0	*1.4*	*1.4*
August	1.2	–4.6	1.7	1.9	4.2	1.0	1.9	*1.1*	*1.2*
September	1.4	–0.1	0.5	1.7	4.5	1.0	1.5	*1.5*	*1.3*
October	2.2	4.3	2.1	2.0	5.6	1.0	1.6	*2.2*	*1.8*
November	2.9	10.2	1.5	2.1	6.5	1.1	1.5	*2.9*	*2.2*
December	3.1	8.7	2.7	2.4	7.6	1.1	2.0	*3.1*	*2.6*

Sources: EC, DGSEI, NBB.
(1) Fruit, vegetables, meat and fish.
(2) Measured by the HICP excluding unprocessed food and energy.
(3) National consumer price index, excluding products considered harmful to health, namely tobacco, alcohol, petrol and diesel.

TABLE IX INCOMES OF THE VARIOUS SECTORS AT CURRENT PRICES[1]

(millions of euro)

	2000	2001	2002	2003	2004	2005	2006	2007 e
Households								
Gross primary income	195,945	205,226	208,125	209,178	213,902	219,841	228,475	239,004
Wages and salaries[2]	130,814	138,074	143,425	146,277	150,326	155,099	162,117	169,373
Incomes from movable property[3]	28,648	29,721	27,795	25,240	25,196	25,312	25,491	27,165
Gross mixed income	24,165	24,613	24,116	24,639	25,221	25,318	25,816	26,769
Gross operating surplus	12,318	12,818	12,789	13,022	13,160	14,113	15,051	15,697
Current transfers[3]	–37,084	–38,981	–39,588	–38,920	–39,668	–40,854	–40,264	–42,241
Transfers received	52,828	55,678	58,444	60,554	62,940	65,212	67,178	69,703
Transfers paid (–)	–89,912	–94,660	–98,032	–99,474	–102,608	–106,067	–107,442	–111,944
Gross disposable income	158,860	166,245	168,537	170,258	174,234	178,986	188,211	196,763
p.m. In real terms[4]	*176,300*	*180,419*	*180,628*	*179,420*	*179,085*	*178,986*	*183,623*	*188,178*
(percentage changes compared to the previous year)	*(1.7)*	*(2.3)*	*(0.1)*	*(–0.7)*	*(–0.2)*	*(–0.1)*	*(2.6)*	*(2.5)*
Companies								
Gross primary income	42,200	38,040	40,797	45,963	51,825	55,281	61,429	64,551
Gross operating surplus	52,433	51,805	54,528	57,539	64,842	70,801	75,028	79,178
Incomes from movable property[3]	–10,233	–13,765	–13,732	–11,576	–13,016	–15,521	–13,599	–14,627
Current transfers[3]	–6,507	–6,480	–6,549	–6,370	–7,566	–8,542	–9,953	–10,686
Gross disposable income	35,693	31,561	34,248	39,593	44,259	46,739	51,476	53,865
General government								
Gross primary income	19,291	19,539	22,114	23,389	26,559	28,521	30,588	31,380
Current transfers[3]	41,051	42,972	43,348	41,582	43,290	45,504	46,659	48,992
Gross disposable income	60,342	62,511	65,462	64,971	69,850	74,025	77,246	80,372
Rest of the world								
Gross disposable income	2,541	2,490	2,789	3,709	3,944	3,893	3,558	3,935
GNI	257,435	262,806	271,036	278,530	292,286	303,643	320,491	334,935

Sources: NAI, NBB.
(1) The data in this table are calculated in gross terms, i.e. before deduction of consumption of fixed capital.
(2) Remuneration (excluding that of owner entrepreneurs), including social security contributions and civil service pensions.
(3) These are net amounts, i.e. the difference between incomes or transfers received from other sectors and those paid to other sectors, excluding transfers in kind.
(4) Data deflated by means of the household final consumption expenditure deflator.

TABLE X SUMMARY OF THE TRANSACTIONS OF THE MAIN SECTORS OF THE ECONOMY AT CURRENT PRICES [1]

(millions of euro)

	2000	2001	2002	2003	2004	2005	2006	2007 e
1. Households								
1.1 Gross disposable income	158,860	166,245	168,537	170,258	174,234	178,986	188,211	196,763
p.m. Gross adjusted disposable income	*191,130*	*200,453*	*204,543*	*208,470*	*214,670*	*221,333*	*231,709*	*242,442*
1.2 Change in net equity of households in pension funds reserves	1,549	1,607	1,541	1,716	1,856	2,020	1,833	1,881
1.3 Final consumption expenditure	135,726	140,300	143,227	146,763	152,641	158,949	166,254	173,674
p.m. Actual final consumption	*167,995*	*174,507*	*179,233*	*184,975*	*193,077*	*201,296*	*209,752*	*219,353*
1.4 Gross savings (1.1 + 1.2 – 1.3)	24,683	27,553	26,851	25,210	23,449	22,057	23,789	24,970
p.m. Percentages of gross disposable income [2]	*15.4*	*16.4*	*15.8*	*14.7*	*13.3*	*12.2*	*12.5*	*12.6*
p.m. Percentages of gross adjusted disposable income [2]	*12.8*	*13.6*	*13.0*	*12.0*	*10.8*	*9.9*	*10.2*	*10.2*
1.5 Capital transfers [3]	–133	–569	–338	–819	–1,092	–1,231	–1,444	–1,509
1.6 Gross capital formation	13,987	13,543	14,228	14,478	16,595	18,429	20,712	22,583
1.7 Financing balance (1.4 + 1.5 – 1.6)	10,564	13,440	12,286	9,913	5,762	2,397	1,633	878
2. Companies								
2.1 Gross disposable income	35,693	31,561	34,248	39,593	44,259	46,739	51,476	53,865
2.2 Change in net equity of households in pension funds reserves	–1,547	–1,606	–1,540	–1,721	–1,853	–2,020	–1,834	–1,887
2.3 Gross savings (2.1 + 2.2)	34,146	29,954	32,708	37,872	42,406	44,718	49,642	51,978
2.4 Capital transfers [3]	1,461	645	779	–2,039	415	1,147	2,385	3,027
2.5 Gross fixed capital formation	33,478	34,839	32,613	32,531	35,401	37,487	39,551	41,957
2.6 Change in stocks	2,548	270	160	905	1,979	1,821	3,922	2,870
2.7 Financing balance (2.3 + 2.4 – 2.5 – 2.6), NAI's point of view [4]	–419	–4,509	714	2,397	5,442	6,557	8,553	10,178
3. General government								
3.1 Gross disposable income	60,342	62,511	65,462	64,971	69,850	74,025	77,246	80,372
p.m. Gross adjusted disposable income	*28,072*	*28,303*	*29,456*	*26,759*	*29,413*	*31,678*	*33,749*	*34,693*
3.2 Change in net equity of households in pension funds reserves	–2	–1	–1	5	–3	0	2	5
3.3 Final consumption expenditure	53,678	56,378	60,303	63,212	66,014	68,732	70,774	73,955
p.m. Actual final consumption	*21,409*	*22,170*	*24,297*	*25,000*	*25,577*	*26,385*	*27,276*	*28,276*
3.4 Gross savings (3.1 + 3.2 – 3.3)	6,661	6,132	5,158	1,764	3,833	5,293	6,475	6,423
3.5 Capital transfers [3]	–1,586	–418	–808	2,702	620	–110	–430	–1,489
3.6 Gross fixed capital formation	4,934	4,399	4,446	4,549	4,671	5,333	5,324	5,692
3.7 Change in stocks	8	–4	4	5	–4	3	3	3
3.8 Overall balance according to the ESA 95 (3.4 + 3.5 – 3.6 – 3.7), NAI's point of view [4]	133	1,318	–100	–87	–214	–153	718	–762
p.m. Overall balance according to the EDP [5]*, NAI's point of view* [4]	*238*	*1,458*	*33*	*41*	*39*	*227*	*915*	*–618*
p.m. Overall balance according to the EDP [5]*, Eurostat's point of view* [4]	*238*	*1,458*	*33*	*41*	*39*	*–6,846*	*1,143*	*–387*
4. Total of domestic sectors								
4.1 Overall balance (1.7 + 2.7 + 3.8)	10,277	10,250	12,899	12,224	10,990	8,801	10,904	10,295

Sources: NAI, NBB.

(1) The data in this table are calculated in gross terms, i.e. before deduction of consumption of fixed capital.

(2) Disposable income, including changes in the net equity of households in pension funds reserves.

(3) These are net amounts, i.e. the difference between transfers received from other sectors and those paid to other sectors, including net acquisitions of non-financial non-produced assets and net acquisitions of valuables.

(4) According to the NAI's point of view, the Railway Infrastructure Fund (RIF), set up in the context of the BNRC restructuring on 1 January 2005, comes under the non-financial corporations sector. According to Eurostat's point of view, the Fund is classified under the general government sector and the assumption of BNRC debt should be recorded as a capital transfer from the general government sector to the non-financial corporations sector.

(5) The ESA 95 methodology was adapted in 2001 to exclude from the calculation of the overall balance the net interest gains on certain financial transactions, such as swaps and forward rate agreements (FRAs). However, this adjustment is not taken into account for the purpose of the excessive deficit procedure (EDP) or for the EC's assessment of the stability programmes.

TABLE XI REVENUE, EXPENDITURE AND OVERALL BALANCE OF GENERAL GOVERNMENT

(millions of euro; according to the NAI's point of view, unless otherwise stated [1])

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 e
Revenue [2]	113,530	118,105	123,686	128,469	133,254	140,390	142,244	148,849	154,240	160,393
Fiscal and parafiscal revenue	102,445	106,585	111,764	115,064	119,519	121,410	128,593	133,796	139,241	144,755
Levies weighing chiefly on earned income	61,651	63,598	66,837	70,102	72,689	73,740	76,268	78,335	79,933	83,568
Personal income tax [3]	28,379	29,032	31,131	32,712	33,440	33,677	34,900	36,058	36,070	37,308
Social security contributions [4]	33,271	34,566	35,706	37,390	39,249	40,063	41,368	42,277	43,863	46,259
Taxes on profits of companies [5]	7,760	7,702	8,089	8,091	8,142	7,912	9,210	10,223	11,835	12,145
Levies on other income and in respect of property [6]	7,981	7,982	8,526	8,700	9,052	9,518	10,418	11,144	11,511	11,984
Taxes on goods and services	25,053	27,304	28,312	28,171	29,637	30,241	32,697	34,095	35,961	37,058
Non-fiscal and non-parafiscal revenue [7]	11,085	11,520	11,923	13,404	13,736	18,979	13,651	15,053	14,999	15,638
Expenditure excluding interest charges	98,465	102,978	106,845	110,304	117,901	125,763	128,550	136,149	140,953	148,531
Social insurance benefits	50,127	51,680	53,737	56,506	59,654	63,109	66,421	68,933	70,938	74,682
Replacement incomes	29,403	30,023	30,748	32,120	34,291	35,812	37,334	38,624	39,891	41,965
Pensions	19,710	20,250	20,968	21,866	22,942	23,812	24,803	25,743	26,678	28,466
Private sector pensions	13,810	14,149	14,549	15,110	15,722	16,253	16,690	17,346	17,843	18,466
General government pensions	5,900	6,101	6,418	6,757	7,220	7,559	8,112	8,397	8,835	10,000
Old persons' guaranteed income	231	227	249	258	258	264	283	276	269	330
Early retirement pensions	1,254	1,215	1,163	1,153	1,144	1,184	1,239	1,257	1,301	1,377
Unemployment benefits	4,520	4,504	4,381	4,637	5,356	5,747	6,024	6,121	6,082	5,844
Career breaks and time credit	160	197	236	274	352	432	488	556	610	648
Sickness and disability insurance benefits	2,635	2,722	2,840	3,023	3,208	3,366	3,485	3,636	3,846	4,159
Industrial accidents and occupational diseases	494	485	486	489	495	494	495	503	507	512
Integration allowance	399	424	426	420	536	514	517	532	600	630
Other social insurance benefits [8]	20,724	21,657	22,989	24,386	25,364	27,297	29,087	30,309	31,047	32,717
of which:										
Health care	12,521	13,208	13,999	15,027	15,372	16,745	18,053	18,896	19,279	20,556
Family allowances	4,241	4,261	4,324	4,433	4,564	4,637	4,731	4,845	5,015	5,166
Other primary expenditure	48,339	51,298	53,108	53,797	58,247	62,655	62,129	67,217	70,016	73,849
Compensation of employees	26,836	28,032	29,039	30,326	32,532	33,833	34,721	36,186	37,481	38,820
Current purchases of goods and services	7,470	7,775	8,193	8,688	10,099	10,291	10,605	10,896	11,446	11,944
Subsidies to enterprises	2,845	3,046	3,199	3,335	3,345	3,818	3,539	4,942	5,540	6,480
Current transfers to the rest of the world	1,791	2,018	2,006	2,167	2,427	2,758	3,085	3,192	3,301	3,311
Other current transfers	2,853	2,879	2,871	3,044	3,177	3,484	3,696	3,888	4,209	3,771
Gross fixed capital formation	3,838	4,658	4,934	4,399	4,446	4,549	4,671	5,333	5,324	5,692
Other capital expenditure	2,706	2,890	2,866	1,839	2,222	3,921	1,813	2,779	2,715	3,829
Net amount excluding interest charges	15,065	15,127	16,841	18,165	15,353	14,626	13,694	12,700	13,287	11,862
Interest charges	16,906	16,332	16,709	16,847	15,454	14,713	13,908	12,853	12,569	12,623
Overall balance according to the ESA 95, NAI's point of view [1]	–1,841	–1,205	133	1,318	–100	–87	–214	–153	718	–762
p.m. Overall balance according to the EDP [9], NAI's point of view [1]	*–1,755*	*–1,188*	*238*	*1,458*	*33*	*41*	*39*	*227*	*915*	*–618*
p.m. Overall balance according to the EDP [9], Eurostat's point of view [1]	*–1,755*	*–1,188*	*238*	*1,458*	*33*	*41*	*39*	*–6,846*	*1,143*	*–387*

Sources: EC, NAI, NBB.

(1) According to the NAI's point of view, the Railway Infrastructure Fund (RIF), set up in the context of the BNRC restructuring on 1 January 2005, comes under the non-financial corporations sector. According to Eurostat's point of view, the Fund is classified under the general government sector and the assumption of the BNRC debt should be recorded as a capital transfer from the general government sector to the non-financial corporations sector.

(2) In accordance with the ESA 95, general government revenues do not include the tax revenues transferred to the EU.

(3) Mainly withholding tax on earned income, advance payments, assessments and proceeds of additional percentages on personal income tax.

(4) Total social contributions, including the special social security contribution and the contributions of non-active persons.

(5) Mainly advance payments, assessments and the withholding tax on income from movable property payable by companies.

(6) Mainly the withholding tax on income from movable property payable by households, the withholding tax on income from immovable property (including proceeds of additional percentages), inheritance taxes and registration fees.

(7) Property incomes, imputed social security contributions, current and capital transfers from other sectors and sales of produced goods and services.

(8) Apart from the two main sub-categories mentioned in the table, this item also includes mainly allowances to handicapped persons and transfers to the institutions accommodating them, payments by subsistence funds and pensions to war victims.

(9) The ESA 95 methodology was adapted in 2001 to exclude from the calculation of the overall balance the net interest gains on certain financial transactions, such as swaps and forward rate agreements (FRAs). However, this adjustment is not taken into account for the purpose of the excessive deficit procedure (EDP) or for the EC's assessment of the stability programmes.

TABLE XII OVERALL BALANCE OF GENERAL GOVERNMENT, BY SUB-SECTORS

(millions of euro; according to the NAI's point of view, unless otherwise stated (1))

	Entity I			Entity II			General government		
	Federal government	Social security	Total	Communities and regions	Local authorities	Total	According to the ESA 95, NAI's point of view (1)	*p.m. According to the EDP (2), NAI's point of view (1)*	*p.m. According to the EDP (2), Eurostat's point of view (1)*
1998	–3,631	872	–2,759	696	222	918	–1,841	*–1,755*	*–1,755*
1999	–3,725	1,554	–2,171	921	45	966	–1,205	*–1,188*	*–1,188*
2000	–1,096	1,345	249	610	–727	–117	133	*238*	*238*
2001	–2,258	1,795	–463	1,953	–172	1,781	1,318	*1,458*	*1,458*
2002	–602	1,360	757	–382	–476	–858	–100	*33*	*33*
2003	810	–737	73	26	–186	–160	–87	*41*	*41*
2004	–559	153	–406	651	–459	192	–214	*39*	*39*
2005	–560	–29	–589	823	–386	436	–153	*227*	*–6,846*
2006	–158	971	813	622	–717	–96	718	*915*	*1,143*
2007 e	–3,436	1,800	–1,637	842	33	875	–762	*–618*	*–387*

Sources: EC, NAI, NBB.

(1) According to the NAI's point of view, the Railway Infrastructure Fund (RIF), set up in the context of the BNRC restructuring on 1 January 2005, comes under the non-financial corporations sector. According to Eurostat's point of view, the Fund is classified under the general government sector and the assumption of the BNRC debt should be recorded as a capital transfer from the general government sector to the non-financial corporations sector.

(2) The ESA 95 methodology was adapted in 2001 to exclude from the calculation of the overall balance the net interest gains on certain financial transactions, such as swaps and forward rate agreements (FRAs). However, this adjustment is not taken into account for the purpose of the excessive deficit procedure (EDP) or for the EC's assessment of the stability programmes.

TABLE XIII CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT [1]

(end-of-period outstanding amounts, millions of euro; according to the NAI's point of view, unless otherwise stated [2])

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Official debt of the Treasury	241,903	246,755	251,061	257,163	262,752	263,018	265,518	269,160	270,601	285,226
In national currency [3]	224,523	236,314	242,455	250,085	257,288	259,295	263,074	267,420	269,145	284,288
At up to one year	41,888	36,553	33,310	34,851	31,115	30,222	30,355	31,036	32,243	37,891
At over one year	182,635	199,762	209,144	215,234	226,173	229,073	232,719	236,384	236,902	246,397
In foreign currencies	17,380	10,441	8,606	7,079	5,464	3,724	2,444	1,740	1,456	937
2. Components of the official debt of the Treasury not included in the consolidated gross debt [4]	3,321	4,595	5,429	4,572	3,996	3,459	0	0	0	0
3. Other federal government liabilities [5]	12,640	12,982	11,533	14,034	13,843	8,528	7,760	7,288	6,901	4,435 e
4. Consolidation between federal government units [6]	3,116	3,792	4,189	7,745	12,974	17,358	21,246	22,649	21,454	30,767 e
of which: Ageing Fund assets [7]	–	–	–	374	1,087	4,266	12,492	13,504	14,661	15,494
5. Consolidated gross debt of federal government (1 – 2 + 3 – 4)	248,105	251,351	252,975	258,881	259,624	250,729	252,032	253,799	256,048	258,893 e
6. Consolidated gross debt of communities and regions	19,416	18,376	17,165	16,800	16,878	15,414	15,003	13,202	12,752	n.
7. Consolidated gross debt of local authorities	12,121	12,163	13,213	14,179	14,446	14,860	15,677	15,747	16,410	n.
8. Consolidated gross debt of social security	1,774	1,429	1,237	0	103	90	52	428	0	n.
9. Consolidation between the general government sub-sectors [8]	12,590	12,640	13,300	14,032	14,263	10,128	9,737	10,149	10,957	n.
10. Consolidated gross debt of general government [1] (5 + 6 + 7 + 8 – 9)	268,827	270,679	271,291	275,827	276,788	270,965	273,026	273,027	274,254	276,927 e
p.m. Consolidated gross debt of general government according to Eurostat's point of view [2]	*268,827*	*270,679*	*271,291*	*275,827*	*276,788*	*270,965*	*273,026*	*278,273*	*279,236*	*281,455 e*

Sources: EC, FPS Finance, NBB.

(1) Concept of debt as defined in Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.
(2) According to the NAI's point of view, the RIF, set up in the context of the BNRC restructuring on 1 January 2005, comes under the non-financial corporations sector. According to Eurostat's point of view, that Fund is classified in the general government sector.
(3) In Belgian franc for 1998 and in euro thereafter.
(4) Mainly Treasury certificates presented to the IMF.
(5) Mainly the debudgeted Treasury debt, the debts of the *Caisse des dépôts et Consignations*, SHLAF (up to 2006), and CREDIBE (until 2002), and coins in circulation.
(6) Federal government debt, the counterpart of which is an asset of a federal government unit.
(7) Including the capitalised interest on "Ageing Fund Treasury Bonds".
(8) Debt of a general government sub-sector, the counterpart of which is an asset of another general government sub-sector.

TABLE XIV CURRENT AND CAPITAL TRANSACTIONS ON A TRANSACTION BASIS

(millions of euro)

	2005			2006			First nine months 2007		
	Credits	Debits	Balances	Credits	Debits	Balances	Credits	Debits	Balances
1. Total current transactions on a transaction basis	311,394	303,535	7,859	334,385	325,953	8,432	271,762	263,638	8,124
Goods and services	256,498	247,781	8,717	271,407	263,690	7,717	217,503	211,100	6,403
Goods	211,341	206,624	4,717	223,967	221,385	2,582	176,105	173,318	2,787
General merchandise	197,910	195,336	2,574	209,556	209,306	250	164,942	164,294	648
Goods for processing	11,531	10,318	1,213	12,114	10,786	1,328	9,868	8,080	1,788
Repairs to goods	311	208	103	320	242	78	347	184	163
Purchases of goods in ports	1,427	505	922	1,604	611	993	921	661	260
Non-monetary gold	162	257	–95	373	440	–67	27	99	–72
Services	45,157	41,157	4,000	47,440	42,305	5,135	41,398	37,782	3,616
Transport	11,149	9,868	1,281	12,459	10,375	2,084	13,055	10,965	2,090
Travel	7,932	12,049	–4,117	8,144	12,298	–4,154	6,121	9,569	–3,448
Communication	1,769	1,065	704	1,623	1,270	353	2,052	1,642	410
Construction	1,533	682	851	1,770	748	1,022	525	388	137
Insurance	671	409	262	737	436	301	559	431	128
Financial services	2,727	2,810	–83	2,877	2,751	126	1,879	1,364	515
Data-processing and information services	2,075	1,500	575	2,288	1,581	707	1,574	1,137	437
Royalties and licence fees	1,095	844	251	1,228	859	369	597	1,003	–406
Other services to enterprises	14,133	10,940	3,193	14,035	10,904	3,131	11,691	8,711	2,980
of which: merchanting (net)	1,468	–	1,468	1,408	–	1,408	3,478	–	3,478
Personal, cultural and recreational services	417	375	42	444	396	48	210	300	–90
Services provided or received by general government, not included elsewhere	1,656	615	1,041	1,835	687	1,148	1,057	121	936
Services not allocated	–	–	–	–	–	–	2,078	2,151	–73
Income	47,366	43,133	4,233	55,967	49,930	6,037	50,303	43,917	6,386
Earned income	5,522	1,619	3,903	5,754	1,673	4,081	4,125	1,421	2,704
Income from direct and portfolio investment	41,844	41,514	330	50,213	48,257	1,956	46,178	42,496	3,682
Current transfers	7,530	12,621	–5,091	7,011	12,333	–5,322	3,956	8,621	–4,665
General government	2,657	6,428	–3,771	2,387	6,641	–4,254	1,260	4,848	–3,588
Other sectors	4,873	6,193	–1,320	4,624	5,692	–1,068	2,696	3,773	–1,077
2. Total capital transactions	319	1,041	–722	768	1,104	–336	311	875	–564
Capital transfers	314	822	–508	179	572	–393	147	351	–204
Acquisitions and sales of non-produced non-financial assets	5	219	–214	589	532	57	164	524	–360
3. Net lending to the rest of the world (1 + 2)	311,713	304,576	7,137	335,153	327,057	8,096	272,073	264,513	7,560

Source: NBB.

TABLE XV FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF HOUSEHOLDS

(millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	First nine months 2006	First nine months 2007	*p.m. Outstanding amount at the end of September 2007*
Formation of financial assets	27,933	21,051	16,767	17,170	17,454	16,416	20,837	16,319	17,989	10,310	17,049	*854,551*
At up to one year	3,914	–600	384	9,300	3,125	10,693	19,817	12,468	9,935	5,924	4,302	*238,078*
Notes, coins and sight deposits	1,236	3,775	2,117	–3,606	4,383	3,537	6,752	6,050	1,228	1,289	433	*53,648*
Savings deposits	4,520	3,422	–5,129	5,554	11,543	17,934	14,180	8,335	1,740	1,245	–9,542	*140,757*
Time deposits	300	–7,138	3,622	5,730	–11,993	–8,588	–1,734	–2,627	8,740	4,433	12,745	*38,453*
Fixed-income securities	–484	–135	252	575	–1,258	–357	–244	–113	238	186	707	*1,339*
Units of monetary UCIs	–1,660	–524	–479	1,046	450	–1,832	862	824	–2,011	–1,230	–41	*3,881*
At over one year	30,798	25,312	18,631	16,568	7,759	8,683	7,174	10,553	18,593	4,553	10,618	*625,794*
Time deposits	–279	–279	–467	223	–503	–627	–371	–637	35	6	1,159	*4,212*
Fixed-income securities	–15	5,644	818	–4,092	–8,536	–15,359	–16,720	–13,667	–7,381	–9,648	–1,600	*73,077*
Shares and other equity	5,363	1,573	–1,362	771	2,831	–714	870	–6,769	4,281	–24	951	*216,477*
Units of non-monetary UCIs	17,558	10,143	8,079	9,036	3,589	9,879	5,772	9,106	8,363	5,086	332	*132,010*
Insurance technical reserves (1)	8,172	8,232	11,562	10,630	10,379	15,504	17,623	22,519	13,295	9,133	9,777	*200,017*
Other assets and statistical adjustments (2)	–6,778	–3,661	–2,247	–8,697	6,569	–2,960	–6,153	–6,703	–10,538	–167	2,129	*–9,321*
New financial liabilities	6,299	5,355	2,121	–2,167	4,137	5,501	6,317	11,901	12,356	8,310	7,998	*160,088*
Loans at up to one year	581	1,601	–659	–1,203	280	–998	–167	811	–54	72	171	*6,096*
Loans at over one year	5,141	3,040	3,191	557	4,331	6,505	5,864	11,419	11,867	8,720	9,110	*146,759*
Mortgage loans	2,568	5,473	2,360	394	4,947	6,165	6,333	10,037	10,748	7,798	8,027	*119,133*
Instalment loans	1,399	326	588	354	325	–208	–481	648	278	524	1,131	*14,042*
Other	1,174	–2,759	243	–191	–941	548	12	735	841	398	–48	*13,584*
Other liabilities (3)	577	714	–410	–1,521	–474	–5	620	–329	543	–482	–1,283	*7,233*
Financial balance (4)	21,634	15,696	14,646	19,338	13,317	10,916	14,520	4,418	5,634	2,000	9,051	*694,463*

Source: NBB.

(1) This item essentially comprises the net claims of households on insurance technical reserves and on pension funds.

(2) This item covers, in so far as they can be recorded, financial derivatives and miscellaneous assets on financial institutions, including interest accrued and not due. It also covers errors and omissions on Belgium's financial account with the rest of the world. To maintain consistency between the accounts, these are regarded as unrecorded capital movements.

(3) This item comprises other accounts payable within the meaning of the ESA 95, such as taxes or contributions due but not yet paid, or interest accrued and not due.

(4) The balances of the financial accounts of the domestic sectors do not correspond to the net financing capacities or requirements as recorded in the real accounts, owing to the differences between the dates of recording of the transactions in these two accounts, statistical adjustments or errors and omissions. Thus, for example, the financial accounts cannot, for lack of data, record most of the trade credits and advances.

TABLE XVI FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

(millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	First nine months 2006	First nine months 2007	*p.m. Outstanding amount at the end of September 2007*
Formation of financial assets	34,751	44,011	80,953	60,702	27,018	58,834	23,536	21,208	46,395	41,928	53,576	*1,059,860*
At up to one year	31,271	30,675	49,386	44,485	2,182	39,746	–8,448	16,278	19,975	14,592	5,284	*314,334*
Notes, coins and sight deposits	3,431	865	156	502	805	1,916	1,346	2,129	4,984	2,396	2,839	*39,290*
Other deposits	2,096	8,180	–2,747	1,810	6,133	–189	3,600	–602	18,422	16,095	4,440	*63,993*
Other (1)	25,743	21,629	51,977	42,173	–4,756	38,019	–13,394	14,751	–3,432	–3,899	–1,994	*211,052*
At over one year	9,382	8,570	34,114	11,698	18,708	22,026	29,345	13,453	25,056	30,303	35,380	*745,784*
Shares and other equity (2)	7,263	1,098	19,432	4,298	–2,832	–951	17,220	10,949	2,498	6,963	24,941	*562,542*
Fixed-income securities	1,011	–329	–922	–156	2,038	–1,546	–1,236	1,458	–2,859	1,370	54	*4,753*
Other (1)	1,108	7,801	15,603	7,557	19,502	24,523	13,362	1,046	25,417	21,970	10,385	*178,489*
Other assets and statistical adjustments (3)	–5,902	4,766	–2,547	4,520	6,128	–2,938	2,639	–8,522	1,365	–2,967	12,911	*–258*
New financial liabilities	41,881	46,680	82,039	69,938	27,520	57,125	27,137	14,196	40,798	31,227	53,064	*1,367,594*
At up to one year	24,342	19,354	39,417	25,663	–4,429	23,416	–11,591	2,700	1,258	1,140	17,051	*226,543*
Loans granted by credit institutions	5,720	5,441	590	–1,276	–551	–2,103	2,508	–6,358	2,639	4,819	16,792	*67,479*
Other loans (1)	17,916	12,480	35,682	25,433	–5,021	23,509	–13,442	11,377	–626	–2,653	–3,392	*150,645*
Fixed-income securities	706	1,433	3,146	1,506	1,143	2,009	–657	–2,319	–755	–1,026	3,650	*8,419*
At over one year	16,383	25,786	42,272	43,668	33,288	32,870	38,335	12,069	38,290	29,229	38,528	*1,135,090*
Loans granted by credit institutions	2,283	4,229	4,549	3,486	2,296	–4,501	1,899	6,092	2,762	–1,460	3,627	*68,645*
Other loans (1)	1,012	7,154	12,442	6,536	20,354	24,850	7,652	846	–1,291	2,752	9,312	*145,237*
Shares and other equity (2)	11,818	12,968	25,876	27,955	9,010	5,716	22,680	9,315	35,068	27,763	28,300	*896,142*
Fixed-income securities	1,271	1,436	–595	5,691	1,628	6,805	6,104	–4,183	1,752	174	–2,710	*25,065*
Other liabilities (4)	1,155	1,540	350	606	–1,340	840	393	–573	1,249	858	–2,515	*5,962*
Financial balance (5)	–7,130	–2,668	–1,087	–9,235	–502	1,709	–3,601	7,012	5,597	10,700	512	*–307,734*

Source: NBB.
(1) Including intrasectoral loans of non-financial corporations.
(2) Including reinvested profits made on foreign direct investments.
(3) See note 2 to table XV.
(4) This item comprises the technical reserves of non-autonomous pension funds and other accounts payable within the meaning of the ESA 95, such as taxes or contributions due but not yet paid, or interest accrued and not due.
(5) See note 4 to table XV.

TABLE XVII FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF GENERAL GOVERNMENT

(millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005 (1)	2006	First nine months 2006	First nine months 2007	*p.m. Outstanding amount at the end of September 2007*
Formation of financial assets	–878	1,801	1,139	5,086	4,432	–4,067	3,982	2,682	1,505	–329	9,507	*91,471*
Deposits, loans and securities other than shares	55	1,575	1,496	3,290	5,153	–3,895	3,854	3,181	–794	–2,697	8,440	*49,694*
With general government	38	516	1,154	4,400	5,556	1,678	3,606	1,742	–347	–3,755	873	*33,494*
With other sectors	17	1,059	342	–1,111	–404	–5,573	248	1,439	–447	1,058	7,567	*16,200*
Other assets (2)	–933	226	–357	1,797	–720	–173	128	–499	2,299	2,369	1,066	*41,778*
New financial liabilities	1,466	2,686	2,076	5,392	5,676	–4,663	3,890	2,509	772	3,468	14,193	*333,625*
In national currency (3)	3,535	2,791	3,926	6,769	6,890	–3,381	5,251	3,208	922	2,451	14,186	*332,219*
At up to one year	–4,942	–5,407	–4,630	–520	206	–372	–1,834	869	1,041	4,652	6,670	*54,881*
of which:												
Treasury certificates	–5,832	–6,807	–3,483	1,383	57	–840	–143	853	99	3,807	6,989	*33,961*
Other securities	1,147	–221	–795	–1,959	–82	594	–504	–160	89	359	2,778	*4,904*
At over one year	8,477	8,198	8,555	7,289	6,684	–3,009	7,085	2,340	–119	–2,201	7,516	*277,338*
of which:												
Linear bonds	8,552	14,455	15,073	12,570	11,628	7,790	4,968	4,125	–14	–1,114	9,096	*223,321*
Other securities	318	–5,415	–6,427	–6,442	–5,778	–9,579	–5,929	–2,370	–1,361	–965	–1,087	*12,179*
In foreign currencies	–2,069	–105	–1,849	–1,377	–1,214	–1,282	–1,361	–699	–150	1,017	7	*1,407*
At up to one year	–887	1,517	–397	372	–164	–762	–50	–329	–77	1,017	7	*467*
At over one year	–1,183	–1,622	–1,452	–1,748	–1,050	–520	–1,310	–370	–73	0	0	*940*
Financial balance (4)	–2,345	–885	–937	–306	–1,243	596	92	173	733	–3,796	–4,686	*–242,154*

Source: NBB.

(1) Data compiled according to the NAI's point of view, whereby the RIF is treated as a non-financial corporation rather than as a government authority in accordance with Eurostat's point of view. In 2005, both the formation of financial assets and the new financial liabilities were influenced by operations concerning the assumption of BNRC debt by the RIF. Those operations consisted in the State's refinancing of part of the debt in the sum of 1.9 billion euro, and the registration of a claim on the RIF for a corresponding amount. There was therefore no effect on the financial balance.

(2) Shares and other equity, UCI units, financial derivatives and other accounts receivable.

(3) In Belgian franc for 1998 and in euro thereafter.

(4) See note 4 to table XV.

TABLE XVIII FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF MONETARY FINANCIAL INSTITUTIONS (1)

(data on a territorial basis, millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	First nine months 2006	First nine months 2007	*p.m. Outstanding amount at the end of September 2007*
Formation of financial assets												
Interbank claims	–536	5,672	–47,874	317	15,680	59,190	48,115	58,245	47,903	–638	59,994	*458,940*
Belgian MFIs	2,055	4,118	–26,509	–5,436	–6,903	8,112	7,093	15,998	2,901	–6,453	–4,537	*62,261*
Foreign MFIs	–2,591	1,554	–21,366	5,753	22,583	51,078	41,022	42,248	45,003	5,815	64,531	*396,679*
Loans (2)	6,519	15,448	12,484	14,280	21,091	14,943	19,465	51,718	31,170	1,030	25,279	*404,164*
of which:												
Households	4,913	4,999	2,051	76	3,284	5,625	6,734	13,367	12,129	9,498	4,617	*130,448*
Non-financial corporations	3,151	5,510	2,271	1,207	–1,364	–7,315	–1,394	1,261	427	185	14,888	*92,284*
Fixed-income securities	1,591	14,142	–12,309	28,201	–11,605	1,888	8,974	10,181	–8,142	–720	–7,083	*222,841*
of which:												
General government	1,245	–12,560	–18,540	–9,405	–8,062	–8,226	–5,683	–545	–4,717	–1,574	–8,462	*53,981*
Rest of the world	3,428	25,291	5,917	38,209	–2,421	9,753	14,408	11,490	–3,678	1,510	–336	*161,813*
Other assets	5,534	9,466	9,238	4,381	–1,538	8,382	29,470	7,858	21,770	17,029	22,776	*182,974*
Total	13,108	44,727	–38,462	47,180	23,628	84,403	106,024	128,003	92,702	16,701	100,967	*1,268,918*
Households	4,940	5,265	1,803	–1,777	3,082	5,665	6,718	13,345	12,274	9,581	4,804	*132,221*
Non-financial corporations	3,862	5,590	3,424	1,047	–4,206	–6,042	–2,127	1,167	10,621	1,039	15,196	*98,257*
General government	973	–12,806	–19,214	–10,814	–9,454	–8,204	–6,294	–1,036	–4,201	–1,231	–7,855	*81,702*
Financial institutions	174	10,500	–22,902	–4,507	–5,477	22,944	27,971	13,859	25,539	16,874	22,643	*209,588*
Rest of the world	3,160	36,177	–1,572	63,230	39,683	70,040	79,755	100,668	48,469	–9,562	66,178	*747,150*
New financial liabilities												
Interbank liabilities	3,202	17,513	–57,890	17,583	786	57,646	48,231	89,243	74,571	9,047	25,429	*515,516*
Belgian MFIs	2,055	4,118	–26,509	–5,436	–6,903	8,112	7,093	15,998	2,901	–6,453	–4,537	*62,261*
Foreign MFIs	1,147	13,394	–31,381	23,019	7,689	49,534	41,138	73,246	71,670	15,499	29,966	*453,255*
Cash and deposits (2)	18,884	16,814	4,808	27,834	22,917	21,277	40,030	47,655	7,115	3,581	36,611	*487,150*
of which:												
Households	7,595	3,927	303	5,820	7,219	10,622	15,513	13,739	9,828	5,389	4,793	*213,932*
Non-financial corporations	2,751	2,141	–395	2,151	5,069	1,340	–372	1,047	10,159	6,275	3,333	*68,039*
Fixed-income securities	–12,447	–602	4,792	–5,777	–4,119	–8,900	–5,499	–9,558	–409	423	9,791	*61,037*
Savings notes	–7,332	–5,905	–3,051	–4,790	–4,033	–6,976	–7,357	–7,280	–2,863	–2,126	403	*28,581*
Other fixed-income securities	–5,115	5,303	7,843	–987	–86	–1,924	1,858	–2,278	2,454	2,549	9,388	*32,456*
Other liabilities and statistical adjustments (3)	3,469	11,003	9,828	7,539	4,043	14,379	23,262	663	11,426	3,650	29,136	*205,215*
Total	13,108	44,727	–38,462	47,180	23,628	84,403	106,024	128,003	92,702	16,701	100,967	*1,268,918*
Households	494	2,101	–543	–1,842	5,122	3,771	6,713	6,187	8,555	6,674	8,969	*262,688*
Non-financial corporations	–14,401	10,397	–3,854	5,965	7,049	414	–3,422	–189	22,244	9,769	3,314	*53,008*
General government	–1,975	–998	212	–35	–1,218	–56	–182	–28	–599	870	2,334	*13,885*
Financial institutions	23,493	13,924	–19,056	–1,697	–7,469	22,648	37,038	20,476	3,015	–512	19,588	*255,940*
Rest of the world	5,496	19,304	–15,220	44,789	20,145	57,627	65,877	101,556	59,488	–100	66,762	*683,397*

Source: NBB.

(1) Credit institutions, monetary UCIs and monetary authorities.

(2) Other than those included in interbank transactions.

(3) Statistical adjustments are due to the equalisation of the total of financial assets and liabilities, Belgian MFIs being treated as pure financial intermediaries.

TABLE XIX FORMATION OF ASSETS AND NEW LIABILITIES OF FINANCIAL INTERMEDIARIES OTHER THAN MONETARY INSTITUTIONS

(millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	First nine months 2006	First nine months 2007	*p.m. Outstanding amount at the end of September 2007*
Non-monetary UCIs												
Formation of financial assets	13,709	14,850	18,524	12,110	3,886	4,029	6,240	6,492	7,935	7,463	3,844	*126,182*
Deposits	5,091	5,291	1,264	2,041	2,957	2,390	1,994	1,860	–655	778	–4,257	*24,670*
Fixed-income securities	2,278	2,023	4,281	1,529	203	–487	4,728	–1,123	3,130	1,538	6,272	*29,966*
Shares and other equity (1)	3,749	5,768	9,630	5,444	1,753	338	–2,465	414	–1,222	–389	–3,109	*38,480*
UCI units	1,770	2,255	3,334	1,962	–2,653	204	–5	5,856	5,058	4,801	618	*20,904*
Other assets	821	–487	15	1,134	1,627	1,583	1,988	–515	1,624	736	4,321	*12,162*
New financial liabilities	13,709	14,850	18,524	12,110	3,886	4,029	6,240	6,492	7,935	7,463	3,844	*126,182*
UCI units held by Belgian households	12,503	11,944	11,046	8,820	5,237	5,905	4,265	1,077	5,515	2,105	–2,588	*86,428*
UCI units held by other investors	1,206	2,906	7,478	3,290	–1,350	–1,876	1,975	5,415	2,420	5,357	3,342	*34,298*
Other assets	–	–	–	–	–	–	–	–	–	–	3,090	*5,456*
Insurance companies and pension funds												
Formation of financial assets	6,872	9,222	8,994	9,971	10,508	16,405	20,418	22,480	15,473	10,389	19,762	*235,688*
Deposits	–561	599	296	420	1,748	3,311	2,589	63	–1,010	–2,566	4,382	*16,144*
Fixed-income securities	3,483	4,171	363	3,115	1,733	11,729	14,867	16,002	14,952	9,039	10,572	*121,458*
Loans	–604	87	157	551	376	–87	–104	–649	315	865	1,332	*11,732*
Shares and other equity	4,093	–36	514	518	3,470	–1,250	76	2,127	–1,370	457	1,921	*35,561*
UCI units	729	4,048	7,168	4,431	2,978	2,206	2,538	4,250	2,330	2,826	1,762	*41,949*
Other assets	–268	354	497	935	203	495	452	688	255	–232	–207	*8,844*
New financial liabilities	6,872	9,179	11,067	10,676	10,774	16,382	20,396	23,965	16,634	10,988	18,626	*243,312*
Net claims of households on life insurance reserves and pension funds reserves	6,242	7,422	9,387	9,315	8,585	13,027	15,121	20,210	11,328	8,088	9,646	*164,877*
Other insurance technical reserves	666	527	557	637	1,069	1,580	2,197	1,838	1,757	1,359	439	*28,415*
Other liabilities	–36	1,230	1,123	725	1,119	1,775	3,078	1,917	3,549	1,541	8,541	*50,020*
Other (2)												
Formation of financial assets	27,217	16,649	6,211	5,026	7,612	5,778	–4,036	4,773	29,600	27,112	16,958	*214,636*
Deposits	221	848	150	711	–299	3,587	95	1,768	299	3,948	783	*6,404*
Loans	–431	103	2,156	1,250	3,200	1,595	267	805	14,575	13,878	5,256	*48,946*
Shares and other equity	27,153	16,102	3,131	2,099	3,671	–1,619	–2,461	1,907	3,515	447	2,637	*135,255*
Other assets	274	–405	775	965	1,040	2,215	–1,936	293	11,212	8,839	8,281	*24,031*
New financial liabilities	27,825	16,498	6,483	3,866	6,020	6,798	–3,993	6,091	29,499	27,878	14,476	*217,768*
Loans	–461	1,337	2,253	3,450	799	8,313	–3,880	1,497	9,157	8,827	5,712	*37,074*
Shares and other equity	27,945	12,938	4,624	1,177	2,901	–68	–63	4,165	18,977	18,709	6,345	*163,857*
Other liabilities	341	2,223	–394	–761	2,319	–1,447	–51	429	1,365	342	2,419	*16,837*

Sources: Belgian Association of Pension Institutions, BEAMA, CBFA, NBB.

(1) Including real estate certificates.

(2) Financial holding companies, real estate investment funds with fixed capital (Sicafi), private closed-end equity funds (Pricaf), undertakings for investment in claims, mortgage companies, regional social housing companies, finance companies, investment firms and UCI management companies.

TABLE XX NET ISSUES OF SECURITIES[1] BY FINANCIAL[2] AND NON-FINANCIAL CORPORATIONS AND GENERAL GOVERNMENT

(millions of euro)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	First nine months 2006	First nine months 2007	*p.m. Outstanding amount at the end of September 2007*
Fixed-income securities	–474	4,163	9,386	6,274	5,315	–4,466	–2,454	–13,538	1,151	3,208	29,877	*383,854*
Financial and non-financial corporations	–2,565	2,938	6,844	1,393	704	–1,146	511	–15,287	2,488	105	12,093	*108,082*
Securities at up to one year	1,093	5,851	7,759	–1,212	1,386	631	888	–3,525	–1,391	–1,703	4,436	*19,994*
Securities at over one year	–3,658	–2,913	–916	2,605	–682	–1,777	–377	–11,762	3,879	1,808	7,657	*88,088*
General government	2,091	1,225	2,542	4,881	4,611	–3,320	–2,965	1,749	–1,337	3,104	17,785	*275,772*
Securities at up to one year	–5,597	–6,194	–4,652	501	–189	–1,011	–693	364	111	5,183	9,775	*39,332*
Securities at over one year	7,688	7,419	7,194	4,380	4,800	–2,309	–2,272	1,385	–1,448	–2,079	8,010	*236,440*
Shares	41,075	26,579	30,952	29,415	12,485	4,415	22,894	13,482	57,200	49,550	36,657	*1,164,266*
Listed shares	12,503	9,367	7,939	5,711	1,048	818	4,182	5,407	5,646	2,994	3,010	*235,171*
Unlisted shares and other equity[3]	28,571	17,212	23,014	23,704	11,437	3,598	18,712	8,075	51,554	46,556	33,647	*929,096*
p.m. Recourse by financial and non-financial corporations to the securities market	*38,510*	*29,517*	*37,796*	*30,808*	*13,189*	*3,269*	*23,404*	*–1,805*	*59,688*	*49,655*	*48,749*	*1,272,348*

Sources: CBFA, Euronext Brussels, NBB.
(1) Excluding derivatives and units of UCIs.
(2) Excluding the Eurosystem.
(3) Including reinvested profits on direct investments effected in Belgium by foreign companies.

TABLE XXI **INTEREST RATES**

(end of quarter, annual percentages)

		Yield on the interbank market		Yield on the Belgian secondary market in securities issued by Belgian general government				
		Overnight [1]	Three-month [2]	Three-month Treasury certificates	Linear bonds			Rates of the ten-year benchmark linear bond
					At one year	At two years	At five years	
2003	I	2.66	2.52	2.42	2.27	2.53	3.31	4.18
	II	2.38	2.15	2.02	1.94	2.21	3.02	3.94
	III	2.10	2.13	2.02	2.03	2.36	3.25	4.09
	IV	2.32	2.12	2.00	2.18	2.62	3.60	4.34
2004	I	2.06	1.96	1.87	1.89	2.23	3.16	4.10
	II	2.13	2.12	2.03	2.28	2.72	3.68	4.44
	III	2.09	2.15	2.02	2.28	2.59	3.36	4.06
	IV	2.21	2.16	2.00	2.23	2.47	3.07	3.68
2005	I	2.12	2.15	2.03	2.24	2.48	3.09	3.73
	II	2.17	2.11	2.00	1.98	2.08	2.53	3.22
	III	2.15	2.18	2.03	2.20	2.35	2.72	3.19
	IV	2.42	2.49	2.27	2.68	2.80	3.04	3.32
2006	I	2.62	2.82	2.62	3.04	3.25	3.59	3.82
	II	2.89	3.06	2.82	3.33	3.55	3.87	4.09
	III	3.10	3.42	3.17	3.55	3.56	3.59	3.69
	IV	3.69	3.73	3.49	3.82	3.87	3.92	3.99
2007	I	3.90	3.92	3.78	4.01	4.02	4.02	4.11
	II	4.14	4.18	4.01	4.35	4.50	4.54	4.63
	III	4.16	4.79	3.93	4.04	4.18	4.26	4.49
	IV	3.92	4.68	3.79	4.13	4.11	4.22	4.47

Sources: ECB, NBB.

(1) The weighted average interest rate on the interbank market of the euro area for unsecured overnight transactions (i.e. transactions not backed by securities) in euro (Eonia).

(2) Average interest rate offered on the interbank market of the euro area for unsecured three-month transactions in euro (Euribor).

TABLE XXII MAIN INTEREST RATES OF THE EUROSYSTEM

(annual percentages)

Year	Dates of announcement of changes	Rate on the main refinancing operations [1]	Rate on the marginal lending facility	Rate on the deposit facility
1998	22 December	3.00	4.50 [2]	2.00 [2]
1999	8 April	2.50	3.50	1.50
	4 November	3.00	4.00	2.00
2000	3 February	3.25	4.25	2.25
	16 March	3.50	4.50	2.50
	27 April	3.75	4.75	2.75
	8 June	4.25	5.25	3.25
	31 August	4.50	5.50	3.50
	5 October	4.75	5.75	3.75
2001	10 May	4.50	5.50	3.50
	30 August	4.25	5.25	3.25
	17 September	3.75	4.75	2.75
	8 November	3.25	4.25	2.25
2002	5 December	2.75	3.75	1.75
2003	6 March	2.50	3.50	1.50
	5 June	2.00	3.00	1.00
2004	–			
2005	1 December	2.25	3.25	1.25
2006	2 March	2.50	3.50	1.50
	8 June	2.75	3.75	1.75
	3 August	3.00	4.00	2.00
	5 October	3.25	4.25	2.25
	7 December	3.50	4.50	2.50
2007	8 March	3.75	4.75	2.75
	6 June	4.00	5.00	3.00

Source: ECB.

(1) Until the operation settled on 21 June 2000, fixed rate of the weekly allotments of two-week credits. From the transaction settled on 28 June 2000, minimum bid rate at the tenders for the credit allotments.

(2) Except for the period from 4 to 21 January 1999, during which the rate for the marginal lending facility was 3.25 p.c. and that for the deposit facility 2.75 p.c. The purpose of this narrower "corridor" (50 basis points) was to facilitate the transition of market operators to the new system.

TABLE XXIII EXCHANGE RATES [1]

(national monetary units per ecu or euro, annual averages)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
US dollar	1.121	1.066	0.924	0.896	0.946	1.131	1.244	1.244	1.256	1.370
Japanese yen	146.4	121.3	99.5	108.7	118.1	131.0	134.4	136.9	146.0	161.3
Swiss franc	1.622	1.600	1.558	1.511	1.467	1.521	1.544	1.548	1.573	1.643
Korean won [2]	1,568.9	1,267.3	1,043.5	1,154.8	1,175.5	1,346.9	1,422.6	1,273.6	1,198.6	1,273.0
Hong Kong dollar [2]	8.695	8.269	7.198	6.986	7.375	8.808	9.688	9.677	9.755	10.691
Singapore dollar [2]	1.876	1.806	1.592	1.604	1.691	1.970	2.102	2.070	1.994	2.064
Canadian dollar	1.665	1.584	1.371	1.386	1.484	1.582	1.617	1.509	1.424	1.468
Norwegian krone	8.466	8.310	8.113	8.048	7.509	8.003	8.370	8.009	8.047	8.017
Australian dollar	1.787	1.652	1.589	1.732	1.738	1.738	1.691	1.632	1.667	1.635
Pound sterling	0.676	0.659	0.610	0.622	0.629	0.692	0.679	0.684	0.682	0.684
Swedish krona	8.916	8.807	8.445	9.255	9.161	9.124	9.124	9.282	9.254	9.250
Danish krone	7.499	7.435	7.454	7.452	7.431	7.431	7.440	7.452	7.459	7.451
Cyprus pound	0.577	0.579	0.574	0.576	0.575	0.584	0.582	0.577	0.576	0.583
Czech koruna	36.32	36.88	35.60	34.07	30.80	31.85	31.89	29.78	28.34	27.77
Estonian kroon	15.75	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65
Hungarian forint	240.6	252.8	260.0	256.6	243.0	253.6	251.7	248.1	264.3	251.4
Bulgarian lev				1.9482	1.9492	1.9490	1.9533	1.9558	1.9558	1.9558
Romanian leu [3]		16,345	19,922	26,004	31,270	37,551	40,510	3.6209	3.5258	3.3353
Lithuanian litas [2]	4.484	4.264	3.695	3.582	3.459	3.453	3.453	3.453	3.453	3.453
Latvian lats [2]	0.660	0.626	0.559	0.560	0.581	0.641	0.665	0.696	0.696	0.700
Maltese lira [2]	0.435	0.426	0.404	0.403	0.409	0.426	0.428	0.430	0.429	0.429
Polish zloty	3.918	4.227	4.008	3.672	3.857	4.400	4.527	4.023	3.896	3.784
Slovak koruna [2]	39.54	44.12	42.60	43.30	42.69	41.49	40.02	38.60	37.23	33.78
p.m. Effective euro exchange rate [4] *(index 1st quarter 1999 = 100)*	*100.1*	*96.2*	*87.0*	*87.7*	*90.1*	*100.6*	*104.3*	*103.3*	*103.6*	*107.7*

Source: ECB.

(1) Ecu exchange rate for 1998, euro exchange rate thereafter.

(2) As the ECB has only provided official reference rates since 2001, the rates shown in the table for the period prior to that date are indicative.

(3) From 2005, new romanian leu.

(4) Data compiled on the basis of the weighted averages of the bilateral euro exchange rates. The weightings are calculated from the trade in manufactured products during 1995-1997 and 1999-2001 with the trading partners (including China) whose currencies appear in the table, and take account of the effects of third markets.

Methodological note

Unless otherwise indicated, when data are compared from year to year, they all relate to the same period of the years in question. In the tables, the totals shown may differ from the sum of the items owing to rounding.

In order to provide an update on various key economic data relating to Belgium in the year 2007 as a whole, it was necessary to make estimates, as the statistical material for that year is inevitably sometimes still very fragmentary. In the tables and charts, these estimates, which were finalised in early February 2008, are marked "e". They represent mere orders of magnitude intended to demonstrate the trends which already seem to be emerging. For the years prior to 2007, the data in the Report are those of the official national accounts. The comments on the international environment and the international comparisons are based on the data from international institutions, published respectively in November 2007 by the EC, in December 2007 by the OECD and in January 2008 by the IMF.

The monetary unit used in the Report for the data concerning Belgium or the other countries of the euro area is the euro, since, on 1 January 1999, it became the currency of all these economies except Greece, Slovenia and finally, Cyprus and Malta, for which it replaced the national currency at the beginning of 2001, 2007 and 2008 respectively. The amounts relating to the periods prior to its introduction are converted at the irrevocable euro conversion rates. Except in the chapters on monetary policy and prices, where the definition coincides with the historical reality, the euro area is defined wherever possible in this Report as consisting of all the EU countries which adopted the single currency, excluding Cyprus and Malta. Apart from Belgium, the area therefore consists of Austria, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and, unless otherwise stated, Slovenia (1). For convenience, the term "euro area" is also used to designate this group of countries for periods prior to the start of Stage 3 of EMU.

Since 1999, the NAI, in accordance with the obligation imposed by Eurostat, has applied the ESA 95 methodology for compiling the national accounts, instead of the ESA 79 methodology. The ESA 95 gives a more accurate and complete picture of economic developments (2). It also provides a better guarantee of the international comparability of the macroeconomic data. As far as possible, the Report incorporates the definitions and methods resulting from ESA 95. However, it still expresses the data in gross terms, as under the ESA 79, although this new system presents the

(1) For the data for which the Report presents or discusses forecasts relating to the year under review, the preferred source for the euro area is the OECD rather than the EC, since the former institution publishes its autumn macroeconomic forecasts almost a month after the latter, thus providing a more reliable picture of developments in the year under review. One disadvantage of this choice is that Slovenia is not included in the OECD's definition of the euro area, as Slovenia is not a member of that organisation, but in view of the country's size that disadvantage is somewhat academic.

(2) For fuller information concerning the ESA 95, see the NAI publication entitled *Comptes nationaux 1998 – Partie 1 : Estimation des agrégats annuels*. The changes caused by the switch to the ESA 95 for the account of general government are specified in more detail in another publication from the same source, entitled *Comptes nationaux 1998 – Partie 3 : Comptes des administrations publiques*.

main aggregates derived from the national accounts in the form of net results for consumption of fixed capital. Gross data have the advantage of reducing the problem connected with the valuation of depreciation, which is based on the assumption of perfect knowledge of the stock of fixed capital. Furthermore, gross data make it easier to interpret certain movements such as those of the gross operating surplus. For similar reasons, the sectoral breakdown groups together, under the heading "individuals", households and non-profit institutions serving households, which constitute separate sectors according to the ESA 95 methodology. Nevertheless, the terms "individuals" and "households" are used as synonyms. The terms "corporations" and "enterprises" are also most frequently used as synonyms, whereas in the commentary from the GDP expenditure angle, "enterprises" also covers self-employed persons, who are included under households in the real and financial sectoral accounts.

The Belgian national accounts, like those of other European countries, underwent a series of important methodological revisions in 2005 and 2006, affecting the basic data and/or the methods of calculation for the majority of the aggregates (value added, consumption, investment, compensation, etc.), and the breakdown of price and volume effects.

One of the main methodological adjustments in 2005 was the change in the treatment of financial intermediation services indirectly measured (FISIM). Before this revision, the FISIM output was recorded, by convention, as intermediate consumption of a notional branch, and was therefore not taken into account for the calculation of GDP. Following the entry into force of a new European Regulation, in January 2005, the FISIMs are now divided among the user sectors, reclassifying part of the interest payments as service payments. This reclassification had a considerable impact on the value of certain aggregate flows of goods and services: the output of financial corporations, intermediate and final consumption, imports and exports. This has affected the value added of the various branches of activity and sectors, as well as GDP.

The 2006 revisions concern the volume estimates and cover three aspects: adjustments to the deflators underlying the series relating to output, intermediate consumption and value added, in order to improve the quality of the national accounts; modification of the methodology used for the volume estimates of the output of non-market educational establishments, those estimates now being based on a direct volume indicator (number of pupil hours per type of education and per region) rather than on the deflators specific to each component of production costs (intermediate consumption, salaries, fixed capital consumption); and the conversion of the series at prices of a fixed base year (2000, in the 2005 edition of the national accounts) into series at the preceding year's prices.

This conversion makes it possible to "chain" the volume change in the aggregates or sub-aggregates. According to this method, their volume growth between two consecutive periods is calculated systematically by reference to the previous year's prices and weights. The changes between consecutive periods are linked together (cumulated) to give a chained index. When the chained index of an aggregate or sub-aggregate is applied to the amount (level) of a *reference year*, such as 2005, as in the official national accounts published in September 2007, that provides a measure of the volume change in "*chained euros (reference year 2005)*". The choice of the reference year has no effect on the growth profile of the series. The introduction of chained indices improves the accuracy of the measure of economic growth and increases the international comparability of the data. However, in using chained level series it is necessary to allow for the fact that this chaining leads to a loss of additivity in regard to the volume levels (except for the figures relating to the reference year and the year immediately following it). Non-additivity implies, for example, that in the case of chained level series, GDP is not equal to the sum of its components (final consumption, investment, change in stocks and net exports).

A more detailed explanation of the changes made to the national accounts methodology was supplied by the NAI in the publications entitled *Comptes nationaux – Partie 2 : Comptes détaillés et tableaux 1995-2004* and *Comptes nationaux – Partie 2 Comptes détaillés et tableaux 1995-2005*, issued in December 2005 and November 2006 respectively.

When this Report went to press, the revised national accounts were available only for the period 1995-2006, so that, to gain a longer historical perspective, it was necessary to make estimates by retropolation, e.g. for the calculation of the ratio of the consolidated public debt to GDP.

In the chapter devoted to the international environment, the presentation is also consistent with the ESA 95 or its equivalent, the System of National Accounts published jointly by the United Nations, the World Bank, the EC, the IMF and the OECD (SNA 1993). Nevertheless, the statistics from the sources to which reference is made in the Report, principally the EC and the OECD, have still not been made completely uniform, because the period for which the methodological revision or the conversions from one ESA system to the other have been carried out still varies greatly from one country to another.

The breakdown of the financial accounts between individuals and corporations is largely based on data from Belgian credit institutions. The information making it possible to break down the other financial transactions of the private sector, especially transactions with foreign countries or purchases of securities, is much more fragmentary. The main statistics which can be used for this purpose, namely the globalisation of the annual accounts of enterprises compiled by the Bank's Central Balance Sheet Office, are in fact partial, are produced only annually and are available only after a time lag of several months. It has therefore been necessary to introduce some assumptions and make various estimates.

Conventional signs

–	the datum does not exist or is meaningless
e	estimate by the Bank
n.	not available
p.c.	per cent
p.m.	pro memoria

List of abbreviations

Countries

BE	Belgium
DE	Germany
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
LU	Luxembourg
NL	Netherlands
AT	Austria
PT	Portugal
FI	Finland
SI	Slovenia
EA	Euro area
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DK	Denmark
EE	Estonia
HU	Hungary
LV	Latvia
LT	Lithuania
MT	Malta
PL	Poland
RO	Romania
SE	Sweden
SK	Slovakia
UK	United Kingdom
EU-15	European Union excluding the twelve countries which joined in 2004 and 2007
EU-25	European Union excluding Bulgaria and Romania
CH	Switzerland
IS	Iceland

NO	Norway
JP	Japan
US	United States

Other

ABCP	Asset-backed commercial paper
ABS	Asset-backed security
APR	Annual percentage rate
BEA	Bureau of Economic Analysis
BEAMA	Belgian Asset Managers Association
BeCeFi	Belgian Knowledge Centre for SME Financing
BIS	Bank for International Settlements
BLEU	Belgian-Luxembourg Economic Union
BLS	Bureau of Labor Statistics
BNRC	Belgian National Railway Company
CAP	Common agricultural policy
CBFA	Commissie voor het Bank- Financie- en Assurantiewezen, Commission bancaire, financière et des assurances (Banking, Finance and Insurance Commission)
CBS	Central Bureau of Statistics
CDO	Collateralised debt obligation
CDS	Credit default swap
CEC	Central Economic Council
CIS	Community Innovation Survey
CIS4	Fourth Community Innovation Survey
CLA	Collective labour agreement
CLO	Collateralised loan obligation
CPI	Consumer price index
CREDIBE	former Central Office for Mortgage Loans
CVTS	Continuing Vocational Training Survey
CYP	Cyprus pound
DGE	Directorate General for Energy (FPS Economy, SMEs, Self-employed and Energy)
DGSEI	Directorate General of Statistics and Economic Information (FPS Economy, SMEs, Self-employed and Energy)
EC	European Commission
ECB	European Central Bank
Ecofin	European Council of Ministers of Economic Affairs and Finance
EDP	Excessive deficit procedure
EIS	European Innovation Scoreboard
EMBIG	Emerging Market Bond Index Global
EMU	Economic and Monetary Union
Eonia	Euro overnight index average
ERM	European exchange rate mechanism
ESA	European System of Accounts
ESCB	European System of Central Banks
ESRI	Economic and Social Research Institute
ETF	Exchange-traded fund
EU	European Union
Eurepo	Euro repurchase agreement
Euribor	Euro interbank offered rate

FAL	Bundesforschungsanstalt für Landwirtschaft
FAO	Food and Agriculture Organization of the United Nations
FISIM	Financial intermediation services indirectly measured
FPS	Federal Public Service
FRA	Forward rate agreement
GAAP	Generally Accepted Accounting Principles
GDP	Gross domestic product
GEM	Global Entrepreneurship Monitor
GNI	Gross national income
HCF	High Council of Finance
HEL ABS	Home equity loan asset-backed security
HICP	Harmonised Index of Consumer Prices
HWWI	Hamburgisches Welt-Wirtschafts-Institut
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPN	Inflation Persistence Network
LBO	Leveraged buy-out
LIBOR	London interbank offered rate
LIMOSA	Social authority's cross-border information system for migration research
LOBO	Lender's option borrower's option
MBS	Mortgage-backed security
MFI	Monetary financial institution
MiFiD	Markets in Financial Instruments Directive
MIR	Monetary financial institutions interest rates
MTL	Maltese lira
Nace-Bel	Belgian version of the EC Nomenclature of economic activities
NAI	National Accounts Institute
NBB	National Bank of Belgium
NCB	National central bank
NEO	National Employment Office
NISSE	National Institute for the Social Security of the Self-employed
NOSS	National Office of Social Security
NYSE	New York Stock Exchange
OECD	Organisation for Economic Cooperation and Development
OLO	Linear bond
OPEC	Organisation of Petroleum Exporting Countries
PLU	Professional Lenders' Union
Pricaf	Private equity sicaf (Private closed-end equity fund)
R&D	Research and Development
RIF	Railway Infrastructure Fund
RIR	Retail interest rates
RMBS	Residential mortgage-backed security

SHLAF	Social Housing Loan Amortisation Fund
Sicafi	Société d'investissement à capital fixe immobilier (real estate investment fund with fixed capital)
SIFMA	Securities Industry and Financial Markets Association
SIV	Structured investment vehicle
SME	Small and medium-sized enterprise
SNA	System of National Accounts
SPF	ECB survey of professional forecasters
SPV	Special purpose vehicle
SRI	Sustainable and responsible investment
STADIM	Belgian real estate research and advice bureau
TEA	Total entrepreneurial activity
UCI	Undertaking for collective investment
UCL	Université catholique de Louvain (LLN)
UMTS	Universal Mobile Telecommunications System
USDA	United States Department of Agriculture
VAT	Value Added Tax
VDAB	Vlaamse dienst voor arbeidsbemiddeling en beroepsopleiding (Flemish employment exchange and vocational training service)
VREG	Vlaamse reguleringsinstantie voor de electriciteit- en gasmarkt

List of boxes, tables and charts

Boxes

Chapter 1 : International environment

Chapter 2 : The monetary policy of the Eurosystem

Chapter 3 : Output, expenditure and current transactions in Belgium

Chapter 4 : Labour market and labour costs

Chapter 5 : Prices

Chapter 6 : Public finances

Chapter 7 : Financial accounts and financial markets

Chapter 8 : Financial stability

Tables

Chapter 1 : International environment

Chapter 2 : The monetary policy of the Eurosystem

Chapter 3 : Output, expenditure and current transactions in Belgium

Chapter 4 : Labour market and labour costs

Chapter 5 : Prices

Chapter 6 : Public finances

Chapter 7 : Financial accounts and financial markets

Chapter 8 : Financial stability

Charts

Chapter 1 : International environment

Chapter 2 : The monetary policy of the Eurosystem

Chapter 3 : Output, expenditure and current transactions in Belgium

Chapter 4 : Labour market and labour costs

Chapter 5 : Prices

Chapter 6 : Public finances

Chapter 7 : Financial accounts and financial markets

Captions to illustrations

The context

Since its foundation in 1850, the National Bank has both issued and printed banknotes, and continues to do so in the context of the single currency. On various occasions during its history, it has called on prominent artists to submit designs. That was the case at the end of the 19th century, when the development of the four-colour printing press opened the way to more effective protection against counterfeiting.

The artists approached in those days included several important figures from the world of painting and graphic art. Owing to the specific, complex nature of the subject – the banknote – very few of their designs were actually produced in the form of currency. However, many preliminary designs are still preserved in the Bank's collections, including many dating from the end of the 19th century and the first decade of the 20th century. They were greatly influenced by symbolism and Art Nouveau, an international movement notable for some particularly brilliant Belgian artists: the architect Horta is undoubtedly the most famous of them, but he is certainly not the only one.

The banknotes produced at the time feature the voluptuous curves typical of Art Nouveau, and educative, patriotic messages presented by allegorical figures.

The artists

Gisbert Combaz

° Antwerp 1869
† Schaerbeek (Brussels) 1941

After studying law at the Université de Bruxelles, Gisbert Combaz soon abandoned the bar for a productive career in art ; until just before he died, he taught decorative composition at the Brussels Academy of Fine Art.

A member of the Art Nouveau movement, Combaz exhibited at the "Libre esthétique". Famous for his posters and illustrations, he was also a painter (portraits, landscapes, religious subjects) and an enlightened orientalist, whose legacy includes a number of studies on Chinese and Khmer art. His knowledge of oriental art is evident throughout his work.

Adolphe Crespin

° Brussels 1859
† Brussels 1944

Trained at the Brussels Academy of Fine Art before going on to study under the French painter Bonnat, Adolphe Crespin was a friend of the architect Paul Hankar. Apart from his paintings, he also designed scenery and costumes, wallpaper and murals. He is noted mainly as one of the pioneers of the Belgian school of poster art dating from the late 19th and early 20th century. Like many artists of his day, Crespin was very interested in Japanese art.

He taught from 1900 to 1924 at the Academy where he had studied.

Constant Montald

° Ghent 1862
† Woluwé-Saint-Lambert (Brussels) 1944

Trained at the Academy of Fine Art in his home town, Montald completed his studies with a course on painting at the école industrielle, subsequently winning a scholarship to the École des beaux-arts de Paris. He won the Rome Prize in 1886, and travelled to various countries, including Italy and Egypt where he lived for three years.

A painter, designer and occasional sculptor who also produced murals and posters, Montald was very soon attracted to the "Idealism" movement: he was fond of symbolic and allegorical compositions, and enjoyed working on public art projects. As a founding member of the "L'art monumental" group, he worked on the decoration of the Cinquantenaire Arcade in Brussels

He taught decorative painting at the Brussels Academy of Fine Art, where his pupils included René Magritte and Paul Delvaux. Constant Montald was a member of the Belgian Royal Academy.

Herman Richir

° Ixelles (Brussels) 1866
† Uccle (Brussels) 1942

Herman Richir was a talented painter, particularly popular with the upper middle classes for his portraits. The National Bank has various portraits signed by him and representing King Albert I and Queen Elisabeth, as well as members of the Bank's Board of Directors. Trained at the Saint-Josse-ten-Noode Academy and the Brussels Academy, Herman Richir was a director of the latter for many years.

Louis Titz

° Bruges 1859
† Brussels 1932

Louis Titz was a painter as well as an engraver specialising in townscapes and a theatrical scenery designer. He taught "applied art aesthetics" at the Brussels Academy of Fine Art. A member of the Art Nouveau movement, Titz was an illustrator whose book illustrations and posters were much admired.

BIBLIOGRAPHY

Paul Piron, *Dictionnaire des artistes plasticiens belges des XIX^{e} et XX^{e} siècles,* Art in Belgium, 2003.
Dictionnaire des peintres belges, Brussels, Renaissance du Livre, 1994.
Dictionnaire biographique illustré des artistes en Belgique depuis 1830, Brussels, Arto, 1995.

The works

COVER

Constant Montald, detail of design for the 1909 series of the 50 franc note. Three allegorical figures representing the arts, science and trade. Watercolour and Indian ink, undated.

PAGE 8

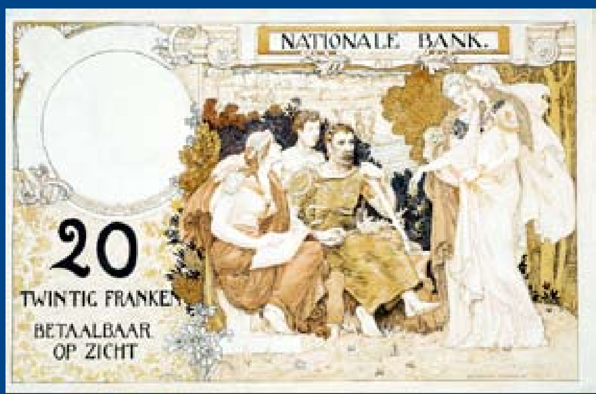
Attributed to Gisbert Combaz, detail from a preliminary design for an unspecified banknote. Mercury, the god of trade, is accompanied by the lion symbolising Belgium. All around are the insignia of the Belgian provinces and a medal decorated with the emblems of Brussels: St Michael slaying the dragon. Indian ink, watercolour and gouache, undated.

PAGE 12

Louis Titz, design for the 1894 series of the 20 franc note: on the left, Minerva accompanied by symbols of the economy and labour with a lion symbolising Belgium at her feet. On the right, the heraldic lion. This was to be the first Belgian banknote printed in four colours. Pencil, Indian ink pen and wash drawing, watercolour, 1893.

PAGES 2 AND 158

Constant Montald, design for a 20 franc note, not produced. Conversation between various allegorical figures, including labour and fortune, in an agricultural landscape. Indian ink and watercolour on paper, undated (1900 ?).

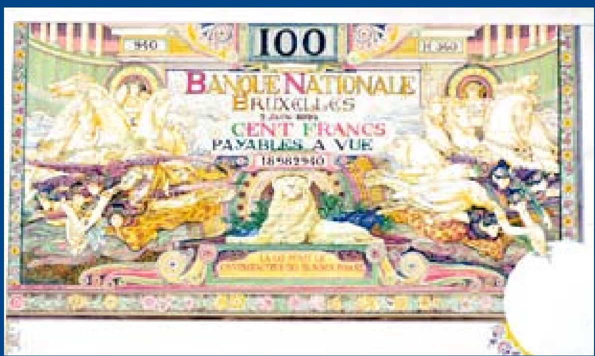


PAGE 32

Louis Titz, design for a 100 franc note, not produced: a heraldic lion representing Belgium against a background divided into two landscapes: an industrial scene on the left and an agricultural scene on the right. Watercolour, Indian ink and gouache on paper, 1905.

PAGES 56 AND 136

Constant Montald, design for a 20 franc note, not produced. Allegorical figures representing industry, the arts, science and trade, coat of arms of the City of Brussels, against the background of the Belgian coat of arms and largely concealed panoramas of Brussels and Antwerp. Watercolour and Indian ink, 1900.



PAGE 80

Constant Montald, design for the 1898 series of the 100 franc note. The Belgian lion is surrounded by various female allegorical figures and the chariots of Ceres and Neptune, land and sea. Watercolour, 1894.

PAGE 102

Constant Montald, preliminary design for the 1929 series of the 10,000 franc note. This banknote was a revised and enlarged version of the 1898 100 franc note. This design is an intermediate version which still shows the old face value. Pencil and watercolour, 1926.

PAGE 120

Herman Richir and Adolphe Crespin, design for a 20 franc note, not produced. Lion lying beside symbols of war against a decorative background dominated by a crown. The natural, peaceful representation of the lion is surprising in the context of an official allegory. Indian ink and watercolour on paper, undated (1897 ?).

PAGE 178

Constant Montald, preliminary design for the 1989 series of the 100 franc note. Pencil, watercolour and chalk, undated.

National Bank of Belgium
Limited Liability company
RLP Brussels – Company number : 0203.201.340
Registered office : boulevard de Berlaimont 14 – BE-1000 Brussels
www.nbb.be

Publisher

Guy Quaden
Governor

Contact person for the Annual Report

Philippe Quintin
Head of the Communication and Secretariat Department

Tel. +32 2 221 22 41 – Fax +32 2 221 30 91
philippe.quintin@nbb.be

Cover and layout : NBB TS – Prepress & Image

Published in March 2008