Report 2004

Part 1 Economic and financial developments

NationalBank
OF BELGIUM

Eurosystem

Foreword

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In 2004, the world economy produced the fastest growth rate seen in the past thirty years, expanding by an estimated 5 p.c. The driving forces behind this strong expansion were the United States and the emerging economies of Asia, primarily China.

However, this rapid growth of the world economy was accompanied by certain tensions which could dampen its vitality in varying degrees.

Thus, the year 2004 brought a renewed rise in oil prices. For various reasons, although its macroeconomic impact cannot be compared with the shocks of the 1970s, this increase dented the confidence of businesses and consumers.

The main source of concern is the persistence and even worsening of the external imbalances in the global economy, the most obvious being that of the United States, whose current account deficit generated further downward pressure on the exchange rate of the dollar.

It is vital for all the countries and regions concerned to step up their efforts in order to ensure that these imbalances are gradually eliminated. The United States will be forced to adjust the growth of its economy and raise the national savings ratio, primarily by a convincing programme designed to reduce its substantial budget deficit. For their part, China and other emerging Asian economies ought to prepare and implement a less restrictive exchange rate policy. As for the euro area, whose currency has already undergone substantial exchange rate adjustments, it should – like Japan – reinforce its growth potential in order to make a more significant contribution towards supporting global demand and activity.

The euro area, too, saw an increase in the pace of economic growth in 2004. According to the provisional estimates, growth was up from 0.6 p.c. in 2003 to 1.8 p.c., but is still modest compared to the rates recorded in many other regions of the world. Moreover, expansion in the euro area was driven mainly by external demand.

While domestic pressure on prices remained subdued, the marked increase in energy costs, although curbed by the continuing appreciation of the euro, caused inflation to edge upwards, to reach 2.4 p.c. at the end of 2004. However, the ECB Governing Council considered that the medium-term inflation outlook remained in line with its definition of price stability, and kept its key interest rate at the historically very low level of 2 p.c. Monetary policy therefore underpinned the economic recovery.

Despite the economic upturn, the budgetary positions of a number of euro area countries continued to deteriorate in 2004. Some of them have recorded a deficit in excess of 3 p.c. of GDP for several years now.

The basic principle underlying the Stability and Growth Pact nevertheless remains valid, namely that a framework ensuring reasonable discipline in all the Member States is absolutely vital in a monetary union where, in the absence of political union, fiscal policy remains a national matter. And it is also essential for those rules to be clear, comprehensible, and applied equally to all countries.

The Lisbon agenda is another important pillar of European economic construction. Unfortunately, the actual achievements have so far fallen short of the ambitions which were endorsed in this area as well. Yet it is precisely the lack of economic dynamism that accounts for the relatively mediocre performance of many European economies, while international competition continues unabated. Successful implementation of the Lisbon strategy requires a clearer political commitment, with the populations concerned being given better information on the objectives in view and the results achieved.

For the second consecutive year, the economic growth rate in Belgium (estimated at 1.3 p.c. in 2003 and 2.7 p.c. in 2004) was well above the euro area average.

Despite the appreciation of the euro, the Belgian economy also benefited from the expansion in foreign demand. The volume growth of Belgian exports came to around 6 p.c. in 2004. In that respect, however, other European countries – especially Germany – have done better. Belgian firms are not the most active in the markets and products enjoying the strongest demand growth and, compared to many other industrialised economies, Belgium has also lost ground in recent years in terms of cost competition. Since imports expanded by slightly more than exports, the net contribution of the rest of the world to Belgium's growth was ultimately negative.

With the benefit of favourable financing conditions due to the recovery of corporate profitability, the low level of interest rates and the rising stock market prices, the business investment growth rate which had been negative in 2002 and 2003 became positive once again in 2004 (1.5 p.c. in real terms).

The very satisfactory dynamism of private consumption (which showed a further volume increase of just over 2 p.c.) was the main feature distinguishing Belgium from many other European countries, especially Germany. This growth of households' consumption outpaced the very subdued rise in their real disposable income, and is therefore attributable to a further decline in their propensity to save. The very high level of private savings compensated at some point for the dissaving on the part of the government. The restored budget balance and the reduction of the public debt, coupled with the progressive implementation of the tax reform, are probably encouraging Belgian households to adjust the amount of their expenditure to more favourable prospects for net income. The consolidation of public finances is therefore producing tangible benefits.

The improvement in activity has not yet been fully reflected in employment. However, an estimated 31,000 additional jobs were already created in 2004, though in view of the expansion of the labour force that did not prevent the harmonised unemployment rate rising from 8.5 p.c. at the end of 2003 to around 9 p.c. at the end of 2004.

The rise in consumer prices increased from 1.5 p.c. in 2003 to 1.9 p.c. in 2004, but the underlying trend in inflation – which excludes primarily administrative price adjustments and changes in energy and unprocessed food prices – dropped from 2 p.c. in 2003 to 1.5 p.c. in 2004.

Finally, in 2004 the general government accounts were again in balance, so that – for the first time since 1982 – the public debt ratio fell significantly below 100 p.c. of GDP. Nevertheless, these favourable results, placing Belgium in a very respectable position in relation to its European partners, are no excuse for any relaxation of vigilance, especially as the maintenance of a balanced budget has been made slightly easier in recent years by factors which cannot be reproduced indefinitely, i.e. certain non-recurring revenues and the exceptionally low level of interest rates.

Is the Belgian economy capable of continuing to record a relatively high rate of economic growth ? The private savings ratio, still well above the European average, could fall further if confidence gains momentum. But potential growth – defined as the growth which, taking account of the availability of the production factors (labour and capital) and productivity gains, can be achieved in the long term without generating imbalances, particularly inflationary pressure – is only just over 2 p.c. in Belgium (which corresponds to the average for the euro area). It could be further lowered in the decades ahead by the ageing of the population which, apart from imposing additional burdens on public finances, implies a contraction in the potential labour supply.

Somewhat paradoxically, some of Belgium's current weaknesses, such as the relatively low activity rate of the population and the still high level of the public debt, offer substantial room for manoeuvre.

The answers to the two major challenges represented by the ageing population and the tougher global competition are therefore clear: we must make unremitting efforts to reduce the public debt by an ambitious fiscal policy, enhance the quantity and quality of the actual labour supply and of employment by increasing the dynamism of the labour market and the education systems, and at the same time control production costs and offer even greater encouragement for entrepreneurial spirit, research and innovative investment.

These fields for action are detailed in this Report. Success here is vital for maintaining a high level of economic prosperity and social cohesion for the benefit of future generations.

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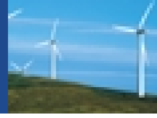
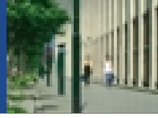


Report presented by the Governor on behalf of the Council of Regency



The global and european economic context

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

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

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

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

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

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

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

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

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

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

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

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

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

The economic situation in Belgium

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

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

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

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

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

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

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

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

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

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

Monetary policy and financial stability

Monetary policy

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

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

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

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

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

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

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

Financial stability

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

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

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

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

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

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

The challenges of globalisation and population ageing

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

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

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

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

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

Maintenance of sound, sustainable public finances

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

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

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

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

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

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

Boosting the economy's growth potential

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

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

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

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

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

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

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

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

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

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

An active employment policy

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

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

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

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

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

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

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

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

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

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

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

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

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

Brussels, 2 February 2005

[5] Guy Quaden, GOVERNOR
[3] Luc Coene, VICE-GOVERNOR
[6] Jean-Pierre Pauwels, DIRECTOR
[7] Marcia De Wachter, DIRECTOR
[4] Jan Smets, DIRECTOR
[1] Françoise Masai, DIRECTOR
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Council of regency

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1 2 3 4 5 7 8 11 13 15 17

Economic and financial developments

NationalBank
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Eurosystem

Economic and financial developments

1. International environment

1.1 Summary

During the year under review, the global economic recovery gathered strength, becoming more widespread and broadly based. Global growth accelerated, rising from 3.5 p.c. in 2003 to 5 p.c., the highest level for decades, and was accompanied by a surge in international trade. Although the United States and the emerging Asian countries, particularly China, remained the engines of this exceptional expansion, economic activity also forged ahead in Japan, the new EU Member States, Latin America and the oil-exporting countries, primarily the OPEC members and the Community of Independent States. Under the impetus of strong external demand, growth in the euro area finally picked up so that this region, too, made a contribution – albeit modest – in 2004. Internal growth in the euro area in general in fact remained weak, although there were marked differences between Member States.

TABLE 1 **GROWTH OF THE MAIN ECONOMIES**

(Percentage changes in GDP at constant prices compared to the previous year)

	2002	2003	2004	*p.m. Weight in the world economy* [1]
United States	1.9	3.0	4.4	*21.6*
Japan [2]	–0.3	1.3	2.9	*7.1*
Euro area	0.9	0.6	1.8	*16.2*
Other EU-15 countries	1.8	2.0	3.1	*4.5*
of which : United Kingdom	1.8	2.2	3.2	*3.5*
New EU member countries [3]	2.5	3.7	4.9	*1.0*
China	8.3	9.3	9.2	*12.9*
Other emerging Asian countries [4]	4.9	4.1	5.8	*5.5*
Latin America, excluding Venezuela	–0.2	3.1	4.7	*7.6*
OPEC	2.1	3.4	6.9	*4.4*
Other OECD countries [5]	3.5	2.4	3.9	*4.6*
Rest of the world	3.3	3.6	6.4	*14.6*
World	2.7	3.5	5.0	*100.0*

Sources : EC, IMF, OECD.

(1) Percentages of world GDP in 2003, based on purchasing power parities.

(2) In view of substantial national accounts revisions in Japan at the end of the year under review, the data for that country are taken from the economic survey published by the OECD on Japan at the beginning of 2005, whereas the other data in the table come from the autumn forecasts produced by that institution, the EC and the IMF.

(3) Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia.

(4) Hong Kong, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.

(5) Australia, Canada, Iceland, New Zealand, Norway, Switzerland, Turkey.

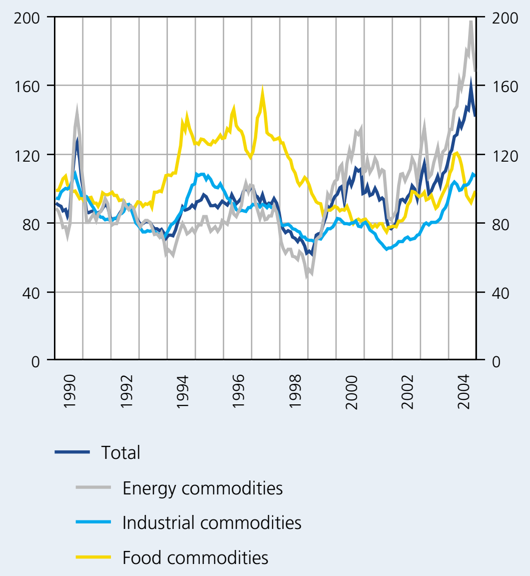
As regards the composition of growth, the main factors driving the global economy were a continuing expansion in business investment, underpinned by advantageous financing conditions and the progress achieved in restructuring, plus an upturn in private consumption resulting from an improvement in the labour market situation.

In the second quarter of the year under review, growth nonetheless ran out of steam somewhat, especially in the United States, Japan and China, partly because of the sharp rise in oil prices. The strong global demand for petroleum products had raised concerns over the adequacy of the producing countries' oil supplies and exerted strong upward pressure on oil prices. This development subsequently curbed the rise in household purchasing power and corporate profits (for details, see box 1).

The rise in crude oil prices denominated in US dollars, which had been more or less continuous since the second quarter of 2003, gathered pace in 2004 : from 25 dollars per barrel of Brent in April 2003, oil prices shot up to 49 dollars per barrel in October 2004. In the euro area, the strength of the euro against the US dollar initially helped to temper the rise in oil prices expressed in local currency between April 2003 and February 2004. In the ensuing months of the year under review, the substantial, steady increase in oil prices could no longer be offset by the appreciation of the euro, and also began to fuel fears of adverse repercussions on the euro area's revival. From November, oil prices subsided, dropping to 40 dollars per barrel of Brent by the end of the year. Taking the average for the year, prices in US dollars were 33 p.c. higher than in 2003, while the increase in terms of the euro came to 21 p.c.

CHART 1 PRICES OF BASIC PRODUCTS

(US dollar, indices 1990 = 100)



Source : HWWA.

As an annual average, energy prices expressed in US dollars rose by 35.3 p.c. in 2004, pushed up by oil prices. The higher cost of energy is not the only factor to have influenced the price index of basic products, which rose by 30.4 p.c. during the year under review. Driven mainly by the strength of world demand, prices of food commodities in fact increased by 11.6 p.c. over 2004 as a whole, and the price index for industrial commodities recorded a 24.8 p.c. rise.

Box 1 – The rise in oil prices in 2004 : explanatory factors and impact on the euro area's economy

The rise in oil prices during 2004 was due mainly to the acceleration in world demand for oil, following the strong recovery in activity led by the United States and China, and the pressure of speculation kindled by geopolitical uncertainty. In this regard, the weight of the industrial sector in China and the rather inefficient use of oil in that country's production process further boosted Chinese demand, which grew by around 15 p.c. in 2004. In response to the growth of demand, the oil-exporting countries stepped up their production substantially. As a result, their excess capacity margins dropped to historically low levels : not only was there a failure to anticipate the sustained increase in demand, but on top of that, the falling oil prices of the 1990s had discouraged exploration and investment in new production capacity. The narrowness of the available margin – especially in the event of unexpected upsets – fuelled fears of inadequate supply, and prices reacted strongly to the geopolitical tensions in the Middle East, particularly the worsening of the conflict in Iraq, and the production problems apparent in a number of producer countries, such as Nigeria and Venezuela, but also owing to the crisis hitting the producer Youkos in Russia.

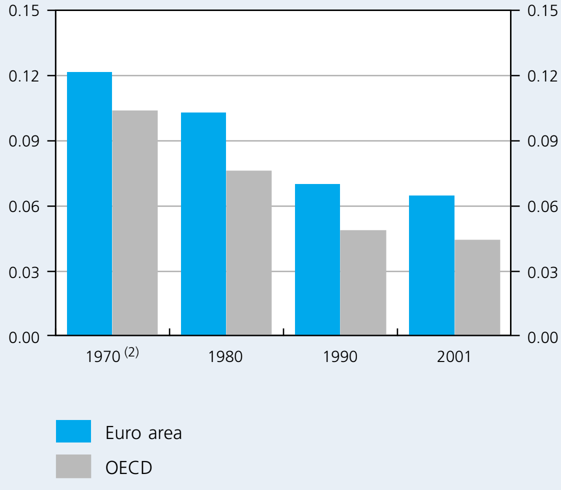
This rise in oil prices brought fears of substantial economic effects for countries which are net oil importers. However, a number of factors indicate that this risk is relatively small.

First, in comparison with the oil shocks of the 1970s or the increases recorded in 1999-2000, the scale of the latest shock appears modest. On the basis of annual averages, the price per barrel of Brent rose in nominal terms by 258 p.c. between 1972 and 1974, 166 p.c. between 1978 and 1980, and 117 p.c. between 1998 and 2000. During 2002-2003, prices of Brent increased by 52 p.c. in dollars, and barely 16 p.c. in euro. Moreover, even though oil prices expressed in dollars approached the levels reached at the end of the 1970s, they remained well below those historical peaks if expressed in real terms, taking account of the general increase in prices.

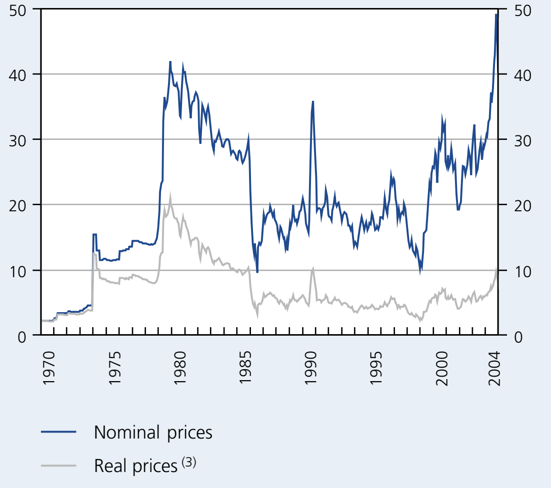
Next, the economic structure of the industrialised countries has undergone a fundamental transformation since the start of the 1970s, particularly in the increasing importance of the tertiary sector, so that these economies have become considerably less vulnerable to an oil price increase. That vulnerability, which is determined by their dependence on oil imports and the oil-based energy content of their production, can be measured by net oil imports per unit of GDP: this ratio has fallen by more than 40 p.c. in the euro area since the 1970s, a trend observed in the OECD countries in general, which suggests that the impact of the price hike could prove less than at the time of the earlier oil shocks.

DEPENDENCE ON OIL AND PRICE MOVEMENTS

DEPENDENCE ON OIL IN THE EURO AREA AND IN OECD COUNTRIES (1)
(tonnes of oil equivalent per thousand dollars of GDP at 1995 prices)



CRUDE OIL PRICES
(monthly averages, per barrel of Brent in US dollar)



Sources: IEA, Thomson Financial Datastream.
(1) Net oil imports in proportion to GDP.
(2) 1973 for the OECD.
(3) Data deflated by the US consumer price index, index 1970 = 100.

Finally, there have been profound changes in the conduct of macroeconomic policy since the first oil shocks. Generally speaking, monetary policy has become more independent and has also focused more explicitly on a price stability objective. This new institutional basis gives the economic agents an assurance that the monetary authorities will respond appropriately and therefore helps to ensure that inflation expectations remain in line with the price stability objective. Where fiscal policy is concerned, the risk that expansionary impulses may amplify the inflationary effects of an oil shock, as in the 1970s, has diminished in principle, at least in the euro area, owing to the constraints imposed by the Stability and Growth Pact.

In order to measure the impact of the oil price rise on an economy, various transmission channels have to be considered. The most obvious is the transfer of income from the net oil-importing countries – such as the euro area – to the net oil-exporting countries, which amplifies the growth of the latter at the expense of the former. The erosion of household purchasing power and corporate profits in the net oil-importing countries after the shock is reflected in the contraction of private consumption and investment. Moreover, if the main trading partners of the country affected are also net oil importers, a weakening of external demand may accompany the fall in domestic demand. Admittedly, the external demand from the oil-exporting countries does have some compensating effect, but that is fairly small because those countries have a lower absorption capacity than the net importing countries. The negative impact of shrinking demand on the activity of the importing country may be aggravated by a loss of confidence, liable to affect both consumption and investment.

Apart from these direct effects on inflation and growth, higher oil prices may engender induced effects. Thus, firms may try to pass on the pricehike affecting their energy inputs in the selling prices of their goods and services. The impact of the producer's price increase on the consumer depends on whether or not firms decide to restore their profit margins ; that adjustment decision will itself depend in particular on whether they view the oil price rise as permanent or temporary. Finally, second-round effects may occur if consumers try to offset the decline in their real income by wage increases. This process holds a danger of rekindling inflationary pressure, if the corresponding increase in labour costs is in turn passed on to consumer prices. However, at the time of the 1999-2000 oil shock, wage moderation prevailed in the euro area despite a continuing decline in unemployment, suggesting that the labour markets are operating better than they did in the 1970s.

CUMULATIVE EFFECT FOR THE EURO AREA OF A PERMANENT 25 P.C. INCREASE IN OIL PRICES

(Percentage differences for the variables, in terms of level, in relation to the basic scenario)

	Year 1	Year 2	Year 3
GDP	–0.29	–0.38	–0.41
Consumer prices	0.22	0.28	0.31

Source : EC.

In the context of relatively high unemployment and substantial unused capacity prevailing in the euro area during the year under review, the second-round effects should be minor, especially as the credibility which the Eurosystem has gained in terms of price stability since its establishment has helped to moderate inflationary expectations. Nonetheless, vigilance is required, as there are growing fears that expensive oil is here to stay. Apparently, it is not just short-term factors that are influencing oil prices : the prices of long-term futures have been rising, indicating that the market participants do not expect a swift resolution of the geopolitical tensions, nor a decline in the strength of demand from the emerging economies.

The EC used an econometric simulation to assess the effect on the euro area of a permanent 25 p.c. increase in oil prices. The simulated shock is similar in magnitude to the rise in the price of Brent – expressed in euro – which occurred between 2003 and 2004. This exercise indicates that, in the first year, economic activity in the euro area would slow by 0.3 percentage point, while consumer prices would rise by 0.2 percentage point. The subsequent impact on growth and inflation would be marginal, at just under 0.1 percentage point each in the second year.

This projection suggests that the impact of the recent oil shock on growth and inflation in the euro area should be muted in the short term. However, the results of these simulations must be interpreted with caution, since they do not incorporate all the mechanisms whereby oil prices affect the economy, such as confidence effects.

Inflation remained under control overall, at global level. The under-utilisation of production capacity combined with a recovery in profitability led firms to absorb part of the increase in the cost of commodities. The effect of that increase on wages was also limited, having regard to the still relatively high level of unemployment. In general, inflation expectations remained in line with the price stability objective set by the central banks, a sign that monetary policy has gained substantial credibility in recent years. That credibility has enabled the monetary authorities to respond gradually to the new environment.

Overall, the monetary policy stance became more neutral though still accommodating. The pace and timing of this change varied between regions, according to their relative positions in the economic cycle. For instance, during the year under review the Bank of England and the United States Federal Reserve raised their target rates on several occasions. Owing to the risk that the rapid expansion in lending would lead to excess capacity in certain sectors, the Chinese monetary authorities initially tightened financial conditions and then also raised their key interest rates. Conversely, the ECB kept its key rate unchanged in 2004. The Bank of Japan also refrained from changing course, and – in view of the persistent deflationary pressure – continued to inject liquidity and to intervene on the currency markets to prevent any tightening of monetary conditions.

Fiscal policies remained relatively expansionary. However, in contrast to previous years, households and firms were not generally given any additional stimulus, and certain areas and countries actually saw the cautious beginnings of consolidation. Thus, public investment was cut in the euro area and Japan, and measures were taken there, in anticipation of rapid population ageing, to guarantee the future sustainability of the social security system.

Despite the tightening of monetary policy in certain countries, there was little increase in nominal and real interest rates, which remained at a historically low level. Share prices sustained their upward trend at the beginning of the year. Thus, financing conditions continued to support growth. Business investment was also encouraged by the strong economic expansion, rising profits and better capacity utilisation. Moreover, in certain countries, including the United States, the need to replace certain obsolete plants after a period of meagre investment became increasingly urgent. In the euro area, gross fixed capital formation by enterprises increased for the first time since 2001, but to a more modest extent than in other regions, partly because of the less far advanced state of the restructuring process, the rather gradual progress in restoring business confidence, and – probably – the uncertainties engendered by the energy price rise and the euro's appreciation. In Japan, a growing number of branches of activity stepped up their investments.

As a general rule, the improvement in the labour market situation is the key factor bolstering the confidence of households and increasing their disposable income, thus supporting private consumption. Especially in Japan, the expansion of employment for the first time since 1997 gave a considerable boost to household confidence, triggering a significant increase in household consumption, as well as new investment in housing. Household consumption expenditure in the euro area regained some momentum, but remained very weak owing particularly to the concerns aroused by the deterioration in public finances and by the forthcoming or current reforms to the social security systems.

On the balance of payments, the current account imbalances worsened during the year under review. In the United States, the deficit reached 669 billion dollars, or 5.7 p.c. of GDP. The trade surpluses in Japan and the euro area increased substantially to reach 3.6 and 0.7 p.c.

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

(Billions of US dollar)

	2002	2003	2004
United States	–473.9	–530.7	–669.0
Japan	111.7	135.3	164.5
Euro area	47.6	32.1	67.4
China	35.4	45.9	18.2
Emerging Asian countries (2)	45.4	64.4	103.0
Other countries	98.9	164.6	229.0
of which: OPEC	61.6	66.9	151.2

Sources: EC, 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 deficit. Owing to the scale of the gross flows of transactions recorded in the balance of payments, these figures frequently contain substantial errors.

(2) Hong Kong, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.

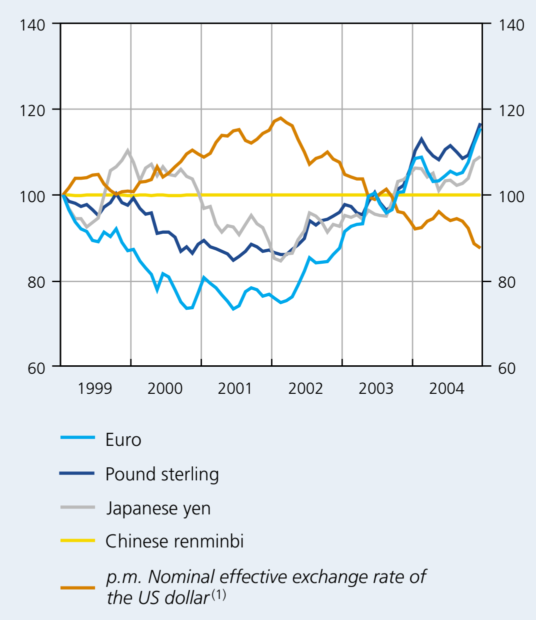
of GDP respectively. A similar movement was seen in the case of the emerging Asian countries, while the Chinese surplus showed a marked fall, dropping to just 18.2 billion dollars or 1.1 p.c. of GDP. In contrast, in the case of the OPEC member countries the surplus more than doubled in 2004, bringing it close to the Japanese surplus, or around 150 billion dollars overall.

Concerns about the sustainability of these imbalances were considerably heightened, particularly following the reappearance, in 2001, of "twin deficits" in the United States – i.e. a simultaneous increase in the current account deficit and the budget deficit. Furthermore, the method of financing the US trade deficit has changed in recent times. Thus, the balance of direct and equity investments has become decidedly negative since the beginning of 2003, while entities such as the Asian central banks have greatly increased their investments in debt securities issued by the American public authorities. By accumulating substantial reserves, the authorities in those countries have been able to restrain or prevent the appreciation of their currencies against the dollar in order to support their growth strategy, which is centred on exports. These developments fuelled fears that foreign investors would be less prepared to continue funding the considerable and ever-growing capital requirements of the United States without any change in the financial conditions. The question of how to correct these imbalances is therefore becoming steadily more urgent. In this connection, to prevent the adjustment of the imbalances from being based exclusively on market forces, which could trigger an uncontrolled slide in the US currency, there are increasing calls for the adoption of simultaneous measures by the various economies in different areas: reduction of the borrowing requirement of public authorities in the United States, implementation of structural reforms in the euro area to stimulate the economy's growth potential, and increase in the flexibility of exchange rates in Asia.

The growing current account deficit and the persistence of a high public deficit are regarded as key factors in the continuing weakening of the dollar during the year under review. At the beginning of 2004, the fall in the weighted average exchange rate of the dollar, recorded since March 2002, came to a temporary halt. Bolstered by an encouraging outlook for the US economy, the dollar actually recovered slightly. However, during the second half of the year, the market's concern about the growing current account deficit regained the upper hand, and the nominal effective exchange rate of the dollar resumed its decline, dropping below the low point of early 2004 by the month of October. Altogether, the weighted average exchange rate of the dollar depreciated by 7.3 p.c. in 2004.

CHART 2 BILATERAL EXCHANGE RATES AGAINST THE US DOLLAR

(Monthly averages, indices January 1999 = 100)



Sources: BIS, IMF.

(1) Average exchange rate of the dollar against the currencies of 21 industrialised countries and four emerging Asian countries, weighted according to their share in US foreign trade.

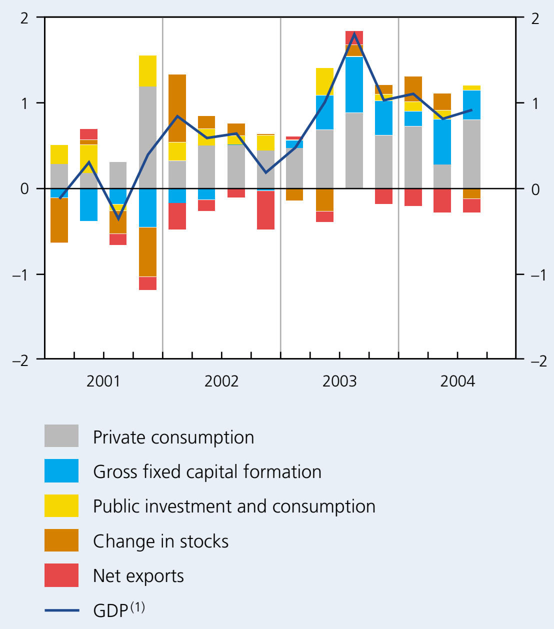
Leaving aside the months of March and April, when there was a slight dip, the euro appreciated against the US dollar almost throughout the year under review, and particularly from October onwards. On average, it thus exceeded its 2003 value by 10 p.c. The yen and the pound sterling followed a pattern fairly similar to that of the euro against the dollar during the year, appreciating by an average of 7.1 and 12.1 p.c. respectively. The exchange rate of the Chinese currency remained fully tied to that of the dollar.

1.2 United States

The American economic recovery which had begun in 2002 was consolidated during the year under review. The situation on the labour market improved, and risks of deflation faded. All the domestic demand components supported this steady expansion, while the contribution of net exports remained negative. The macroeconomic policy stance underwent a gradual change during the year, though it remained strongly expansionary.

CHART 3 CYCLICAL PROFILE OF GDP AND THE MAIN COMPONENTS OF EXPENDITURE IN THE UNITED STATES

(Seasonally adjusted data; contribution to the change in GDP at constant prices against the preceding quarter, percentage points, unless otherwise stated)



Source: BEA.
(1) Percentage changes against the preceding quarter.

TABLE 3 ECONOMIC DEVELOPMENTS IN THE UNITED STATES

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

	2002	2003	2004
Expenditure at constant prices			
Final domestic demand	2.1	3.4	4.3
Final consumption expenditure			
Households	3.1	3.3	3.6
General government	4.0	2.9	1.8
Gross fixed capital formation			
Housing	4.8	8.8	9.8
Enterprises	–8.9	3.3	10.2
General government	6.0	2.1	3.4
Change in stocks (1)	0.4	–0.1	0.5
Net exports of goods and services (1)	–0.7	–0.5	–0.6
Exports	–2.3	1.9	8.9
Imports	3.4	4.4	10.1
GDP	1.9	3.0	4.4
Labour market			
Employment (2)	–0.3	0.9	1.1
Unemployment (3)	5.8	6.0	5.5
Prices and costs			
Consumer prices	1.6	2.3	2.7
Unit labour costs in enterprises	–0.6	0.3	0.4
Prices of imported goods and services	–1.2	3.4	5.2
Terms of trade	0.9	–1.2	–1.5
Balance of payments and budget balance			
Balance of current transactions (4)	–4.5	–4.8	–5.7
Financing balance of general government (4)	–3.8	–4.6	–4.4
p.m. Private savings ratio (5)	*2.0*	*1.4*	*0.8*

Sources: OECD, BLS.
(1) Contribution to the change in GDP.
(2) According to the household survey.
(3) Ratio between the number of unemployed and the labour force.
(4) Balance expressed as a percentage of GDP.
(5) Savings expressed as a percentage of disposable income.

On average, GDP growth came to 4.4 p.c. in 2004, against 3 p.c. a year earlier. The expansion of activity, still robust in the first quarter, slowed down in the second quarter in a context marked by the rise in energy prices and weaker than expected expansion in employment. The third quarter brought a modest recovery. From the second quarter onwards, growth thus proceeded at a pace close to its long-term trend rate, estimated at between 3 and 3.5 p.c. on an annual basis.

The continuous support for economic growth provided by households, in terms of both private consumption and investment in housing, was remarkable in view of their financial position. The debt service ratio in relation to their disposable income hardly declined at all during the year under review, remaining at around 13 p.c., one of the highest levels for the past twenty years. However, the disposable income of households did rise in real terms by an average of 2.9 p.c., against 2.3 p.c. in 2003, benefiting from the expansion in the number of jobs, the small rise in wages and larger reductions in taxes. The continued growth of private consumption, close to 4 p.c., was therefore only made possible by a further decline in the savings ratio, already at a historically low level, from 1.4 to 0.8 p.c. of disposable income. Private consumption expenditure was further stimulated by rising house prices and low interest rates. This last factor also continued to support private investment in housing, which grew even faster than the year before. Only in the second quarter was a temporary lull recorded, coinciding with a rise in long-term interest rates.

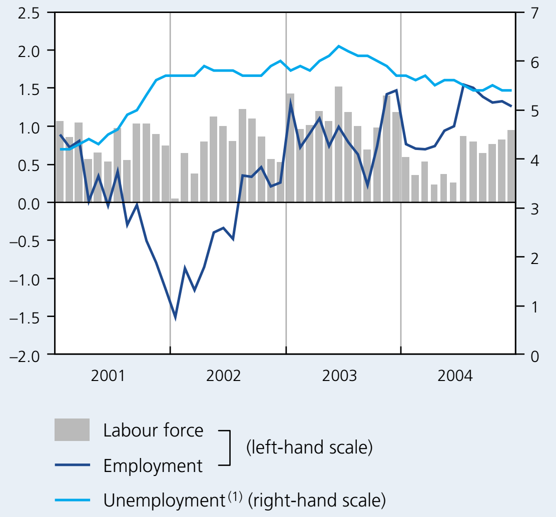
The revival in business investment no longer applied just to information and communication technology equipment (ICT), but also machinery and transport equipment, so that strong growth in the gross fixed capital formation of companies was maintained throughout the year. The favourable financing conditions, with persistently low interest rates and a continuing rise in stock market prices plus the improvement in corporate profitability are all factors which contributed to this development. Moreover, owing to the low level of investment in previous years, the equipment of some firms became so obsolete that its replacement or modernisation could no longer be put off. Finally, the fact that tax concessions for investment would expire at the end of 2004 encouraged firms to bring forward the execution of certain projects.

Since the second half of 2003, firms have rapidly rebuilt their stocks in order to cope with the sustained expansion of final domestic demand. Changes in stocks made a substantial contribution to growth, especially in the first half of the year under review: taking the average over the year, that contribution came to 0.5 percentage point of GDP.

United States exports recovered strongly in 2004, but imports expanded even faster, so that foreign trade curbed economic growth yet again. The main factor stimulating the strong expansion of imports was the persistent vigour of domestic demand, which once again outpaced that of a number of trading partners. In consequence, the contribution of net exports was again negative, totalling 0.6 percentage point of GDP.

CHART 4 LABOUR MARKET IN THE UNITED STATES

(Seasonally adjusted data; percentage changes against the corresponding month in the previous year, unless otherwise stated)



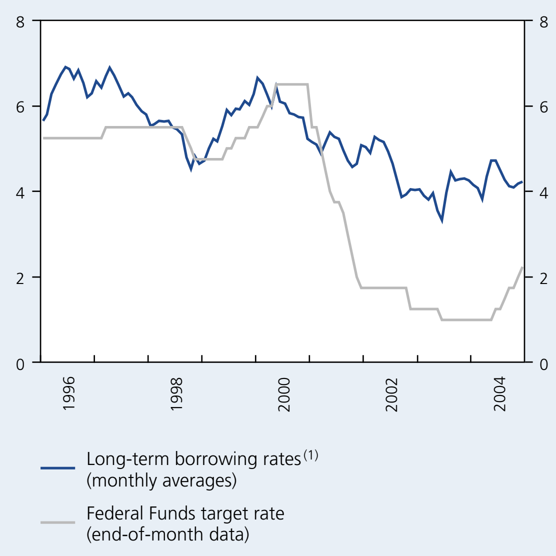
Source: BLS.
(1) Ratio between the number of unemployed and the labour force.

Strengthening of the recovery in employment took longer than expected: it was only from May onwards that any marked acceleration in job creation appeared. Thus, employment grew by an average of 1.1 p.c., against just 0.9 p.c. a year earlier. This expansion was accompanied by a steady decline in unemployment, which dropped from 6.0 to 5.5 p.c. of the labour force in 2004. Productivity gains speeded up, reaching an average of 3.3 p.c.

Inflation averaged 2.7 p.c., thus remaining moderate in an environment featuring strong economic expansion and sustained oil price rises. This is attributable to the continuing low level of capacity utilisation, the still plentiful labour reserve and productivity gains.

For the first time since the 2001 recession, the sustained activity growth brought a rise in corporate income tax revenues. However, this was counterbalanced by the continuing increase in expenditure on military operations and reconstruction in Iraq and Afghanistan, and higher health care spending. Individuals benefited from the implementation of tax cuts even larger than those in 2003; this had a considerable impact on public sector budgets, totalling 1.3 p.c. of GDP compared to 0.6 p.c. The cyclically adjusted budget deficit thus rose from 4.1 to 4.2 p.c. of GDP.

CHART 5 MAIN INTEREST RATES IN THE UNITED STATES



Sources: Thomson Financial Datastream, Federal Reserve.
(1) Interest rate on US Treasury bonds with a residual maturity of ten years.

The reversal of monetary policy, hitherto highly expansionary, began on 30 June when the Federal Funds target rate was raised for the first time by 25 basis points. Later in the year, on 10 August, 21 September, 10 November and 14 December, this rate was increased by the same amount, bringing it to 2.25 p.c. Although the *Federal Open Market Committee* stood by its opinion that economic growth had slackened in the middle of the year, owing to the surge in energy prices, it confirmed in its statements that the economy seemed to have resumed a more robust growth rate in the second part of the year. In addition, it continued to repeat that the expansionary monetary policy would be gradually phased out.

The fluctuations in long-term rates more or less mirrored the expectations that the Federal Reserve would implement an interest rate hike sooner or later. Long-term rates continued their downward trend during the initial months of the year, when it emerged that the Federal Reserve would maintain its accommodating policy for some time, in the absence of significant job creation, despite the sustained expansion. In the second quarter, long-term rates increased by roughly one percentage point, as market operators anticipated an increase in the Federal Reserve key rate earlier than expected, taking account of the renewed expansion in employment and the upward adjustment of the growth and inflation expectations. However, once the employment revival proved rather hesitant and concerns were raised about the sustainability of growth, long-term rates subsided once again, dropping to 4.1 p.c. in October and 4.2 p.c. in the two ensuing months.

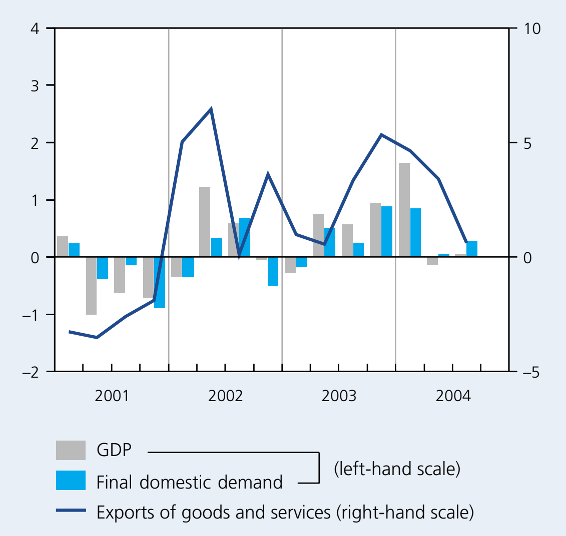
1.3 Japan

The growth of the Japanese economy gathered momentum in 2004, as private consumption finally joined external demand and business investment in underpinning the recovery. GDP grew by 2.9 p.c., the biggest rise in economic activity since 1996. This result reflects the exceptional expansion of the global economy and international trade. It is also the outcome of the restructuring which has been pursued consistently for a number of years in the financial sector and in industry.

Nonetheless, the progress of the Japanese economy was patchy in the year under review. In fact, it benefited mainly from the spill-over effect at the start of 2004, the expansion in activity having been remarkable in the fourth quarter of 2003 and the first quarter of 2004, driven essentially by the dynamism of private consumption and exports. In the second and third quarters, however, the more moderate rise in these categories of expenditure and a reduction in stocks called a halt to the revival in activity. Nevertheless, in its estimates published for Japan at the beginning of 2005, the OECD expected GDP to pick up in the final quarter of 2004.

CHART 6 CYCLICAL PROFILE OF GDP AND THE MAIN CATEGORIES OF EXPENDITURE IN JAPAN

(Seasonally adjusted data, percentage changes at constant prices compared to the previous quarter)



Source: OECD.

TABLE 4 ECONOMIC DEVELOPMENTS IN JAPAN

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

	2002	2003	2004
Expenditure at constant prices			
Final domestic demand	–0.7	0.6	2.1
Final consumption expenditure			
Households	0.5	0.2	2.0
General government	2.6	1.2	2.6
Gross fixed capital formation			
Housing	–4.3	–1.3	1.8
Enterprises	–6.6	6.5	6.5
General government	–4.3	–10.7	–11.1
Change in stocks (1)	–0.2	0.2	0.1
Net exports of goods and services (1)	0.6	0.6	0.9
Exports	7.2	9.0	14.3
Imports	1.2	3.9	8.4
GDP	–0.3	1.3	2.9
Labour market			
Employment	–1.3	–0.2	0.3
Unemployment (2)	5.4	5.3	4.7
Prices and costs			
Consumer prices	–0.9	–0.3	–0.2
p.m. Deflator of final consumption expenditure of individuals	*–0.8*	*–0.7*	*–0.6*
Unit labour costs in enterprises	–3.2	–3.6	–4.2
Prices of imported goods and services	–1.2	–0.9	2.5
Terms of trade	0.3	–2.4	–4.2
Balance of payments and budget balance			
Balance of current transactions (3)	2.8	3.1	3.6
Financing balance of general government (3)	–7.9	–7.7	–6.6
p.m. Private savings ratio (4)	*6.4*	*6.3*	*5.1*

Source: OECD, ESRI (Japan), NBB's own calculations.
(1) Contribution to the change in GDP.
(2) Ratio between the number of unemployed and the labour force.
(3) Balance expressed as a percentage of GDP.
(4) Savings expressed as a percentage of disposable income.

Private consumption was one of the factors driving the strong expansion in Japan. The economic situation of households in fact improved sharply during the year under review, as is evident from the consumer confidence index which, in August, reached its highest level since 1991. The turnaround in the labour market situation indubitably contributed to this favourable development: for the first time since 1997, employment increased, namely by 0.3 p.c., bringing a fall in the unemployment rate. However, this rise in employment mainly concerned temporary and part-time jobs, rather than permanent, full-time jobs, which is part of the reason why nominal wages per worker declined by a further 0.4 p.c. Nonetheless, the real disposable income of households increased by 0.7 p.c. in 2004, owing to the continued decline in price levels. The improvement in the purchasing power of households evidently encouraged them to increase their consumption expenditure substantially, by 2 p.c., and thus to reduce their savings ratio once again. The boost to their confidence was also reflected in a revival in households' investment in housing.

Japanese firms increased their expenditure on gross fixed capital formation by 6.5 p.c. in 2004, encouraged by the strength of domestic and foreign demand, the sustained rise in profits and the continuing low cost of borrowing.

Exports, which had for decades been the main engine of the Japanese economy, surged by an exceptional 14.3 p.c. in 2004, owing to the dynamism of demand not only from China but also from other Asian countries. Thus, net exports of goods and services made an even larger positive contribution to GDP growth than in 2003, namely 0.9 p.c. against 0.6 p.c.

Despite the strong growth, deflation persisted. While the fall in consumer prices was slightly smaller than in 2003 – 0.2 p.c. compared to 0.3 p.c. –, if the impact of the energy price rise is excluded, the fall was actually larger, confirming that – after six years – deflation remains firmly rooted in the Japanese economy. Lower rice prices and the accelerating fall in unit labour costs contributed to this development.

Neither fiscal nor monetary policy saw any radical change of course in 2004. However, thanks to the vigour of economic activity and the further cut in public investment expenditure, the financing requirements of general government declined, dropping from 7.7 to 6.6 p.c. of GDP. The Japanese government set itself the target of eliminating the deficit on the primary balance by 2010; at the end of the year under review, that deficit totalled 5 p.c. of GDP. Taking account of the rising interest charges and the growth of social security spending, due to the ageing of the population, a number of measures relating to the retirement scheme were adopted in 2004, with the aim of increasing contributions and reducing benefits.

The Bank of Japan continued to grant abundant liquidity to the financial sector at zero interest, a policy launched in September 2001. By constantly upgrading its target for the amount of assets held by banks on current accounts in its books – the latest revision was in January 2004, when the target was raised from 32,000 to 35,000 billion yen – the Bank of Japan supported the monetary base and was able to preserve the stability of the financial system. However, the amount of bank lending continued to fall as a result of the restructuring carried out by banks and by firms in other sectors, impairing the effectiveness of the Bank of Japan's monetary policy. Moreover, in 2003 and early 2004, when the financial markets were focused on the United States current account deficit, the yen came under upward pressure against the dollar. In order to avert any tightening of monetary conditions, the Bank of Japan intervened on a massive scale on the foreign exchange markets.

Given the particularly strong economic growth, the renewed rise in share prices and the constant pressure from the supervisory authority, the situation in the financial sector improved considerably, particularly among the big banks. In contrast, the smaller regional banks, which are less subject to regulation, are still lagging behind somewhat in their restructuring process. For this group of banks, an *Action program for enhancement of relationship banking functions* was launched in 2004, and they were offered a recapitalisation facility.

1.4 China

During the year under review, Chinese economic activity continued its sustained expansion at a pace little slower than in 2003. Year-on-year GDP growth remained at around 10 p.c. in the first quarter of 2004, as in the last quarter of 2003, then moderated slightly during the second and third quarters under the impact of measures taken by the government to avoid overheating of the economy. Chinese growth is attributable essentially to the strength of investment and exports, notably to the United States and the euro area.

Fixed capital formation, estimated at 45.8 p.c. of GDP during the year under review, was encouraged by the rapid expansion of lending and by local authority projects. Exports of goods and services also provided substantial support for GDP growth, thanks partly to the highly competitive exchange rate of the renminbi, having regard to the maintenance of the fixed parity with the US dollar. In addition, the low unit labour costs encouraged foreign firms to relocate to China, contributing to the vigour of exports. However, imports grew faster than exports in 2004, driven by robust domestic demand, but also owing to the increased trade liberalisation following China's accession to the WTO in 2001. China recorded a current account surplus totalling 1.1 p.c. of GDP in 2004, which was lower than in 2003. This surplus was still largely due to transactions in goods and services; the size of China's trade surplus with the United States was once again largely offset by its deficit with the other emerging Asian economies. In fact, China is a valuable source of outlets for those economies, particularly via its assembly role in the regional production chain.

Inflation in China, measured by the consumer price index, came to 4.2 p.c. in 2004, against 1.2 p.c. in the previous year. On the one hand, temporary factors such as adverse weather conditions affected food prices, which increased sharply. Also, the strength of Chinese demand contributed to a marked rise in commodity prices. In particular, the increase in the cost of oil had a substantial impact on the consumer price index, given the highly energy-intensive nature of the economy.

In a context of accelerating inflation, fiscal policy played a role in cooling the economy down, particularly via a reduction in public investment. Under the impact of this cut and the strong economic growth, the general government financing requirement came to 2 p.c. of GDP in the year under review, down against 2003 when it had reached 2.5 p.c.

TABLE 5 ECONOMIC DEVELOPMENTS IN CHINA

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

	2002	2003	2004
Expenditure at constant prices			
Final domestic demand	7.9	9.5	8.9
Exports of goods	25.6	30.5	20.0
Imports of goods	24.3	34.9	26.0
GDP	8.3	9.3	9.2
p.m. Fixed capital formation (1)	*40.1*	*44.4*	*45.8*
Prices			
Consumer prices	–0.8	1.2	4.2
Balance of payments and budget balance			
Balance of current transactions (1)	2.8	3.1	1.1
Financing balance of general government (1)	–3.0	–2.5	–2.0

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

Fears of a rise in bad debts prompted the Chinese authorities to take a series of measures in 2004 to curb the rapid expansion of lending, which was fuelling fixed capital formation. The capital requirements applicable to commercial banks were gradually increased, and credit standards were tightened up in the sectors where the profitability of certain investments was in doubt, such as metallurgy, cement, motor vehicles and real estate. In October, the People's Bank of China raised its reference rates for the first time in a number of years : rates on bank loans and deposits at one year were increased by 27 basis points to 5.58 and 2.25 p.c. respectively. By taking preventive action, the Chinese authorities are trying to avoid a hard landing for the economy, similar to that experienced in the 1990s, when the cooling measures were taken too late and were reversed too soon.

China's sizeable trade surplus with the United States and the abundance of foreign direct investment flows – China having become one of the main countries attracting capital at global level – plus portfolio investments driven by the anticipation of a future currency appreciation exerted upward pressure on the renminbi. In that context, the People's Bank of China continued to intervene on the foreign exchange market and to accumulate substantial foreign exchange reserves in order to maintain a fixed parity against the US dollar. However, the sterilisation of those intervention measures seems to be posing ever-increasing problems, and the excess liquidity in the Chinese banking system presents a risk to the sustainability of growth. The strong expansion of lending has already prompted the Chinese authorities to take the first steps towards tightening monetary conditions. All this fuelled the debate on the undervaluation of the renminbi and a possible move towards a more flexible exchange rate, which would provide the Chinese economy with an instrument facilitating adjustment to external shocks. Moreover, a movement towards greater flexibility on China's part could encourage similar action by the other emerging Asian economies which have copied China in anchoring their currency to the US dollar.

Despite the exceptional progress which China has made in terms of reforms in the direction of a market economy, and in terms of economic growth, serious structural weaknesses persist and hamper the maintenance of the country's momentum. A crucial problem which the commercial banks must address is the proliferation of non-performing loans, which began with the financing of inefficient public enterprises by the public commercial banks and has spread to the country's other banks. In mid 2003, non-performing loans were said to represent 21 p.c. of total lending. A process of banking sector reform was launched on 30 December 2003, with capital worth the equivalent of 45 billion US dollars being injected into two of the four public commercial banks which dominate the banking sector. Other measures are planned for these banks, such as an improvement in corporate governance. The stricter credit standards approved during the year under review should apply to the entire banking sector and contribute to a further reduction in the growth of bad debts. Outside the banking sector, the capital markets also remain underdeveloped. Nonetheless, guidelines published in January 2004 and enabling non-banking financial institutions to participate to a greater extent in the capital markets are a step towards the development of these markets.

Another weakness of the Chinese economy lies in the inefficiency of the public enterprises which enjoyed cheap funding provided by the public banks ; many of them continue to operate at a loss while employing a significant proportion of the population. Although these enterprises are in need of restructuring, the Chinese authorities seem rather reluctant to tackle this problem, owing to the dramatic social implications, especially as China has practically no social security system.

1.5 European Union

1.5.1 Euro area

ACTIVITY

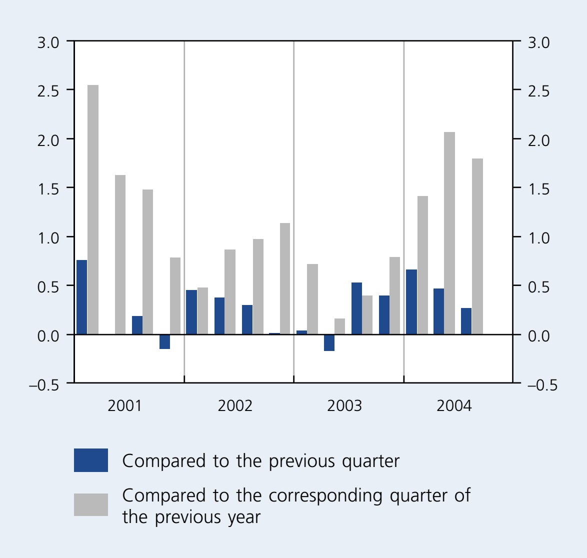
In 2004, the euro area's GDP grew by 1.8 p.c. In the first quarter, GDP was 0.7 p.c. higher than in the preceding quarter. After that, the recovery which had begun in mid-2003 slowed down somewhat. Exports were the engine of growth, but domestic demand also strengthened.

In 2004, private consumption expenditure exhibited weak growth of a little more than 1 p.c. This is comparable to that of the previous year, although the growth of real disposable incomes of households had gained a little momentum, up from 0.7 to 1.1 p.c., stimulated by a slight increase in job creation. The lack of any noticeable improvement on the labour market plus the uncertainty, particularly regarding the consequences of the oil price hike and the progress of the structural reforms, probably impaired consumer confidence.

Nevertheless, the pattern of private consumption varied greatly between countries. It declined in Germany and remained relatively sluggish in Italy and, especially in the Netherlands. Conversely, in other euro area countries, particularly France, it picked up. In some countries, such

CHART 7 CYCLICAL PROFILE OF GDP IN THE EURO AREA

(Data adjusted for seasonal and calendar effects, percentage changes at constant prices)



Source: EC.

as Germany, the Netherlands and Italy, the household savings ratio increased, whereas it showed a marked fall in France and Belgium.

Gross fixed capital formation, which in 2003 had been slightly below the previous year's level, increased once again.

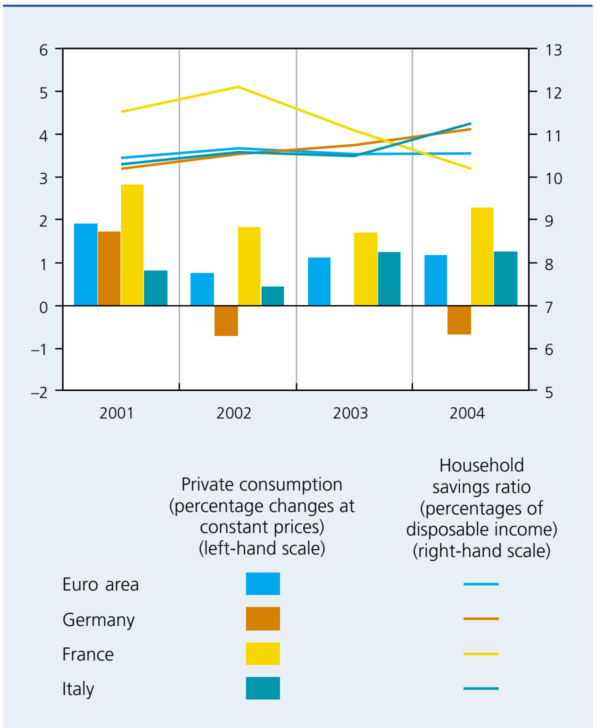
Thus, investment in housing expanded by 1.8 p.c. in 2004, against just 0.5 p.c. in 2003. Developments in this area continued to vary widely between Member States. In particular, Germany once again recorded reduced investment in housing. Business investment, which had weakened significantly in the preceding years, grew by an average of 2.4 p.c. In industry, business confidence gradually strengthened, owing to a more positive view of order books, and particularly export orders. In the context of the continuing revival in activity, the capacity utilisation rate increased in manufacturing industry during 2004. In the market services sector, on the other hand, confidence remained more or less unchanged throughout the year, though it had already improved considerably in 2003.

Finally, in 2004 it seems that the overall financial position of firms ceased to put a brake on investment in the euro area: business financing costs remained low and the balance sheet position of non-financial corporations improved. The restoration of profitability seems to have continued and a general improvement in the market indicators was also recorded in respect of corporate creditworthiness. However, investments in the euro area as a whole may have been curtailed by the uncertainty over the future profitability of firms, following the steep rise in energy costs and the growing perception that this could be permanent, plus the appreciation of the euro.

In 2004, public investment remained steady, whereas 2003 had seen a small rise of 0.2 p.c.

While the volume of exports of goods and services had hardly increased at all over 2003 as a whole, there was expansion of 5.9 p.c. in 2004. During the first half of the year, exports were the engine of the euro area's recovery, but the pace slackened in the third quarter. Import growth also showed a marked acceleration, up from 1.9 p.c. in 2003 to 5.9 p.c. Net exports thus had a neutral impact on growth, in contrast to 2003 when their contribution had been decidedly negative at 0.6 p.c.

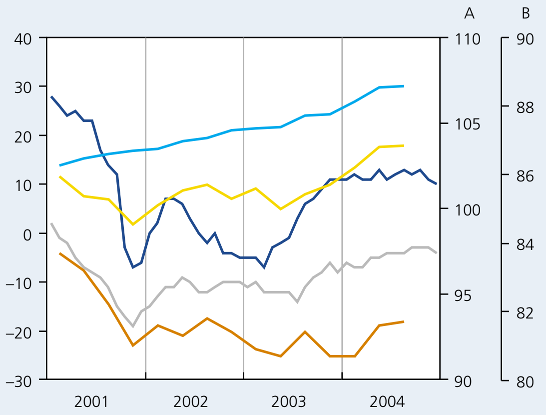
CHART 8 PRIVATE CONSUMPTION AND SAVINGS RATIO OF HOUSEHOLDS IN THE MAIN EURO AREA COUNTRIES



Source: OECD.

CHART 9 BUSINESS CONFIDENCE AND ACTIVITY IN THE EURO AREA

(Seasonally adjusted data)



Source: EC.
(1) Calendar adjusted data.

The export growth has to be viewed in the context of global GDP growth and around 10 p.c. expansion in international trade, leading to substantial enlargement of the euro area's export markets. Although the real effective exchange rate of the euro did stabilise to some extent in the first half of 2004, the appreciation which had begun in 2002 continued, particularly at the end of the year. Overall, however, this did not appear to prevent firms in the euro area from taking advantage of the expansion of their export markets, although the picture differed from country to country. The export product mix probably contributed to the strong surge in exports: owing to the relatively high proportion of investment goods in total exports, the euro area exporters were able to capitalise on the demand for these goods, particularly from the new EU Member States, China and the United States. Germany, where these goods represent a particularly high proportion of total exports, thus recorded very strong export growth during the year under review.

Overall, substantial differences were recorded between Member States of the euro area in 2004, not only in the scale of the growth, but also – and perhaps primarily – in its composition. In certain Member States, such as France, Spain and Belgium, the economy expanded strongly, driven by final domestic demand, whereas the growth contribution of net exports was negative. In contrast, in Germany the revival in activity was largely due to net exports, whereas final domestic demand made a negative contribution to activity growth for the third consecutive year. In the Netherlands, net exports were the main source of economic growth. A number of smaller euro

TABLE 6 ECONOMIC DEVELOPMENTS IN THE EURO AREA

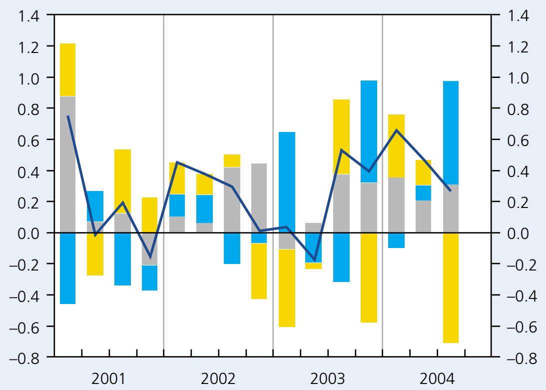
(Percentage changes compared to the previous year, unless otherwise stated)

	2002	2003	2004
Expenditure at constant prices			
Final domestic demand	0.6	0.9	1.4
Final consumption expenditure			
Households	0.8	1.1	1.2
General government	3.1	1.7	1.4
Gross fixed capital formation			
Housing	−0.9	0.5	1.8
Enterprises	−3.7	−1.0	2.4
General government	2.2	0.2	0.0
Change in stocks (1)	−0.1	0.3	0.3
Net exports of goods and services (1)	0.4	−0.6	0.1
Exports	1.7	0.1	5.9
Imports	0.6	1.9	5.9
GDP	0.9	0.6	1.8
Labour market			
Employment	0.5	0.2	0.7
Unemployment (2)	8.4	8.9	8.9
Prices and costs			
Consumer prices (HICP)	2.3	2.1	2.1
Unit labour costs in enterprises	2.0	1.7	0.7
Prices of imported goods and services	−1.8	−1.2	1.2
Terms of trade	1.6	0.8	−0.4
Balance of payments			
Balance of current transactions (3)	0.7	0.4	0.7
p.m. Private savings ratio (4)	*10.7*	*10.5*	*10.5*

Sources: EC, OECD.
(1) Contribution to the change in GDP.
(2) Ratio between the number of unemployed and the labour force.
(3) Current balance expressed as a percentage of GDP.
(4) Savings expressed as a percentage of disposable income.

CHART 10 MAIN CATEGORIES OF EXPENDITURE IN THE EURO AREA

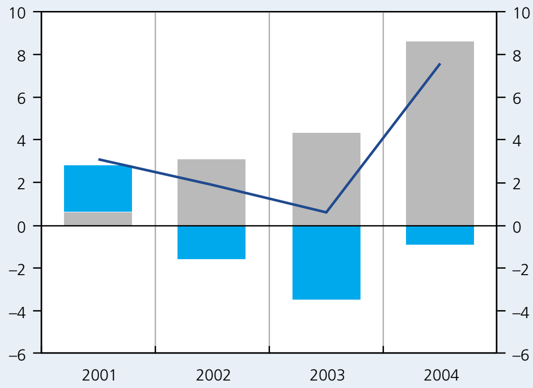
(Data adjusted for seasonal and calendar effects; contribution to the change in GDP at constant prices, compared to the previous quarter, percentage points unless otherwise stated)



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

CHART 11 EXPORTS OF GOODS BY THE EURO AREA [1]

(Percentage changes compared to the previous year)



Source: EC.
(1) Volumes, including intra-Community trade.

area countries, such as Ireland and Finland, combined relatively vigorous expansion of domestic demand with a positive contribution to growth by net exports.

LABOUR MARKET

The year under review brought a slight amplification of employment growth in the euro area, namely 0.7 p.c. against 0.2 p.c. in 2003. As in the two preceding years, a large number of jobs were axed in industry, albeit at a steadily slower rate, but these job losses were offset by gains in services. Thus, since the second quarter of 2003, there has been a clear revival in employment in the trade and transport sector, and this recovery continued during the year under review. Furthermore, the financial and business services sector, which has produced the strongest employment growth for quite some time, once again recorded the highest level of job creation.

In all, the rise in employment remained fairly modest. Admittedly, the fall in job creation following the slowdown in economic activity in 2001 had been surprisingly moderate. It seems in fact that firms had established certain manpower reserves, in view of the shortages seen in certain occupations in the past, or in anticipation of a

TABLE 7 COMPOSITION OF GDP GROWTH IN THE EURO AREA AND IN THE MAIN MEMBER STATES IN 2004

(Contribution to the change in GDP at constant prices, percentage points, unless otherwise stated)

	Euro area	Germany	France	Italy	Spain	Netherlands	Belgium e
Final domestic demand	1.3	–0.8	2.5	1.7	3.5	0.2	2.2
Change in stocks	0.3	1.0	0.7	–0.4	0.0	0.1	0.8
Net exports	0.1	0.9	–1.2	0.1	–0.9	1.1	–0.3
GDP [1]	1.8	1.2	2.1	1.3	2.6	1.2	2.7

Sources: OECD, NBB.
(1) Percentage changes compared to the previous year.

rapid growth revival. Another explanation for the weak rise in employment may be that the economic expansion in 2004 was supported to a significant degree by activity in the industrial sector, where growth has a structurally lower job content. As already noted, job losses also continued in this branch.

Looking at the various Member States, employment stagnated in Germany and France. In the Netherlands it contracted, whereas in Spain, Italy, Ireland and Greece it showed a marked rise.

In 2004, unemployment remained stable overall at 8.9 p.c. of the labour force. The unemployment rate was around 8 p.c. for men and 10 p.c. for women. For those under the age of 25, the unemployment rate remained in the region of 17 p.c.

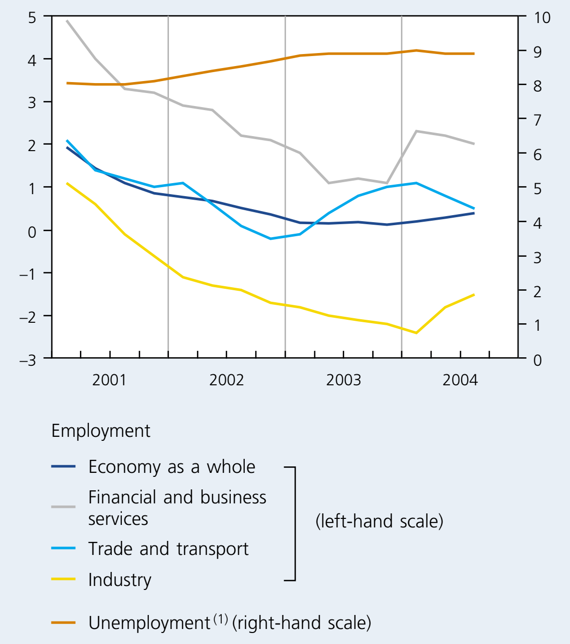
During the year under review, some Member States took significant steps to improve the operation of their labour market, in response to the recommendations made to them by the EU under the European Employment Strategy. Thus, in Germany the "Hartz" reforms were extended, as explained in more detail in box 2. Entry into force of the "Hartz I" and "Hartz II" reforms in 2003 was followed by the adoption of a set of measures known as "Hartz III" and "Hartz IV", which included reorganisation of the Federal Labour Office and amalgamation of unemployment benefits and social assistance into a single system of basic support for job-seekers. These measures are being implemented progressively, some of them taking effect in 2004 and others in 2005 or 2006. Moreover, the labour market reform act, which relaxes certain aspects of the legislation on worker protection, particularly as regards redundancies, and which shortens the period of entitlement to unemployment benefits, came into effect in January 2004.

The European Employment Strategy adopted at the Luxembourg summit in 1997 helped to bring about more consistent, coordinated implementation of the Member States' employment policies. Since the mid-1990s, there has been a substantial increase in the job-content of economic growth on the European labour market, and in the EU-15 the employment rate has risen from 62.5 p.c. in 1999 to 64.4 p.c. in 2003.

However, recent years have brought a slackening of the pace of progress towards the target set by the Lisbon summit in 2000 of an employment rate of 70 p.c. for the EU as a whole by 2010. The intermediate target of 67 p.c. by 2005 will be difficult to meet, and it also seems increasingly obvious that the 70 p.c. target will not be attainable either unless additional measures are taken.

CHART 12 LABOUR MARKET IN THE EURO AREA

(Percentage changes compared to the corresponding quarter in the previous year, unless otherwise stated)



Source: ECB.
(1) Seasonally adjusted data, percentages of the labour force.

At the March 2004 summit, the European Council stressed the need for urgent action, and in June it adopted new recommendations concerning employment policy in the Member States, in order to reinforce the European Employment Strategy. While the employment guidelines approved in June 2003 remain unchanged, the new recommendations should enable the EU Member States to concentrate their efforts better on the priorities. In particular, the recommendations call on them to enhance the adaptability of workers and firms, to get and retain more people in work, to invest more resources more effectively in human capital and life-long training, and to ensure the effective implementation of the reforms by means of improved governance.

Box 2 – Recent labour market reforms in Germany

In Germany, the recommendations of the Commission on modern labour market services, more commonly known as the "Hartz" Commission, have given a new impetus to the modernisation of that country's employment policy. The four laws concerning modern labour market services, resulting from those recommendations and known as the "Hartz I to IV" laws, are intended to augment the flexibility of the labour market and encourage the participation of a larger number of people in working life. The labour market reform law which came into force at the beginning of 2004 is also part of this process. It relaxes certain aspects of the worker protection legislation (redundancy rules) and also provides for the progressive implementation of a general limit on the period of entitlement to unemployment benefit (type I) to twelve months, and eighteen months for workers aged 55 or over. These new rules will be fully operational from 1 February 2006.

The first two "Hartz" laws came into effect at the beginning of 2003. The "Hartz I" law aims at faster, more efficient placement, in particular by the requirement to register immediately with the employment agency in the event of redundancy, the application of penalties on refusal of an appropriate job and the establishment of personnel service agencies (*Personal-Service-Agenturen*), i.e. agencies which recruit the unemployed and "hire them out" for a limited period to firms so that they can be trained. This law also opens up new job opportunities, in particular by converting undeclared employment into legal jobs, e.g. in the domestic services sector, and introduces new measures concerning basic training and retraining, as well as measures designed to encourage the reintegration of older workers on the labour market. The "Hartz II" law governs the creation of one-man businesses (*Ich-AGs*), which qualify for social protection and favourable tax rules during the launch phase. It also introduces new rules for "mini-jobs" and "midi-jobs", or small jobs attracting a monthly wage of no more than 400 euro or between 400 and 800 euro respectively. In addition, it stipulates the conditions for establishing what are called "job centres", namely labour market contact points for job-seekers and employees, offering advice and information. The aim of these measures is to avoid wasting time by failing to allocate responsibilities clearly between the employment agencies and the social services authorities. Overall, around 1.7 million new "mini-jobs" were recorded between April 2003 and June 2004, and over 170,000 unemployed persons set up their own business (Ich-AG) between the beginning of 2003 and mid 2004.

A major part of the third "Hartz" law came into effect on 1 January 2004. It regulates the reorganisation of the Federal Labour Office and its conversion into a more efficient Federal Employment Office with a stronger customer focus. It also provides for the simplification of certain provisions on unemployment benefits and the procedures for implementing various active employment policy instruments.

The fourth "Hartz" law, most of which came into force on 1 January 2005, institutes what is called the type II unemployment benefit (*Arbeitslosengeld II*) which combines social assistance with unemployment benefits in order to form a new basic form of support for job-seekers. Under these new rules, an unemployed person who has been receiving type I unemployment benefit and who does not have enough to live on will receive support in the form of type II unemployment benefit which, as a general rule, will be less than type I. The aim of these new rules is to reintegrate the long-term unemployed into the labour market. Thus, the threshold beyond which casual earnings are offset in full against the benefits has been raised: a person who accepts a job, even a "mini-job", will therefore receive more income than a person who does not participate in working life. Moreover, persons who refuse an acceptable job, training or integration measures may have their type II unemployment benefit reduced or withdrawn altogether. The "Hartz IV" law also provides for cooperation between the regional employment agencies and the municipal social services in order to prevent inefficient parallel operation of these services.

PRICES AND COSTS

Inflation in the euro area measured by the HICP stood at 2.1 p.c., as in the previous year. After a deceleration at the end of 2003 and during the initial months of 2004, the rate increased from March 2004 onwards, reaching a peak of 2.5 p.c. in May. The higher energy prices and the unfavourable base effects – oil prices had fallen steeply during the corresponding period of the previous year, following the start of the armed conflict in Iraq – are the main reason for this development, which also stemmed from increases in indirect taxes and administered prices in certain countries. Subsequently, inflation subsided, dropping to 2.1 p.c. in September, mainly as a result of the fall in unprocessed food prices brought about by favourable weather conditions in the summer. This volatile component of the HICP thus counterbalanced the rise in the annual rate of change in energy prices. From October onwards, inflation edged up again, reaching 2.4 p.c. by the end of the year.

The underlying trend in inflation – i.e. inflation excluding unprocessed food and energy – showed little change, rising from 2 p.c. in 2003 to 2.1 p.c.. Taking account of the rise in energy prices, the stability of the underlying trend in inflation is probably due to the persistence of excess production capacity. It also indicates that the increase in oil prices was not reflected in wages, and therefore did not trigger any price-wage spiral. The labour cost indicators in fact suggest that wage moderation still prevailed during the year under review, continuing the trend which had begun in 2001. The rise in compensation per employee actually slowed, falling from 2.2 p.c. in 2003 to 1.9 p.c. The sluggishness of the labour market in the euro area was certainly a factor limiting the rise in unit labour costs. The increase in those costs declined from 1.7 p.c. in 2003 to 0.7 p.c. in 2004, under the impact of marked productivity gains. The same applied in all euro area countries except for Ireland and Greece. Prices of imported goods and services, which had been falling in 2003, began to rise again, as the higher energy costs were not entirely offset by the appreciation of the euro.

TABLE 8 PRICE INDICATORS FOR THE EURO AREA

(Percentage changes compared to the previous year)

	2002	2003	2004
HICP	2.3	2.1	2.1
Underlying inflation rate (1)	2.5	2.0	2.1
Deflator of GDP	2.5	2.0	1.9
Compensation per employee (2)	2.4	2.2	1.9
Productivity (2)	0.5	0.4	1.2
Unit labour costs (2)	2.0	1.7	0.7
Prices of imported goods and services	–1.8	–1.2	1.2

Sources: EC, OECD.
(1) Measured by the HICP excluding unprocessed food and energy.
(2) In enterprises.

TABLE 9 INFLATION IN THE COUNTRIES OF THE EURO AREA (1)

(Percentage changes in the HICP compared to the previous year)

	2003	2004
Germany	1.0	1.8
France	2.2	2.3
Italy	2.8	2.3
Spain	3.1	3.1
Netherlands	2.2	1.4
Belgium	1.5	1.9
Austria	1.3	2.0
Greece	3.4	3.0
Finland	1.3	0.1
Ireland	4.0	2.3
Portugal	3.3	2.5
Luxembourg	2.5	3.2
Minimum	1.0	0.1
Maximum	4.0	3.2
Interval	3.0	3.1
Standard deviation	1.0	0.8

Source: EC.
(1) The countries of the euro area are ranked in order of the size of their GDP in 2004.

The rise in inflation during the year was apparent from April onwards in all the countries of the euro area except Ireland and Finland, where the increase in inflation came a little later. Finland actually recorded price falls between March and June 2004, following a sharp reduction in taxes on alcohol. Price increases well above the euro area average were recorded in Greece, Spain and Luxembourg. In the case of Greece, this may be due to energy price increases which are above average for the euro area, and a substantial rise in unit labour costs. Spain was confronted by a rise in the prices of unprocessed food which was much steeper than in the other euro area countries. In Luxembourg, inflation accelerated owing to the upward pressure exerted on the energy component of the HICP: on the one hand, this component has a relatively high weight in that country; also, the low level of the flat-rate taxes on petroleum products there increases the sensitivity of the price index to fluctuations in oil prices. The pace of price rises in Germany, Finland and the Netherlands remained below the average for the euro area throughout the year. These were also the countries which recorded a decline in their unit labour costs in 2004, whereas those costs were still rising in 2003. In all, the inflation differential between euro area countries, measured by the unweighted standard deviation, diminished in 2004.

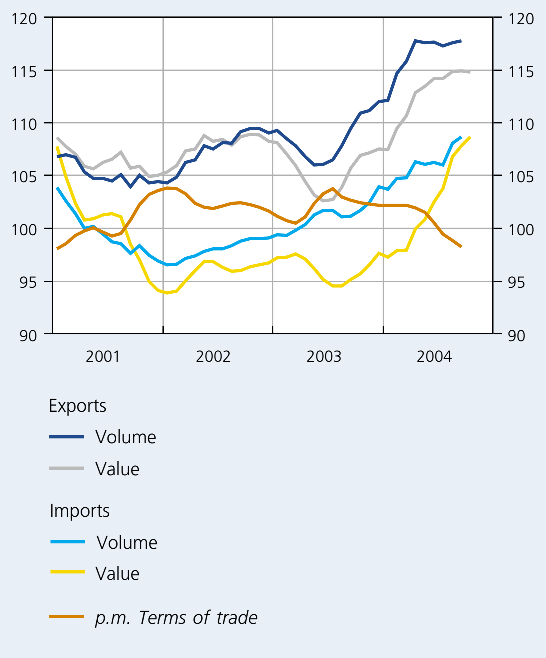
BALANCE OF PAYMENTS

During the first ten months of the year under review, the current account surplus of the euro area as a whole – i.e. considering only trade with countries outside the euro area – showed a marked rise, reaching around 30 billion euro, whereas it had totalled only around 13 billion during the same period of 2003.

This improvement is due largely to the increase in the surplus on trade in goods, up from 88.4 to 94.5 billion euro.

CHART 13 TRADE IN GOODS BETWEEN THE EURO AREA AND COUNTRIES OUTSIDE THE EURO AREA

(Indices 2000 = 100, three-month moving average of seasonally adjusted data)



Source: ECB.

TABLE 10 BALANCE OF PAYMENTS OF THE EURO AREA

(Billions of euro)

	2003 (1)	2004 (1)
Current account balance	12.9	29.8
Goods	88.4	94.5
Services	14.8	15.6
Income	–42.8	–33.1
Current transfers	–47.5	–46.9
Capital account balance	7.1	12.1
Financial account balance	–7.1	–41.6
Direct investment	0.9	–46.6
Equity capital and reinvested earnings	–8.1	–44.9
Other capital, mostly inter-company loans	8.9	–1.9
Portfolio investment	67.2	40.6
Equities	37.6	18.9
Debt instruments	29.5	21.7
p.m. Combined net direct and portfolio investment	*68.1*	*–6.0*
Financial derivatives	–6.8	0.4
Other investments (2)	–85.6	–47.3
Reserve assets	17.0	11.1
Errors and omissions	–12.8	–0.5

Source: ECB.
(1) First ten months of the year.
(2) Primarily the balance resulting from the new financial liabilities of MFIs vis-à-vis non-residents of the euro area and from their formation of financial assets vis-à-vis these, excluding transactions relating to the reserve assets of the Eurosystem.

Up to April in the year under review, the volume growth of exports continued to outpace that of imports, as it had in the second half of 2003. During the first four months of 2004, the volume exported rose by about 5.1 p.c., boosted mainly by the surge in foreign demand, particularly on the part of the new EU Member States, the United States and China; during this period, the volume growth of imports was barely half that figure. At the same time, the terms of trade changed little, so that the surplus on the balance of trade in goods increased practically month by month to reach almost 9 billion euro in April.

This favourable trend came to a halt in May: the volume of goods exported remained steady, as did the volume of imports. On the other hand, the value of imports began to rise faster than that of exports, owing to the oil price hike. This substantial deterioration in the terms of trade caused the surplus on the balance of trade in goods to contract month by month, dropping to under 3 billion euro in October.

The reduction in the deficit on the income account was the main source of the improvement in the current account balance. It stemmed from the rise in incomes generated by foreign direct investment, and to a lesser extent by portfolio investments in equities.

The balance of all capital movements resulting from direct and portfolio investments, which had still been decidedly positive in 2003, deteriorated to become a deficit of 6 billion euro, mainly on account of direct investment. Foreign direct investment in the euro area in fact fell sharply, the main reason being that the growth prospects were not as good as elsewhere in the world. This decline in inward investment, in the form of both equity capital and inter-company loans, was only offset to a very small extent by a fall in foreign investments by residents. There was also a sharp decline in the portfolio investment surplus, owing to the reduction in investments by non-residents in euro area equities and the fall in their purchases of money market instruments issued by the euro area. This development was only partly counterbalanced by the reduction in purchases of foreign debt securities by residents. However, this reduction conceals some significant movements, namely a noticeable decline in investments in foreign bonds and a rise in purchases of foreign money market instruments.

FISCAL POLICY

Since the introduction of the euro, the general government financing requirement has increased year by year throughout the euro area, except in the year 2000. It reached almost 3 p.c. of GDP during the year under review. It is mainly the three largest Member States that contributed to this adverse development: Germany and France recorded an excessive deficit for the third consecutive year, while Italy also failed to adhere to the limit of 3 p.c. of GDP. Spain which, in recent years, had pursued an orthodox fiscal policy, and whose deficit of 1.2 p.c. of GDP in 1999 had been converted to a surplus of 0.4 p.c. of GDP in 2003, recorded a deterioration amounting to 1 p.c. of GDP. The budget position of the small countries also worsened, except in the Netherlands where the government made a particular effort to bring the deficit down below 3 p.c. of GDP, following a sudden rise in 2003. Finland alone managed to maintain its comfortable surplus.

TABLE 11 FINANCING REQUIREMENT (–) OR CAPACITY OF GENERAL GOVERNMENT IN THE EURO AREA [1] [2]

(Percentages of GDP)

	1999	2000	2001	2002	2003	2004		
						Actual figures [3]	Stability programme target [4]	Difference
Germany	–1.5	–1.2	–2.8	–3.7	–3.8	–3.9	–3.3	–0.7
France	–1.8	–1.4	–1.6	–3.3	–4.1	–3.7	–3.6	–0.1
Italy	–1.8	–1.8	–2.6	–2.3	–2.4	–3.0	–2.2	–0.8
Spain	–1.2	–1.0	–0.4	–0.1	0.4	–0.6	0.0	–0.6
Netherlands	0.7	1.5	–0.1	–1.9	–3.2	–2.9	–2.3	–0.6
Belgium	–0.4	0.2	0.4	0.1	0.4	0.0 e	0.0	0.0
Austria	–2.4	–1.9	0.3	–0.2	–1.1	–1.3	–0.7	–0.6
Greece	–3.4	–4.1	–4.2	–3.7	–4.6	–5.5	–1.2	–4.3
p.m. Idem before revision [5]	*–1.8*	*–2.0*	*–1.9*	*–1.4*	*–3.0*	*–3.2*	*–1.2*	*–2.0*
Finland	2.2	7.1	5.2	4.3	2.3	2.3	1.7	0.6
Ireland	2.5	4.4	0.9	–0.4	0.1	–0.2	–1.1	0.9
Portugal	–2.9	–3.2	–4.4	–2.7	–2.8	–2.9	–2.8	–0.1
Luxembourg	3.7	6.0	6.4	2.8	0.8	–0.8	–1.8	1.0
Euro area	–1.4	–1.0	–1.7	–2.4	–2.7	–2.9	–2.3	–0.6

Sources: EC, national stability programmes, NBB.

(1) The euro area countries are ranked in order of the relative size of their GDP in 2004.

(2) Including, under the rules laid down for the excessive public deficit procedure (EDP), net interest gains on certain financial transactions such as swaps, and excluding the proceeds from the sale of UMTS licences.

(3) According to the EC's autumn 2004 economic forecasts, except for Belgium, where the Bank's estimate was used.

(4) On the basis of the stability programme updates at the end of 2003, except for Spain, where the update did not take place until January 2004.

(5) Data published for Greece in the EC's spring 2004 forecasts.

Box 3 – Reform of the Stability and Growth Pact

Since 2003, the Stability and Growth Pact has faced a stern test, mainly because of the slippage of public finances in France and Germany. In both those countries, the public deficit has in fact exceeded the limit of 3 p.c. of GDP since 2002. Similarly, the public debt has exceeded the 60 p.c. ceiling since 2002 in Germany and since 2003 in France. In that context, the implementation of the procedures laid down by the Stability and Growth Pact for dealing with excessive public deficits proved very problematic. Initially strict EC recommendations have sometimes been watered down or ignored by the Ecofin Council, while the EC has also shown some flexibility in certain cases, in particular by proposing in November 2003 that the German and French governments should be given until 2005 to reduce their deficit below the 3 p.c. limit. This recommendation was accompanied by the obligation to make a greater effort at budgetary consolidation in 2004 than the two States concerned had declared that they were willing to make. On 25 November 2003 the Ecofin Council decided to disregard this recommendation and to hold in abeyance the excessive public deficit procedures initiated against Germany and France. Instead, it formulated new recommendations to replace its earlier ones. These decisions prompted the EC to refer the matter to the Court of Justice of the European Communities, which ruled in July 2004 that the Ecofin Council had failed to respect either the rules or procedures of the pact. The failure to respect the pact lay not so much in the fact that the Council had not taken any decision on the EC's recommendations – the EC's action was in fact declared inadmissible by the Court on this point – than in the Council's decision to hold the procedure in abeyance and formulate new recommendations, in violation of the right of initiative of the EC, which has that prerogative. What is more, the Ecofin Council had acted against the recommendations which it had itself adopted previously.

European Commission proposals

Meanwhile, the Intergovernmental Conference on the Treaty establishing a Constitution for Europe, meeting at the level of the heads of state and government, adopted a declaration on 18 June 2004 which stated that strengthening growth potential and guaranteeing sound budget positions are the two pillars of the economic and fiscal policy of the Union and of the Member States. At the beginning of September, in line with that declaration, the EC published a communication to the Council and to the Parliament containing proposals for reinforcing economic policy and clarifying the implementation of the pact. Those proposals are based on four pillars:

1) accord greater importance to the public debt and the long-term sustainability of public finances. Among other things, that implies defining more precisely the debt criterion stated in the Treaty establishing the European Community, particularly the rate at which it must be reduced in cases where it exceeds the 60 p.c. limit, in order to avoid confirmation of an excessive public deficit. It must also be possible to take account of all the factors which influence long-term sustainability, particularly future expenses linked to population ageing;
2) when defining the medium-term target for the general government balance, take greater account of a country's specific circumstances. The aim of the pact in stipulating a budget close to balance or in surplus in the medium term is to ensure that the Member States have sufficient scope to allow the automatic stabilisers to operate freely and to bring about a reduction in the public debt ratio. According to the EC's proposal, Member States with a higher debt ratio should adopt a more restrictive budget target than those with a lower debt ratio;
3) make greater allowance for economic conditions and developments when applying the excessive public deficit procedure. At present, a deficit of more than 3 p.c. of GDP need not automatically be regarded as excessive in certain special circumstances, namely if GDP has fallen by at least 2 p.c. in one year. The EC considers that greater flexibility is necessary so that a longer period of weak yet positive growth can also be regarded as special circumstances. Moreover, the time within which a country must eliminate its excessive public deficit, limited to one year, in principle, under the pact, could be extended depending on the particular economic conditions facing the country concerned;

4) intervene sooner to rectify any undesirable budgetary developments. It is also affirmed that mutual monitoring by the Member States can help all countries to pursue a prudent fiscal policy, which means creating surpluses when economic conditions are favourable, so that the balances are symmetrical across the economic cycle. The ruling handed down by the Court of Justice of the European Communities and the provision in the draft European Constitution whereby the Council must act on the basis of the EC's proposals, rather than on the basis of recommendations, should make it possible to tighten up the pact. In connection with the monitoring of the Broad Economic Policy Guidelines, the Constitution also makes provision for the EC to issue early warnings without their being subject to the approval of the Ecofin Council, as they have been hitherto. Furthermore, the EC proposes strengthening the link between national budget procedures, the pact and the Broad Economic Policy Guidelines, e.g. by bringing forward the dates for the submission and assessment of the stability or convergence programmes, and giving them a more strategic content, so that they can be used to a greater extent than in the past as the central thread running through national fiscal policies.

Following the publication of this communication, fundamental revisions to the Greek public finance statistics also showed the importance of reliable, good quality data for monitoring the budgetary provisions of the Treaty and the pact, and complying with them. A number of proposals were subsequently formulated in this area, too.

All these proposals were still being examined by the Economic and Financial Committee and Ecofin at the date of completion of this Report.

Assessment of the European Commission's proposals

In a monetary union without political union, the fiscal policy of the Member States has to be coordinated at supranational level, and there must be safeguards to prevent developments in the budget deficit or the public debt prejudicial to macroeconomic and financial stability[1]. In addition, it is essential that the rules which the Member States must respect should be clear, comprehensible and applied to all countries without discrimination. From that point of view, the Stability and Growth Pact is a serviceable instrument. True, some of the EC proposals may help to improve its application: that is so, for example, in the case of the proposal whereby the European institutions can intervene more vigorously and promptly, and the one advocating the creation of surpluses during periods of favourable economic conditions. Conversely, other proposals which make the excessive public deficit procedure less stringent, such as the idea of allowing for the specific national context when deciding the deadline for rectifying an excessive deficit, may lead to an undesirable weakening of the pact, by adding to the risk that the public deficit may exceed the limit of 3 p.c. of GDP, and depriving the pact of its ability to take effective action against excessively lax fiscal policies.

It is also vital for the credibility of the monitoring of public finances that the data should be reliable and available on time, comparable between countries and unaffected by political considerations. To enhance data quality, it would be expedient to increase the independence of the competent statistical institutions and extend their powers to pass on data for the purposes of the excessive public deficit procedure. Periodic presentation in greater detail of the data underlying the deficit and debt figures would permit more rigorous control, thus also promoting transparency and hence greater credibility.

(1) In this connection, see also box 1 *Economic foundations of the European rules on the fiscal policy of the Member States* in the NBB Report 2003 (Part 1), pp. 21-22.

As in previous years, the majority of the countries missed the targets specified in their stability programmes: only Finland, Ireland and Luxembourg, countries enjoying an enviable budget position right from the start, exceeded the targets which they themselves had set, while Germany, Italy, Spain, the Netherlands, Austria and – above all – Greece fell far short of the set objective. Belgium achieved a balanced budget, as announced in its stability programme.

During the year under review, it also emerged that Greece's statistics on public finances contained serious errors. While it had previously been thought that Greece's deficits had usually remained well below 3 p.c. of GDP, it became apparent that the country had recorded an excessive deficit every year since joining the euro area in 2001, and even before that.

Since 1999, the increase in the euro area's financing requirement has been due primarily to discretionary fiscal measures adopted in the three largest Member States, as is shown by the sharp downward trend in their cyclically adjusted primary balance over that period, although certain small countries – Greece being the most glaring example – have also contributed. During the year under review, Italy, Spain, Greece and Luxembourg were the main countries to reduce their cyclically adjusted primary surplus, as did Belgium, although it still retained the highest surplus in the euro area. Conversely, France and the Netherlands were the only countries to record an improvement in their adjusted primary balance.

In November 2003, Germany and France had been ordered by the Ecofin Council to bring their deficit down below 3 p.c. of GDP in 2005, and at all events to reduce its size in 2004. Germany succeeded in maintaining its public spending at a more or less constant level in nominal terms during the year under review, mainly as a result of reforms in health care and pensions. Nonetheless, the general government financing requirement was undiminished, owing to the decline in revenues following the substantial income tax cuts. Moreover, the proceeds from the tax amnesty were very disappointing. France's deficit contracted, falling from 4.1 p.c. of GDP in 2003 to 3.7 p.c. in 2004, mainly because of the favourable economic climate, but also thanks to slower expenditure growth.

Disregarding Greece, Italy is the country that fell farthest short of the target set by its stability programme; its cyclically adjusted primary surplus also contracted sharply. This result is attributable primarily to the absence of substantial non-recurring revenues collected in 2003, although the successful 2004 tax amnesty did partly compensate for the effects. Spain's primary balance deteriorated, the main reason being a capital transfer to the national railway company. For Greece, which – according to the Ecofin Council decision of 5 July 2004 – is in an excessive

TABLE 12 CYCLICALLY ADJUSTED PRIMARY BALANCE OF GENERAL GOVERNMENT IN THE EURO AREA (1) (2)

(Percentages of GDP)

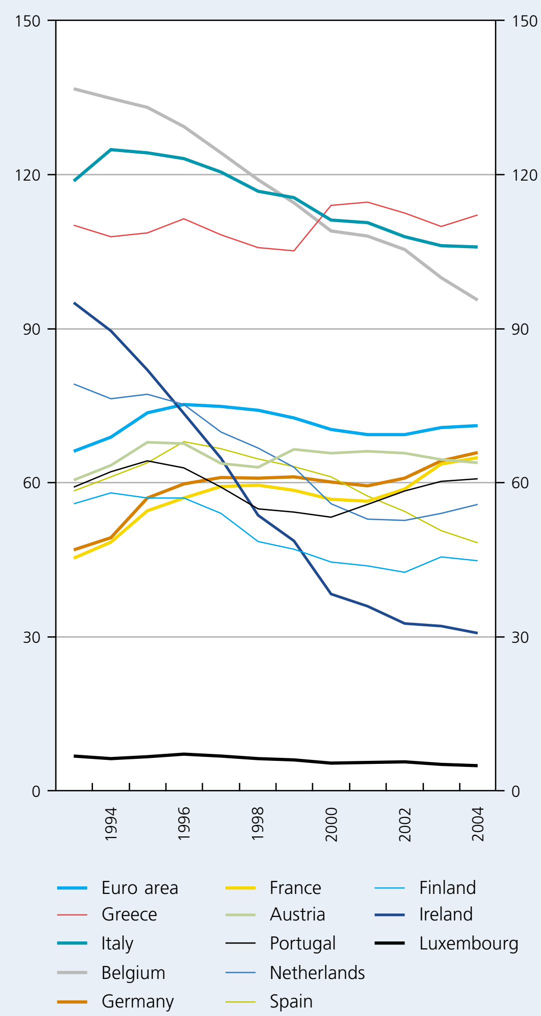
	1999	2000	2001	2002	2003	2004
Germany	2.2	1.7	0.2	–0.3	0.1	–0.3
France	1.2	0.9	0.8	–0.6	–0.9	–0.6
Italy	4.8	3.9	3.2	3.4	3.4	2.6
Spain	2.5	1.6	2.1	2.4	2.7	1.7
Netherlands	3.6	3.3	2.1	1.0	1.1	1.4
Belgium	6.3	5.9	6.7	6.5	6.5	5.3
Austria	0.8	1.0	3.5	2.9	2.2	2.0
Greece	7.0	4.2	2.9	2.5	0.7	–0.7
Finland	3.9	7.5	7.2	6.3	4.7	4.5
Ireland	3.8	4.7	1.3	0.1	1.4	1.4
Portugal	–0.3	–0.9	–1.9	0.1	1.0	0.9
Luxembourg	2.8	3.0	5.5	3.1	1.9	0.6
Euro area	2.8	2.3	1.7	1.2	1.3	0.9

Source: EC.
(1) The euro area countries are arranged in order of the relative size of their GDP in 2004.
(2) Excluding the proceeds of the sale of UMTS licences.

deficit situation, the impact of the costs entailed in organising the Olympic Games presented an additional reason for the budgetary slippage. Portugal, which had already recorded an excessive deficit in 2000 and 2001, and which had systematically remained close to the limit of 3 p.c. of GDP thereafter, was unable to keep below that threshold in 2004 except by taking a number of one-off measures, the main ones being the sale of tax arrears and of properties, and the transfer to the government of the pension reserves of a number of public enterprises.

CHART 14 CONSOLIDATED PUBLIC DEBT IN THE EURO AREA (1)

(Percentages of GDP)



Sources: EC, NBB.

(1) For some countries, the data have been revised for only part of the period covered by the chart. This means a significant break in the series for Greece in 2000.

Confronted by an excessive deficit in 2003, the Dutch authorities responded with a series of extra economy measures, including in particular the moderation of civil service wages and welfare benefits, health insurance reforms and a range of one-off measures. This brought the deficit in the Netherlands down below 3 p.c. of GDP.

Since 1993, the debt level of the euro area as a whole has risen by around 5 p.c. of GDP, increasing from 66.2 to 71.1 p.c. of GDP. That is the outcome of two opposing movements during the period in question. On the one hand, some countries – and more particularly Ireland and Belgium – achieved a significant reduction in their public debt. Conversely, France and Germany in particular allowed their debt to increase by very similar proportions: having been in the region of 50 p.c. of GDP in the early 1990s, their debt increased during the year under review to a level well in excess of the limit set by the Maastricht Treaty.

Belgium and Ireland are the only Member States of the euro area to have achieved a reduction in their public debt as a percentage of GDP every year since 1994. That percentage has thus been reduced by around one-third altogether in Belgium's case, to 95.6 p.c. of GDP, and just over two-thirds in Ireland, where it has fallen to 30.8 p.c. of GDP. In that country, which had one of the highest debt ratios in the euro area at the start of the period considered, exceptionally strong economic growth greatly assisted that debt reduction. Since 1995, Italy's debt ratio has also declined, but far less steeply than that of Belgium and Ireland. In the past few years, Italy appears to have been growing tired of austerity measures, so that the debt has remained above 100 p.c. of GDP. Greece, the other country with the highest level of debts, has actually seen repeated increases in its debt ratio in the recent past.

1.5.2 EU Member States not belonging to the euro area

On 1 May 2004, following several years of intensive preparations, the enlargement of the EU by the accession of ten new countries became a reality. However, the Union as a whole did not undergo any fundamental transformation in economic terms, in view of the relatively modest size of the new Member States. Nonetheless, there was a significant increase in economic diversity within the EU, since the institutional and structural characteristics of the new members are often very different from those of the other Member States.

For the euro area as a whole, the thirteen other EU Member States are extremely important, not only because of the political and institutional links but also in economic terms, since around one-third of the euro area's trade takes place with those countries, against just 14 p.c. with the United States, roughly 5 p.c. with China and 4 p.c. with Japan.

RECENT ECONOMIC DEVELOPMENTS

During the year under review, economic growth gathered speed in the EU Member States outside the euro area, reaching an average of 3.6 p.c. compared to 2.3 p.c. a year earlier. The expansion in activity was strongest in the new Member States with the lowest per capita GDP, namely the Baltic States, Poland and Slovakia, but very sustained growth was also recorded in the United Kingdom and Sweden, where it reached 3.3 and 3.7 p.c. respectively. Investments were the main engine of the accelerating growth in the EU Member States outside the euro area. Strengthening business confidence, the high level of capacity utilisation and the improving demand outlook made a substantial contribution here. The inflow of financial resources from the structural and cohesion funds also stimulated investment in the new Member States. Moreover, the growth of private consumption was generally sizeable in those countries. On the eve of the accession, household spending there was in fact given a temporary boost by the anticipation of price increases following enlargement, and sustained growth of lending to the private sector. Conversely, in the United Kingdom private consumption slowed during the year under review, in parallel with the easing of tension on the housing market.

As regards public finances, three countries – Denmark, Sweden and Estonia – recorded a budget surplus while six new Member States recorded a deficit in excess of 3 p.c. of GDP in 2004. In Poland and Slovakia, the situation even deteriorated in relation to the previous year. In its recommendations, the Ecofin Council of 5 July therefore considered that these six countries were in an excessive public deficit situation, though it did acknowledge that, except for Cyprus, they faced special circumstances owing to the structural adjustments following their recent accession to the EU, and that justified postponing the correction of this problem to the medium term. Cyprus and Malta were the only countries to record a public debt in excess of 60 p.c. of GDP, but a rise was recorded in a number of new Member States whose public debt ratio had been relatively low, owing to the historical and institutional context.

Several new Member States recorded an increase in their current account deficit : in Estonia's case, that deficit actually exceeded 10 p.c. Conversely, Denmark and Sweden recorded a surplus, while the United Kingdom's deficit remained modest. In the new Member States, the expansion of the deficit is due to the buoyancy of imports and a rising deficit on the income account. While the current account deficit is still financed largely by a constant inflow of foreign direct investment, capital inflows – which give rise to interest payments – are also increasing. This development may be attributed partly to the ending of the process of privatisation and to an increase – linked to substantial budget deficits – in the issue of government bonds, which are bought mainly by foreign investors and thus augment the level of the external debt.

MONETARY POLICY DEVELOPMENTS

While the primary objective of the monetary policy of all the EU Member States outside the euro area is to achieve price stability – as it is in the euro area –, the monetary policy strategies adopted differ widely, as some of the new member countries opt for an explicit exchange rate target and thus for the advantages of external anchorage, in order to curb inflation expectations, and others make partial or exclusive use of an inflation target. Estonia, Lithuania and Slovenia, which joined the multilateral exchange rate mechanism, ERM II, on 28 June 2004, and in practice allow their currency to fluctuate within a narrow "corridor" against the euro (for more details, see box 4), indisputably belong to the first group. Apart from these three countries, Cyprus, Latvia and Malta also pursue an exchange rate objective. Thus, Cyprus unilaterally applies a system comparable to the ERM II, and the Cyprus pound in fact fluctuates within a narrow range either side of the stated central rate. Latvia and Malta do not tie their currency to the euro but, respectively, to the SDR and to a basket comprising the euro, the US dollar and the pound sterling. In Cyprus and Malta, the full liberalisation of capital movements since 1 May 2004 has had no immediately obvious effect on exchange rate movements.

Other new Member States pursue a mixed strategy. Hungary, in particular, has an exchange rate and inflation target but in the event of any conflict, priority is given to the exchange rate target, in view of a legal obligation. In 2004, the key interest rate was cut from 12.5 to 9.5 p.c. : this was possible partly because the increased stability in the macroeconomic climate reduced the need to raise the risk premium, and partly because inflation declined in the second half of the year. The Hungarian forint appreciated slightly against the euro in 2004, but remained within the 15 p.c. fluctuation bands defined by the Hungarian authorities around the unilaterally determined central rate. Slovakia also has an inflation target, but at the same time it tries to safeguard its exchange rate against excessive movements. In an environment featuring substantial capital inflows in the form of foreign direct investment, the Slovakian central bank therefore intervened on several occasions to combat the pressure on the exchange rate of the Slovak koruna against the euro.

Finally, Poland and the Czech Republic have only set an inflation target, and both countries raised their key interest rate in 2004, owing to the upward pressure on consumer prices resulting from the steady rise in oil prices and various increases in indirect taxes.

At the beginning of the year under review, the Riksbank twice cut its key interest rate by 0.25 p.c. in response to the downward adjustment to inflation forecasts, but maintained that rate at 2 p.c. from April onwards. The inflation rate, measured by the national consumer price index, in fact remained very subdued in Sweden, even during the recent cyclical upturn, mainly on account of a weak rise in import prices and strong productivity growth. The rise in this index, which was only 0.4 p.c. in 2004 (1 p.c. according to the HICP), thus fell short of the target set by the monetary authorities, namely a 2 p.c. rise in consumer prices with a tolerance margin of 1 p.c. The Bank of England also set itself an inflation target, defined since December 2003 as a rise of 2 p.c. in the HICP with a tolerance margin of 1 p.c. Since November 2003, the key interest rate has been raised five times in the United Kingdom, in view of the persistent rise in house prices, the good performance of the British economy and the resulting effects on inflation expectations, bringing the rate to 4.75 p.c. in August 2004. Denmark remained a member of the ERM II in 2004 and thus pursued the policy of a fixed exchange rate against the euro while maintaining a narrow corridor of 2.25 p.c. in relation to its central rate. Between March and June, the Danish krone appreciated slightly as a result of net acquisitions of bonds denominated in that currency, which encouraged the central bank to intervene on the foreign exchange market. Nevertheless, the exchange rate remained within the set margins throughout the year under review. The interest rate target has remained unchanged since June 2003, as has the spread in relation to the ECB key rate, at 15 basis points.

TABLE 13 ECONOMIC SITUATION OF THE EU MEMBER STATES NOT FORMING PART OF THE EURO AREA IN 2004 (1)

	GDP at constant prices	HICP	Unemployment (percentages of the labour force)	Public finances		Balance of payments current account	Share in the GDP of the EU (percentages)
				Financing balance	Debt		
	(Percentage changes compared to the previous year)			(Percentages of GDP)			
United Kingdom	3.3	1.3	4.9	–2.8	40.4	–2.0	16.8
Sweden	3.7	1.0	6.3	0.6	51.6	7.3	2.7
Denmark	2.3	0.9	5.8	1.0	43.4	3.2	1.9
Poland	5.8	3.6	19.0	–5.6	47.7	–2.6	1.9
Czech Republic	3.8	2.6	8.3	–4.8	37.8	–6.1	0.8
Hungary	3.9	6.8	5.8	–5.5	59.7	–8.7	0.8
Slovakia	4.9	7.4	18.4	–3.9	44.2	–2.9	0.3
Slovenia	4.0	3.6	6.3	–2.3	30.9	–0.2	0.3
Lithuania	7.1	1.1	11.4	–2.6	21.1	–8.7	0.2
Cyprus	3.5	1.9	4.2	–5.2	72.6	–4.5	0.1
Latvia	7.5	6.2	9.9	–2.0	14.6	–9.9	0.1
Estonia	5.9	3.0	9.7	0.5	4.8	–13.0	0.1
Malta	1.0	2.7	8.6	–5.1	72.4	–4.0	0.0
EU excluding euro area	3.6	1.7	9.5	–2.5	42.6	–1.1	26.1
p.m. Idem in 2003	*2.3*	*1.7*	*9.5*	*–3.1*	*42.2*	*–1.2*	

Source : EC.
(1) These countries are ranked in order of the relative size of their GDP in 2004.

Box 4 – The ERM II mechanism

Three new Member States have joined the ERM II

The ERM II, which was established by a resolution of the European Council on 16 June 1997, came into force on 1 January 1999, at the beginning of the third stage of EMU. This mechanism links to the euro the currencies of the EU Member States which do not belong to the euro area. Those Member States are free to decide whether or not to participate in the ERM II; nevertheless, they are expected to join the mechanism one day, since that is one of the convergence criteria for permanent accession to the euro area, required of every Member State except the United Kingdom and Denmark under the Treaty establishing the European Community.

The foreign exchange policy conducted by the Member States which are not in the ERM II does not entirely escape the rules on coordination, since it is subject to the treaty provision whereby it is considered a matter of mutual interest. That means a prohibition on competitive devaluations, which could undermine the functioning of the internal market.

As regards the operational aspects of the exchange rate mechanism, defined by the agreement of 1 September 1998 between the ECB and the NCBs of the Member States not belonging to the euro area, a central rate against the euro and a (standard) fluctuation band of 15 p.c. on either side of the central rate are determined for the currency of each Member State participating in the mechanism. If a threshold is reached, intervention on the foreign exchange market is, in principle, automatic and unlimited, with very short-term financing. This automatic intervention may be suspended in the event of a conflict with the main objective of the ECB and the NCBs, which is to maintain price stability. The cooperation concerning the foreign exchange policy may be reinforced, in particular by applying narrower fluctuation bands, where that is appropriate to foster greater convergence.

At the request of the authorities of Estonia, Lithuania and Slovenia, the ministers of finance and economic affairs of the euro area Member States, the president of the ECB and the ministers of finance and economic affairs and central bank governors of the other Member States participating in the mechanism decided by mutual agreement, following a procedure involving the EC and after consulting the Economic and Financial Committee, that the currencies of the three countries mentioned above would participate in the ERM II from 28 June 2004. The central rate of the Estonian kroon was set at EEK/EUR 15.6466, that of the Lithuanian litas at LTL/EUR 3.45280 and that of the Slovenian tolar at SIT/EUR 239.640, with a standard fluctuation band of 15 p.c. on either side of the central rate for the three countries. The central rate of the Danish krone, set at DKK/EUR 7.46038, remained unchanged, as did the compulsory intervention rates resulting from the 2.25 p.c. fluctuation band for that currency. Following a careful assessment of the appropriateness and sustainability of the currency boards in operation in Estonia and Lithuania, the two countries were authorised to join the ERM II with the existing arrangements remaining in place; however, the commitment is unilateral, so that the ECB has not incurred any additional obligation.

Since the recent accession to the ERM II of the Estonian kroon, the Lithuanian litas and the Slovenian tolar, the foreign exchange markets have not shown signs of any pressure on these currencies, which have traded at or close to their central rate. The short-term interest rate differentials in relation to the euro area have been less than 1 p.c. for Estonia and Lithuania, while dropping to around 1.9 p.c. in the fourth quarter of 2004 in the case of Slovenia.

Participation in the ERM II exchange rate mechanism and convergence criteria

Participation in the ERM II is just one of the criteria mentioned in the Treaty establishing the European Community as a condition of accession to the euro area. There are accompanying conditions concerning the movement in exchange rates, and other criteria have to be met in regard to the convergence of the inflation rate, the budget deficit, the public debt, long-term interest rates and the legislation concerning the national central bank. Apart from these convergence criteria which are described in detail in the treaty, account must also be taken of other factors explicitly mentioned in the treaty, such as the degree of market integration, the situation and development of the current account of the balances of payments, and the development of unit labour costs and other price indices.

The exchange rate criterion stipulates that a Member State must have succeeded in maintaining the normal fluctuation bands specified by the exchange rate mechanism of the European Monetary System without any serious tension for at least two years preceding the convergence assessment. Thus, during that period, the Member State must certainly not have devalued, on its own initiative, the bilateral central rate of its currency against the euro. Moreover, the question of the absence of "serious tension" is assessed by taking account of the degree of divergence between the exchange rate and the central rate, the short-term interest rate differentials in relation to the euro area and how they have moved, and the role of the intervention carried out on the foreign exchange markets.

The other four criteria stipulate that: a) the average inflation rate, observed over a period of one year before the convergence assessment, must not be more than 1.5 percentage points higher than that of the three best performing EU Member States in terms of price stability; b) the government budgetary position must not show any excessive deficit, i.e. the public deficit must not exceed the limit of 3 p.c. of GDP and the public debt ratio must not exceed the reference value of 60 p.c. of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace; c) during a period of one year preceding the examination, the long-term average nominal interest rate must not be more than two percentage points higher than that of the three best performing EU Member States in terms of price stability; d) the national legislation and the statutes of the NCB must be compatible with the provisions of the treaty concerning the NCBs, particularly those relating to their functional, institutional, personal and financial independence. The national legislation must explicitly assign price stability as an objective for the NCB. Another particularly important aspect is the provision banning the NCB or its decision-making bodies from seeking or taking instructions from other Community or national authorities.

2. The monetary policy of the Eurosystem

2.1 Strategic aspects

The primary objective of the Eurosystem's monetary policy is to maintain price stability in the euro area, in accordance with the provisions of the Maastricht Treaty. By firmly anchoring long-term inflation expectations at a stable and low level, monetary policy contributes towards an economic environment conducive to sustainable growth and employment. The ECB Governing Council defined that primary objective as an annual increase in the HICP for the euro area of less than, but close to, 2 p.c. in the medium term.

Under the Eurosystem's monetary policy strategy, the risks to price stability are assessed on the basis of two pillars: economic analysis and monetary analysis. The economic analysis comprises detailed examination of a wide range of indicators which can supply information on the inflation outlook for the short and medium term, such as data on prices and costs, economic activity, exchange rates, the labour market, the financial markets and fiscal policy, as well as the macroeconomic projections of the Eurosystem and various other institutions. The monetary analysis is used mainly to check the information supplied by economic analysis from a medium- and long-term perspective. To that end, it examines not only the development of the broad monetary aggregate M3, but also that of the components and counterparts of M3, as well as measures of liquidity. Within this analytical framework, the ECB Governing Council systematically studies all the available data in order to assess as accurately as possible the risks to price stability.

Economic analysis

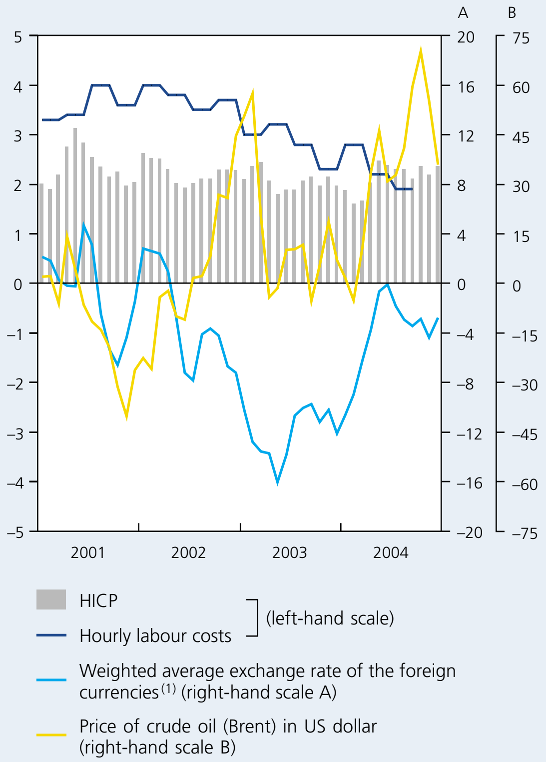
The main purpose of economic analysis is to assess the risks to price stability in the short and medium term. In addition, if the Eurosystem is to respond appropriately, it is vital to know what economic shocks lie behind those risks. Monetary policy obviously cannot prevent the direct effects of temporary shocks on prices. On the other hand, the Eurosystem will intervene swiftly if such shocks produce second-round effects or in the event of excess demand which could cause a persistent price drift.

Inflation, measured by the annual increase in the HICP for the euro area, was running at just over 2 p.c. during the second half of 2003, and had thus slightly exceeded the upper limit of the definition of price stability set by the ECB. At the beginning of the year under review, the Governing Council nevertheless considered that inflation would subside fairly rapidly and remain below 2 p.c. thereafter. The main shocks which had pushed up prices in 2003, namely the rise in the price of unprocessed food and crude oil and the increases in indirect taxes and administered prices in various euro area countries, were in fact regarded as temporary. The impact of the high oil prices was also expected to be partly offset by the appreciation of the euro which, more generally, attenuated the upward pressure exerted on import prices. Finally, the Governing Council considered that the risk of second-round effects was very low, since wage increases were likely to remain modest in view of the persistently high unemployment and an only gradual recovery in economic activity. Inflation did in fact fall from 2.1 p.c. in November 2003 to 1.6 p.c. in February 2004.

At the same time, the Governing Council considered that the economic upturn, which had begun in the second half of 2003 under the impetus of the strong expansion in foreign demand, would continue. It counted on the

CHART 15 PRICES AND COSTS IN THE EURO AREA

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



Sources: EC, ECB.

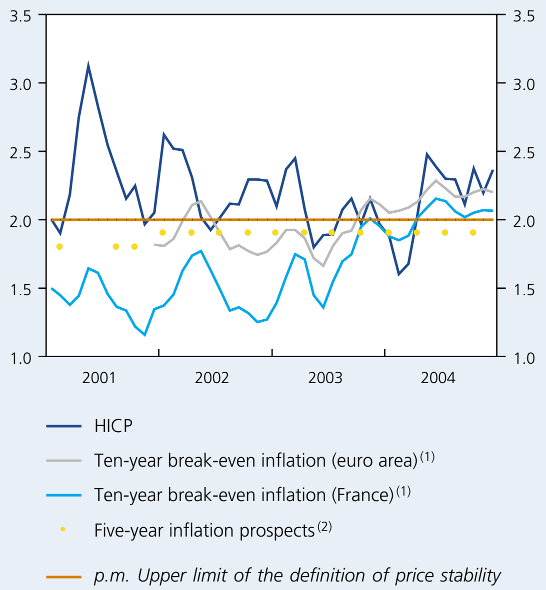
(1) Inverse of the effective exchange rate of the euro against the currencies of the 23 main trading partners of the euro area.

fact that domestic demand would recover fairly quickly, so that economic growth would continue to gather speed during 2004 and 2005. Investment was expected to start benefiting not only from the strength of global demand but also from the very low level of interest rates and the generally favourable financing conditions. Furthermore, firms were set to reap the benefits of restructuring, which had increased their productivity and profitability. The conditions were also present for stronger growth of private consumption. Following the improvement in the terms of trade, due to the appreciation of the euro, and the tax cuts in a number of euro area countries, the real disposable income of individuals was expected to increase more strongly. Moreover, consumer confidence would continue to recover as the employment outlook improved.

However, from March 2004 inflation quickened again in the euro area. Not only was there a very strong surge in prices of commodities, especially crude oil, but also the compensatory effect of the euro's appreciation was waning rapidly. Although it had become obvious that inflation would remain above 2 p.c. for longer than previously expected, the Governing Council still considered that it would drop below that threshold in 2005 and would thus conform to the price stability objective. One factor which played a key role here was the absence of any signs that workers were trying to extract substantial pay rises to offset the loss of purchasing power due to the temporary increase in inflation. The downward trend in most indicators of the pace of labour cost increases was maintained during the first three quarters of the year under review, and there was nothing to indicate any rapid change in that regard. On the other hand, the financial markets did appear to have revised upwards their long-term inflation expectations, and that gave cause for concern, though the accelerating appreciation of the euro in the final quarter was likely to moderate the upward pressure on prices. In all, despite some concern about the medium-term outlook for price stability, the most probable scenario was still a steady decline in inflation to below the 2 p.c. limit.

CHART 16 INFLATION AND LONG-TERM INFLATION EXPECTATIONS

(Annual percentage changes)



Sources: EC, ECB.

(1) Calculated on the basis of the comparison between the yields of nominal bonds and those of bonds index-linked respectively on the basis of the HICP of the euro area and of the national consumer price index in France (excluding tobacco in both cases), issued by the French State.

(2) Survey of professional forecasters.

The rise in oil prices also weakened the demand encountered by firms in the euro area. Over time, new information suggested that the level of economic activity would be lower than expected at the beginning of the year under review. Although the most likely scenario was still a gradual acceleration in growth, the assessment of the risks became increasingly downbeat. Global growth remained at an exceptionally high level, but had apparently already reached its peak in the first quarter of 2004. At the same time, in a number of euro area countries, the expected broadening of the growth dynamics into domestic spending did not materialise. The improvement in consumer confidence fell short of expectations, perhaps because of growing uncertainty in several countries concerning fiscal policy and structural reforms in social security benefits and the labour market. The perception that inflation was higher than indicated by the official figures may also have been a factor curbing private consumption: following the introduction of the euro notes and coins, perceived inflation as indicated by the consumer surveys increased sharply during 2002, while the actual inflation rate was steady at around 2 p.c.; during 2003 and 2004, although perceived inflation did decline, it remained significantly above the actual inflation figure. Taking account of highly favourable financing conditions, the revival in corporate investment was also fairly modest, probably because of the extent of the production capacity still unused and the increasingly prevalent view that more expensive energy was here to stay. Although it seemed that the economic recovery would be slower than previously thought, the Governing Council remained convinced that interest rates were already particularly low, and were therefore making a sufficient contribution to economic growth, especially as some concerns had emerged regarding the medium-term outlook for price stability.

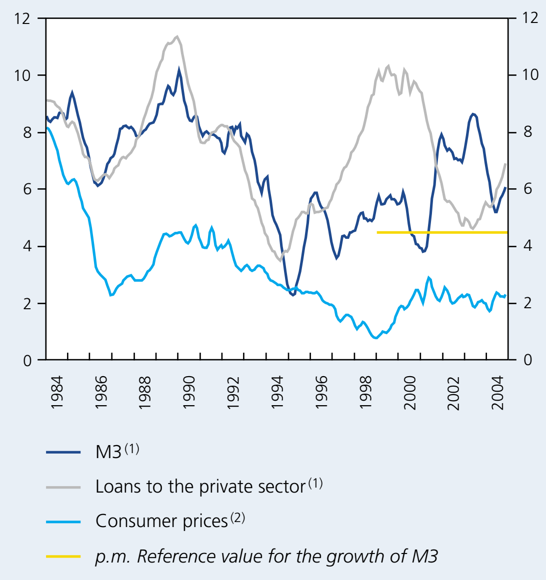
Monetary analysis

Monetary analysis permits assessment of the medium- and long-term trend in inflation and confirmation of the information supplied by economic analysis concerning the risks to price stability. In the medium and long term, developments in the monetary and credit aggregates may in fact contain useful information about the future trend in inflation in the euro area.

The downward trend in the annual growth of M3, which had begun in the summer of 2003, continued during the first five months of the year under review. The annual rate of growth of M3 dropped from close to 9 p.c. in July 2003 to just under 5 p.c. in May 2004. This substantial slowdown reflected a less marked preference for liquidity on the part of the economic agents

CHART 17 M3, LOANS TO THE PRIVATE SECTOR AND CONSUMER PRICES IN THE EURO AREA

(Three-month centred averages of the annual percentage changes)



Sources: EC, ECB.
(1) Data adjusted for seasonal and calendar effects.
(2) Weighted average of the national consumer price indices up to 1990, HICP from 1991.

in the euro area, the main reason being that investment behaviour had returned to normal, so that the accent shifted from monetary assets to longer term financial assets not included in M3. These portfolio adjustments were fostered by the dissipation of the uncertainty on the financial markets and the continuing stock market rally in the first quarter of the year under review. In addition, the improvement in the economic outlook during the second half of 2003 and the first half of 2004 probably helped to rein in the accumulation of precautionary savings.

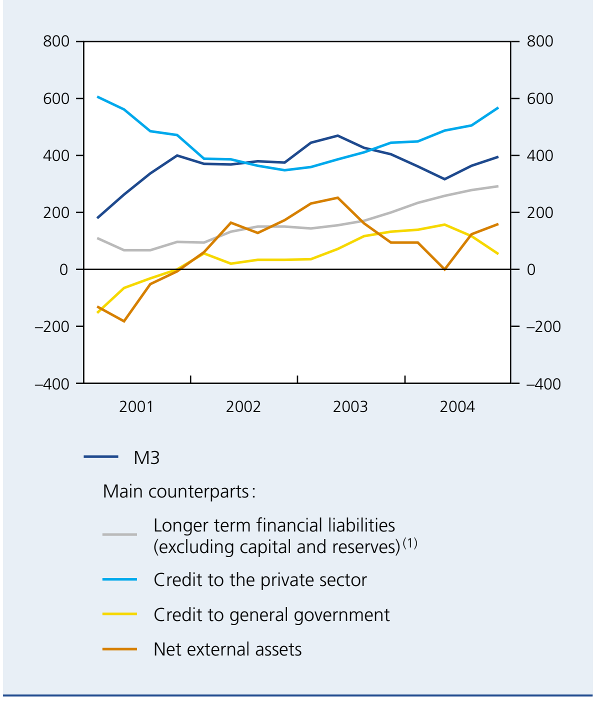
The hypothesis that investment behaviour was starting to return to normal is borne out by analysis of the components and counterparts of M3. Thus, the main area of weaker growth seems to have been demand for marketable instruments, while the rate of expansion speeded up in the case of longer term financial liabilities of monetary financial institutions (MFIs). Moreover, the annual increase in the net external assets of these institutions slowed down during the first five months of the year; according to the balance of payments figures, this was due mainly to more substantial purchases of foreign securities by euro area residents. The rate of expansion in savings deposits also lessened considerably in the first half of the year under review, probably as a result of weaker demand for liquidity for precautionary savings purposes. It seems that consumers took a slightly less negative view of their future employment situation.

However, the slackening pace of M3 growth in the first five months of the year was not as pronounced as one might have expected on the basis of past observations. On the one hand, the reversal of the earlier portfolio shifts took longer. The low level of long-term interest rates may be part of the reason for this, but greater risk aversion following the losses sustained on the stock markets probably also dissuaded a number of investors from acquiring such financial assets on a large scale again. On the other hand, the exceptionally low level of short-term interest rates contributed to the strong expansion of balances normally held for transaction purposes. The low opportunity cost of holding liquid instruments prompted very strong growth in the narrow monetary aggregate M1 (comprising notes and coins plus overnight deposits). The low interest rates also could have boosted private sector borrowing, although demand for new loans did not increase very strongly in the first five months of the year. In particular, the expansion of lending to non-financial corporations fell short of the forecasts. These firms probably had more internal resources following the rise in their profitability, but the delay in stepping up their investments, despite highly favourable financing conditions, also seems to have been a major factor. The growth of lending to households was considerably greater, owing to the very strong expansion of mortgage loans (see box 5).

Despite the slowing of M3 growth, the measures of excess liquidity remained at a very high level in the euro area. The question whether this excess liquidity will trigger a rise in inflation depends mainly on the purpose for which it is used. In that regard, there are three possibilities. First, individuals and firms may decide to start investing more again in longer term financial assets – such as equities and bonds – and thus to reverse their previous portfolio shifts. This will gradually reduce the excess liquidity, so that the risks to price stability will also diminish. The second possibility is that the economic agents may decide to use their excess liquidity to finance new expenditure. Although that decision may initially have a favourable impact, namely the elimination of excess production capacity in the economy, it could ultimately exert upward pressure on consumer prices. The risk that the

CHART 19 M3 AND ITS MAIN COUNTERPARTS IN THE BALANCE SHEET OF MFIs

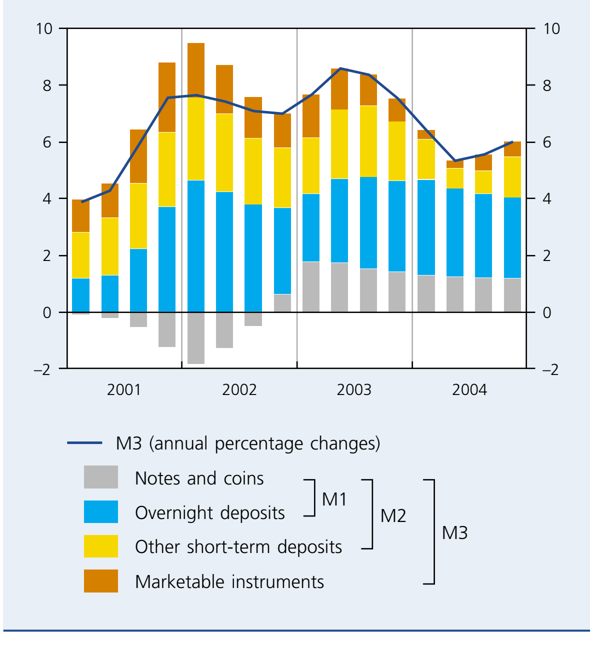
(Data adjusted for seasonal and calendar effects, annual flows at end of quarter, billions of euro)



Source: ECB.
(1) If other balance sheet items remain unchanged, an increase corresponds to a reduction in M3.

CHART 18 M3 AND ITS COMPONENTS

(Data adjusted for seasonal and calendar effects; contribution to the percentage changes in M3, unless otherwise stated; quarterly averages)



Source: ECB.

excess liquidity may be used for transaction purposes is admittedly low in an environment featuring a very gradual economic recovery, but the risk increases as the expansion gathers momentum. Finally, it cannot be excluded that the economic agents' preference for liquidity may have increased structurally. In that case, the current measures overestimate the actual excess liquidity, so that the risks to price stability are limited. On the basis of these factors, the Governing Council concluded that the excess liquidity did not entail risks to price stability so long as the earlier portfolio shifts were reversed sufficiently promptly and the economic recovery continued at a gradual pace.

From June 2004, the growth of M3 accelerated once again. While the strong monetary growth of 2001-2003 was due mainly to the portfolio shifts made in a context of economic and financial uncertainty, that which occurred in the second half of 2004 was due more to the low level of interest rates, as indicated by the strong expansion of the most liquid components of M3 and the revival in lending to the private sector. Mortgage loans to households were obviously still the most dynamic component of lending, while loans to non-financial corporations and consumer credit gradually began to pick up.

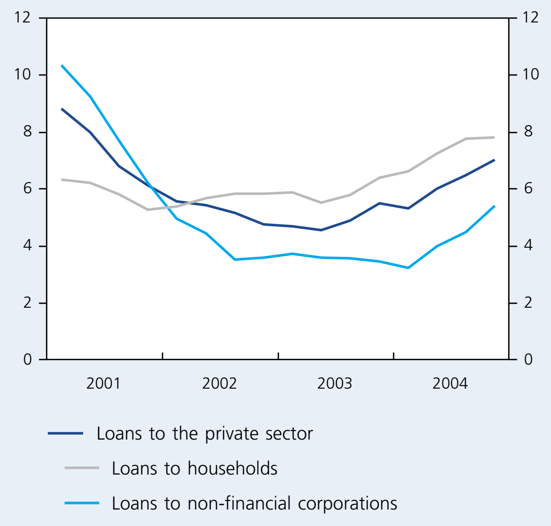
Although the Governing Council still considered that the excess liquidity did not constitute a threat to price stability in the medium term, the concern over the potential risks increased. In that context, the Council emphasised that monetary developments had to be closely monitored, not only to identify inflationary risks in time, but also because persistent excess liquidity combined with strong expansion of lending could fuel an unsustainable rise in the prices of certain assets, especially housing.

Box 5 – Bank lending to the private sector in the euro area

The rate of expansion in lending to the private sector by monetary financial institutions (MFIs) in the euro area accelerated, rising from an annual average of 4.9 p.c. in 2003 to 6 p.c. in 2004. However, the picture as regards lending to households was very different from that for lending to non-financial corporations. During the year under review, the former increased by an average of 7.2 p.c., whereas the latter expanded by only 4 p.c.

LOANS TO THE PRIVATE SECTOR

(End-of-quarter data, annual percentage changes)



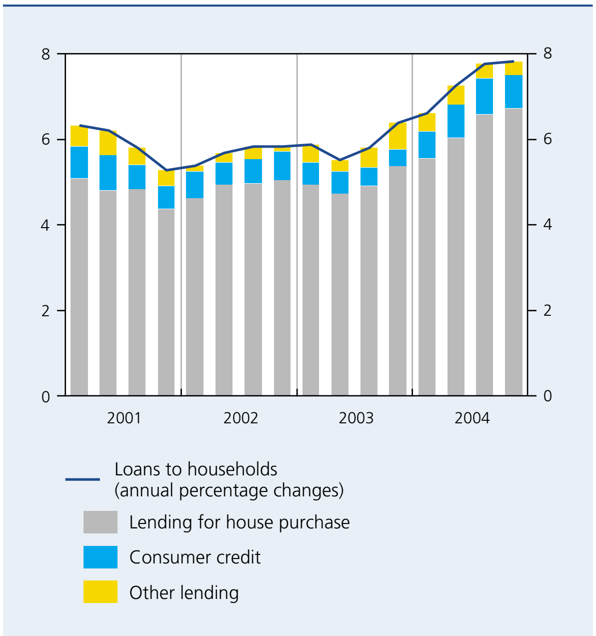
Source: ECB.

This relatively weak pace of growth of lending to non-financial corporations, despite a recovery from the second quarter, indicates that firms took only limited advantage of the historically low level of interest rates. An initial reason for the phenomenon lies in the muted demand for new loans. On the one hand, many firms adopted a wait-and-see attitude towards new investment, since they still had sufficient unused production capacity and the economic recovery was only gradually taking hold. On the other hand, the increased profitability of firms probably meant that more internal resources were available to finance any investments or to repay existing loans. A second reason for the weak growth of lending to non-financial corporations lies in the fact that, in a number of euro area countries, the banks were fairly reluctant to grant cheap loans because they considered the credit risk to be too great. As the economic situation improved, however, the majority of the banks relaxed their credit standards somewhat, and that could be part of the reason for the revival of lending to non-financial corporations during the year under review.

Conversely, households contracted significantly more loans during the year under review than in 2003. This seems to be due mainly to a very strong expansion of mortgage loans, although there was also a gradual recovery in consumer credit. Following a slight increase in households' willingness to make major purchases, evident from consumer surveys, and owing to the low level of interest rates, the average pace of expansion in consumer credit rose from just 3.4 p.c. in 2003 to 5.2 p.c. However, it was mainly loans for house purchase that produced highly dynamic growth, averaging 9.1 p.c. during the year under review. The low level of interest rates made it easier to afford to buy or build a house for a given level of income. In particular, in the countries where mortgage interest rates dropped sharply during the period preceding stage 3 of EMU, there was a structural increase in demand for housing. Since the supply expanded far more slowly, prices soared, in turn triggering further growth in mortgage lending.

LOANS TO HOUSEHOLDS

(End-of-quarter data ; contribution to the percentage changes in loans to households, unless otherwise stated)



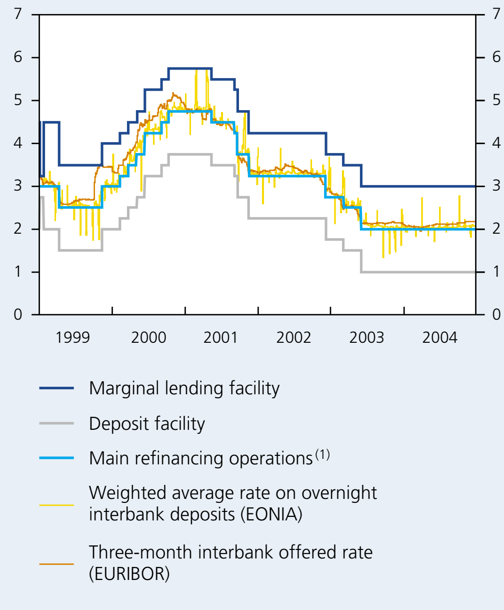
Source : ECB.

Strong expansion of mortgage lending combined with a surge in property prices may also harbour risks, but they were kept within bounds in 2004. It could tend to amplify the negative effect on consumption of any tightening of monetary policy. Since more and more households used variable rate loans to finance the purchase or construction of a house, an increase in interest rates would in fact have a greater impact than in the past in obliging them to allocate a larger proportion of their disposable income to the payment of interest charges. Moreover, there would be a risk of precipitating a sharp fall in house prices if they had exceeded their equilibrium value. Such a correction could engender a negative wealth effect, that could also depress private consumption. In the extreme case of a steep rise in interest rates and a sudden downward correction to house prices, financial stability could even come under threat, since the majority of houses are also used as collateral for current mortgage loans.

Monetary policy decisions and monetary conditions

Throughout the year under review, the Governing Council concluded, on the basis of the economic and the monetary analysis, that the level of interest rates set in June 2003 was still appropriate to guarantee price stability in the euro area in the medium term. In addition, the historically low interest rates helped to underpin economic activity. Consequently, no adjustment was made to the Eurosystem key rates. The minimum bid rate for the main refinancing operations was kept at 2 p.c., while the rates on the marginal lending facility and the deposit facility were held at 3 and 1 p.c. respectively.

CHART 20 EUROSYSTEM AND MONEY MARKET INTEREST RATES



Source: ECB.
(1) Fixed rate up to 28 June 2000, minimum bid rate thereafter.

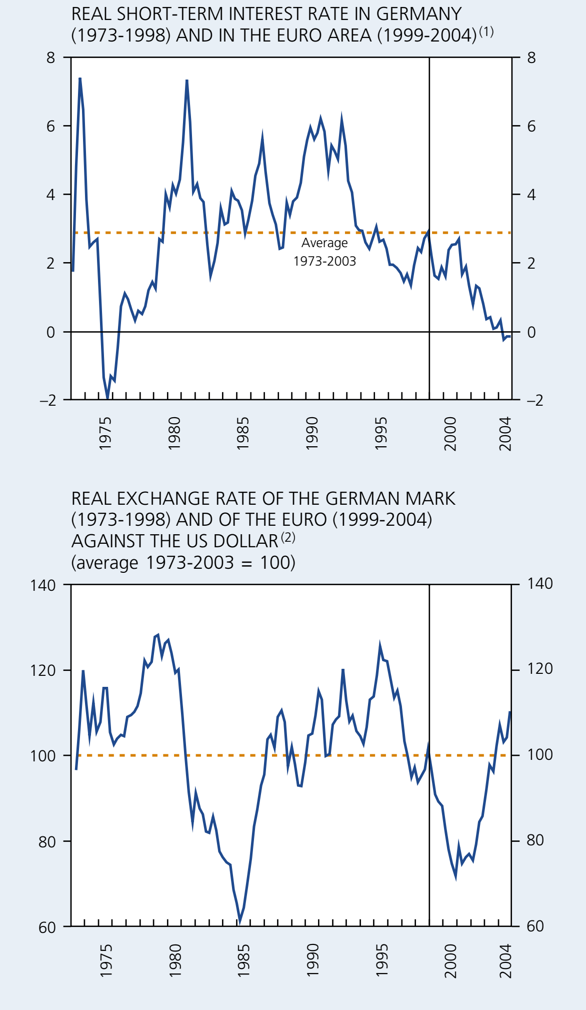
Although real short-term interest rates in the euro area had already fallen to a very low level in 2003, they continued to decline for the fourth consecutive year. From May onwards, the three-month interbank rate was actually lower than the year-on-year rise in the HICP. The last time rates were that low was in the mid 1970s, when the real short-term interest rate was also negative, even in the lowest inflation country, namely Germany.

The exceptionally low level of real short-term interest rates and the abundance of liquidity show that monetary policy was accommodating throughout the year under review. It thus made a significant contribution towards supporting economic activity in the euro area. Such a policy was possible because the inflation outlook indicated that price stability in the euro area would be maintained in the medium term.

The appreciation of the real exchange rate of the euro provided a counterbalance to the decline in the real short-term interest rate in 2004. The euro's appreciation against the US dollar, which had begun in the spring of 2002, persisted during the first two months of 2004. A correction followed, but the euro resumed its rise in May, and the pace accelerated from October onwards. In the fourth quarter of the year under review, the average real exchange rate against the US dollar was more than 10 p.c. above the average for the preceding 31 years, assuming that the euro has taken over the role of reference currency from the German mark. However, it remained well below the levels reached by the German mark in the late 1970s or in 1995, for example. Also, the euro has been more stable against other currencies: in December 2004, the effective exchange rate appreciated by 7.2 p.c. against the average for 2003, whereas the appreciation against the US dollar came to 18.5 p.c.

CHART 21 INDICATORS RELATING TO MONETARY CONDITIONS

(Quarterly averages)



Sources: BIS, EC, ECB.

(1) Three-month rate, deflated by the annual percentage change in the consumer price index.

(2) Nominal exchange rate of the German mark (1973-1998) or the euro (1999-2004) against the US dollar, deflated by the ratio between the consumer price indices in the United States and Germany (1973-1998) or the euro area (1999-2004).

2.2 Operational aspects

The operational framework of the Eurosystem's monetary policy hinges mainly on open market operations in the form of the main refinancing operations. The minimum bid rate for the weekly tenders relating to these operations, normally set by the ECB Governing Council at its first meeting in each month, signals the monetary policy stance. These allotments play a predominant role in liquidity management, since they are intended to cover the bulk of the liquidity needs of credit institutions in the euro area. The liquidity shortage generated by "autonomous factors" such as demand for banknotes is augmented by the obligation to maintain reserves with the NCBs. During each reserve maintenance period, the reserve assets may vary freely in relation to the minimum average amount required, thus softening the impact of temporary liquidity shocks on volatility in money market interest rates. The Eurosystem remunerates the compulsory monetary reserves at the marginal rate of the main refinancing operations, in order to minimise the opportunity cost of holding the reserves. Finally, standing facilities enable credit institutions to borrow or deposit funds overnight at pre-announced rates, which create a symmetrical corridor within which market overnight interest rates can fluctuate.

Two adjustments were made to the Eurosystem's operational framework in 2004. These measures are intended primarily to avoid the effects on the money market of speculation on interest rate changes during a reserve maintenance period, with downward expectations mostly causing a shortage of bids for the weekly tenders and upward expectations widening the difference between the very short-term money market rates and the minimum bid rate. In the past, such speculation has caused temporary excess volatility in very short-term rates.

First, the reserve maintenance periods were adjusted. They now start on the main refinancing operation settlement day following the monthly meeting of the Governing Council assessing the monetary policy stance. It is at the start of a new period that any change in the rates is now applied, unless there are exceptional circumstances. Second, the maturity of the main refinancing operations was reduced from two weeks to one, so that these operations no longer overlap different reserve maintenance periods. These changes, which had been the subject of public consultation, were implemented smoothly from 10 March 2004. In addition, from March onwards the ECB published revised liquidity forecasts on the allotment day, and a benchmark allotment amount, to supplement the information for money market participants.

In 2004, the average liquidity deficit came to 310.7 billion euro, against 242.2 billion the previous year, a rise of 28.3 p.c. This increase was due mainly to the expansion in demand for banknotes. The shorter term fluctuations in the liquidity needs during 2004 were due mainly to fluctuations in government deposits held with certain NCBs.

TABLE 14 CONSOLIDATED AND SIMPLIFIED FINANCIAL STATEMENT OF THE EUROSYSTEM (1)

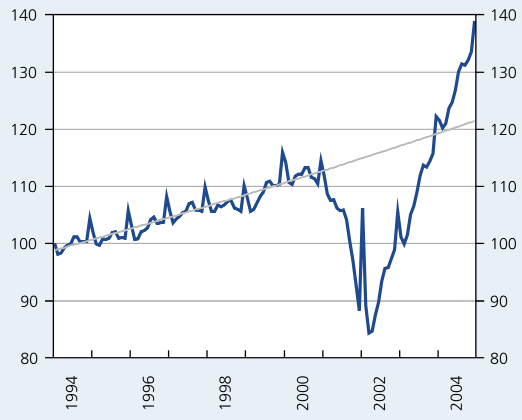
(Average of daily outstanding amounts, billions of euro)

	2003	2004
Operations unrelated to monetary policy (2)	–111.2	–174.2
Notes in circulation (3)	–377.9	–450.5
Net gold and foreign exchange assets	330.9	302.8
Government deposits	–50.4	–53.4
Miscellaneous (net)	–13.8	27.0
Average reserve requirement	–131.0	–136.5
Total : liquidity needs of credit institutions	–242.2	–310.7
Open market operations	242.5	311.7
Main refinancing operations	197.5	241.6
Longer-term refinancing operations	45.0	70.2
Structural operations	0.0	0.0
Fine-tuning operations	0.0	0.0
Total : residual money market surplus	0.3	1.0
Standing facilities	0.0	0.0
Marginal lending facility	0.3	0.2
Deposit facility	–0.2	–0.2
Difference between current account deposits and the average reserve requirement : surplus (–) or deficit	–0.3	–1.1

Source : ECB.
(1) A plus sign indicates a Eurosystem asset, which is a factor expanding liquidity; a minus sign indicates a Eurosystem liability, a factor reducing liquidity.
(2) Including debt certificates issued and securities acquired before 1 January 1999.
(3) Excluding national currency banknotes, which come under "Miscellaneous (net)".

CHART 22 NOTES ISSUED BY THE EUROSYSTEM, OUTSTANDING AMOUNTS IN REAL TERMS

(Monthly averages, index January 1994 = 100)



Sources : EC, ECB.
(1) Outstanding amount, excluding national currency banknotes from 1 January 2003, deflated by the HICP.

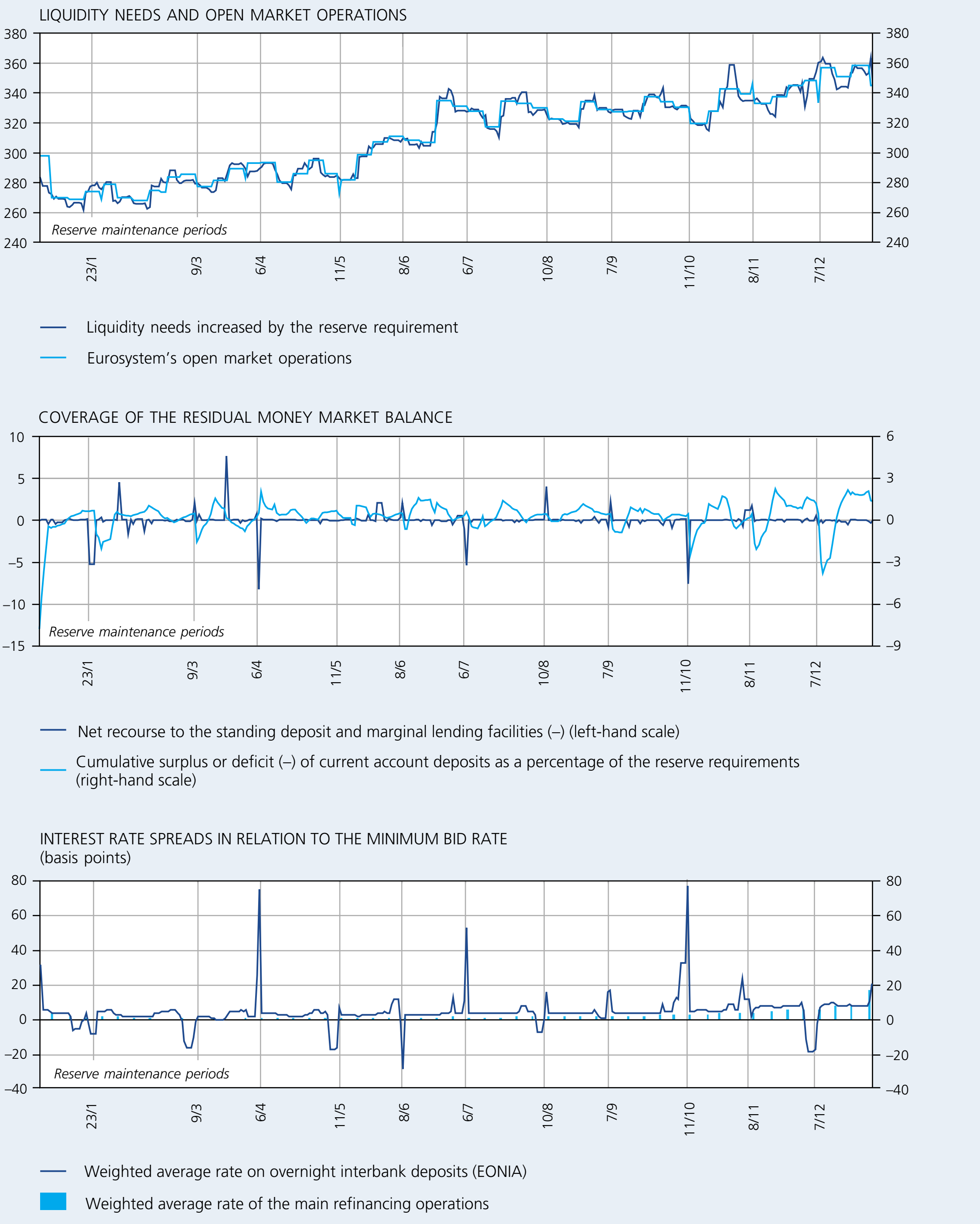
There are several factors which help to explain why the rise in the volume of banknotes in circulation amounted to much more than the rebuilding of cash holdings which had been reduced considerably in the run-up to the introduction of euro notes and coins. Demand was amplified by the existence of denominations with a much higher face value than that of the old banknotes in the majority of the member countries. Also, demand from non-residents was accentuated by the euro's status as a reserve currency and the closer trade and financial links with neighbouring countries. Finally, owing to the very low level of interest rates and the prospect of continuing price stability, the opportunity cost of holding cash has become very small.

The development of the Eurosystem's net gold and foreign exchange assets also contributed, although to a lesser extent, to the increase in the liquidity needs of credit institutions during the year under review, since the participating central banks effected net sales of foreign exchange by way of customer and portfolio transactions, as well as some sales of gold in accordance with the agreement on the gold assets of central banks, concluded on 26 September 1999 and renewed on 27 September 2004.

Designed to ensure neutrality in liquidity management – i.e. not to push credit institutions into either the marginal lending facility or the deposit facility – the Eurosystem's open market operations covered the whole of the liquidity needs, chiefly via the main refinancing operations. Moreover, the Governing Council decided with effect from 29 January 2004 to increase from 15 to 25 billion euro the amount allotted for the monthly three-month credit operations. The aim of this increase was to take account of the expected rise in the refinancing requirement of banks in the euro area in 2004, but without calling into question the predominant role of the main refinancing operations.

CHART 23 OPERATIONAL CONDUCT OF THE EUROSYSTEM'S MONETARY POLICY IN 2004

(Daily outstanding amounts, billions of euro, unless otherwise stated)



Source: ECB.

In the operational framework modified from March 2004, a serious shortage of bids for the weekly tenders has become less likely. Although there was a minor shortage on 23 March, this occurred for technical reasons and had no significant impact on overnight market rates.

Since the ECB also aims to maintain neutral liquidity conditions, the overnight rate normally remains close to the minimum bid rate, except on the very last days of the reserve maintenance periods, when the liquidity needs turn out to deviate from the forecasts and it is no longer possible to reckon on any subsequent compensatory effect.

The ECB can also decide to conduct fine-tuning operations in such circumstances. In the first ten months of the year under review, it did so only once: on 11 May, the last day of a reserve maintenance period, liquidity totalling 13 billion euro was withdrawn. In November, the ECB decided that in future it would use this instrument a little more often to counteract liquidity imbalances due to unexpected variations in autonomous factors, to keep the overnight rate more stable. Thus, the Eurosystem injected 6.5 billion euro into the money market on 8 November and withdrew 15 billion euro on 7 December.

3. Output, expenditure and current transactions in Belgium

3.1 Summary

In Belgium, the strengthening of activity which had begun in the middle of the previous year was maintained in 2004. Over the year as a whole, GDP thus increased by 2.7 p.c. in real terms, following a 1.3 p.c. rise in 2003.

This growth consolidation follows a period of over two years of turbulence in the external environment and internal adjustments in Belgium. In line with the widespread stock market correction which began in 2000, the global economy faced falling investment and a sharp slowdown in foreign trade. Geopolitical tensions also impaired the confidence of the economic agents and contributed to a rise in oil prices. On top of that, the euro's appreciation from 2002 onwards tended to curtail activity in the euro area. In Belgium, firms responded to these shocks by cutting back on their investments and their labour recruitment.

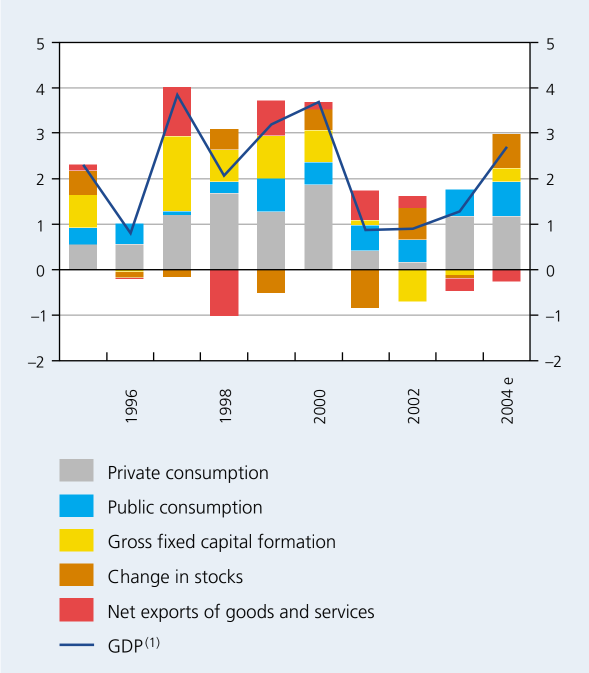
Most of these restraining factors were gradually eased, and in 2004 the dynamism of the global economy and strengthening of trade in the euro area predominated. But the maintenance of unusually high oil prices, to some extent due specifically to the strong global demand, plus the appreciation of the euro against the dollar from October onwards, caused growth to dip slightly at the end of the year.

Another factor boosting activity in Belgium was the expansion of domestic spending which, leaving aside the changes in stocks, made a contribution to GDP growth of 2.2 percentage points in 2004, against 1.6 percentage points in 2003 and an average of 0.5 percentage point in the two preceding years. Stock building also bolstered the expansion, with a contribution of 0.8 p.c. of GDP.

However, the dynamism of domestic demand in general caused the volume of imports to grow even faster than that of exports, so that the net contribution of foreign trade in goods and services was negative in 2004, at 0.3 p.c. of GDP.

CHART 24 MAIN CATEGORIES OF EXPENDITURE, AT 2000 PRICES

(Calendar adjusted data; contribution to the change in GDP, percentage points, unless otherwise stated)



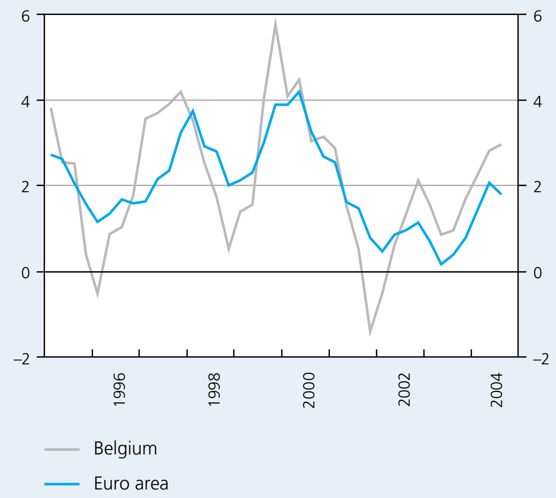
Sources : NAI, NBB.
(1) Annual percentage changes.

As in the two preceding years, the growth rate of the Belgian economy thus outstripped that of the euro area in 2004. That applies both to the data on an annual basis and to those on a quarterly basis since, after the cycle bottomed out in the last quarter of 2001, GDP growth measured by the quarter-on-quarter figure was consistently higher than that of the euro area.

There is nothing unusual about a temporary growth differential between Belgium and the euro area. In view of the openness of the economy and the importance of semi-finished products in industrial output, Belgium is more sensitive to cyclical variations than the euro area. Thus, in an economic recovery phase, Belgium's growth generally outpaces that of the euro area, and in a slowdown, economic activity weakens more sharply in Belgium. The positive growth differential, which has persisted for almost three years, is therefore remarkable since it has been maintained continuously through the fluctuations in activity. As explained in more detail in box 6, it therefore seems attributable not only to cyclical factors but also to more fundamental ones.

CHART 25 GDP IN BELGIUM AND IN THE EURO AREA

(Data adjusted for seasonal and calendar effects, percentage changes at constant prices compared to the corresponding period of the previous year)



Sources: EC, NAI, NBB.

Box 6 – Recent growth developments in Belgium and in the euro area

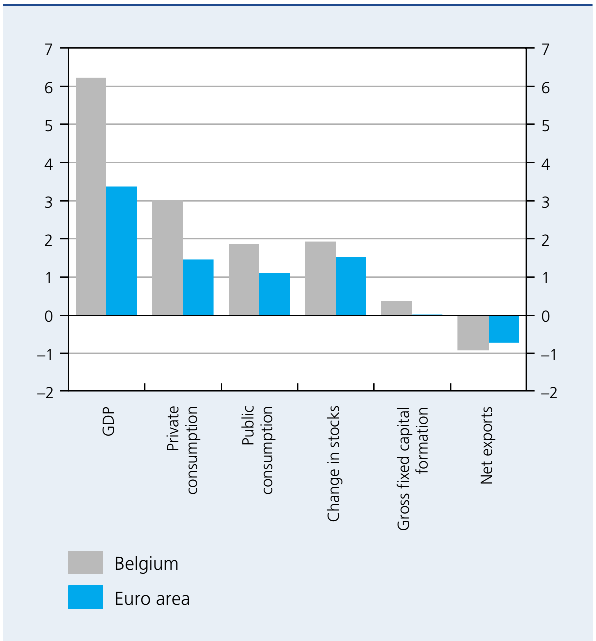
Between the start of 2002 and the third quarter of 2004, GDP growth came to 6.2 p.c. in Belgium, against just 3.4 p.c. in the euro area. The breakdown of the growth differential according to the various categories of expenditure shows that it is mainly attributable to domestic demand, which was more dynamic in Belgium than in the euro area. In fact, although the expansion of exports outstripped the figure for the monetary union as a whole, particularly at the end of the period in question, imports grew at a slightly faster rate still, buoyed up by the stronger growth of domestic demand. In all, the contribution of net exports to growth was slightly more negative in Belgium, reaching –0.9 percentage point against –0.7 point in the euro area.

Among the components of domestic demand, private consumption accounts for more than half the growth differential observed in relation to the euro area, at 1.6 percentage point. The contribution of public consumption to GDP growth was also higher in Belgium, by 0.7 percentage point. The change in stocks added 0.4 percentage point to the growth differential, as did gross fixed capital formation which, throughout the period, produced very modest growth in Belgium while remaining static in the euro area.

The vigour of private consumption seems to be due mainly to the fall in the household savings ratio, down by 2.1 percentage points in Belgium over the past three years, whereas it has been practically steady in the euro area. Where private disposable incomes are concerned, growth has been weak in Belgium and, on average, in the euro area, owing to a moderate rise in compensation of employees following the low level of net job creation. However, the developments observed within the monetary union did vary. In the Netherlands and Germany, private consumption was weak, and was accompanied by an increase in the savings ratio. Only France, which also recorded sustained growth of private consumption, also saw the private savings ratio decline, but to a lesser extent than Belgium. Although it has declined more or less continuously since 1994, the household savings ratio in Belgium is still well above the figure recorded in neighbouring euro area countries.

ECONOMIC GROWTH AND CONTRIBUTION OF THE MAIN CATEGORIES OF EXPENDITURE IN BELGIUM AND IN THE EURO AREA FROM THE BEGINNING OF 2002 TO THE THIRD QUARTER OF 2004

(Data at constant prices, adjusted for seasonal and calendar effects ; contribution to the change in GDP, percentage points)



Sources : EC, NAI, NBB.

Taking a longer term view, households build up a certain amount of wealth during their working life to finance their later consumption, so that a fall in their savings ratio may be explained either by a permanent rise in the value of their accumulated assets or by a brighter outlook for future income. In either case, the same level of wealth may ultimately be attained by reducing current savings. For example, higher income expectations may result from an improvement in employment, which may ease the uncertainty relating to earned incomes, or a consolidation of public finances viewed as permanent, offering the prospect of a reduction in the tax burden or guaranteeing future transfers, e.g. by way of pensions.

Among the factors mentioned as possibly causing a rise in permanent income, it is mainly the last factor which, in recent years, has taken a much more favourable turn in Belgium than in the euro area. Unlike the majority of the Member States, Belgium has succeeded in keeping its public finances relatively balanced, and in continuing to reduce the public debt. As regards the labour market, developments have generally been the same as elsewhere.

It therefore seems that the vitality of private consumption compared to the euro area and, more generally, the vigour of economic growth over the period in question are not only a purely cyclical phenomenon but may also be due, in part, to structural trends such as the reduction in the private savings ratio. This movement may also have been reinforced by the implementation of the personal income tax reform at the beginning of the decade, or changes relating to taxes on savings – e.g., the reform of the rules on gifts in Flanders, the one-off tax regulation

CONSUMPTION, DISPOSABLE INCOME AND SAVINGS RATIO OF HOUSEHOLDS

(Annual percentage changes, average over the period 2002-2004, unless otherwise stated)

	Belgium	Euro area	Germany	France	Netherlands
Nominal disposable income	2.5	2.9	1.1	3.2	2.2
Compensation of employees	3.2	2.9	0.6	2.8	3.2
Non-wage incomes (1)	0.1	1.5	–0.2	2.3	0.4
Net current transfers paid	0.9	–0.3	–4.3	0.2	4.1
of which : Direct taxes	2.0	1.1	–2.0	2.1	4.0
Real disposable income	0.6	0.9	–0.2	1.5	0.1
Real private consumption	1.5	1.0	–0.5	1.9	0.1
Savings ratio (2) (3)	–2.1	0.1	0.9	–1.3	1.2
p.m. Average savings ratio (2) (4)	*15.4*	*10.6*	*10.8*	*11.1*	*10.3*
p.m. Consolidated public debt (5)	*–12.4*	*1.7*	*6.5*	*8.4*	*2.8*

Sources : EC, OECD, NAI, NBB.

(1) These incomes include the gross operating surplus, gross mixed income and incomes from movable property.

(2) In accordance with the ESA 95, savings are calculated as disposable income plus the net change in claims on pension fund reserves and minus private consumption. The net rise (fall) in the claims mentioned may lead to an increase (reduction) in the savings ratio, even if the change in consumption is greater (lower) than the change in disposable income. On average, the change in this equity came to 8.8 p.c. of disposable income in the Netherlands, against 1.4 p.c. in Belgium.

(3) Percentages of disposable income, difference between 2004 and 2001.

(4) Percentages of disposable income.

(5) Percentages of GDP, difference between 2004 and 2001.

or the prospect of the entry into force of the European directive on the taxation of savings – although similar factors applied in other European countries.

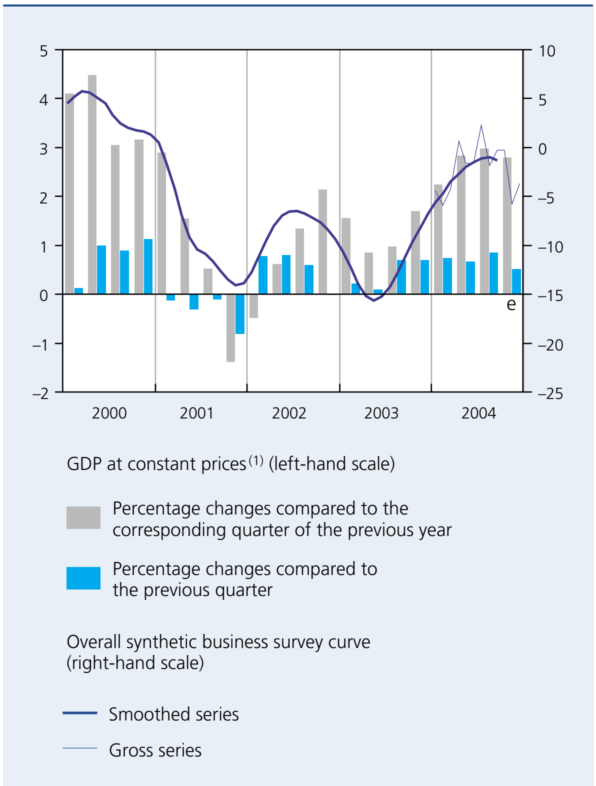
However, a growth differential is unlikely to persist in the long term between Belgium and the euro area unless it is based on higher potential growth made possible, for example, by policies aimed at greater mobilisation of the labour supply, promoting research and development or enhancing the quality of the production factors, particularly by commitment to education and training.

3.2 Development of activity

After three successive years of weak expansion in activity in Belgium, growth gained momentum in 2004, reaching 2.7 p.c. For the first time since 2000, it thus outstripped the economy's potential growth rate, which – as is evident from box 7 – appears to be in the order of 2 p.c. The revival in economic activity had already begun in the third quarter of 2003, and GDP grew continuously at a steady pace of 0.7 to 0.8 p.c. per quarter, until the third quarter of 2004.

Another indication of the cyclical recovery phase is the movement in business confidence, measured by the Bank's overall synthetic business survey curve which was rising from mid-2003. This trend continued to become more marked in 2004, and confidence passed the previous peak recorded in 2002, when the strengthening of economic activity had proved modest and short-lived. However, the curve gradually flattened out during 2004, at a relatively high level. In November and December, the results for the gross curve were nevertheless down against that level.

CHART 26 GDP AND BUSINESS SURVEY INDICATOR
(Seasonally adjusted data)



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

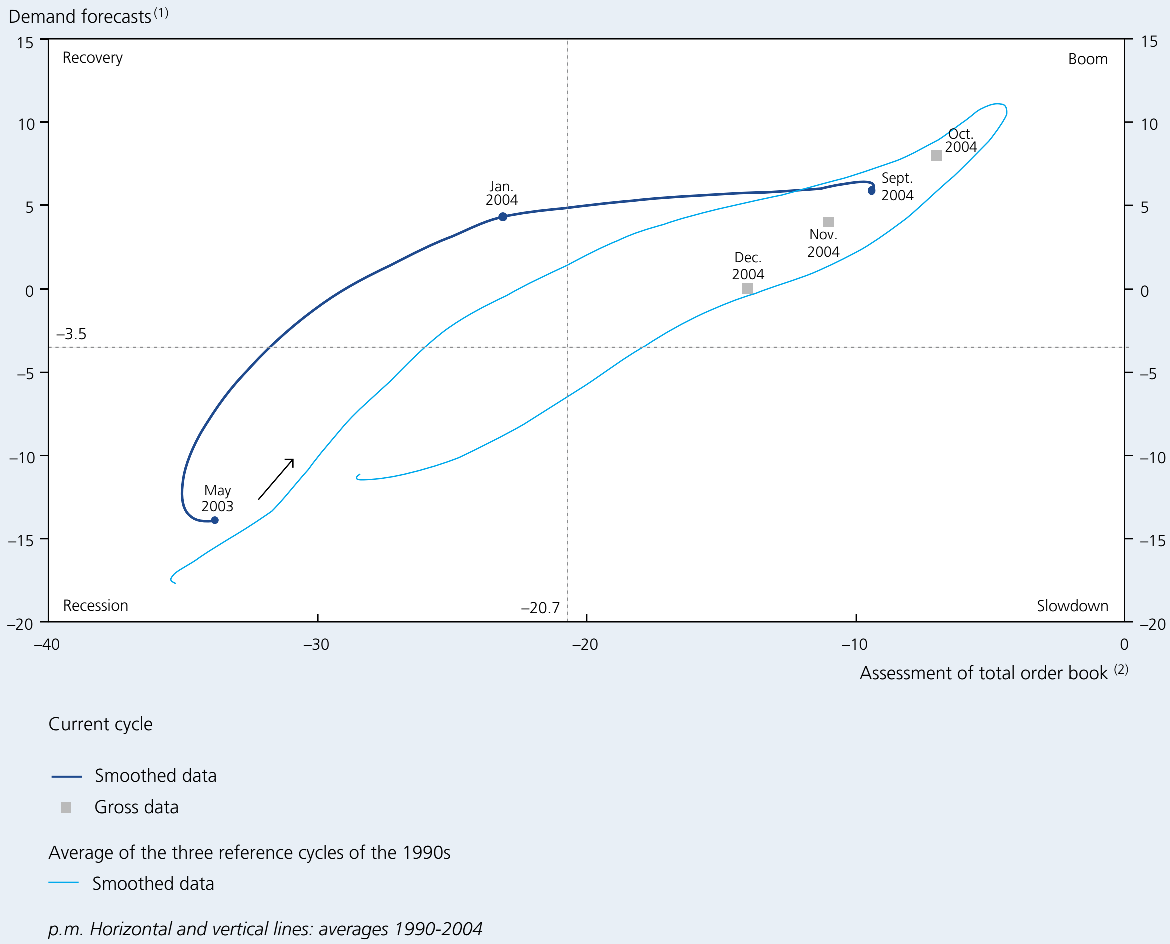
The business cycle can be roughly divided into four successive phases. Once the cycle has bottomed out, one can generally expect that the main feature of the recovery periods will initially be an improvement in the outlook for demand. Confirmation of that outlook by an actual strengthening of demand eventually leads to a boom phase. Conversely, a slowdown is signalled by a deterioration in the outlook which, once actual demand becomes progressively weaker, ultimately leads to a recession phase.

This cycle can be illustrated with the aid of two partial indicators taken from the monthly business surveys conducted by the Bank in manufacturing industry, namely those relating to the demand outlook and to the assessment of overall order books. The first gives indications concerning changes in expectations, while the second indicates actual demand. Statistical analysis shows that these two indicators present a profile comparable to that of the business cycle, but that the former anticipates economic activity by three months, while the movements in the latter coincide with developments in economic activity.

According to these indicators, it appears that the current business cycle reached maturity during 2004. After the trough of May 2003, the steep rise in the curve indicates that the demand outlook had improved, under the impetus of buoyant domestic demand and the steady weakening of the euro's tendency to appreciate, while actual demand initially contracted a little further. Subsequently, the two indicators rose strongly, mainly thanks to the marked recovery in foreign demand, and the cycle entered a recovery phase which, during the current year, progressively led to a boom phase. However, in comparison with previous cycles, this phase apparently featured a strong surge in actual demand, whereas the demand outlook hardly improved after the first quarter of 2004. The oil price rise probably kindled fears concerning the ability to maintain the recovery, but the robustness of foreign demand, itself one of the reasons for the high level of oil prices, continued to sustain the expansion of actual demand. Both the demand outlook and actual demand suffered a significant setback at the end of the year. Apart from the persistence of high prices for petroleum products, the main factor explaining this movement seems to be the appreciation of the euro, which may have an adverse impact on export demand.

CHART 27 PARTIAL INDICATORS RELATING TO THE CYCLICAL SITUATION IN MANUFACTURING INDUSTRY

(Seasonally adjusted data)



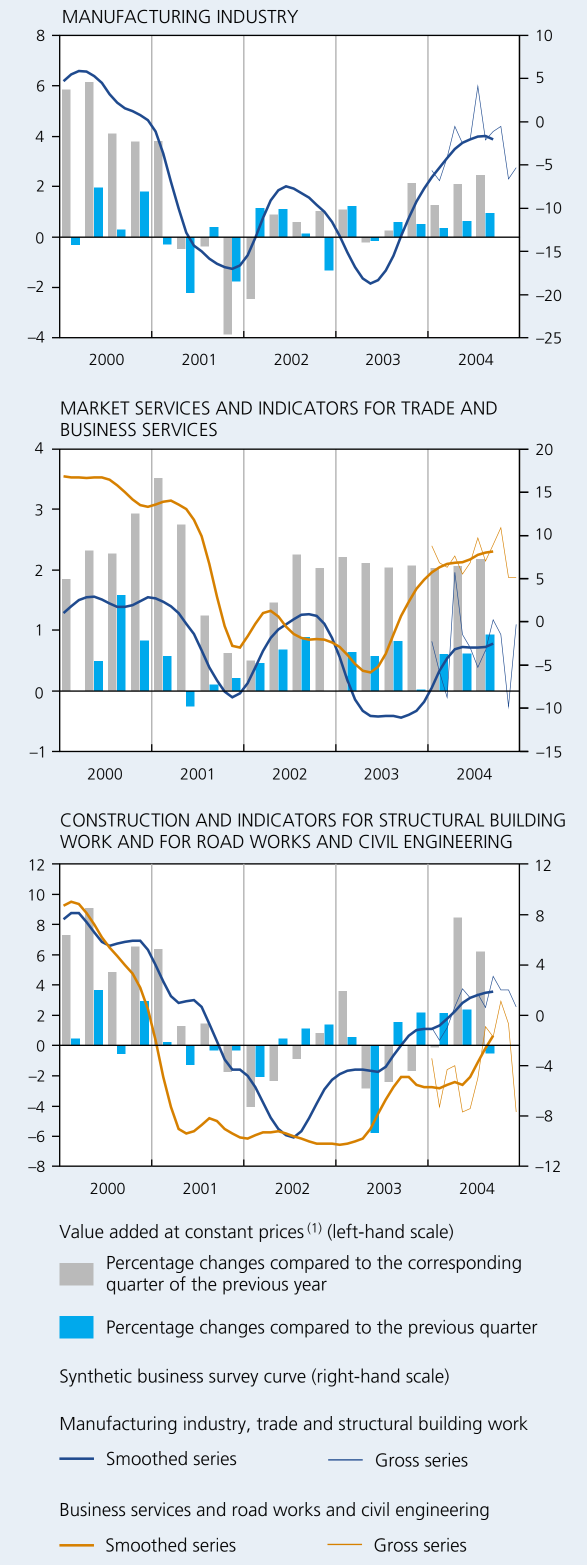
Source : NBB.
(1) Indicator reflecting the demand outlook. An upward shift indicates an improvement in the outlook.
(2) Indicator reflecting actual demand. A shift to the right indicates an improvement in demand.

The revival in economic activity was carried mainly by the expansion in manufacturing industry. Thus, after stagnating overall for a year up to mid-2003, that sector's value added began rising again in the second half of 2003, and the recovery was maintained in 2004. During the first three quarters of 2004, activity expanded by 2 p.c. against the corresponding period of the previous year. In manufacturing industry, the three best-performing sub-sectors, namely petroleum product refining, machinery manufacture and the production of non-metallic minerals, produced an overall contribution of 1.7 percentage points to the growth of manufacturing industry during the first nine months of 2004.

In the case of market services, growth came to 2.1 p.c. in the first three quarters of 2004, comparable to the rate recorded in 2003. Although market services still made the principal contribution to GDP growth, at 1 percentage point, the development of activity in that sector has proved unusually independent of the overall business cycle in the past three years. Following a widespread downturn in 2001, and despite the low level of confidence, services soon attained a robust growth rate, while the expansion of GDP remained feeble until mid-2003. Conversely, from that point on, the growth of services remained on average slightly below the rate usually achieved during an economic recovery period. However, trade and hotels & restaurants formed an exception, accelerating in line with the recovery of confidence in 2004. Growth here came to 0.8 and 1.7 p.c. respectively, year-on-year, in the third

CHART 28 VALUE ADDED IN THE MAIN BRANCHES OF ACTIVITY AND BUSINESS SURVEY INDICATOR

(Seasonally adjusted data)



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

quarter of 2004, after lagging behind other services in 2003.

In construction, the recovery coincided with that of GDP; it was particularly marked in the first half of 2004. Over the first three quarters of 2004, activity in this sector, which accounts for 4.9 p.c. of the economy's value added, grew by 4.8 p.c. compared to the corresponding period of the previous year. This revival is also evident in the continuing improvement in confidence in the case of both civil engineering activities and structural building work.

Box 7 – Potential growth in Belgium

An economy's potential growth can be defined as the output growth which can be sustained over time, taking account of the availability of the production factors – labour and capital – and productivity gains, without generating imbalances on the product and labour markets, particularly in terms of inflationary pressure. Consequently, it is compatible with stable inflation and a restrained rise in wages. Since potential growth cannot be measured directly, it has to be estimated. One of the methods most commonly used, in particular by the EC, is based on a production function which permits identification of the determinants – the production factors (labour and capital) and the total factor productivity (TFP).

According to the EC, potential growth is estimated at just over 2 p.c. in Belgium and has changed little in the past twenty years. It seems to be in the same order of magnitude as the average for the euro area countries. Within the euro area, however, certain countries such as Ireland and Luxembourg, are distinguished by much higher potential growth, while others such as Italy and, more recently Germany, are noted for lower potential growth.

In Belgium, since 1985, the factor labour has contributed an average of 0.3 percentage point to growth. However, this contribution has tended to edge upwards over the years, reaching 0.5 percentage point during 2000-2004. Three factors have contributed to that acceleration. The population of working age has risen slightly faster in recent years. The increase in the activity rate, or the proportion of that population available on the labour market – which in Belgium is below the European average – has also accelerated slightly since the mid-1990s. Finally, the structural unemployment rate, i.e. the unemployment rate below which inflationary pressures are liable to appear on the labour market, has tended to fall to a limited extent.

The growth contribution of the expansion of the capital stock has been relatively stable over time. However, it showed a slight fall from 2001, owing to the slackening pace of gross fixed capital formation.

DETERMINANTS OF POTENTIAL GROWTH IN BELGIUM
(Annual averages; percentage points, unless otherwise stated)

	1985-2004	Sub-period		
		1985-1994	1995-1999	2000-2004
Potential growth (1)	2.1	2.1	2.1	2.1
p.m. Euro area	*2.2*	*2.3*	*2.1*	*2.0*
Contributions to potential growth:				
Stock of labour (2)	0.3	0.2	0.4	0.5
Stock of capital (3)	0.7	0.8	0.7	0.6
Total factor productivity (4)	1.0	1.1	0.9	1.0

Source: EC.
(1) Percentage changes compared to the previous year.
(2) The potential labour stock is assessed by taking account of the population of working age, an activity rate smoothed by means of the Hodrick-Prescott filter method, and a structural unemployment rate, also known as the non-accelerating inflation rate of unemployment (NAIRU).
(3) The potential capital stock is assumed to correspond to the actual capital stock.
(4) Total factor productivity is estimated as a net figure on the basis of a Cobb-Douglas production function. It measures not only the efficiency with which production processes are organised, but also the impact, in terms of productivity, of other elements such as the quality of the production factors used, which is not included in the measure of the stock of labour and capital. In order to determine the trend, total factor productivity is smoothed by means of the Hodrick-Prescott filter method.

Conversely, there was hardly any change in the contribution made by TFP. TFP is an indicator of the efficiency with which the factors of production are combined. By that token, it reflects a range of elements such as the efficiency of the organisation of the production processes or the quality of the production factors used. That quality may be influenced, for example, by the workers' standard of education or the technological quality and average age of the capital stock.

3.3 Categories of expenditure and domestic sectors

In contrast to the previous year, when firms had cut back on their investment and exports had produced only a weak rise, the consolidation of GDP growth in 2004 and the accompanying acceleration of imports were spread evenly across all the sectors. Each of the demand categories expanded in real terms at a rate comparable to that of 2003 or higher, except for expenditure on housing.

Households

Private consumption grew by 2.1 p.c. in volume, a change comparable to the 2003 figure. As then, individuals thus stepped up their consumption spending by significantly more than the additional purchasing power which they gained.

The increase in the real disposable income of individuals in fact totalled just 0.7 p.c. in 2004, following a 1.1 p.c. rise. This relatively stable rate of change masks a slightly more

TABLE 15 GDP AND MAIN CATEGORIES OF EXPENDITURE, AT 2000 PRICES

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

	2000	2001	2002 (2)	2003	2004 e
Final consumption expenditure of individuals	3.4	0.7	0.3	2.2	2.1
Final consumption expenditure of general government	2.3	2.7	2.3	2.7	3.4
Gross fixed capital formation	3.4	0.6	–3.4	–0.6	1.5
Housing	1.0	–3.4	–3.3	2.6	1.5
Enterprises	4.4	3.6	–3.8	–1.9	1.5
p.m. Excluding purchases of public buildings	*4.4*	*2.7*	*–3.5*	*–1.9*	*0.9*
General government	1.9	–11.4	–0.6	1.0	0.8
p.m. Excluding sales of public buildings	*1.9*	*–4.7*	*–3.3*	*1.0*	*5.8*
p.m. Total final domestic expenditure	*3.2*	*1.1*	*–0.1*	*1.7*	*2.3*
Change in stocks (1)	0.5	–0.9	0.7	–0.1	0.8
Exports of goods and services	8.2	1.8	1.3	1.7	6.0
Imports of goods and services	8.3	1.0	1.0	2.1	6.5
p.m. Net exports of goods and services (1)	*0.2*	*0.6*	*0.3*	*–0.3*	*–0.3*
GDP	3.7	0.9	0.9	1.3	2.7

Sources: NAI, NBB.

(1) Contribution to the change in GDP.

(2) These figures are influenced by the reclassification of the public radio and television companies from the non-financial corporations sector to the general government sector. Without that operation, final consumption expenditure of individuals was up by 0.8 p.c. in 2002, that of general government was up by 1.7 p.c., gross fixed capital formation by enterprises fell by 3.7 p.c. and that of general government fell by 1.5 p.c., final domestic expenditure grew by 0.1 p.c. and GDP by 1 p.c.

TABLE 16 GROSS DISPOSABLE INCOME OF HOUSEHOLDS, AT CURRENT PRICES

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

	2000	2001	2002	2003	2004 e	*p.m. 2004 e, billions of euro*
Gross primary income	4.9	5.2	2.3	1.7	2.6	*215.8*
Compensation of employees	4.4	5.7	3.5	2.6	3.5	*150.8*
Employment	2.5	1.9	–0.3	0.1	0.8	
Compensation per person	2.0	3.6	3.8	2.5	2.7	
Gross operating surplus and gross mixed income	3.5	2.5	0.3	2.8	3.3	*42.3*
Income from movable property (1)	9.9	7.2	–0.6	–5.3	–3.9	*22.7*
Current transfers (1)	7.1	5.4	4.5	–3.2	1.4	*–39.2*
Current transfers received	2.6	5.6	4.7	3.7	3.4	*62.4*
Current transfers paid	4.4	5.5	4.6	0.9	2.6	*101.7*
Gross disposable income	4.4	5.2	1.8	2.9	2.9	*176.5*
p.m. At constant prices (2)	2.0	2.7	0.1	1.1	0.7	*162.8*
Final consumption expenditure	5.9	3.1	2.0	4.0	4.6	*153.5*
Savings ratio (3)	14.4	16.3	16.6	15.5	14.2	

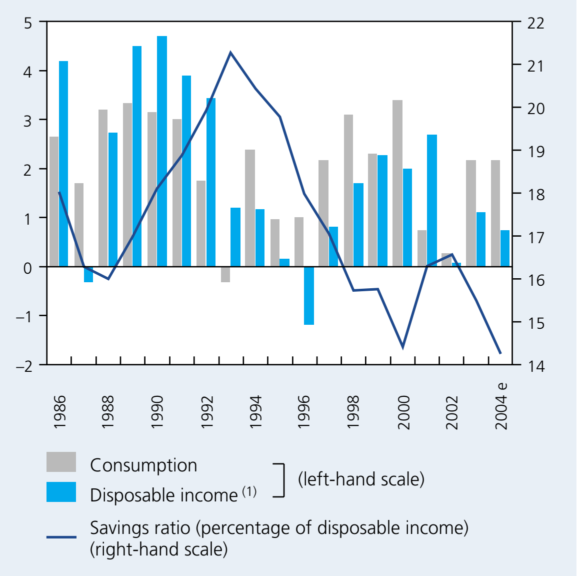
Sources : NAI, NBB.
(1) These are net amounts, i.e. the difference between income or transfers received from other sectors and those paid to other sectors, excluding transfers in kind.
(2) Figures deflated by the deflator of final consumption expenditure of individuals.
(3) Gross savings, including the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

marked increase in their primary income during the year under review, which was offset by a slightly less favourable contribution of the net current transfers which they make to other sectors of the economy.

The said acceleration in the primary income of individuals, from 1.7 to 2.6 p.c. in nominal terms, resulted from the favourable movement in various categories of income. Growth of the wage bill remained moderate, though still slightly higher than in the previous year, in terms of both paid employment and compensation per employee. Bolstered by the upturn in economic activity, self-employed incomes, amalgamated with rents under the item "gross operating surplus and gross mixed income", increased by 3.5 p.c., the strongest growth in the past ten years. It was mainly the incomes of traders and health care professionals that increased, driven by the growth in private consumption and the expansion of public health care spending. In contrast, net incomes from movable property declined in 2004, although to a lesser extent than in 2003, the main reason being the general fall in interest rates. Moreover, the strong expansion in the volume of mortgage lending added to the interest burden. On the other hand, companies paid out larger dividends to individuals.

CHART 29 CONSUMPTION, DISPOSABLE INCOME AND SAVINGS RATIO OF HOUSEHOLDS

(Percentage changes at constant prices compared to the previous year, unless otherwise stated)



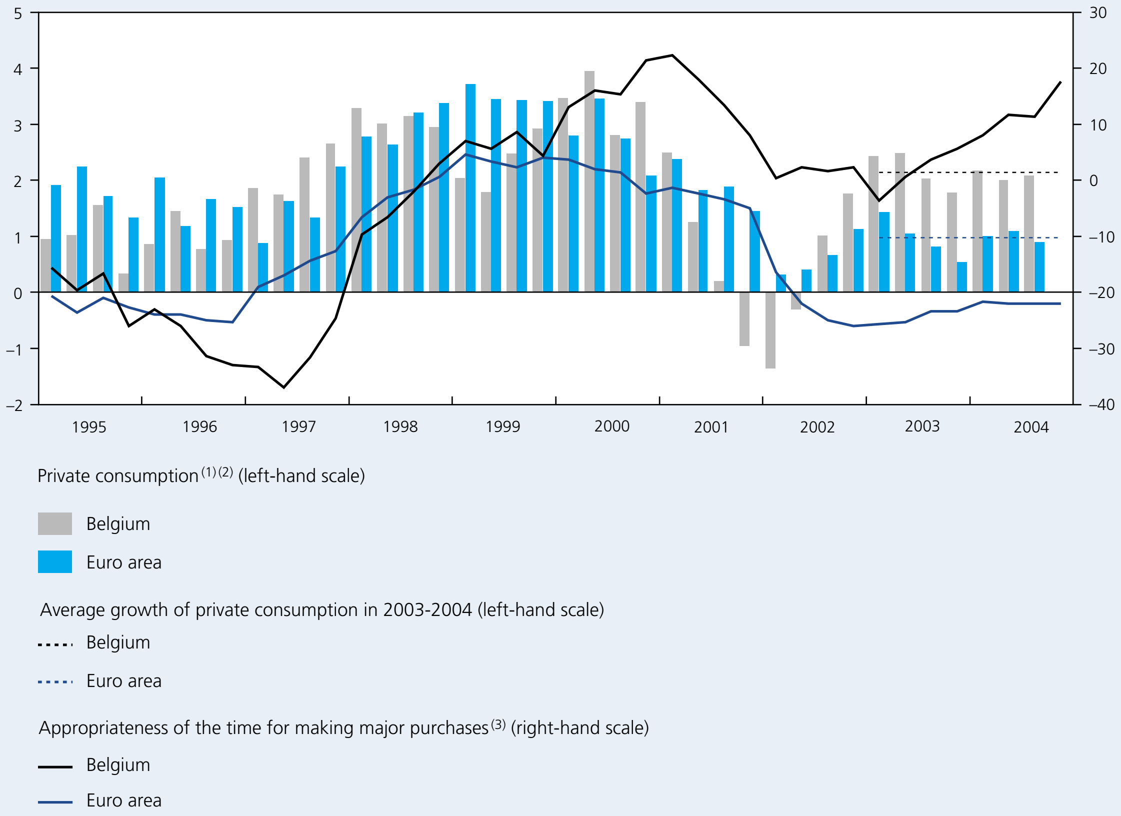
Sources : NAI, NBB.
(1) Data deflated by the deflator of final private consumption expenditure.

The increase in primary incomes received by households was once again supported by the movement in net current transfers in 2004, but to a lesser extent than in 2003. On the one hand, the rise in transfers received was down slightly against the previous year, from 3.7 to 3.4 p.c. Also, the transfers paid by individuals were 2.6 p.c. up, against a small rise of 0.9 p.c. in 2003. The main factor behind this acceleration was the growth of incomes of employees and the self-employed. In addition, the tax reform launched in 2001 combined with the gradual abolition of the complementary crisis contribution from 2000 onwards boosted disposable incomes by the equivalent of 0.3 p.c. in 2004, compared to 0.6 p.c. in 2003. In all, between 2000 and 2004 the reductions in direct taxes implemented here represented 1.5 p.c. of disposable income, and additional effects will continue to occur in the next three years, via the tax assessments. All other things being equal, these measures to reduce the burden of direct taxes underpin private consumption via their effect on disposable income. Furthermore, since they were implemented without endangering the programme for the consolidation of public finances, they probably also contributed to the resumption of the fall in the savings ratio observed since 1994.

Following a temporary rise, occurring mainly in 2001 when the level of uncertainty had been greatly heightened, particularly by the plunging stock market prices and the difficult situation on the labour market, the households savings ratio dropped by more than 1 percentage point in both 2003 and 2004.

The fall in the savings ratio came at a time when consumer confidence was still dented by the difficult conditions on the labour market. On the other hand, as is evident from the replies to the consumer survey, households became

CHART 30 PRIVATE CONSUMPTION AND WILLINGNESS OF HOUSEHOLDS TO MAKE MAJOR PURCHASES
(Seasonally adjusted data)



Sources : EC, NAI, NBB.
(1) Percentage changes at constant prices compared to the corresponding period of the previous year.
(2) Calendar adjusted quarterly data.
(3) Quarterly averages of the balance of replies to the question in the EC's harmonised monthly survey on whether it is a good time to make major purchases. An increase reflects greater optimism on the part of consumers.

more inclined to effect major purchases, despite the modest rise in their disposable income. In the 1990s, that indicator had followed a comparable pattern in Belgium and in the euro area, but between 2000 and 2002 it fell faster and more steeply in the latter. Subsequently, it began rising again in Belgium, whereas the increase in the euro area was only marginal, and that was reflected in the respective movements in the savings ratios. As suggested by box 6, one possible explanation lies in the sound state of public finances in Belgium, whereas in the rest of the euro area the situation was decidedly less positive overall. Owing to the varying behaviour in terms of savings, the expansion of private consumption in Belgium was almost twice as rapid as in the euro area during the last two years.

Growth of private investment in housing fell back from 2.6 p.c. in 2003 to 1.5 p.c. However, this growth remains higher than that of disposable income. The renewed fall in mortgage lending rates, bringing them to their lowest level since the beginning of 1999, apparently supported not only the activity on the second-hand market, but also the growth of house building and renovation.

Enterprises

The strengthening of activity in 2004 generated a marked rise in corporate operating results. Apart from the increase in incomes of the self-employed, mentioned earlier, this improvement was due to a rise of close on 9 p.c. in the gross operating surplus of companies. That had already risen by 6 p.c. in 2003, after suffering the repercussions of the weak economic activity of the two preceding years.

The stronger growth of corporate profitability in 2004 stemmed from the increase in the volume of sales, buoyed up by domestic demand and even more so by exports. The gross operating margin per unit of sales grew at a slightly slower rate than in 2003, the main reason being a deterioration in the terms of trade. After two years of decline, both import costs and export prices increased in 2004, driven mainly by the sustained international demand and the higher commodity prices, but the increase in import prices was in fact more pronounced. On the other hand, unit labour costs remained stable, having regard to the substantial productivity gains recorded in 2004, owing to the absorption of labour reserves accumulated previously. The gross operating surplus of companies thus increased from 18.5 p.c. of GDP in 2003 to 19.2 p.c., practically regaining the level achieved in 2000. In 2004, the additional resources generated by corporate activities gave rise to an increase in the dividends paid to shareholders, and an increase in taxes. Part was also allocated to investment. As a proportion of GDP, investment increased from 11.6 p.c. in 2003 to 11.8 p.c. in 2004. However, the rise – the first since 2000 – was modest and the level of investment remained below that of the 1990s.

Overall, companies taken as a whole recorded a financing capacity of 1.6 p.c. of GDP in 2004, which was similar to the 2003 figure, excluding the capital transfer effected by Belgacom to the government in return for the latter's assumption of its pension liabilities. Thus, companies reduced their net debt levels.

Following a cumulative decline of 5.6 p.c. in 2002 and 2003, gross fixed capital formation by enterprises grew by 1.5 p.c. in real terms during the year under review. This resumption of an upward trend was facilitated by financial conditions even more favourable than those in 2003. While interest rates remained at a very low level, it became less expensive to use risk capital owing to the effect of the rising share prices from April 2003. Moreover, companies had more ample liquidity available, thanks to the continuing recovery in profitability which had begun in 2002.

However, the main explanation for the still hesitant investment recovery lies in the renewed dynamism of final demand and the fact that business managers viewed this as sustainable. Following the adjustments made since 2001, in particular to restore the balance sheet position of companies, the need to replace equipment became more acute, and the available production capacity margins were reduced. Thus, in manufacturing industry the proportion of firms mentioning a shortage of demand as the reason for under-utilisation of capacity has fallen sharply since mid-2003. The capacity utilisation rate also increased from then onwards.

TABLE 17 COMPANIES ACCOUNT : MAIN COMPONENTS AND DETERMINANTS OF THE GROSS OPERATING SURPLUS

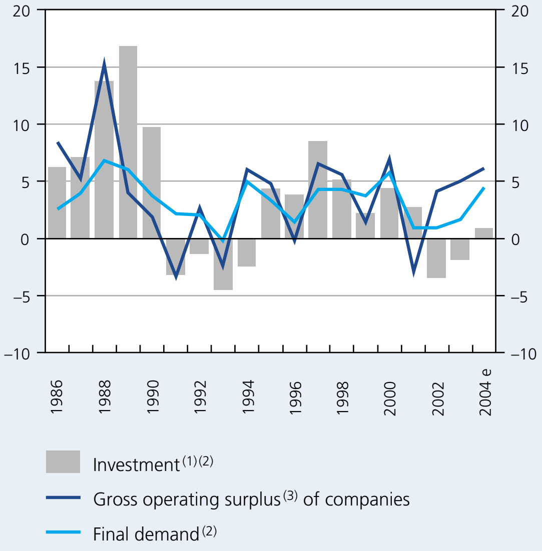
	2000	2001	2002	2003	2004 e
Determinants of the gross operating surplus of companies (percentage changes compared to the previous year)					
Gross operating surplus	8.8	–3.4	1.7	6.0	8.9
Gross operating margin per unit of sales	2.2	–4.2	0.8	4.1	3.6
Unit selling price	6.3	1.4	–0.4	0.2	2.7
On the domestic market [1]	3.0	1.4	0.5	1.8	3.2
Exports	9.6	1.4	–1.1	–1.2	2.2
Costs per unit of sales	6.9	2.2	–0.6	–0.3	2.5
Imported goods and services	12.0	1.3	–2.1	–1.0	3.1
Costs of domestic origin per unit of output [1] [2]	0.2	3.3	1.5	0.6	1.3
of which : Unit labour costs	0.5	5.6	1.7	0.7	0.1
Final sales at constant prices	6.5	0.8	0.9	1.9	5.1
On the domestic market [1]	4.4	0.2	0.3	2.0	3.1
Exports	8.4	1.3	1.5	1.7	6.8
Main components of the companies account (percentages of GDP)					
Gross disposable income					
Gross operating surplus [3]	19.3	18.2	18.0	18.5	19.2
Other components of gross disposable income [4]	–5.5	–6.3	–5.9	–5.8	–6.2
Uses					
Gross capital formation	13.7	13.0	11.8	11.6	11.8
Capital transfers [5] [6]	–0.7	–0.3	–0.1	1.5 [7]	–0.4
Financing balance	0.7	–0.8	0.4	–0.5 [7]	1.6

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. In 2003, the government transferred to the BNRC part of the subsidy due to it for 2004; this contributed to a reduction in the company costs of domestic origin in 2003 and an increase in 2004.
(3) Including the negative value of the gross operating surplus of financial intermediation services indirectly measured (FISIM).
(4) Net property incomes and net current transfers, including changes in the net claims of households on pension funds.
(5) These are net amounts, i.e. the difference between transfers paid to other sectors and those received from other sectors.
(6) Including net acquisitions of non-financial non-produced assets. These comprise, for example, land or patents and goodwill.
(7) Including the capital transfer of 1.9 p.c. of GDP effected by Belgacom in return for the government's assumption of its pension liabilities.

Despite the recent upturn, business investment in the third quarter of the year under review was still below the level attained when the cycle bottomed out in the fourth quarter of 2001. The relatively slow response by firms, which ordinarily adjust their capital formation to the rate of activity after a delay of about nine months, on average, is a peculiar feature of the last business cycle. The more detailed examination of this issue in box 8 in fact reveals that the recent situation differs from that of the earlier cyclical downturns in 1996 and 1998, when the pace of investment had hardly been affected. In contrast, it is more similar to that of 1993. The reason for the delayed response by companies, apart from the persistence of excess production capacity, may have been their relatively high debt levels, the extent of the uncertainty over the outlook for growth or the refocusing of their investment on new geographical growth areas.

CHART 31 BUSINESS INVESTMENT AND DETERMINANTS

(Percentage changes at constant prices compared to the previous year)



Sources : NAI, NBB.

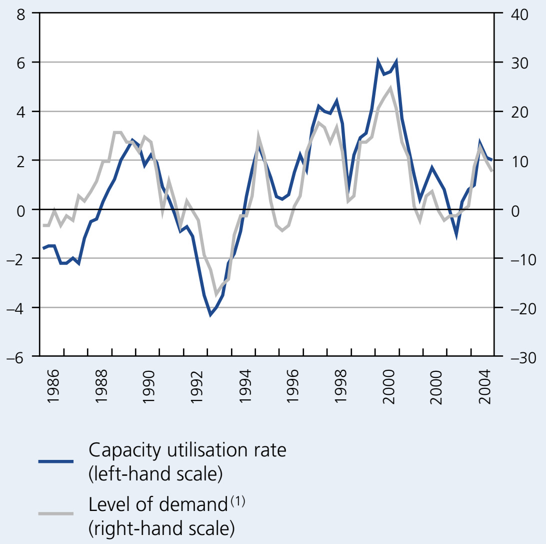
(1) Excluding purchases of public buildings.

(2) Calendar adjusted data.

(3) Data deflated by the business investment deflator.

CHART 32 CAPACITY UTILISATION RATE AND LEVEL OF DEMAND IN MANUFACTURING INDUSTRY

(Seasonally adjusted data, differences in percentage points compared to the average for 1980-2003)



Source : NBB.

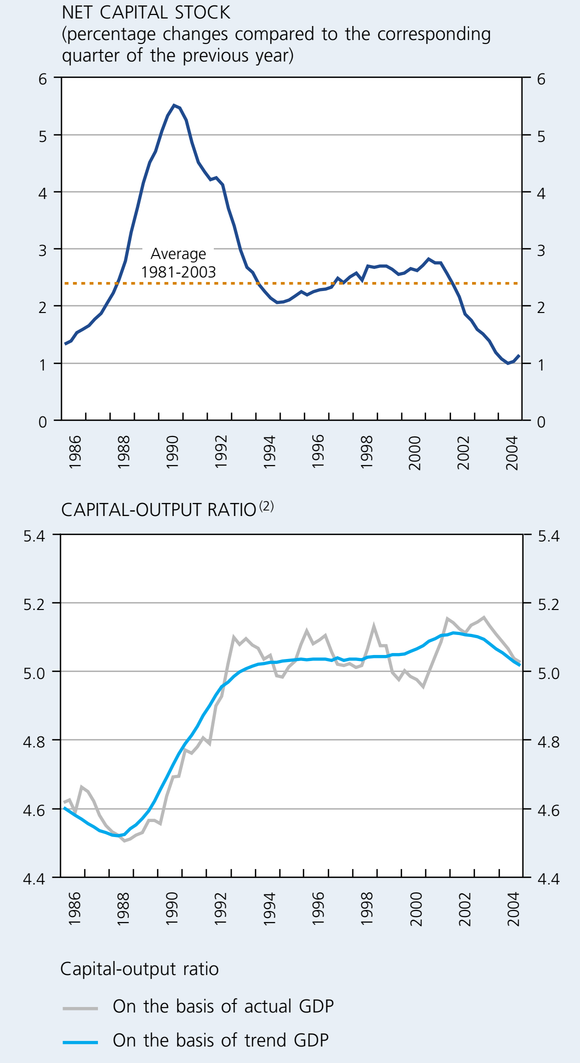
(1) Proportion of firms which did not mention a shortage of demand as a factor explaining the under-utilisation of production capacity in the Bank's quarterly survey of manufacturing industry.

Box 8 – Why did the business investment revival come so late in the current cycle ?

The cyclical profile of investment spending is governed mainly by the need for firms to adjust their production capacity to the level of activity and the business outlook. Since investment flows are relatively small in relation to the capital stock, the changes in gross fixed capital formation are generally larger than the movements in GDP. However, this phenomenon – known as the accelerator effect – took a long time to emerge after the trough of the fourth quarter of 2001. This peculiarity of the current cycle is due primarily to the hesitancy and the initially moderate pace of the revival in activity from 2002, and consequently the appearance of excess production capacity over a relatively long period.

The pressure exerted on production capacity by movements in demand and activity may be assessed by the difference between the capital-output ratio measured on the basis of the trend GDP and that measured by actual GDP. The first of these ratios gives an approximate idea of the reference movement in the capital stock, taking account of the trend level of GDP. The ratio calculated by actual GDP diverges in the short term from those reference figures. The divergences are due mainly to the relative inertia of the capital stock in comparison with the changes in the actual volume of output, since they are usually caused and corrected by the cyclical fluctuations in GDP, even though the adjustment of the capital stock may also play a part in cushioning these imbalances.

ADJUSTMENT OF THE CAPITAL STOCK OF ENTERPRISES (1)



Sources : NAI, NBB.
(1) Investments excluding purchases of public buildings.
(2) Capital stock in enterprises as a proportion of the actual GDP or the trend GDP. The latter is obtained by applying the Hodrick-Prescott filter to actual GDP, adjusted to avoid its inherent end-of-period bias.

In 1999 and 2000, economic activity had been particularly dynamic. Actual GDP grew faster than potential GDP and the net stock of capital, so that there appeared to be a shortage of production capacity at that time, despite a sustained increase in net investment.

In 2001, demand suddenly dropped, bringing GDP back to its trend level or even below it from 2002. Almost simultaneously, firms adjusted their excess production capacity by cutting jobs and reducing investment. That year, the growth rate of the net capital stock slowed down.

Subsequently, the volume of gross investment stagnated and, given the trend rise in depreciation, there was a constant decline in the rate of expansion of the net capital stock. In the second quarter of 2004, it was estimated at 1 p.c. – the weakest growth since 1986. This behaviour by firms curtailed the appearance of substantial excess capacity in a context of persistently weak GDP. It was only from mid-2003 onwards, when actual GDP growth gained lasting momentum, that the capital-output ratio measured by actual GDP approached the figure based on trend GDP.

Such an adjustment of the net capital stock does not occur in every business cycle. Thus, investment speeded up during the 1996 and 1998 troughs in activity, which entrepreneurs probably viewed as temporary. Conversely, the rate of net capital stock expansion slowed down during the 1993 trough. However, this came after the very sustained investment phase which had followed the restoration of financial health in firms in the 1980s and which had preceded the creation of the single market in 1992. At the time of the slowdown at the beginning of the 1990s, the rate of growth in the net capital stock always exceeded 2 p.c. and was therefore much higher than that observed throughout 2003 and 2004.

However, other factors must also be mentioned in order to understand the scale of the decline in business investment in 2002 and 2003, such as the persistence of a high level of uncertainty, particularly in view of the geopolitical tensions, the higher cost of oil and the appreciation of the euro, as well as the necessary adjustment of corporate balance sheets. The debt ratio of non-financial corporations had in fact risen steadily, particularly after 1995. There is also a possibility that the increasing strength of the emerging economies, especially the new EU Member States and China, caused firms to give priority to executing investment projects in those regions, to secure their presence on buoyant markets.

General government

The consumption expenditure of general government bolstered growth to a greater extent than in previous years, expanding by 3.4 p.c. in 2004, following 2.7 p.c. growth in 2003. Net current purchases of goods and services increased more steeply than in the previous year, while health spending once again expanded by around 7.5 p.c. in 2004.

Like the other domestic sectors, public authorities stepped up their gross fixed capital formation during the year under review, by 0.8 p.c. against 1 p.c. the previous year. The rate of expansion of local authority investments was halved, but the federal government and the communities and regions, which had invested little in 2003, once again participated in the expansion of the investments of this sector as a whole in 2004. These entities nevertheless proceeded to sell off buildings for a total value more than twice the 2003 figure. Leaving aside these sales, recorded as disinvestments by this sector, according to the accounting conventions, public investment at constant prices grew by 5.8 p.c., against 1 p.c. in 2003.

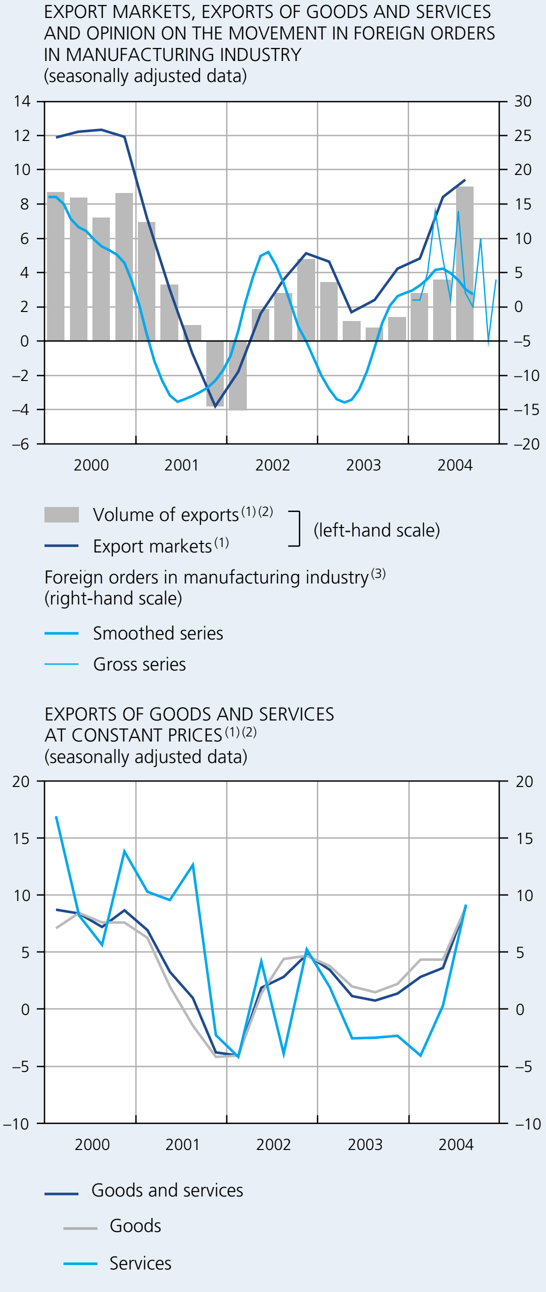
3.4 Foreign trade and current transactions on the balance of payments

Exports and imports of goods and services

Underpinned by the dynamism of international trade, in a context of vigorous expansion of activity in the majority of economies and a gradual strengthening in the euro area, the volume of Belgium's exports of goods and services grew by 6 p.c. in 2004, following a 1.7 p.c. rise in 2003. Foreign demand, which had triggered the revival in activity in mid-2003, was thus once again an engine of growth in the year under review. According to the business survey indicators concerning the movement in foreign orders in manufacturing industry, however, entrepreneurs did notice a slackening of momentum here in the second half of the year.

Belgium's export growth trailed well behind the expansion in world trade over the past two years. While this was due to a significant extent to the dynamism of trade in regions which, in relative terms, are not among the principal outlets for Belgian exporters, it nevertheless seems that, up to mid-2004, there was a widening gap between

CHART 33 EXPORTS OF GOODS AND SERVICES AND OPINION ON THE MOVEMENT IN FOREIGN ORDERS IN MANUFACTURING INDUSTRY



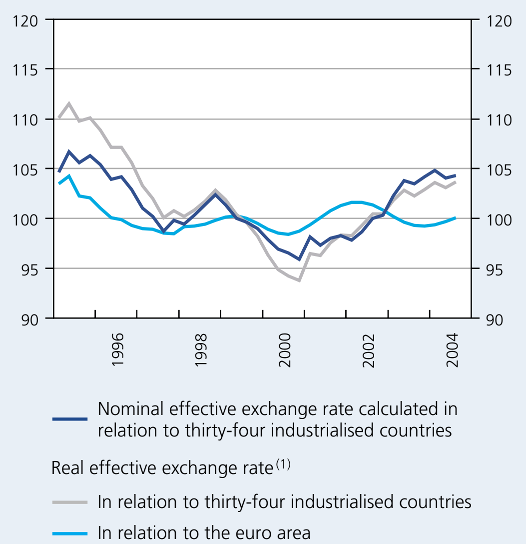
Sources : OECD, NAI, NBB.
(1) Percentage changes compared to the corresponding period of the previous year.
(2) Calendar adjusted data.
(3) Balance of replies to the question in the monthly business survey concerning foreign orders.

export growth and the expansion of the relevant markets for Belgium. That was also the case for the majority of euro area countries, the main exception being Germany, according to the EC.

The loss of competitiveness caused by the euro's substantial appreciation in 2002 and 2003 accounts for at least part of the initially muted response by exports to the vigour of foreign demand. The competitiveness indicators published by the EC reveal a sharp deterioration in the cost competitiveness of the BLEU : thus, the real effective exchange rate of the BLEU calculated on the basis of unit labour costs for the economy as a whole rose by 6.5 p.c. between 2001 and the first nine months of 2004 against a reference group composed of thirty-four industrialised countries ; this reflects the fact that the increase in these costs outpaced the average rise expressed in a common currency in this group of countries. Most indicators of the same type based on other measures of prices or costs produce similar results, which are also broadly valid for the Belgian economy, in view of its size in relation to that of Luxembourg. However, this deterioration in competitiveness occurred after a more substantial improvement between 1995 and 2000. It was mainly apparent in regard to producers located outside the euro area, reflecting the movements in exchange rates. On the other hand, since 1995 the movements in competitiveness have been on a small scale in relation to the monetary union partners.

The volume growth of exports was also held back by a decline in services, which represent around one-fifth of Belgium's foreign trade. According to the detailed balance of payments figures, this fall was due mainly to lower

CHART 34 EFFECTIVE EXCHANGE RATES OF THE BLEU
(Indices 1999 = 100)



Source : EC.
(1) Nominal effective exchange rate deflated by unit labour costs for the economy as a whole.

transport revenues in 2003, especially those relating to the transport of passengers by air, and to sea freight traffic, which were hit respectively by the geopolitical uncertainties and the still modest growth of international trade in goods. This last factor also depressed incomes from commission and brokerage. These various types of revenue increased once again at the beginning of 2004, thanks to the trade revival, but weak international triangular trade results continued to depress service revenues during the first half year, and the same applied in the building sector and the IT activities and marketing. However, the third quarter brought a significant improvement.

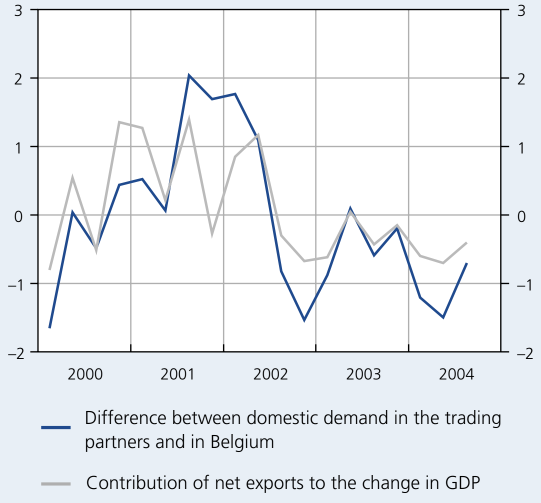
Where goods are concerned, as in 2003, the product mix of foreign demand seems to have had a more favourable effect on Belgium's export performance than over the period 1995-2002 as a whole when, as indicated by box 9, the vigour of world trade had been supported mainly by products in which Belgian exporters are not well represented, namely IT, electronic and telecommunications equipment. Thus, for the first ten months of 2004, the 6.9 p.c. growth in the volume of Belgium's exports of goods was based chiefly on chemicals, iron and steel processing and non-ferrous metals. Trade in diamonds also accelerated sharply, by 18.9 p.c. for exports and 17.9 p.c. for imports, swelling the gross foreign trade flows. Leaving aside this last product, exports of goods were up by 6.1 p.c. in real terms over the same period.

Driven by both exports and domestic demand, the growth of imports of goods and services gathered momentum from the third quarter of 2003. Over 2004 as a whole, the volume increase came to 6.5 p.c., outpacing the growth of exports.

The contribution of net exports to the volume growth of GDP was therefore negative once again in 2004, totalling 0.3 percentage point as in 2003. These figures contrast with the slightly positive contribution which foreign trade normally tends to make to growth in Belgium. They reflect the fact that domestic demand in Belgium has been more robust than in the main trading partners since mid-2002. All other things being equal, such a development gives rise to higher imports in Belgium, and therefore depresses the trade balance.

CHART 35 RELATIVE MOVEMENT IN DOMESTIC DEMAND IN BELGIUM AND IN THE TRADING PARTNERS (1) AND CONTRIBUTION OF NET EXPORTS OF GOODS AND SERVICES TO THE CHANGE IN GDP

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



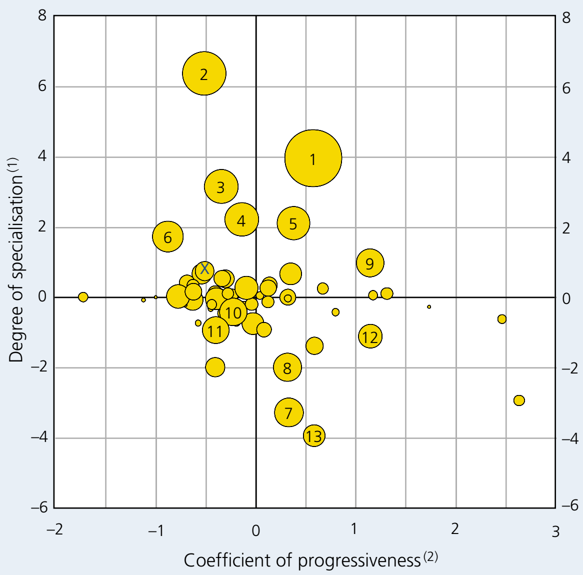
Sources : EC, NAI, NBB.
(1) Average change in the growth of domestic demand in the main trading partners, weighted according to their share of Belgium's exports. In 2003 they represented 80.2 p.c. of exports altogether.

Box 9 – Belgium's export product mix from 1995 to 2002 [1]

Being determined by structural and historical factors, linked to the progressive changes in the economic fabric, the export product mix changes only gradually. Its appropriateness may therefore vary according to changes in international demand, and it may thus affect export performance in the same way as price competitiveness or the geographical focus of the export markets.

(1) For more detailed information on this question, see *Characteristics and development of Belgium's foreign trade*, Melyn W. (2004), Economic Review, NBB, 3rd quarter, pp. 7-27.

SUMMARY OF THE PRODUCT STRUCTURE EFFECT FOR BELGIUM



In order of importance
(share in the value of exports) (3)

1 Road vehicles
2 Non-metallic mineral manufactures (including diamonds) (4)
3 Plastics in primary forms
4 Iron and steel
5 Organic chemicals
6 Textile yarn, fabrics and made-up articles
7 Electrical machinery, apparatus and appliances
8 Petroleum and derivatives
9 Medicinal and pharmaceutical products
10 General industrial machinery and equipment
11 Manufactures of metals
12 Telecommunications and sound recording and reproducing apparatus and equipment
13 Office machines and automatic data processing machines

Sources : EC, NAI.
(1) The degree of specialisation per product category is calculated as the difference between the share of a product category in Belgium's exports and that share in the imports of the EU-15.
(2) The coefficient of progressiveness per product category is calculated as the relationship, expressed as a percentage deviation, between the import growth for the EU-15 of the product category and the average growth of all the products.
(3) The size of the circles represents the importance of the product categories in Belgium's exports as a whole.
(4) The position of the category non-metallic mineral manufactures excluding diamonds is shown by the cross.

Analysis of the composition effects requires detailed data by product[1] for Belgium and for a reference area providing satisfactory market coverage. Owing to data availability, this box will confine itself to the volume of imports of the EU-15 partners over the period 1995 to 2002. On that basis, the effects of the export structure and the relative dynamism of demand for the various products are examined jointly. The first dimension is assessed by calculating the degree of specialisation for each product category, on the basis of the difference between that category's share in Belgium's exports and its relative weight in EU-15 imports. The relative vigour of demand is judged by the progressiveness ratio, which corresponds to the difference between the growth of that category of imports in the EU-15 and the growth of all that area's imports. A product category is classed as progressive (regressive) if its imports grow faster (more slowly) than imports as a whole.

(1) The product category breakdown is based on the two-digit standard international trade classification (SITC). This identifies some sixty product categories.

By combining the criteria of specialisation and progressiveness, it is possible to divide the product categories into four classes and thus determine whether they have exerted a positive or negative effect on the movement in foreign trade. A country has a favourable product structure if, in comparison with the reference area, its exports are specialised in progressive categories and not in regressive categories. In the opposite case, it is unfavourable. For Belgium, the results are as follows:

– specialisation in products for which the markets are progressive (north-east quadrant in the chart below): around 28 p.c. of Belgium's exports. This concerns, in particular, road vehicles, organic chemicals and medicinal and pharmaceutical products;
– non-specialisation in products for which the markets are regressive (south-west quadrant): almost 17 p.c. of exports. The product categories in this class include manufactures of metals, general industrial machinery and equipment;
– specialisation in products for which the markets are regressive (north-west quadrant): 39 p.c. of exports. This applies in particular to non-metallic mineral manufactures, plastics in primary forms, iron and steel, textile yarn, fabrics and made-up articles;
– non-specialisation in products for which the markets are progressive (south-east quadrant): 16 p.c. of exports. These markets cover electrical machinery, apparatus and appliances, office machines and automatic data processing machines, telecommunications and sound recording and reproducing apparatus and equipment.

During 1995-2002, the structure of Belgian exports was therefore favourable for around 45 p.c. of the amount of exports. The same calculations for Belgium's main trading partners show that the Netherlands had a relatively similar export mix. In Italy, on the other hand, the structure was far less favourable, with 80 p.c. of exports having an adverse focus. France and Germany had a more favourable product structure, as around 60 p.c. of exports had a favourable orientation.

In order to arrive at a more composite view of the effect of specialisation per product on foreign trade, it is more relevant to examine the orientation of foreign trade by calculating a weighted market growth figure. During 1995-2002, the effect of the product structure was negative for Belgium, and to an even greater extent for Italy. Conversely, in the three large neighbouring countries the product structure effect was positive, as the exports of those countries were sufficiently centred on product markets with strong growth. The detailed results reveal that the difference may be due mainly to the relatively small proportion of Belgian exports represented by electrical machinery, apparatus and appliances, office and automatic data processing machines, and telecommunications and sound recording and reproducing apparatus and equipment.

PRODUCT STRUCTURE EFFECT FOR BELGIUM AND ITS MAIN TRADING PARTNERS FROM 1995 TO 2002

(Market movements compared to EU-15 trade, indices 1995 = 100)

	Markets weighted geographically and by products	Geographically weighted markets	Product structure effect [2]
Belgium	131.7	132.3	99.5
Netherlands	131.7	127.9	102.9
France	140.4	131.6	106.7
Germany	137.0	134.0	102.3
p.m. Three main neighbouring countries [1]	*136.8*	*131.5*	*104.1*
Italy	127.2	129.9	97.9

Sources: EC, NAI, NBB.

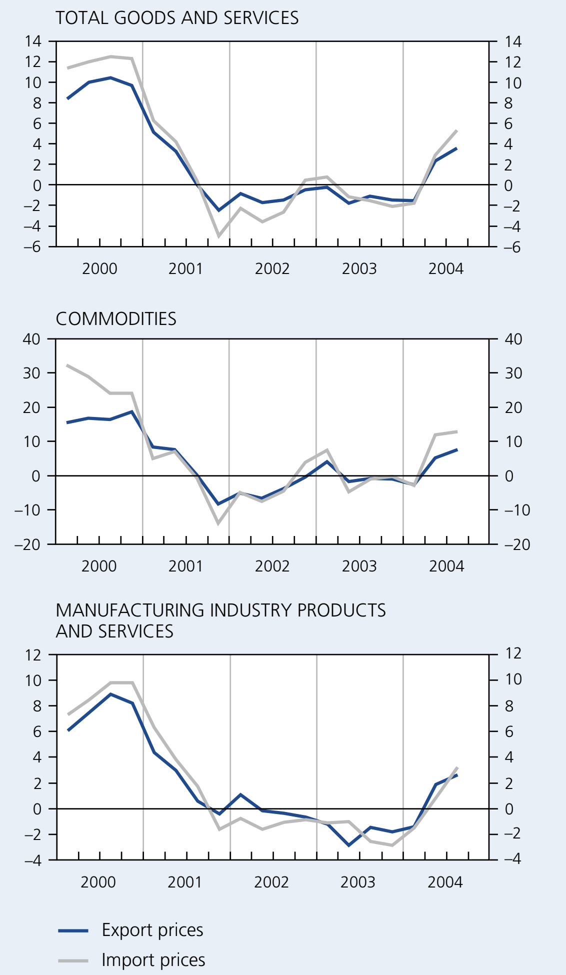
(1) Trade-weighted average.

(2) Ratio between the index of markets weighted geographically and by products and the index of markets weighted geographically only. A figure of more than 100 indicates that the product structure is favourable.

These results should be assessed by taking account of the degree of detail in the available data and the period considered. At a more detailed level, for example, some products may prove decidedly more dynamic than the category in which they are placed. Finally, demand per type of product may vary over time: thus, Germany has probably benefited recently from stronger demand for capital goods than previously. Nonetheless, when placed in a long-term perspective, the analysis of the structure effects – the results of which are corroborated by other studies – shows that it would probably be better for Belgium's exports to specialise more in higher technology products.

CHART 36 **EXPORT AND IMPORT PRICES**

(Calendar adjusted data, percentage changes compared to the corresponding quarter of the previous year)



Sources: NAI, NBB.

Apart from the catalyst effect which it exerted on the volume of international trade, the vigour of the global expansion of activity also pushed up world prices. Commodities were the most sensitive here, owing to the exceptional level of demand – especially from the United States and China – for petroleum products and metal ores, whereas the supply of these goods is relatively inelastic in the short term. These increases were reflected in prices of semi-finished goods, notably iron and steel and certain chemicals for which large increases were recorded in Belgium's foreign trade, and manufactured articles, in proportion to the use of raw materials in the various production stages.

In 2003 the euro's appreciation against the US dollar, which remains the reference currency for international prices for the majority of commodities and standardised products, had dominated these price movements, but that was no longer the case in 2004. Thus, after falling for the two preceding years, Belgium's foreign trade prices began rising again in 2004. In all, prices increased by 2.2 p.c. for exports and 3.1 p.c. for imports, against a fall of 1.2 and 1 p.c. respectively in 2003. The terms of trade therefore deteriorated by 0.8 p.c. during the year under review, the price rises having been largest for basic products which account for a larger proportion of imports than exports.

Current transactions on the balance of payments

According to the concepts of the balance of payments, for which the amounts of transactions by Belgian residents with the rest of the world are recorded without any adjustment for calendar effects, in contrast to the national accounts and foreign trade figures used in the rest of this chapter, the trade surplus in goods and services dropped from 10.7 billion euro in 2003 to 9.5 billion in 2004. This decline is attributable exclusively to trade in goods, where the balance deteriorated owing to the adverse movement in the terms of trade.

TABLE 18 NET LENDING TO THE REST OF THE WORLD

(Balances; billions of euro, unless otherwise stated)

	2000	2001	2002	2003	2004 e	First nine months 2003	First nine months 2004
1. Current account	9.8	9.9	15.0	11.8	9.7	8.3	6.2
Goods and services	7.5	8.2	11.5	10.7	9.5	7.9	6.6
Goods	5.3	6.2	9.3	9.0	7.5	7.3	5.8
Services	2.3	2.0	2.2	1.7	2.0	0.6	0.8
Transport	2.1	1.7	1.0	0.8	n.	0.6	0.8
Travel	–3.1	–3.2	–3.4	–3.5	n.	–3.1	–3.1
Other services	3.2	3.5	4.6	4.5	n.	3.2	3.1
Factor incomes	6.4	6.3	8.0	7.0	6.0	5.2	4.3
Earned incomes	3.0	3.1	3.3	3.3	n.	2.4	2.6
Incomes from direct and portfolio investment	3.4	3.2	4.7	3.7	n.	2.8	1.7
Current transfers	–4.2	–4.6	–4.6	–5.9	–5.8	–4.9	–4.7
Transfers to general government	–3.3	–3.6	–3.7	–4.4	n.	–3.8	–3.4
Transfers to other sectors	–0.9	–1.0	–0.9	–1.5	n.	–1.1	–1.3
2. Capital account	–0.1	–0.4	–0.7	–0.8	–0.2	–0.7	–0.1
3. Net lending to the rest of the world (1 + 2)	9.6	9.5	14.3	11.0	9.6	7.6	6.1
p.m. Percentages of GDP	*3.9*	*3.7*	*5.5*	*4.1*	*3.4*	*3.8*	*2.9*

Sources: NAI, NBB.

Although smaller than the surplus in goods and services, the surplus produced by the payment of factor incomes between Belgium and other countries also makes a significant contribution, year after year, to the economy's current account surplus. As in 2003, it was down slightly, following the decline in the balance of incomes from direct and portfolio investment, and equalled 6 billion euro. While there was hardly any change in the gross incoming and outgoing interest flows, the dividends paid by firms based in Belgium to their foreign shareholders grew faster than those received by Belgians holding foreign shares, be it in the form of direct investment or investments in securities portfolios. On the other hand, the structural surplus produced by earned incomes – due largely to wages paid by the European institutions to their staff resident in Belgium – increased slightly once again during the year under review.

The deficit in current transfers paid to the rest of the world also diminished slightly, falling from 5.9 billion euro in 2003 to 5.8 billion in 2004. This resulted from a more favourable balance in respect of taxes, customs duties and fines. This year, as usually happens, Belgium once again received a net payment from Luxembourg under the agreement on the allocation of excise duties within the BLEU. In 2003, that same agreement had given rise to a transfer from Belgium, owing to substantial purchases of cigarettes by non-residents in this country. In terms of amounts, net transfers of general government are still largely determined by transactions effected with the EU. Belgium's total contribution to the EU budget over the first nine months of 2004, in the order of 3.2 billion euro, was comparable to that for the corresponding period of the previous year. Following changes in the method of financing the EU budget, however, the proportion of VAT revenues transferred declined during the year under review, while the contribution based on GNI increased. The funds paid by the EU to Belgium in the form of aid under the common agricultural policy and the structural policies remained steady.

In all, taking account of all the above transactions with the rest of the world, the current account surplus dropped from 11.8 billion euro in 2003 to 9.7 billion in 2004.

The capital account, which records transactions relating to transfers of the ownership of fixed or intangible assets, produced a deficit of 0.2 billion euro in 2004. This negative balance was due largely to investment grants made by the government to other countries. On the other hand, no substantial debt remission was recorded during the year under review, in contrast to 2003 when the capital account deficit of 0.8 billion euro was largely attributable to the waiving of a claim by the Ducroire/Delcredere.

Net lending to the rest of the world totalled 9.6 billion euro in 2004, down by 1.4 billion against 2003. As a percentage of GDP, it thus dropped from 4.1 to 3.4 p.c. in 2004. Despite this fall, Belgium's domestic sectors therefore once again produced significant net financial savings overall.

4. Labour market and labour costs

4.1 Labour market

Net job creation in 2004 averaged around 31,000 units, representing a 0.7 p.c. rise in domestic employment compared to 2003. The harmonised employment rate thus increased by 0.8 percentage point to 60.4 p.c. Over the same period, the number of unemployed job-seekers increased by 38,000 units, bringing the harmonised unemployment rate to 8.6 p.c. of the labour force in 2004.

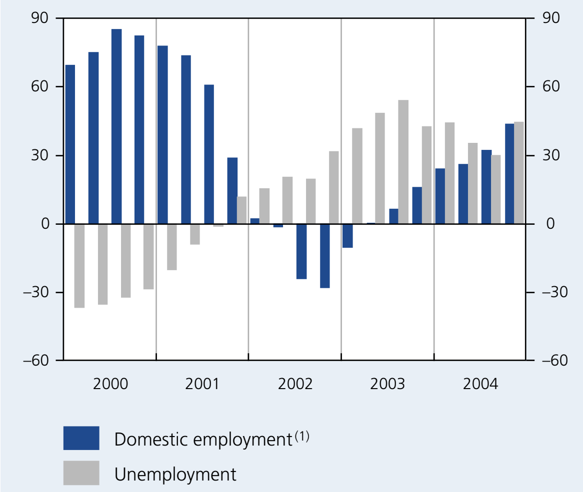
The recovery in employment which had begun in 2003 was thus maintained. The low point had been reached in the last quarter of 2002, but the year-on-year change in the number of persons in work did not become positive again until mid 2003. On average, around 2,000 additional jobs were already created in that year. However, some caution should be exercised when comparing the 2002 and 2003 employment figures: the introduction by the NSSO of the multi-functional declaration (Dmfa) for firms in 2003 may in fact have caused a break in the series of the source data used by the NAI to compile the statistics on the number of private sector employees.

In contrast to previous years, the rise in employment in 2004 was due to a simultaneous increase in the number of employees and self-employed persons. During the year under review, and for the first time since 1997, the number of new entrepreneurs may have exceeded the number of self-employed persons terminating their activity. However, this increase totalling some 4,000 persons was due partly to the improved registration of assisting spouses, owing to a change in the social security rules applicable to them. Salaried employment, which had remained more or less steady, on average, in 2003, increased by 27,000 persons in 2004, a rise of 0.8 p.c. This acceleration stemmed mainly from the sectors most sensitive to the business cycle, where the workforce had still declined in 2003. However, as in that year, the strongest employment growth occurred in the "other services" branch, which includes health care.

Average working hours per employee are tending to fall year by year, mainly because of the increasing proportion of part-time workers. Depending on the economy's position in the business cycle, this steady trend is amplified, or wholly or partly offset. During a downturn in activity, many employers – fearing a shortage of skilled labour once the economy picks up – do not adjust their workforce fully to the decline in activity, and thus engage in "labour hoarding". As a result, at the beginning of

CHART 37 LABOUR MARKET

(Changes compared to the corresponding quarter of the previous year, thousands of persons)



Sources: NAI, NEMO, NBB.
(1) Estimate for the third and fourth quarters of 2004.

TABLE 19 DOMESTIC EMPLOYMENT
(Annual averages)

	2000	2001	2002	2003	2004 e
Domestic employment					
Number, thousands of persons	4,088	4,148	4,136	4,138	4,169
Percentage change	1.9	1.5	–0.3	0.1	0.7
of which :					
Self-employed					
Number, thousands of persons	688	683	679	677	681
Percentage change	–0.6	–0.8	–0.5	–0.4	0.6
Employees					
Persons in work					
Number, thousands of persons	3,400	3,466	3,457	3,462	3,488
Percentage change	2.5	1.9	–0.3	0.1	0.8
Volume of work (1) (2)					
Number, millions of hours	5,174	5,258	5,225	5,225	5,270
Percentage change	3.0	1.6	–0.6	0.0	0.9
p.m. Average working hours (1) (2)					
Number, hours per person	*1,522*	*1,517*	*1,512*	*1,509*	*1,511*
Percentage change	*0.5*	*–0.3*	*–0.4*	*–0.1*	*0.1*

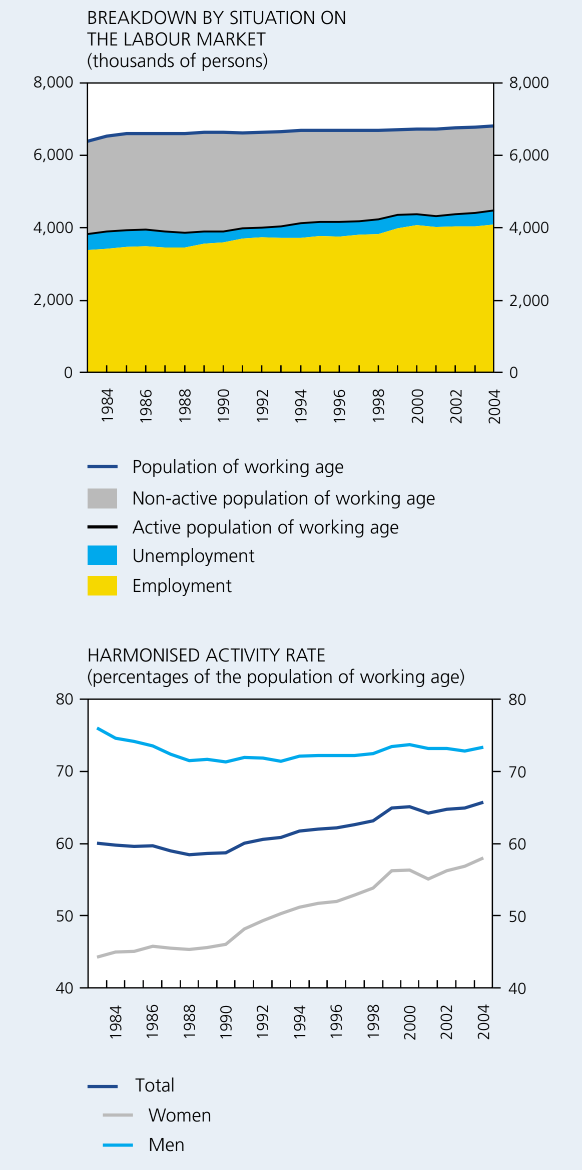
Sources : NAI, NBB.
(1) The volume of work is estimated by the NAI on the basis of NSSO data. For part-time workers, the number of paid hours is known. For full-time workers, estimates are produced on the basis of the working hours of a reference worker and the number of days worked. Overtime worked by full-time employees is not included in these data, which are also not adjusted to take into account temporary lay-offs.
(2) Calendar adjusted data.

the next recovery phase, working hours per employee increase first, and it is only some time later that net recruitment takes place. Thus, average working hours per employee increased slightly in 2004, after declining during three successive years of subdued activity : the downward trend in the average number of hours worked was more than offset by the longer hours worked by individuals. Moreover, under the draft central agreement concluded in January 2005, the social partners agreed to propose more flexible arrangements for managing overtime, increasing the annual maximum permitted per worker from 65 to 130 hours and applying more favourable tax treatment to some overtime hours for both workers and employers.

In addition to developments in employment, the economic cycle also influences the situation of the labour force, which includes the unemployed as well as those in work. When activity is at a high level, more people have a chance of finding a job, which not only increases the number of persons in work, but also expands the labour supply by mobilising people who were previously non-active and are now attracted by these improved job prospects. When the economy is not doing so well, the opposite applies.

Thus, cyclical fluctuations are reflected in the activity rate, which is the ratio between the labour force and the population of working age, and as such it indicates the extent to which people of working age actually present themselves on the labour market. More than by the cyclical profile, the development of the ratio is characterised by a marked upward trend, due essentially to the increasing participation of women in the labour market. Although their activity rate is still well below that of men – the gap was 16 percentage points in 2003 – women are rapidly expanding their participation in the labour market. In the past two decades, the activity rate of women has in fact increased by almost 13 percentage points. This increase is all the more remarkable given that the male participation rate has fallen by 3 percentage points during this period. The increased participation and greater success rate of the female population at higher levels of education suggest that this tendency will persist in the years ahead, as obtaining a certificate of higher education is generally a fast route to permanent inclusion in the labour market. However, it should be noted that, in contrast to what happens in other EU-15 countries, young people in Belgium take little part in the labour market while studying, and that depresses the overall activity rate at that moment.

CHART 38 POPULATION OF WORKING AGE (1)



Source : EC.
(1) Population aged 15 to 64 years. Data from the harmonised labour force survey. Since 1999, this survey has been conducted continuously, and not just in the second quarter. Up to 1998, the data therefore correspond to the second quarter results, whereas for the period 1999-2003 they are annual averages. For 2004, the figures are the average of the first three quarters.

The rise in the participation rate was accompanied by an expansion of the population of working age so that, according to the data from the labour force survey, the labour force expanded from around 3.8 million persons in 1983 to almost 4.5 million in 2004. During the year under review, this upward trend was reinforced by the cyclical component and – following full implementation of the rules obliging new unemployed persons aged 50 to 58 years to remain available for the labour market – by the inclusion in the labour force of a large contingent of unemployed job-seekers. The overall activity rate thus increased by 1.2 percentage point, to 66.1 p.c.

Combined with a higher activity rate, the expansion of the population of working age, by around 23,000 persons in 2004, resulted in an increase of 70,000 units in the labour force. This increased labour supply was only partly absorbed by the expansion of the demand for labour, so that the number of unemployed job-seekers increased by 38,000 units. In view of the simultaneous rise in the labour force, the harmonised unemployment rate rose on average by 0.4 percentage point to 8.6 p.c. Following a sharp deceleration, the growth rate of the number of unemployed persons picked up again to 8 p.c. on a year-on-year basis in the last quarter of 2004.

The total number of unemployed persons, like the labour force and the number of persons in work, is influenced by the business cycle, but the effect is not necessarily uniform for all age groups. Thus, in the case of young people under the age of 25, unemployment shows a marked cyclical profile, with year-on-year changes showing deeper troughs and higher peaks and turning points that come sooner than for older unemployed persons.

Young unemployed persons were the first to be covered by the new system of following up job-seekers, which came into force on 1 July in the year under review, replacing the system of exclusion on grounds of abnormally lengthy unemployment pursuant to article 80 of the Royal Decree laying down the unemployment regulations. Under the new system, persons who are wholly unemployed and claiming benefits must prove, after fifteen months of unemployment in the case of those under the age of 25 and twenty-one months in other cases, that they have actually made efforts to find work. If that is the case, they are recalled after a further sixteen months. If their efforts are considered inadequate, a contract is concluded between the unemployed person concerned and NEMO, and a new interview takes place four months later. If their efforts are again deemed unsatisfactory, an initial penalty applies and a new agreement is drawn up. A third and final interview takes place four months later: if the outcome is a third negative assessment, the person

TABLE 20 **HARMONISED LABOUR MARKET INDICATORS**

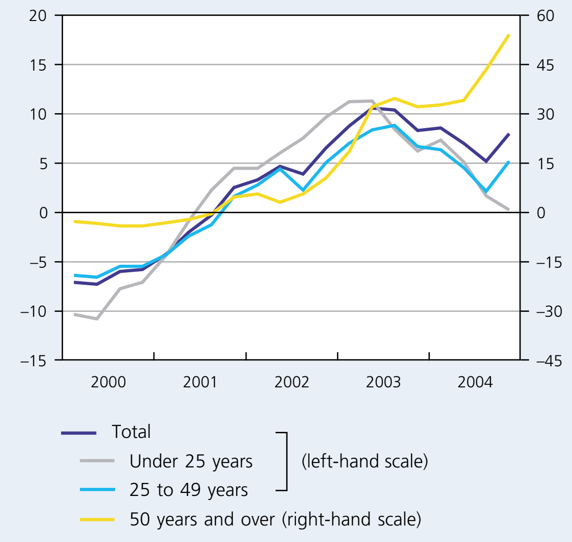
(Annual averages)

	2000	2001	2002	2003	2004 e (1)
Activity rate (2)					
Total	65.1	64.2	64.8	64.9	66.1
Women	56.4	55.1	56.3	56.9	58.0
Men	73.7	73.2	73.2	72.9	73.4
Employment rate (2)					
Total	60.5	59.9	59.9	59.6	60.4
Women	51.5	50.9	51.4	51.8	52.4
Men	69.5	68.8	68.3	67.3	67.8
Unemployment rate (3)					
Total	7.0	6.6	7.6	8.2	8.6
Women	8.7	7.5	8.7	8.9	9.6
Men	5.8	6.0	6.7	7.7	7.5

Sources: EC, NBB.
(1) Estimated annual average for the total, average of the observed results for the first three quarters for women and men.
(2) Percentages of the population of working age, i.e. persons aged 15 to 64 years.
(3) Percentages of the active population of working age.

CHART 39 **UNEMPLOYED JOB-SEEKERS: BREAKDOWN BY AGE GROUP**

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



Source: NEMO.

concerned loses his entitlement to benefits. At the same time, in order to increase their chances of finding work, unemployed persons are given individual guidance and may possibly reorient their careers, e.g. by pursuing additional training. For practical reasons, this guidance cannot be offered to all job-seekers simultaneously; the scheme is therefore staggered. Unemployed persons under the age of 30 come first; from mid 2005, unemployed persons between the ages of 30 and 39 will be called, and from mid 2006 those aged between 40 and 49. The effectiveness of this new system will be assessed in 2007.

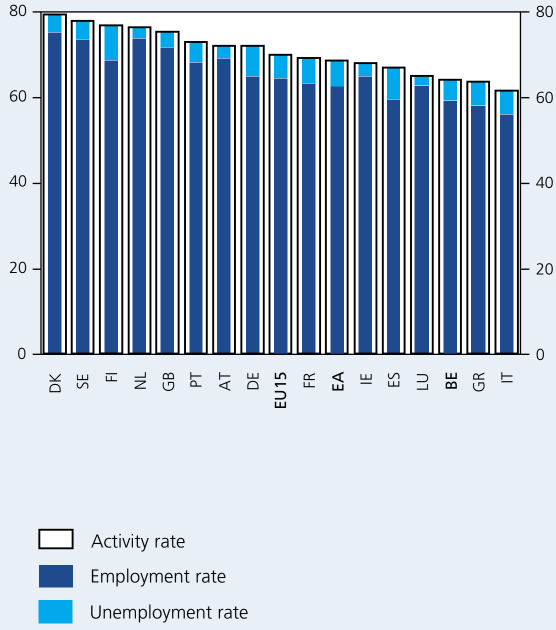
For the time being, the scheme will therefore not apply to unemployed persons aged over 50. However, in 2003 and 2004, the numbers of unemployed in this age group increased very sharply. This rise was due largely to the modification of the criteria for acquiring the status of wholly unemployed, receiving benefits and not seeking work. Between July 2002 and July 2004, the minimum age for claiming that status was gradually increased, from 50 to 58 years. From now on, newly unemployed persons in this age group must remain available for the labour market implying that, unlike in the past, they are included in the administrative statistics on unemployed job-seekers. Existing claimants, even those aged under 58, are not affected. Since these new rules took effect, there has been a marked fall in the number of older unemployed persons not seeking work: in 2004, they totalled just

Box 10 – The Belgian labour supply in a European perspective

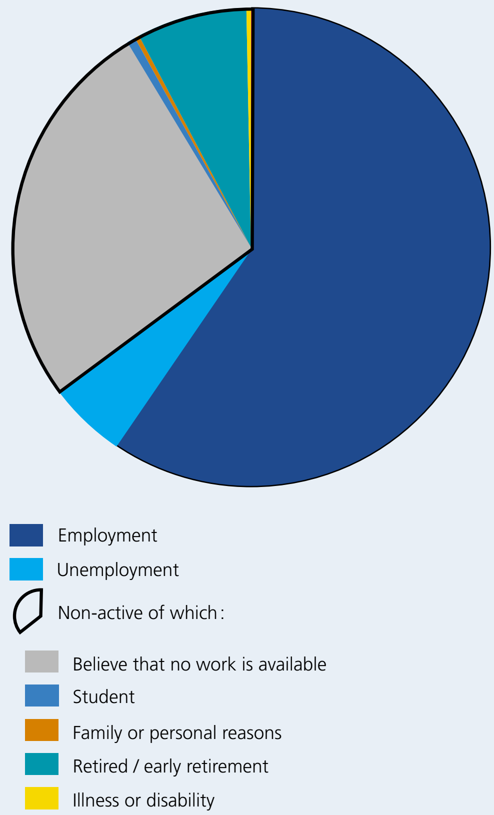
The number of persons in work in Belgium is decidedly lower, in relative terms, than the average for the other EU countries. In the second quarter of 2003, the harmonised employment rate, which measures the ratio between the number of persons in work and the population of working age, stood at 59.3 p.c. in Belgium, against the EU-15 average of 64.4 p.c. and the euro area figure of 62.5 p.c. There were only two countries where this ratio was lower: Greece and Italy.

LABOUR SUPPLY IN BELGIUM AND IN EUROPE

ACTIVITY RATE, EMPLOYMENT RATE AND UNEMPLOYMENT RATE IN 2003 (1)
(percentages of the population of working age)



STRUCTURE OF THE POPULATION OF WORKING AGE IN BELGIUM IN 2003 (2)
(percentages of the population of working age)



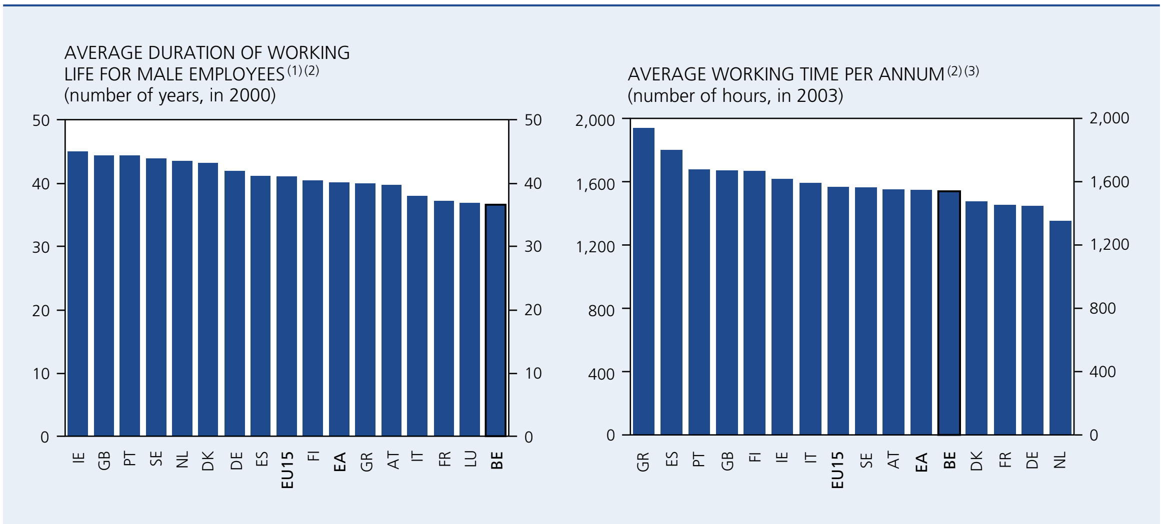
Source: EC.
(1) Second quarter data to permit the international comparison of results.
(2) Annual averages.

However, the employment rate provides only a partial view of the volume of labour available for use as a factor of production. Thus, if demand for labour is sufficiently strong, employment could be increased thanks to the potential labour supply represented by people without a job: this primarily means unemployed job-seekers who, in Belgium, represented around 5 p.c. of the population of working age, but it also includes non-actives, in the statistical sense of the word, who are interested in taking a job in the short or long term. According to the labour force survey, 35 p.c. of the population of working age, or almost 2.4 million people, were non-active in 2003.

Around three-quarters of them stated that they were interested in working but were not looking for a job because they thought none was available. Students and possibly people who, for family or personal reasons, do not wish to work, i.e. 1.7 and 0.8 p.c. of non-actives respectively, may also ultimately enter the labour force. Altogether, these people represent just over 27 p.c. of the population of working age. On the other hand, 22 p.c. of non-actives have taken early retirement or are retired, sick or disabled, and are unwilling or unable to enter the labour market. The desire to work is not enough: among those who would like a job, there are in fact people who cannot be integrated directly into the ordinary working world because they lack the necessary skills. The proportion of non-actives representing a genuine potential labour reserve is therefore difficult to assess, both for Belgium and for other countries.

The labour force which, apart from persons in work, also includes unemployed job-seekers, is therefore a minimum but convenient estimate of the actual labour supply. The activity rate, which expresses the ratio between the labour force and the population of working age, permits comparison of the degree to which the potential labour supply is mobilised in the various countries. For this ratio, too, Belgium ranks low in Europe. In the second quarter of 2003, 64.3 p.c. of Belgians between the ages of 15 and 64 were working or looking for a job, against 70 p.c. in the EU-15 and 68.6 p.c. in the euro area. Only Greece and Italy had a lower score. It seems that a high (low) employment rate is associated with a high (low) activity rate. However, the proportion of unemployed job-seekers is not directly correlated with the level of the employment rate so that, in the comparison of the labour supply between countries, the differences observed may go together with a different breakdown between employment and unemployment.

WORKING TIME IN BELGIUM AND IN EUROPE



Source: OECD.

(1) The average duration of working life is calculated as the difference between the average age of withdrawal from the labour market and the average age of starting work. These two ages are calculated on the basis of a probability model which, depending on the country, uses administrative statistics or the results of the harmonised labour force survey.

(2) The EU-15 and euro area (EA) averages were calculated by weighting the results for the various Member States by their share in total employment.

(3) No data available for Luxembourg.

Variables other than the number of active persons, such as the average duration of working life and the average number of hours worked per annum, give an indication of the labour supply in an economy. On the basis of OECD figures, it appears that the average working life of male employees in Belgium was around 36.6 years in 2000, the lowest figure for all EU-15 countries. For comparison, the average working life lasted 41.1 years in the EU-15 and 40.2 years in the euro area. As regards the actual annual average working time, the series compiled by the OECD indicate that the figure for Belgium was slightly below the average for the other European countries. However, the gap is much smaller than for the other variables. Annual average working time totalled 1,542 hours in 2003, against 1,549 hours in the euro area and 1,570 hours in the EU-15. For this aspect, Belgium is in fact ahead of the three main neighbouring countries, namely France, Germany and the Netherlands, as well as of Denmark.

Belgium's results are therefore below the European average as regards the number of persons in work, the number of potential workers, the annual number of hours worked, as well as the length of working life. Taking into account the expected population ageing and its potential impact on prosperity, Belgium therefore seems to have some scope for maintaining or even augmenting the labour supply by influencing not only the employment rate but also the length of working life and, to a lesser extent, the average working hours. In this context, it is necessary to be aware that measures taken in one area also affect the other variables. Thus, employment may be encouraged by promoting part-time working, but that has the effect of reducing the average annual working time. It is also possible to take action on several variables simultaneously : thus, in Belgium the shorter working life is accompanied by rather low employment rates for young people and older workers, depressing the overall employment rate ; extending the average actual working life would therefore boost the employment rates.

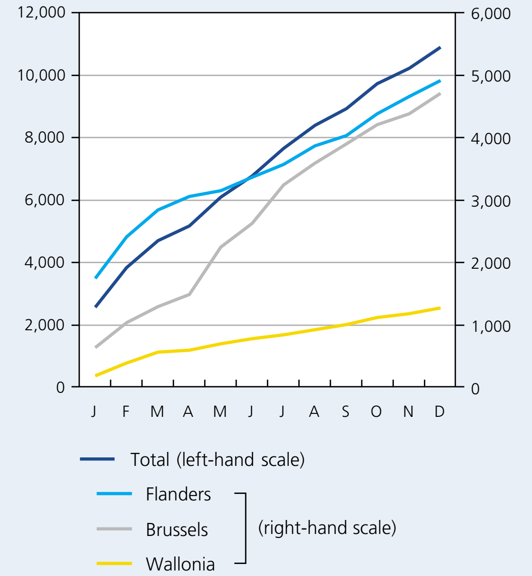
137,000, against 152,000 two years earlier. However, at the same time the number of unemployed job-seekers over the age of 50 increased from around 26,000 to almost 56,000, though admittedly in a context of weak employment growth.

Moreover, since 1 March 2004 the local employment agencies (LEAs) have no longer been allowed to offer domestic help services, causing the number of unemployed job-seekers to increase by around 18,000 people who were previously supplementing their benefits by taking small jobs via the LEAs and who were, by so doing, exempt from the obligation to look for work.

Subsidised domestic help is now arranged exclusively via the service voucher system ; the service is provided by employees working for certified companies. Since the system was launched in 2003, the number of workers hired by these firms has increased steadily, reaching almost 11,000 persons by the end of 2004. Altogether, over 5.6 million hours of work were performed under the service voucher scheme during the year under review. Initially, this new scheme was particularly successful in Flanders ; since mid 2004 it has also developed in Brussels – so much so that, despite its smaller market, almost as many jobs were created in Brussels as in Flanders by the end of 2004. That is most likely because the certified firms in Brussels also provide services in the Flemish region.

CHART 40 SERVICE VOUCHERS : WORKERS RECRUITED IN 2004

(Cumulative number of persons)



Source : NEMO.

In Wallonia, the system is still in its infancy: at the end of 2004, the number of workers recruited totalled barely a quarter of the figures for Flanders or Brussels.

The service voucher system, aiming to enable low-skilled persons to get a job, is also intended to regularise undeclared employment, which is widespread in the domestic services sector. The rise in the number of jobs created bears witness to its success, but has only a rather small impact on the overall employment level. The NAI's employment statistics in fact include an estimate of undeclared employment and the number of persons working via the LEAs, both of which should now be revised downwards. The scale of the success of the introduction of service vouchers is due to a large extent to the substantial government subsidy. This totalled 19.47 euro per hour worked, whereas the direct cost to the user was 6.20 euro per service voucher; eventually, this cost was limited to 4.34 euro, as 30 p.c. of this expenditure is tax deductible. From mid November 2004, the direct personal contribution from users was increased to 6.70 euro per hour worked.

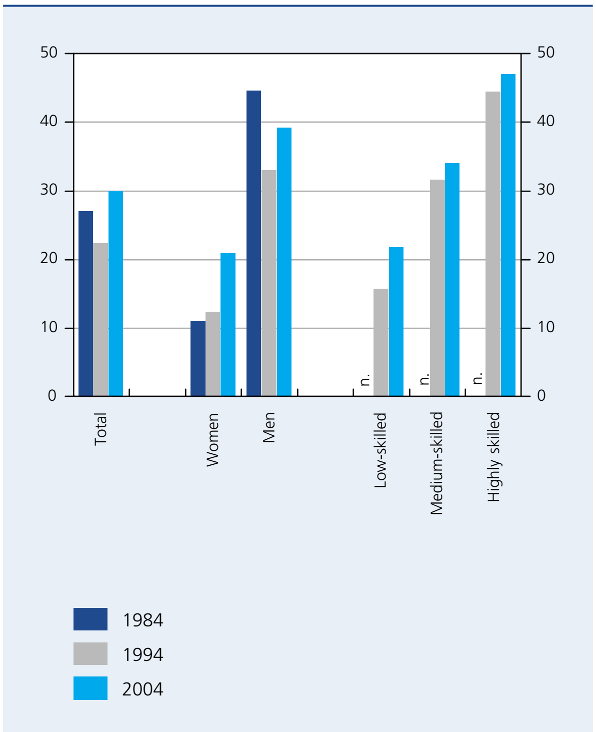
Recent years have seen an increase in the participation in the labour market of persons aged 55 and over, though admittedly from a particularly low initial level. Between 1994 and 2004, their employment rate rose by almost 8 percentage points to 30 p.c. This upward trend concerns both men and women, but is particularly marked for the latter. Nevertheless, the women's employment rate, at 20.9 p.c., is still only about half the figure for men, which is close to 39 p.c. The increase observed in the employment rate is apparent for all levels of education. The strongest rise is recorded among the low-skilled, owing partly to the arrival in this age group of cohorts of women with a proportionally higher labour market participation rate than those who preceded them. Nonetheless, the difference in relation to the higher skilled remains considerable, since 22 out of 100 persons aged 55 or over with low skills are in work, against 47 of those with a university degree or certificate of higher education. In proportion, the rise in the employment of highly skilled persons was rather modest during the past decade. Part of the reason is that these people took advantage of early retirement schemes to a greater extent than in the past, even though their working conditions are generally better and their career prospects are, in principle, more favourable up to a more advanced age. In so far as the average age of the population is rising and its level of education improving, a continuation of this trend would be detrimental to the future development of the labour market and the economy in Belgium.

In the majority of cases, older workers leaving the labour market receive financial benefits from the government until they actually retire. In 2004, over 250,000 persons aged 50 and over thus received an allowance on the basis of their status as wholly unemployed, receiving benefits and not seeking work, or as persons taking full-time early retirement, or on account of a complete career break or time credit. NEMO allowances are also available for persons who wish to reduce their working time, e.g. via part-time early retirement or a partial career break or time credit. The purpose of these schemes is to keep older workers in employment for longer by allowing them to reduce their volume of work.

The total number of persons aged 50 and over receiving NEMO allowances is increasing steadily: thus, it went up from around 326,000 persons in 2000 to 400.000 in 2004. Apart from the above-mentioned steep increase in the number of wholly unemployed, receiving benefits and seeking work, observed in 2003 and 2004, which was partly offset by the decline in the number of unemployed not seeking work, the main factor explaining this

CHART 41 EMPLOYMENT RATE OF PERSONS AGED 55 YEARS AND OVER (1)

(Number of persons aged 55 to 64 in work in relation to the population of the same age group)



Source: EC.

(1) Since 1999 the labour force survey has been conducted continuously, and not just in the second quarter. For 1984 and 1994, the data therefore correspond to the second quarter results, whereas for 2004 they are the average for the first three quarters. The breakdown by level of skills was not available in 1984.

TABLE 21 BENEFITS PAID BY NEMO TO PERSONS AGED 50 YEARS AND OVER
(Number of beneficiaries, annual averages)

	2000	2001	2002	2003	2004
Total	326,151	336,303	351,617	377,840	400,034
of which :					
Wholly unemployed and receiving benefits (1)					
Seeking work	24,848	24,065	26,316	39,668	55,535
Not seeking work	140,763	147,919	152,309	146,417	136,907
Early retirement					
Full-time	114,478	109,950	106,482	107,915	109,869
Part-time	1,092	1,214	1,198	1,073	926
Career breaks / Time credit					
Complete break	3,258	3,800	4,175	4,935	5,922
Partial break	27,058	33,018	43,463	57,663	68,774
Other	14,654	16,337	17,673	20,168	22,101

Source : NEMO.
(1) Between July 2002 and July 2004, the minimum age for claiming the status of "wholly unemployed, receiving benefits and not seeking work" was gradually raised from 50 to 58 years.

development is the large increase in the use of the time credit scheme with a partial break from work.

The low participation rate of persons aged 50 and over in the Belgian labour market caused the federal government to formulate, in its general policy statement of 12 October 2004, a series of proposals aimed at creating conditions to keep these people available longer on the labour market. That implies, in particular, that they should not prematurely withdraw from the labour market by making use of the broad range of schemes permitting early withdrawal, such as pension/pre-pension schemes, the status of older unemployed person, or the "Canada Dry" schemes which are based on the status of older unemployed person, or more recently, the time credit. To that end, the government proposals contain measures aimed at encouraging older persons to continue working and inducing firms to keep them at work longer or to hire them, but also to reduce the attractiveness of the various early withdrawal schemes, for both employers and workers, by revising the relevant access criteria and financial conditions. An overall approach is needed in order to avoid a system of communicating vessels in which provisions helping to tighten access to one scheme or make it less attractive would give rise to increased use of other systems which remained more advantageous. In this connection, the federal government has initiated consultation with the employers' organisations and those representing employees, with the aim of reaching an agreement on the measures to be taken in the spring of 2005.

4.2 Labour costs

In December 2002, at the time of the conclusion of the central agreement relating to 2003-2004, the social partners had taken into account the rather slack economic environment prevailing at that time and agreed to an indicative norm of 5.4 p.c. for the increase in hourly labour costs in the private sector. They had also requested the negotiators on the joint committees to defer the bulk of the collectively agreed pay increases until 2004. This request was honoured, since the real sectoral agreed increases averaged 0.4 and 1 p.c. respectively in the two years. Taking into account wage indexation, which had an average impact of around 1.4 p.c. in each of these two years, nominal collectively agreed wages in the private sector increased by 2.4 p.c. in 2004 against 1.8 p.c. in 2003.

Once the wage drift – which consists in particular of the increases and bonuses granted by firms – is incorporated into these developments, gross hourly wages increased overall by 3.3 p.c. during the year under review, against 3.1 p.c. in 2003; that is an annual rise slightly below that observed in the two preceding years when the increase averaged around 3.7 p.c. per annum.

As well as reflecting changes in gross wages, which are its chief component, the movement in labour costs also reflects fluctuations in social security contributions payable by employers. In 2003 and 2004, these employers' contributions exerted a moderating effect on the increase in labour costs, curbing it by 0.4 and 0.6 p.c. respectively.

The reduction in these contributions is due mainly to a cut in the contributions paid to the government. In 2004, various measures came into effect: those announced at the employment conference of September and October 2003, and those aimed at simplifying and harmonising the reductions in employers' social security contributions, also adopted during 2003. Thus, the majority of the previous arrangements were replaced by an overall reduction in employers' contributions consisting of two parts: the structural reduction, which varies according to the worker's reference pay and is aimed specifically at both the low paid (up to 1,956.60 euro gross per month) and the high wage earners (paid over 12,000 euro gross per quarter), and a specific deduction for target groups, namely people in their first job, the long-term unemployed, older workers and young workers. Special abatements were also granted in the case of a collective reduction in working hours. In addition, the reductions in contributions for low wage earners were stepped up to encourage employers to retain or even to recruit low-skilled workers performing low-paid jobs: for that purpose, the fixed amount of the general reduction is augmented by a supplement which increases the lower the worker's pay.

The other social security contributions payable by employers, i.e. those paid to private entities, for example, in the form of pension funds or group insurance, and those which are imputed, in particular redundancy pay, have increased steadily in recent years. Two factors, in particular, have influenced this trend: the democratisation of access to the supplementary pensions scheme, called "second pillar" pensions, and the bursting of the stock market bubble in 2000, which in some cases necessitated the payment of larger premiums to ensure that future commitments were covered.

In all, the rise in labour costs in the private sector amounted to 2.6 p.c. in 2004, against 2.7 p.c. in 2003. These figures conceal variations in wage developments between branches of activity. Looking at the period 1995-2002 for which detailed data by branch are available in the national accounts, it is possible to deduce from the observed dispersion of the annual increases in hourly labour costs that the existence of both the one time maximum and the one time indicative wage norm did not impede a degree of flexibility in the determination of wages between branches of activity, even if there is a common tendency towards the average.

The explanation for this result is that wage developments are largely determined by their automatic link to the movement in consumer prices and by the collectively agreed increases decided by the joint committees. However, this macroeconomic finding can be further

TABLE 22 LABOUR COSTS IN THE PRIVATE SECTOR

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

	2000	2001	2002	2003 e	2004 e
Gross wages per hour worked (1)	2.3	3.7	3.6	3.1	3.3
Collectively agreed wages (2)	2.8	3.3	3.8	1.8	2.4
Real agreed adjustments	1.3	0.8	1.5	0.4	1.0
Indexations	1.5	2.5	2.3	1.5	1.4
Wage drift (3)	–0.4	0.3	–0.2	1.2	0.7
Employers' social security contributions (4)	–0.8	0.4	0.6	–0.4	–0.6
Contributions paid to government	–0.7	0.0	0.3	–0.5	–0.5
Other contributions (5)	–0.1	0.5	0.4	0.1	0.0
Labour costs per hour worked (1)	1.5	4.1	4.2	2.7	2.6

Sources: FPS Employment, Labour and Social Dialogue; NAI; NBB.
(1) Calendar adjusted data.
(2) Wage increases fixed by joint committees.
(3) 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 (e.g. as a result of scale increases and job creation programmes), and errors and omissions.
(4) Contribution to the rise in labour costs.
(5) Payments made to private agencies, e.g. pension funds and group insurance, and imputed employers' contributions (including redundancy pay).

qualified: if the analysis is refined by examining the changes in hourly labour costs at the level of the firms in each branch of activity, a different picture emerges. This examination is based on data taken from social balance sheets filed by firms for the financial years 1997 to 2003. During that period, labour costs increased on average by more than one and a half times the mean rate in around 40 p.c. of firms, together employing 35 p.c. of private sector workers. This proportion of firms is 38 p.c. or more in all branches of activity, except for transport and communications where it is lower. Conversely, in 36 p.c. of firms, employing 32 p.c. of private sector workers altogether, hourly costs increased by less than half the average. Finally, in a quarter of companies the hourly pay increase fell between these two thresholds and was therefore close to the average for all firms. Companies in this last category are generally larger than the average, since together they employ one third of workers.

This confirms that the national wage coordination does not restrict the scope for firms to adapt the course of labour costs to their own specific situation. The tendency towards decentralisation which has begun at the level of the sectoral negotiations should endorse and reinforce this practice, by giving the firms themselves greater latitude to decide about the pay rises they grant. However, the flexibility observed in the movements of labour costs does not result exclusively from the central or sectoral wage bargaining or agreements concluded within firms; the recruitment policy of firms, bilateral arrangements between employers and workers, and employment promotion measures etc. also play a part.

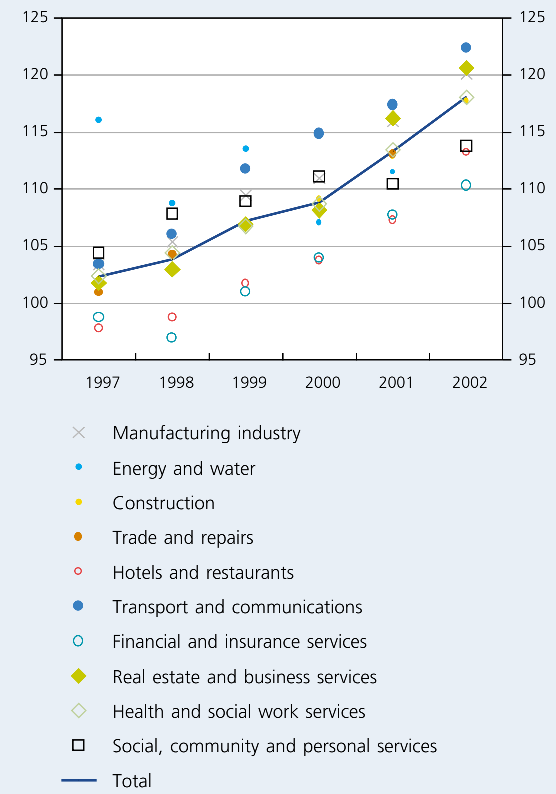
This flexibility also manifests itself at regional level, as is evident from the analysis of the staff costs per branch of activity and per region shown in box 11, which also uses data obtained from social balance sheets.

Hourly labour productivity in the private sector, measured as the ratio between value added at constant prices and the volume of labour expressed in hours, increased by 2.1 p.c. in 2004, a rate close to the rise in labour costs per hour worked. As a result, the increase in unit labour costs was only 0.5 p.c.

The profile of the movement in labour productivity broadly reflects that of economic activity. Productivity gains, which were high in 1997, a year of buoyant activity, declined in 1998 and then rose again in 1999 and 2000, the year in which economic activity peaked. In 2001, the apparent labour productivity fell as the hours worked continued to increase while the rate of increase in value added slowed. Productivity subsequently recovered, initially as a result of the contraction in employment brought about notably by

CHART 42 HOURLY LABOUR COSTS IN THE PRIVATE SECTOR: BREAKDOWN BY BRANCH OF ACTIVITY [1]

(Indices 1996 = 100)



Source: NAI.
(1) Only the most representative branches of private sector employment have been used.

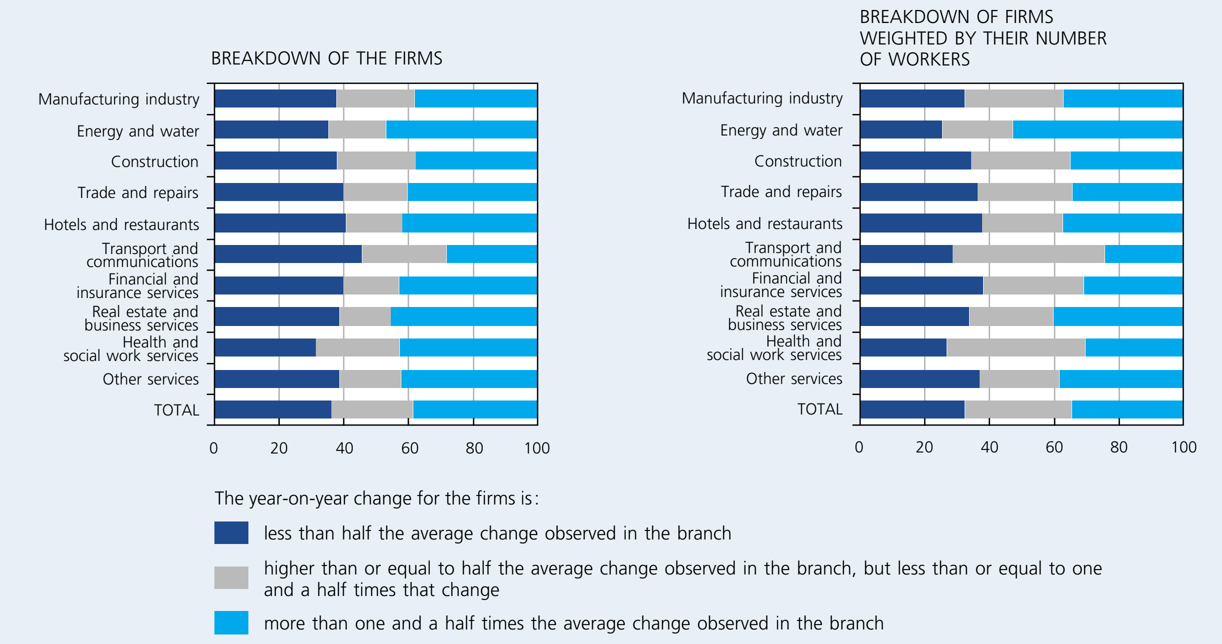
corporate restructuring, then as a result of the resumption of more dynamic activity growth in the private sector.

The low increase in unit labour costs combined with the increase in the unit price of value added was reflected in a marked rise in the gross operating margin of companies. Thus, the share of labour incomes in value added, which had risen sharply in 2001 and 2002 as a result of the steep increase in hourly labour costs, declined for the second consecutive year. In 2004, it was around 2.8 p.c. below the level observed in 1996, the year in which the law on the promotion of employment and the safeguarding of competitiveness came into force.

For a small, open economy, this internal assessment has to be supplemented by an appraisal of the relative movement in labour costs compared to competing countries, since that is still a key factor determining the competitiveness of firms and employment in Belgium. That is why the

CHART 43 DISPERSION OF THE CHANGES IN PERSONNEL COSTS PER HOUR WORKED IN FIRMS REQUIRED TO SUBMIT A SOCIAL BALANCE SHEET, BETWEEN 1997 AND 2003

(Percentages of the total, annual averages [1])



Source: NBB (social balance sheets).

(1) The annual averages were calculated on the basis of the relative shares recorded for the populations of firms filing a social balance sheet for two successive financial years between 1997 and 2003.

Box 11 – Wage policy of firms in the Belgian regions: some information taken from the social balance sheet [1]

The social balance sheets, which contain a range of information on employment, the volume of labour and personnel costs of firms based in Belgium, show that the firm's location is a factor in labour cost differentiation. The analysis is confined to the financial years 1998 to 2002, in order to ensure that the data are of adequate quality and that the results are representative at the regional level for all branches of activity. Firms were divided into single-region and multiple-region firms, according to whether or not they have establishments in more than one region.

Single-region firms, established in a single region, are generally small firms employing on average 19 people. The structure of activity of single-region firms is fairly similar for those in Flanders and Wallonia, although more workers are employed in the industrial branches in Flanders and in the "Other services" branch – which comprises mainly businesses in the health and social sector – in Wallonia. In Brussels, it is the "financial, insurance, real estate and business services" and "trade transport and communications" branches which account for the largest proportion of workers.

(1) For more detailed information on this matter, see: *The Social Balance Sheet 2003*, Heuse P. and Delhez Ph. (2004), Economic Review, NBB, 4th quarter, pp. 89-124.

The predominance of the "financial, insurance, real estate and business services" branch in the economic activity of Brussels influences the average cost of labour there, since hourly wage costs in that branch are among the highest in the economy. However, the personnel costs seen in single-region firms based in Flanders and Wallonia are significantly lower than those observed in firms operating in Brussels, though the average size of the latter is admittedly twice as great. The level of hourly labour costs does generally increase with the size of the firm. However, among the single-region companies, regardless of their size or their branch of activity, those based in Brussels almost systematically record the highest labour costs, and those based in Wallonia the lowest. On average, hourly labour costs total around 32 euro in Brussels single-region firms and almost 27 and 25 euro respectively in Flanders and Wallonia.

STRUCTURE OF EMPLOYMENT AND PERSONNEL COSTS PER HOUR WORKED IN 2002 :
BREAKDOWN BY REGION AND BY BRANCH OF ACTIVITY

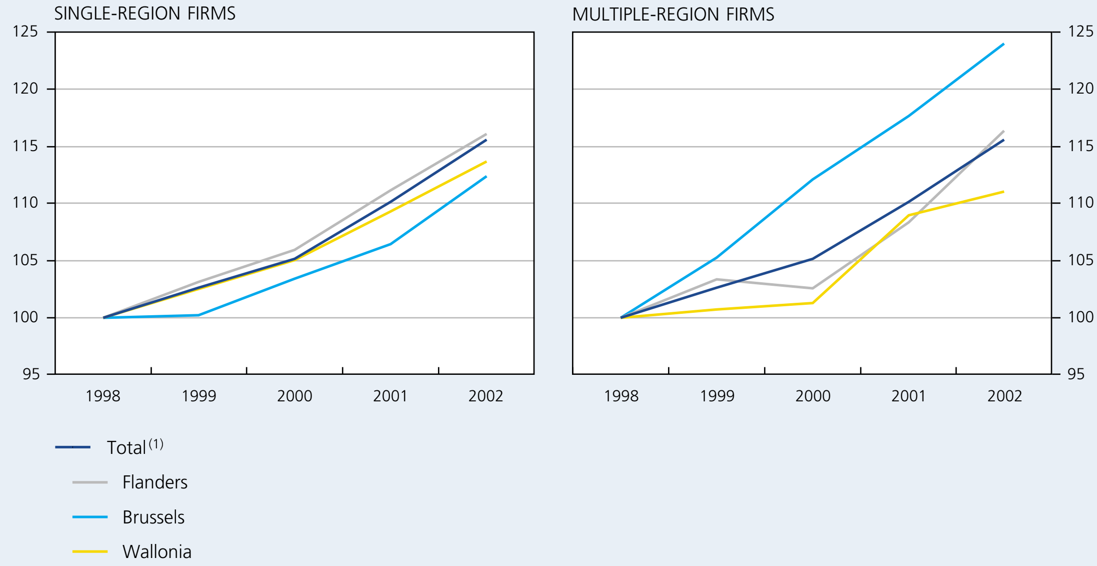
	Single-region firms			Multiple-region firms			Total
	Brussels	Flanders	Wallonia	Brussels	Flanders	Wallonia	
Structure of employment (percentages of the total)							
Agriculture	0.1	0.7	0.6	0.0	0.0	0.0	0.5
Industry	10.8	33.7	28.0	7.4	22.2	43.3	27.2
Construction	3.6	8.4	10.4	5.0	3.9	8.7	7.3
Trade, transport and communications	30.7	25.2	25.1	29.9	53.3	26.3	30.7
Financial, insurance, real estate and business services	30.0	10.7	7.7	55.4	13.7	16.0	15.8
Other services	24.8	21.3	28.1	2.3	6.9	5.7	18.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Personnel costs per hour worked (in euro)							
Agriculture (1)	–	–	–	–	–	–	18.4
Industry	31.2	30.1	28.8	36.1	44.8	36.8	32.3
Construction	23.7	24.4	22.6	34.3	30.1	27.9	25.1
Trade, transport and communications	28.9	24.1	21.1	32.2	24.9	23.4	25.0
Financial, insurance, real estate and business services	39.0	29.8	27.6	46.4	36.2	35.6	36.2
Other services	27.7	24.4	23.2	24.8	21.4	20.5	24.4
Total	31.7	26.9	24.6	39.8	31.0	31.5	28.7
p.m. Number of firms (units)	*8,994*	*44,031*	*17,590*	*311*	*535*	*221*	*71,682*
p.m. Number of workers employed (units)	*174,956*	*857,064*	*312,703*	*126,596*	*304,896*	*59,857*	*1,836,072*

Source : NBB (social balance sheets).
(1) The results at regional level are not given because they are not representative : this branch in fact comprises a large proportion of self-employed persons who are not obliged to submit a social balance sheet, regardless of whether they employ staff.

Multiple-region firms are allocated to the region in which they have the largest number of jobs ; on average, they employ 460 workers. Brussels multiple-region firms mainly specialise in "financial, insurance, real estate and business services", a branch that employs over half of their workers. Flemish multiple-region firms have a greater presence in the "trade, transport and communications" branch (53 p.c. of workers) and Walloon multiple-region firms in industry (43 p.c.).

RISE IN PERSONNEL COSTS PER HOUR WORKED: REGIONAL BREAKDOWN

(Indices 1998 = 100)



Source: NBB (social balance sheets).

(1) Total of single-region and multiple-region firms.

The average level of staff costs per hour worked in multiple-region firms based mainly in Brussels was close to 40 euro in 2002, against approximately 31 euro in multiple-region firms in Flanders and Wallonia. In comparison with those two regions, the labour costs recorded in Brussels were significantly higher, not only in the "financial, insurance, real estate and business services" branch, but also in "trade, transport and communications", these two branches together employing 85 p.c. of the workforce of Brussels multiple-region firms. However, the similarity between Flanders and Wallonia is only apparent: it is due to the relative specialisation of the two regions. The hourly costs are in fact higher in Flanders than in Wallonia for all branches, but the predominance in Wallonia of industrial firms, which record the highest hourly labour costs in the region, pushes up the average, while the opposite situation applies in Flanders, where the dominant branch, "trade, transport and communications", records nearly the lowest hourly costs.

The relative position of the six groups of firms did not change between 1998 and 2002, as movements between those two years were fairly uniform. On average, hourly labour costs increased by just over 15 p.c. in the total population of firms. In Flanders, this rise was slightly steeper, namely 16 p.c. for both single-region and multiple-region firms. Elsewhere, the growth rate was more modest, except in multiple-region firms based mainly in Brussels where, starting from an already higher wage level, the increase came to 24 p.c.

1996 law on the promotion of employment and the safeguarding of competitiveness stipulated in particular that the wage norm, which establishes the framework for the movement in nominal hourly wages in the private sector in Belgium, must be calculated on the basis of the average rise in labour costs in the three main neighbouring and competing countries, namely Germany, France and the Netherlands.

TABLE 23 UNIT LABOUR COSTS IN THE PRIVATE SECTOR

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

	2000	2001	2002	2003 e	2004 e
Labour costs per hour worked	1.5	4.1	4.2	2.7	2.6
Apparent labour productivity [1]	1.4	–0.4	2.3	1.9	2.1
Unit labour costs	0.1	4.6	1.9	0.8	0.5

Sources: NAI, NBB.

(1) Ratio between value added at constant prices and the hours worked by employees and self-employed workers. In the case of the latter, the number of hours worked is estimated by considering that each person works a number of hours equivalent to the average for employees.

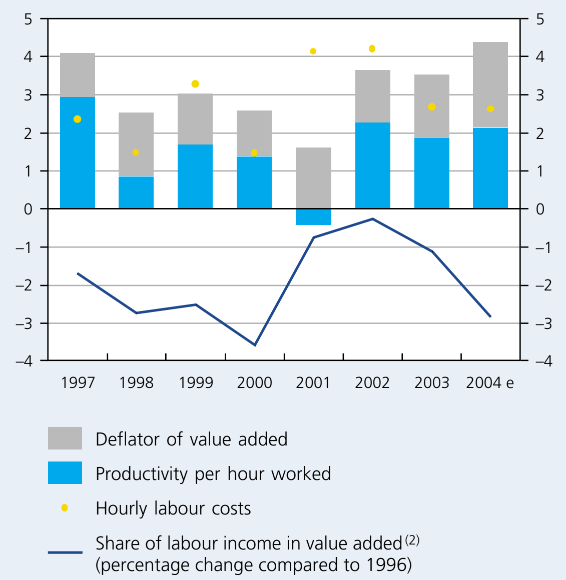
On the basis of the latest national data, the Central Council for the Economy (CCE) has established that the hourly labour cost increased by an average of 2.8 p.c. in the neighbouring countries in 2003 and 1.6 p.c. in 2004, which is significantly less than the indicative margin which was fixed in December 2002 and based mainly on the forecasts of labour cost increases prevailing at the time. This rise was also well below the increase in wages seen in Belgium, although that finding should perhaps be qualified, taking account of the continuing uncertainty over the actual movement in labour costs in 2003. A problem similar to that mentioned at the beginning of this chapter with regard to the employment statistics may in fact have caused a break in the series of the compensation data, supplied to the NAI.

The lower than expected average increase in wages in the three partner countries is due mainly to the labour market developments in Germany, where the deterioration in the level of activity and the rise in unemployment curbed the growth of wages. The results of the tax reform implemented in that country, which caused net wages to rise faster than gross wages, were another factor here. In addition, a negative wage drift caused mainly by the ever-increasing use of flexible working time arrangements – known as annualisation of working hours – and by the creation of jobs with very short working hours and low hourly wages, was also observed.

In all, since 1996, the year of entry into force of the law on the promotion of employment and the safeguarding of competitiveness, Belgium has – according to the OECD and the CCE – recorded a rise in hourly labour costs which is 2.2 percentage points higher than the average for the firms in the three neighbouring countries. In relation to the euro area, the slippage is estimated at around 1.1 percentage point. Expressed in terms of unit labour costs, i.e. taking account of differences in labour productivity growth, the handicap which Belgium has accumulated in relation to the three main neighbouring countries over the whole period covered by the 1996 law appears to be greater, namely 4.4 percentage points. In contrast to the gap in terms of hourly labour costs, however, the difference only widened slightly in 2004 as the acceleration in productivity gains was greater in Belgium than in the partner countries. In relation to the euro area, Belgium's relative position in terms of labour costs per unit of value added appears to have deteriorated by 2.1 percentage points since 1996.

CHART 44 LABOUR COSTS, DEFLATOR AND LABOUR PRODUCTIVITY IN THE PRIVATE SECTOR [1]

(Percentage changes compared to the previous year)



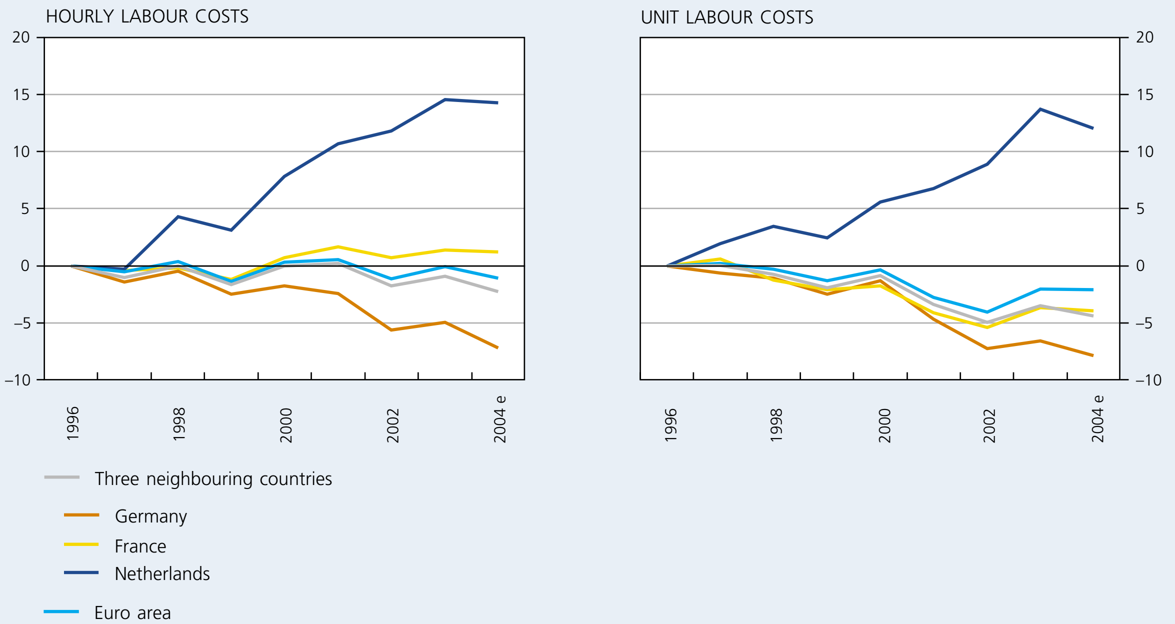
Sources: NAI, NBB.

(1) Calendar adjusted data.

(2) Labour costs plus labour incomes imputed to the self-employed as a ratio of value added at market prices.

CHART 45 LABOUR COSTS IN THE PRIVATE SECTOR IN BELGIUM AND IN THE EURO AREA

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



Sources : OECD, CCE.

As stipulated by the law, the CCE calculated the maximum margin for increases in labour costs in 2005 and 2006 by taking account of the increase in wages expected in the three main neighbouring countries : the figure came to 5.3 p.c. In theory, this margin – which comprises at least the indexations and scale increases – may be reduced in line with the differences recorded in previous years between wage developments in Belgium and in the three reference countries.

In that context and in order to preserve the competitiveness of firms and promote job creation, the draft central agreement concluded between the social partners in January 2005 provides for an indicative norm for the increase in labour costs of 4.5 p.c. in the private sector for 2005 and 2006, which is less than the increase predicted by the CCE in the three neighbouring countries. The social partners have asked the sectors and all employers and employees to negotiate a modest wage increase by way of solidarity with employees whose jobs are under threat, and with job-seekers. Moreover, they have recommended the employers and workers in sectors and firms exposed to international competition to act responsibly when negotiating the wage part of this agreement.

5. Prices

5.1 Inflation in Belgium

During the year under review, inflation measured by the harmonised index of consumer prices (HICP) came to 1.9 p.c., against 1.5 p.c. the previous year. However, Belgium still recorded one of the lowest inflation rates in the monetary union, where inflation was running at 2.1 p.c. in 2004.

TABLE 24 **HARMONISED INDEX OF CONSUMER PRICES IN BELGIUM**

(Percentage changes compared to the previous year)

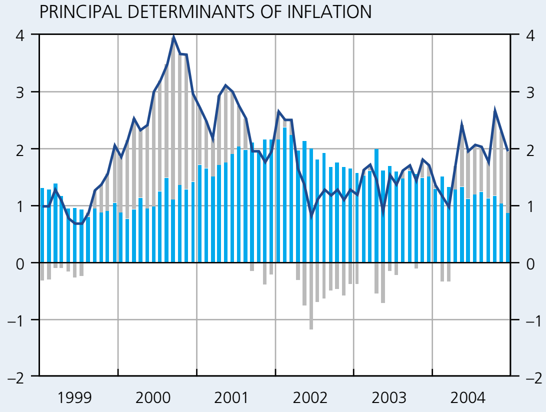
	Total	Energy	Unprocessed food (1)	Underlying trend in inflation (2)	Processed food	Non-energy industrial goods	Services	*p.m. Health index* (3)
1999	1.1	2.0	0.0	1.1	0.6	0.8	1.8	*0.9*
2000	2.7	16.3	0.2	1.1	1.3	0.0	2.3	*1.9*
2001	2.4	1.4	6.9	2.1	2.2	2.0	2.1	*2.7*
2002	1.6	–3.6	3.2	2.1	1.5	1.7	2.6	*1.8*
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*
	Excluding primarily administrative price changes (4)							
1999	1.2	1.7	0.0	1.3	0.6	0.8	2.2	
2000 (5)	3.0	16.8	0.2	1.5	1.2	0.7	2.4	
2001	2.6	1.9	6.9	2.2	2.1	1.9	2.5	
2002	1.9	–2.7	3.2	2.4	1.5	1.6	3.4	
2003	1.8	1.0	1.7	2.0	2.1	1.0	2.7	
2004	1.8	5.1	0.9	1.5	2.2	0.3	2.3	

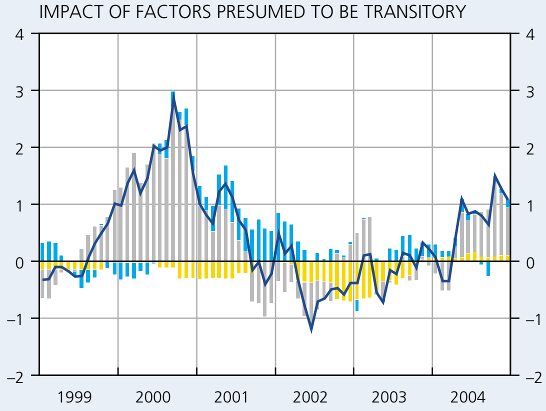
Sources: EC, FPS Economy, SMEs, Self-employed and Energy, NBB.
(1) Fruit, vegetables, meat and fish.
(2) Measured by the HICP excluding unprocessed food and energy.
(3) National consumer price index, excluding products considered harmful to health, namely tobacco, alcoholic beverages, petrol and diesel.
(4) That is measures relating to the radio and television licence fee, tariff changes in the network industries in which liberalisation is farthest advanced, namely telecommunications, electricity and gas, and changes to indirect taxes.
(5) 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.

This was the outcome of a notable acceleration of inflation in the year under review. The rate of inflation thus increased from 1.2 to 2.3 p.c. between the first and last quarter of 2004. This rise is attributable to a range of factors which may have a rapid and significant impact on consumer prices but whose influence is presumed to be short-lived. Thus, the acceleration in inflation in 2004 is due primarily to the sharp rise in crude oil prices, which triggered substantial increases in energy prices. It was also driven by an increase in indirect taxes on tobacco and motor vehicle fuel, while the contribution to inflation produced by this type of administrative measures as a whole had still been decidedly negative in 2003. The moderate rise in prices of unprocessed food, resulting from relatively favourable supply conditions, made only a small contribution towards curbing the increase in consumer prices.

CHART 46 INFLATION: ANALYTICAL BREAKDOWN

(Contributions of the various components in percentage points, unless otherwise stated)





Sources: EC, NBB.

(1) Percentage changes compared to the corresponding month of the previous year, 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.

(2) HICP excluding primarily administrative price changes, unprocessed food and energy.

(3) That is measures relating to the radio and television licence fee, tariff changes in the network industries in which liberalisation is farthest advanced, namely telecommunications, electricity and gas, and changes to indirect taxes.

Similar factors also affected inflation in the euro area. This type of price shock generally has an almost immediate inflationary impact which cannot really be controlled, given the time-lag in the monetary transmission. That is precisely why the Eurosystem's monetary policy strategy stipulates that price stability must be maintained in the medium term. However, such a strategy implies that monetary policy must ensure that these shocks do not induce "second round" effects, i.e. the start of a price-wage spiral. Only then will their impact on inflation be purely transitory.

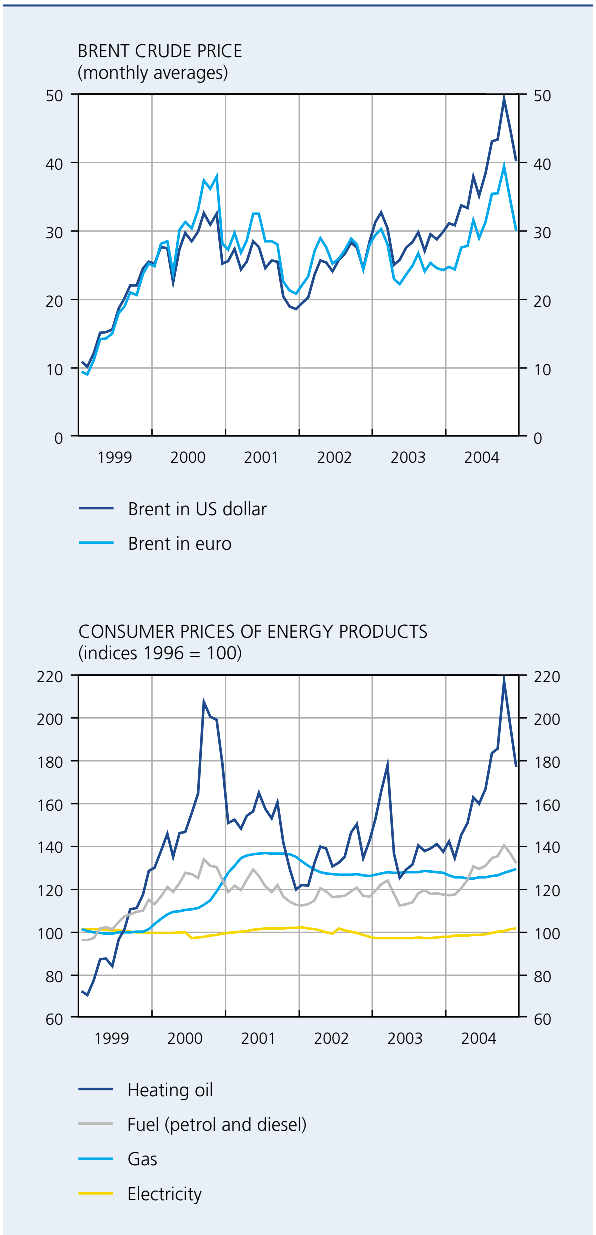
Leaving aside the influence of factors which are presumed to be transitory, i.e. primarily administrative price changes and changes in the prices of energy and unprocessed food, a clearer picture emerges of factors which determine inflation in the medium term. In 2004, the underlying trend in inflation measured in this way slowed significantly, falling from 2 p.c. in 2003 to 1.5 p.c.

Impact of factors presumed to be transitory

During the year under review, inflation was greatly influenced by the movement in energy prices, which largely reflect the prices of crude oil. During the first quarter of 2004, energy prices declined as a result of a base effect, as oil prices per barrel had risen temporarily at the beginning of 2003. However, from May onwards, energy became much more expensive. By October, prices were 16 p.c. higher than in the corresponding month of the previous year. In 2004, crude oil prices expressed in dollars in fact surged strongly, exceeding the levels recorded in 2000. However, the appreciation of the single currency mitigated part of that increase. Expressed in euro, it was only in October 2004 that the price of a barrel of Brent slightly exceeded the peak attained at the end of 2000.

The movement in euro-denominated prices of crude oil is passed on to energy products almost immediately in the case of heating oil and motor fuel, where the consumer prices are linked by the "programme contract" to the

CHART 47 CRUDE OIL PRICES AND CONSUMER PRICES OF ENERGY PRODUCTS



Sources : EC, IMF, NBB.

prices of refined petroleum products – which track the movement in crude oil prices very closely (see also box 12). Conversely, in the case of natural gas, it takes a considerable time for changes to be passed on, as long-term supply contracts for gas are indexed to the movement in oil prices with an average delay of about six months. Moreover, since the gas price is measured in the consumer price index on the basis of annual invoices, an additional time lag occurs before changes in import prices are reflected in the HICP. In fact, the movement in oil prices only began to affect consumer prices of gas from the third quarter of 2004. There is also a significant time lag before movements in oil prices are passed on in consumer prices of electricity, and, moreover, throughout the 1999-2004 period that effect was counteracted by the movement in domestic costs.

The degree to which movements in oil prices are passed on to energy products depends to a great extent on the proportion of the final selling price represented by domestic value added at the various levels of the production and distribution process, and by lump sum taxes. The changes in these factors are generally far smaller than the movements in the crude oil price, and in certain cases they may even move in the opposite direction.

Thus, the scale of the pass-through is greater in the case of heating oil, for which the refined product represents almost 80 p.c. of the consumer price. It is significantly less in the case of motor fuel and gas. For these products, the fuel costs account for around 30 and 40 p.c. of the selling prices respectively, having regard in particular to the higher level of excise duty on motor fuel, and transport and distribution costs in the case of natural gas. In the case of electricity, fuel represents only 20 p.c. of the selling price, given the high level of production and distribution costs. For this product, the transmission of crude oil prices is further attenuated by two other factors, namely the significant share of fuel other than oil and the reduction in domestic costs following successive tariff adjustments. In order to prepare the sector for liberalisation, tariff cuts were introduced progressively from 2000 onwards at the request of the federal government, so that the electricity price hardly varied between 2000 and 2004. While the system of regulated electricity prices still applies in Brussels and Wallonia, the market has been totally liberalised in Flanders since July 2003 (see also box 12). However, prices on the liberalised market segment in Flanders, which are cheaper than the regulated prices, are not yet taken into account in the HICP.

Consumer prices of energy were also influenced by changes in indirect taxes. During the first half of 2004, excise duties on petrol and diesel were increased following the activation of the ratchet system introduced in 2003. Under this system, half of each price reduction resulting from the application of the "programme contract" is offset by a permanent increase in excise duty. In 2004, it was in June that the cumulative increase in excise duty reached the annual maximum determined by law, namely 28 euro per 1,000 litres, for diesel and petrol. Despite the upward trend in the prices of refined petroleum products, these increases in excise duty were made possible by temporary reversals in that trend.

TABLE 25 PRIMARILY ADMINISTRATIVE PRICE CHANGES

(Contribution to inflation, percentage points)

	2002	2003	2004
Indirect taxes on petroleum products and tobacco	–	0.12	0.19
Electricity and gas tariff changes	–0.09	–0.13	–0.01
Environmental taxes and eco-rebates	–	–	–0.05
Radio and television licence fee			
Abolition in Flanders and Brussels	–0.27	–0.27	–
Reduction in Wallonia	–	–0.05	–0.05
Total	–0.36	–0.33	0.09

Source: NBB.

For the system to be activated, it is in fact sufficient for a price fall to be recorded, regardless of whether the fall follows a price increase. On the other hand, the levy on electricity consumption, intended to compensate for the loss of local authority revenue resulting from liberalisation, already provided for in the programme law of 24 December 2002 and confirmed by the programme law of 27 December 2004, was not yet included in invoices to private consumers during the year under review.

Other increases in indirect taxes were also implemented in 2004, notably for tobacco. In all, the increases in indirect taxes contributed 0.2 percentage point to inflation. Only a very small part of the increases was offset by tariff reductions for electricity and the entry into force in April 2004 of the law on environmental taxes and eco-rebates. That law is intended to modify the relative prices of drinks according to whether their packaging is reusable, in order to encourage the purchase of reusable containers. In 2004, this took the form of a reduction in excise duty and VAT on non-alcoholic beverages and the introduction of the packaging levy, applicable to all drinks in non-reusable containers. The net effect of this law on the prices of drinks was negative.

Despite the residual impact of the reduction in the radio and television licence fee in Wallonia, primarily administrative price changes made a positive contribution to inflation in 2004, totalling 0.1 percentage point overall, whereas that contribution had been negative in both 2003 and 2002, mainly as a result of the abolition of the radio and television licence fee in Flanders and Brussels.

Prices of unprocessed food are traditionally a further source of short-term volatility. These prices are strongly influenced by sometimes highly unstable supply conditions. During the year under review, however, those conditions were relatively favourable, so that the rate of increase in unprocessed food prices slowed further, after being hit in 2001 and 2002 by the repercussions of the crisis in the meat sector, and in 2002 and 2003 by the adverse weather conditions, especially the drought in the summer of 2003. However, the slackening pace of the increase in unprocessed food prices, at 0.9 p.c., only partly offset the acceleration in inflation caused by the movement in crude oil prices and the primarily administrative price changes.

Underlying trend in inflation

A good indicator of the underlying trend in inflation can be obtained by excluding from overall inflation the impact of the factors presumed to be transitory, namely primarily administrative price changes and changes in the prices of energy and unprocessed food. Measured in this way, the price rise decelerated significantly, dropping from 2.4 p.c. in 2002 to 2 p.c. in 2003 and 1.5 p.c. in 2004. The deceleration continued throughout the year, a small rise of 1.1 p.c. being recorded in December against 1.7 p.c. in January. This development is due mainly to the absence of any marked pressure on prices from either domestic or external sources. Domestic pressures were limited by the moderation in wage growth and by the fact that production capacity remained sufficient, despite the acceleration in demand. As regards external pressures, the appreciation of the euro and the decline in inflation in neighbouring countries pushed down non-energy import prices in 2002 and 2003 and thus tempered the rise in consumer prices of non-energy products. The muted increase in the underlying trend in inflation indicates that the recent rise in commodity prices was only passed on to a limited extent in 2004 (see also box 13).

However, the deceleration did not apply to all components of the underlying trend in inflation. Leaving aside the price adjustments resulting from increases in indirect taxes on tobacco products and the entry into force in April 2004 of the law on environmental taxes and eco-rebates, the rate of increase in processed food prices deviated slightly from the underlying trend in inflation, mainly because of the higher bread prices. The raising of the maximum prices for certain types of bread in January 2004, and the full liberalisation of those prices in July 2004, in fact interrupted the deceleration which had begun in 2003 (see also box 12).

Box 12 – Easing of price regulation

In the recent past, three types of price regulation have been applied in Belgium. The first is compulsory notification of all price changes for all firms with a turnover in excess of 7,436,805.74 euro. The second type of price regulation concerns the system of sectoral maximum prices. Finally, the third form of regulation is the price increase application system, which covers nine product classes.

During the year under review, two important changes led to an easing of these controls. Since March 2004, the obligation on all large firms to notify the authorities of price changes has been totally abolished, greatly simplifying the administration. In addition, the price of certain types of bread, which was regulated by a system of sectoral maximum prices, was fully liberalised on 1 July.

Therefore, apart from a maximum price for taxi services, Belgium still has a system of applying for price increases in the case of the following products: petroleum products, waste treatment, care homes for the elderly, gas and electricity on the non-liberalised market, water supply, prescription drugs, cable television and compulsory insurance. Under these rules, any price increase must be preceded by an application. The increase can then be applied once approval has been received, or – in the absence of any response – after sixty days. It must also be notified as soon as it is applied. In the case of prescription drugs, the procedures are more complicated, depending on whether the cost is refundable.

IMPORTANCE OF PRICE REGULATION AT THE LEVEL OF CONSUMER SPENDING

(Weighting in the HICP, per thousand)

	2000 (1)	End of 2004
System of notification of price changes	yes (2)	abolished
System of maximum sectoral price	4.7	0.6
Taxis	0.6	0.6
Regulated bread	4.1	abolished
System of applications for increases	190.0	108.4
Drugs	15.0	15.0
Care homes (3)	–	–
Cable television	7.6	7.6
Water supply	10.4	10.4
Waste treatment	1.3	1.3
Compulsory insurance (4)	7.1	7.1
With specific regulation		
Petroleum products (programme contract)	49.7	49.7
Electricity and gas, for the non-liberalised market segment (5)	43.6	17.4
Motor vehicles	55.5	abolished
Total	194.8	109.1

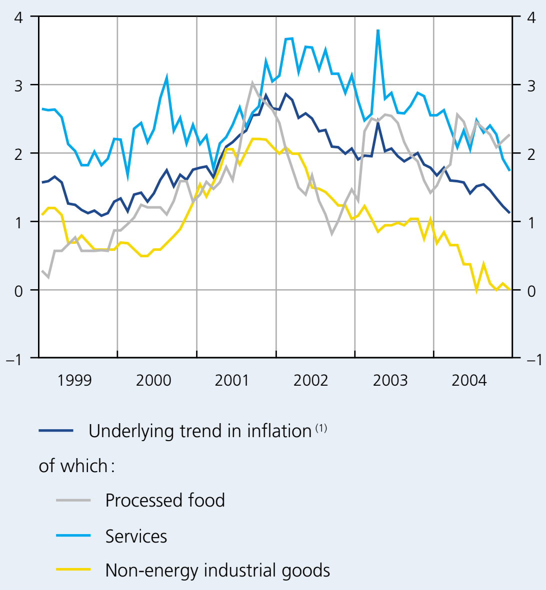
Source: NBB.
(1) Calculated on the basis of the 2004 weightings, in order to neutralise the impact of annual changes in the weightings.
(2) These rules applied to all large firms and to all types of products, whether or not they were destined for final consumption.
(3) The cost of staying in a care home is not included in the HICP.
(4) Third party motor insurance; other types of compulsory insurance are not included in the HICP.
(5) The non-liberalised market in Wallonia and Brussels corresponds to around 40 p.c. of the residential market in Belgium since the implementation of full liberalisation in Flanders.

For some of the products concerned, derogations are available if an agreement has been concluded with the government concerning a price adjustment rule. That is the case for petroleum products, for which the consumer prices may be freely fixed so long as they remain below the maximum price, which is adjusted according to a mechanism defined by the "programme contract". According to that mechanism, these prices vary in line with the movement in the prices of refined petroleum products on the international markets and with cost components and margins of domestic origin, the amounts of which are negotiated. Moreover, the maximum price thus determined is modified only after certain thresholds are exceeded, in order to limit price volatility. In practice, however, this rule leads to only a very slight delay in the adjustment of prices. As regards the prices of electricity and gas intended for the unliberalised segment of the market, the tariff formulas are indexed on the basis of cost indices reflecting both fuel prices and other costs, such as wages or costs of capital.

Taking the weightings of the harmonised index of consumer prices as a guide to the share of regulated products in consumer spending, the proportion of products remaining subject to regulation is 10.9 p.c. overall, with energy products accounting for 6.7 p.c. The recent progress in the easing of the regulations, notably with regard to bread prices in July 2004, electricity prices in Flanders in July 2003, and motor vehicle prices – which were subject to the rules on applying for price increases until March 2001 – is quite considerable. The share of regulated products in consumer spending has therefore been reduced by 8.6 percentage points.

CHART 48 UNDERLYING TREND IN INFLATION

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



Sources: EC, NBB.

(1) Measured by the HICP excluding unprocessed food and energy, and primarily administrative price changes.

Since the beginning of 2002, the pace of service price changes has tended to slacken, despite some volatility attributable partly to the prices of package holidays. This trend is largely determined by domestic factors, and more particularly by the slowing of the rise in labour costs, which represent a larger share in services than in the other components of the HICP. In fact, there has been a deceleration in the increase in labour costs for the period 2003-2004 compared to the years 2001-2002, attributable partly to the slower rise of the health index, which has limited the effect of indexation. However, the rise in that index quickened significantly in the year under review, from 1.1 p.c. in March 2004 to 1.7 p.c. in December. The health index does not in fact offer full protection against the rise in energy prices since it does not exclude, among others, the prices of heating oil, gas and electricity.

However, the risk of "second round" effects remains limited insofar as the impact of these developments is anticipated and is deducted from the available room for manoeuvre for real wage increases. That is even more true if the overall macroeconomic policy – both fiscal and monetary policy – remains geared to stability. In that context, the rise in crude oil prices probably has only an indirect impact on the underlying trend in inflation, as oil is an intermediate input in the production process for a large range of goods and services. That applies especially to non-energy industrial goods, so that – in principle – these indirect effects should become apparent primarily and most obviously in the movement in the prices of those goods. During the year under review, however, the rate of increase in those prices continued to slow down. Apart from the deceleration in the pace of labour cost increases, the decline in non-energy import prices over the past two years also helped to slow down the underlying trend in inflation – the effect being more marked for goods than for services – insofar as import price changes take some time to be passed on in consumer prices.

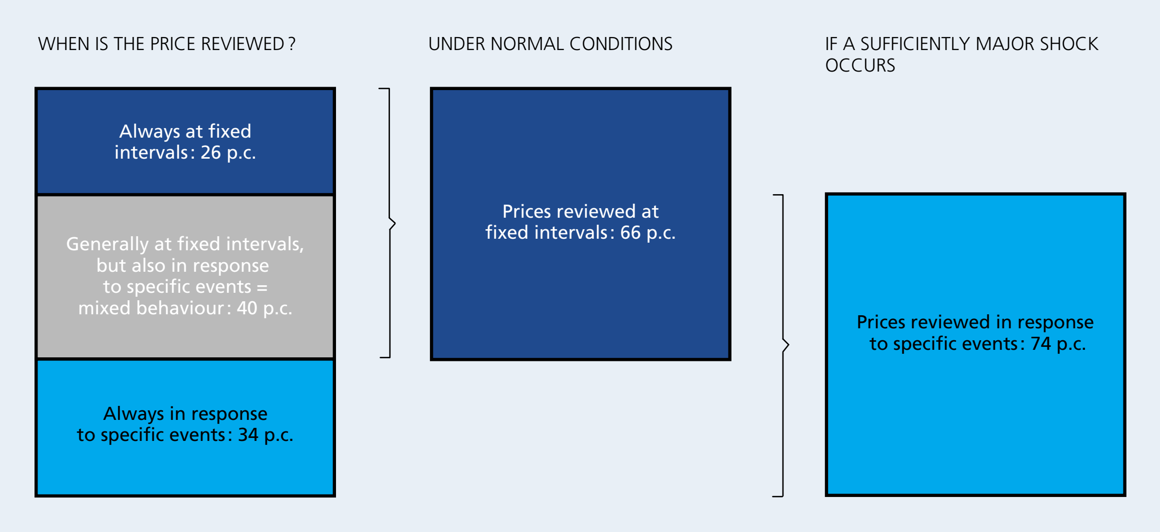
Box 13 – Price-setting by firms in response to shocks

This box examines the speed with which firms adjust their prices to changes in their environment, especially in the case of large fluctuations in commodity prices, as in the year under review. For that purpose, it is based on the results of a survey on price-setting behaviour conducted by the Bank in February 2004 among some 2,000 firms active in Belgian manufacturing industry, construction, trade and business services.(1) The sectors covered by the survey together represent 60 p.c. of GDP.

The survey results indicate a relatively high level of price rigidity, at least under normal circumstances. The average time elapsing between two successive price reviews is ten months, and between two successive price adjustments it is thirteen months. The timing of the price reviews conducted by firms to assess whether their prices conform to current conditions does not necessarily coincide with that of the actual price adjustments, and it is perfectly logical that the calculations are carried out more frequently, given the specific additional costs associated with a price change. The highest level of price rigidity was observed in the business services sector, and the lowest was in construction.

Price rigidity may (temporarily) constitute an equilibrium, given that the environment in which firms operate is not a perfect competition situation. The price is set as a mark-up (margin) above the cost. It is this mark-up that leaves firms some latitude for not adapting prices immediately to changes in costs. However, that does not mean that firms are insensitive to economic shocks, such as demand fluctuations, and changes in labour costs or commodity

CALCULATION OF PRICES AT FIXED INTERVALS OR IN RESPONSE TO SPECIFIC EVENTS



Source : NBB.

(1) For more detailed information on the results of this survey, see *Price-setting behaviour in Belgium : what can be learned from an ad hoc survey?*, Aucremanne L. and Druant M. (2004), Economic Review, NBB, 4th quarter, pp. 17-48.

prices. Moreover, that sensitivity depends on the scale of the shocks. Under normal conditions, the majority of firms (66 p.c.) calculate their prices at fixed intervals. However, if a sufficiently major shock occurs, two-thirds of them (40 p.c.) will review their prices according to the situation, in addition to the firms which review them only in the case of specific shocks (34 p.c.). This makes a total of 74 p.c. of firms which will behave in this way, meaning that they will adapt their prices when the gap between the price charged and the new optimum price level has become large enough to offset the costs of adjustment. The remaining 26 p.c. of firms will wait for a pre-determined moment before adjusting their prices, and therefore will not react immediately to the shock.

The survey also provides some information on the types of shock which may cause prices to be reviewed according to the situation. Shocks concerning cost factors, namely labour costs and other production costs, seem to be the main reason for price changes, with slightly more increases than decreases. Competitors' prices are also an important reason for price adjustments, and this applies to price reductions more than to increases. Competitors' prices play a slightly more significant role in manufacturing industry, which is generally more exposed to competition. Fluctuations in demand mainly constitute grounds for reducing prices.

Despite the relatively high degree of price rigidity under normal conditions, Belgian firms show greater flexibility when a major shock occurs. It is mainly when the shock concerns cost factors that firms can be expected to respond swiftly. In the case of the recent surge in commodity prices, firms for which commodities represent a significant cost factor will presumably react fairly promptly. That may explain why the impact of the rise in commodity prices during the year under review was not only more widespread but was also apparent sooner in the case of certain producer prices, such as the price of steel, while no indirect impact has yet been observed on consumer prices.

5.2 Inflation differential between Belgium and the euro area

The start of Stage III of the Economic and Monetary Union (EMU) led to profound changes for the euro area countries in terms of economic policies. Since then, the Member States have in fact ceded their monetary sovereignty to the Eurosystem. As the authority responsible for the common monetary policy, the Eurosystem ensures that price stability is maintained in the euro area as a whole, regardless of any inflation differentials which might occur in certain countries. In any case, the Eurosystem has no instruments for reducing those differentials; it is therefore up to the Member States encountering inflation significantly different from the European average to identify the undesirable inflation differentials and to react accordingly.

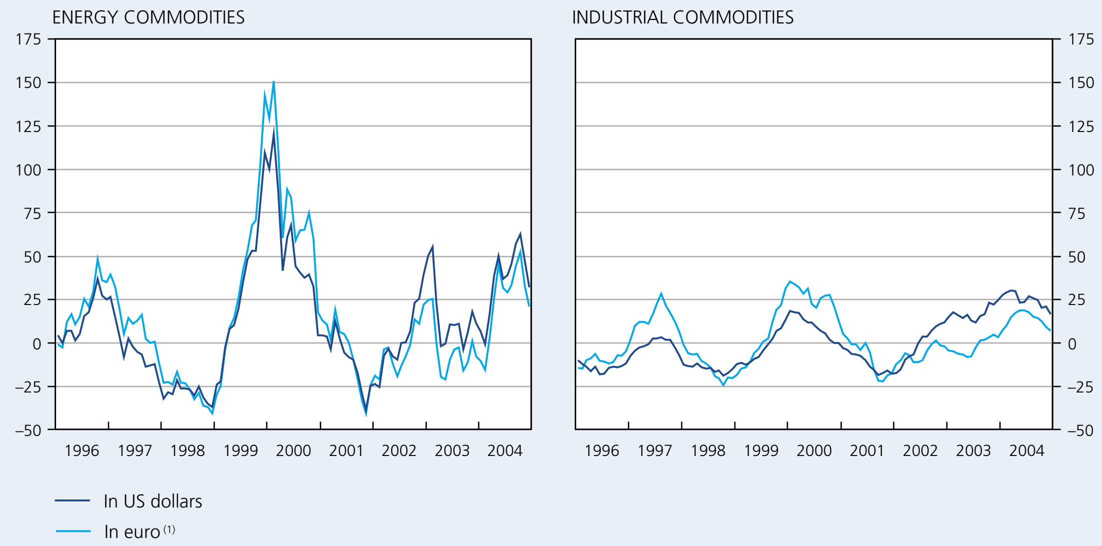
Such an analysis is essential for a small, open economy like Belgium, since any positive inflation differential is translated into real appreciation relative to the euro area, and therefore – as a general rule – into loss of competitiveness. In this regard, the almost continuous increase in commodity prices in the period under review generally raises question marks over the potential impact on inflation differentials between Belgium and the euro area. Despite the symmetrical character of this type of shock within the euro area, the Belgian economy could still be affected differently by these developments.

During the year under review, prices of energy and industrial commodities denominated in US dollars increased by an annual average of 35.3 and 24.8 p.c. respectively. Admittedly, the rise in the prices of ferrous metals, such as steel, was much greater, reaching 87.4 p.c. in some cases, mainly owing to the substantial rise in demand from the Chinese economy. However, the upward pressures were attenuated by the significant appreciation of the euro. Moreover, the considerable increase in the price of energy commodities was still not as great as that seen in the year 2000. Furthermore, industrial commodity prices seem essentially to follow the pattern of economic cycles. The acceleration in these prices during 2004 was not in fact any more marked than that observed during the periods of strong demand in 1997 and in 1999-2000.

Examination of the changes in producer prices during the period under review shows that commodity prices are passed on relatively quickly in producer prices both in Belgium and in the euro area, reflecting in particular a degree of synchronisation in producer price movements in the two economies. However, a significant difference emerges in the scale of the producer price fluctuations in

CHART 49 ENERGY AND INDUSTRIAL COMMODITY PRICES

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



Sources : IMF, HWWA, NBB.
(1) Prices based on the exchange rate of the Belgian franc up to 1 January 1999.

Belgium and the euro area. As in 2000, the transmission of commodity price fluctuations to industrial producer prices as a whole was more marked in Belgium than in the euro area. Thus, during the period under review, producer prices increased on average by 4.4 p.c. in Belgium against just 2.3 p.c. in the euro area.

This divergence is not a recent or exceptional phenomenon. In fact, throughout the period 1996-2004, producer prices in Belgium were much more volatile than in the euro area. A more precise statistical measure, the difference between the standard deviations of Belgium and the euro area, confirms this finding. That differential – systematically positive – oscillated between 1.1 and 3.8 depending on the price index considered, the most significant difference being observed in the case of producer prices for energy products.

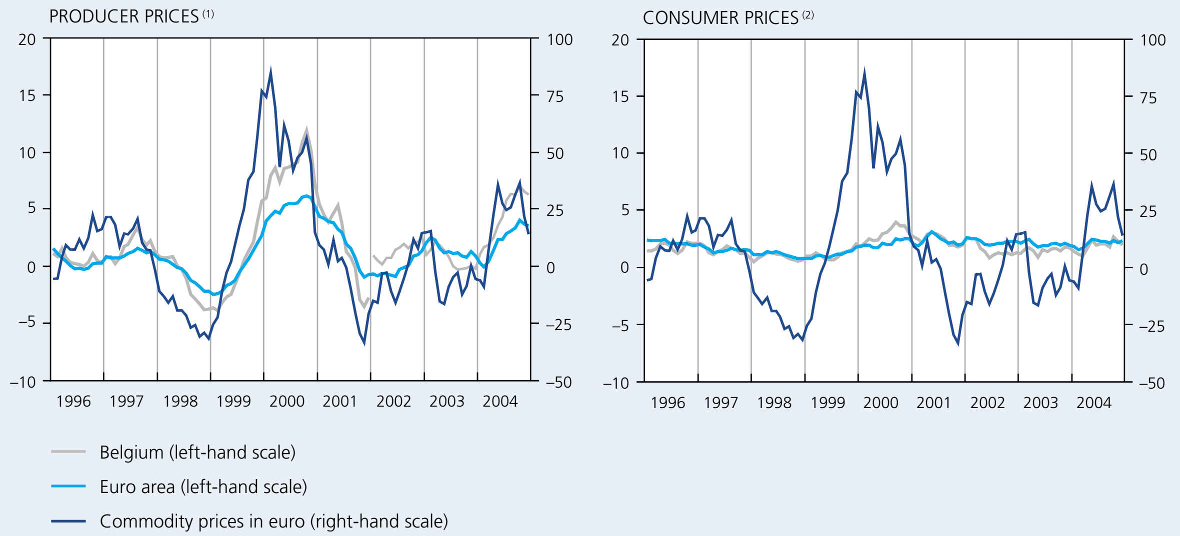
Part of these differences may be due to the national data aggregation process underlying the statistics of the euro area. This process may in fact reduce the value of the standard deviation, in that shocks confined to certain countries usually tend to be mutually offset or attenuated. However, the impact of this factor is probably limited to a great extent to short-term movements and should therefore have less effect on more cyclical movements.

Therefore, the greater volatility of producer prices in Belgium is probably due primarily to the specific character of its production structure. The Belgian economy in fact specialises more in the manufacture of semi-finished products, comprising a higher proportion of raw materials whose prices are generally more variable. In the case of more finished products, such as consumption or capital goods, the difference is much smaller. This peculiarity of the Belgian economy is also reflected in the fact that the energy component has a higher weight in the index of industrial producer prices in Belgium than in the euro area.

A similar comparison between consumer prices in Belgium and the euro area offers an entirely different perspective from that seen in the case of producer prices. Unlike industrial producer prices, consumer prices in Belgium are not systematically more volatile than in the euro area, and the scale of these differences is also considerably smaller. Thus, the difference between the standard deviations is zero for the underlying trend in inflation and 0.2 for overall inflation. However, energy and unprocessed food present wider fluctuations in Belgium, with the difference between the standard deviations totalling 2 and 0.6 respectively.

CHART 50 TRANSMISSION OF CHANGES IN COMMODITY PRICES TO PRODUCER AND CONSUMER PRICES

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



Sources: EC, IMF, HWWA, NAI, NBB.

(1) In Belgium, following a change in the methodology of the producer price index for the domestic market, there was a break in the series between the old index (base 1980 = 100) and the new index (base 2000 = 100) which took effect on 1 January 2002.

(2) Measured by the HICP, excluding in the case of the Belgian index 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.

TABLE 26 VOLATILITY OF PRODUCER AND CONSUMER PRICES DURING THE PERIOD 1996 TO 2004

(Standard deviation of year-on-year changes)

	Belgium	Euro area	Difference between Belgium and the euro area
Producer prices			
General index	3.4	2.1	1.3
Energy	10.4	6.6	3.8
Intermediate goods	5.5	2.5	3.0
Consumption goods	2.0	0.9	1.1
Capital goods	1.7	0.4	1.3
Consumer prices (HICP) (1)			
General index	0.7	0.5	0.2
Energy	7.0	5.0	2.0
Unprocessed food	3.0	2.4	0.6
Underlying trend in inflation	0.5	0.5	0.0

Sources: EC, IMF, HWWA, NAI, NBB.

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

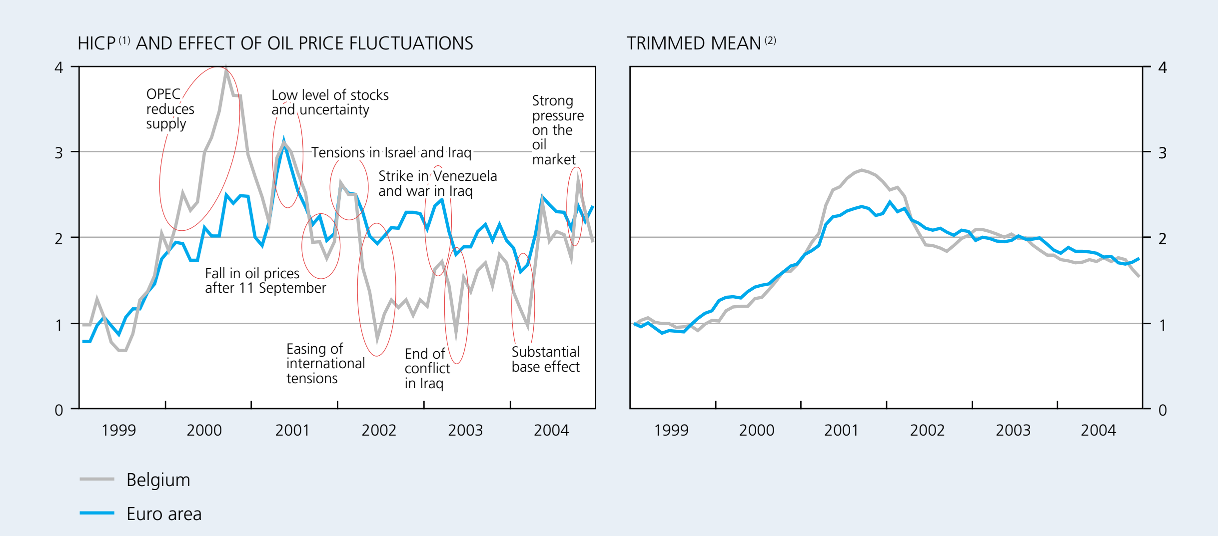
The smaller variations in the prices of unprocessed food in the euro area are probably due to the aggregation process mentioned earlier. Prices of these products are in fact affected mainly by weather conditions, which are generally specific to a limited group of countries. These effects tend to be mutually offset at euro area level, whereas they may be fully apparent in the Belgian index. In contrast, in the case of energy prices, the divergences observed are due mainly to characteristics specific to the Belgian economy, which cause both upward and downward fluctuations in oil prices to affect inflation in Belgium to a greater extent, in the short term, than in the euro area.

This greater short-term sensitivity of the Belgian HICP to fluctuations in oil prices per barrel is due primarily to the higher weight of energy products in Belgium's HICP. This sensitivity is further reinforced by a lower level of excise duty on petroleum products since, owing to their lump-sum character, excise duties moderate the impact of fluctuations in oil prices.

Since monetary union, the influence of oil prices on the inflation differential between Belgium and the euro area seems significant: the marked variations in the inflation differential in fact coincide with major fluctuations in crude oil prices. During the year under review, the

CHART 51 INFLATION IN BELGIUM AND THE EURO AREA

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



Sources : EC, NBB.

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

(2) Measured via the components of the HICP according to the *JB-Monthly estimator*, discussed in Aucremanne L. (2000), *The use of robust estimators as measures of core inflation*, National Bank of Belgium Working Papers – Research Series, n° 2 (March).

steep rise in oil prices generated slightly higher inflation in Belgium in October and November 2004, whereas inflation there had been systematically lower since the first quarter of 2002.

In 2002 and 2003, this negative inflation differential was due essentially to primarily administrative price changes which exerted significant downward pressure in Belgium, whereas in the euro area these measures contributed to an increase in the inflation rate. During the year under review, this factor had an upward influence in both economies, and that positive contribution was greater in the euro area than in Belgium.

These factors aside, the movement in inflation in Belgium seems broadly comparable to that in the euro area. Thus, inflation measured by the "trimmed mean" method – which eliminates extreme price fluctuations regardless of product category – confirms this finding. The movement in this measure of the underlying trend in inflation has in fact been very largely comparable in the two economies ever since the start of Stage 3 of the Economic and Monetary Union.

Furthermore, the cumulative inflation differential between Belgium and the euro area proved to be the smallest in absolute terms from January 1999 to December 2004, thus reflecting the absence of any persistent inflation differential. On the basis of these observations, there was

TABLE 27 CUMULATIVE INFLATION DIFFERENTIAL IN THE EURO AREA MEMBER STATES FROM JANUARY 1999 TO DECEMBER 2004

(Percentage points)

Ireland	14.1
Greece	11.9
Portugal	8.7
Spain	7.7
Netherlands	4.9
Luxembourg	3.1
Italy	2.9
Belgium	**–1.4**
France	–2.0
Finland	–2.9
Austria	–2.9
Germany	–4.6

Sources : EC, NBB.

therefore no significant, real appreciation in relation to the euro area as a whole. Moreover, there is no sign that the higher oil prices in 2000 had a more marked effect in Belgium than in the euro area in the medium term, despite the greater short-term sensitivity of the HICP to oil price fluctuations and the existence of an automatic wage indexation system. On the other hand, certain economies such as Ireland, Greece, Portugal, Spain and the Netherlands have accumulated substantial positive inflation differentials since the beginning of EMU. The resulting real appreciation may, in certain cases, have had a detrimental effect on their competitive position. Conversely, Germany has seen the development of a large negative inflation differential which has helped to restore its competitiveness, eroded by significant wage drift following the reunification with the former East Germany.

Overall, inflation in Belgium presents a profile broadly comparable to that in the euro area as a whole. Only temporary factors seem to cause Belgian inflation to deviate from the euro area average. This situation is due essentially to the implementation of economic policies consistent with the current functioning of EMU, more particularly as regards the liberalisation of product markets, wage setting and fiscal policy.

6. Public finances

6.1 Revenue, expenditure and overall balance

General government ended the year 2004 with a balanced budget, in line with the objective set in the November 2003 stability programme. However, that result could not have been achieved without substantial non-recurring transactions which were effected to improve the budget balance, as indeed they were in the previous year. Nevertheless, this was the fifth consecutive year in which Belgium's public finances produced a balance or a small surplus.

The new December 2004 stability programme confirmed the commitments made in November 2003, namely a balanced budget in 2005 and 2006 followed by a surplus of 0.3 p.c. of GDP in 2007. The creation of budget surpluses remains a key element of the strategy intended to cushion the effects of population ageing. With that in mind, the government has set itself the goal of augmenting the public sector financing capacity to 0.6 p.c. of GDP in 2008, so as to keep to the plan advocated by the High Council of Finance (HCF) in its annual report in July 2004. As explained in box 14, the HCF recommends the public authorities to create increasing structural surpluses from 2007 onwards, in order to achieve a budget surplus of 1.5 p.c. of GDP in 2011 and to maintain it at that level until 2018, to absorb the costs associated with ageing.

TABLE 28 TARGETS FOR THE FINANCING REQUIREMENT (–) OR CAPACITY OF BELGIAN GENERAL GOVERNMENT
(Percentages of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Successive stability programmes									
December 2000	–0.1	0.2	0.3	0.5	0.6	0.7			
November 2001		0.0	0.0	0.5	0.6	0.7			
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
p.m. Actual figures according to the EDP (1)	*0.2*	*0.6*	*0.1*	*0.4*	*0.0 e*				
Actual figures according to the ESA 95	*0.2*	*0.6*	*0.1*	*0.3*	*–0.1 e*				

Sources: NAI, FPS Finance, NBB.

(1) 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. However, in the framework of the excessive deficit procedure (EDP) no account is taken of this adjustment, which is also disregarded in the EC's assessment of the stability programmes. The resulting differences are limited so that, for simplicity and in order to be consistent with the other sector accounts, the remainder of this chapter gives only the data according to the ESA 95.

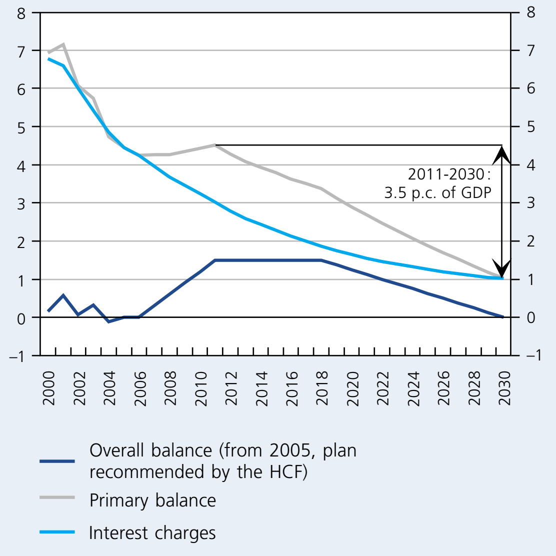
Box 14 – Population ageing and the sustainability of public finances

As in most industrialised countries, public finances in Belgium will gradually face the costs associated with the ageing of the population. According to the Study Group on Ageing – set up under the High Council of Finance – this will amplify public spending between 2003 and 2030 by the equivalent of 3.4 percentage points of GDP, with most of the impact of population ageing being felt from 2010 onwards.

Assuming that welfare benefits are adjusted in line with prosperity by an average of 0.5 p.c. per annum, the cost of pensions would increase by 2.8 percentage points of GDP over the whole period and would thus be the main source of the growth. Health care would also substantially reinforce the costs of ageing, at 2.4 percentage points of GDP: the Study Group on Ageing assumes that expenditure on health care will increase at a rate of 4.5 p.c. per annum in real terms up to 2007 (leaving aside the impact of a change in the rules for self-employed persons), as decided in the July 2003 coalition agreement, and will then drop back to an average of 2.8 p.c. between 2008 and 2030. In contrast to pensions and health care, other social spending will probably attenuate the cost of ageing. Thus, unemployment benefits are likely to fall by 1.2 percentage points of GDP, and family allowances by 0.5 percentage point of GDP. The Study Group on Ageing adopts the hypothesis that GDP will grow at an annual average of 1.9 p.c. at constant prices from 2003 to 2030, on the basis of average productivity and employment growth totalling 1.7 and 0.3 p.c. per annum respectively. However, this expansion of employment, which should boost the employment rate by 7 percentage points by 2030, requires the pursuit of an active policy, particularly to reduce the level of structural unemployment.

OVERALL BALANCE, PRIMARY BALANCE AND INTEREST CHARGES OF GENERAL GOVERNMENT

(Percentages of GDP)



Sources : HCF, NAI, NBB.

In that context, in its annual report for 2004 the HCF recommended the creation of structural budget surpluses, to be increased gradually to 1.5 p.c. of GDP by 2011. That level should be maintained until 2018 in order to obtain the additional scope necessary to absorb the rising budgetary cost of ageing without having to raise extra revenue or cut certain expenditure. This would provide public finances with a dual margin for covering the cost of ageing, derived on the one hand from the reduction in interest charges associated with the diminishing public debt, and on the other hand from the progressive elimination of the budget surplus after 2018. Under the December 2004 stability programme, the government set itself the goal of creating a surplus of 0.3 p.c. of GDP in 2007, and increasing it to 0.6 p.c. in 2008, a movement in line with the plan recommended by the HCF.

The relevance of the strategy advocated by the HCF – the gradual creation of budget surpluses up to 1.5 p.c. of GDP in 2011, maintained until 2018 and then gradually reduced to return to balance in 2030 – can be illustrated by the mechanics of the movement in the primary balances and interest charges between now and 2030. The surpluses to be accumulated in the next few years would in fact permit rapid debt reduction and correspondingly rapid reduction in the interest charges. If interest rates were to remain unchanged at 2004 levels, those charges would fall by 2 percentage points of GDP between 2011 and 2030. Combined with the gradual elimination of the budget surplus from 2018, that fall would permit a reduction in the primary surplus of 3.5 percentage points of GDP, or broadly speaking the margin necessary to cover the budgetary cost of ageing. Such a scenario would also make it possible to bring the public debt below the threshold of 60 p.c. of GDP by 2014. Taking the measures necessary to carry out the HCF recommendations is therefore clearly a strategy which helps to diminish the risk that the budgetary cost of ageing may jeopardise public finances.

Conversely, if the targets advocated by the HCF are not attained, the favourable profile of public finances could be mortgaged. The margin available in the primary balance would be smaller, partly because of higher interest charges. In that case, it would be impossible to rule out the risk of a substantial deficit and recurrence of the public debt snowball effect at the end of the period.

Revenue

The fiscal and parafiscal revenues of general government totalled 45 p.c. of GDP during the year under review, thus remaining more or less steady at their 2003 level. The decline in the proportion of GDP represented by levies on earned incomes was offset by an increase in other taxes. The overall impact of the fiscal and parafiscal measures was almost neutral, in contrast to previous years when they had led to a reduction in revenue.

As in 2003, there was a marked fall in the levies on earned incomes during the year under review, totalling around 0.7 percentage point. Apart from the measures implemented by the public authorities, this decline reflects changes in the share of GDP represented by earned incomes – compensation of employees and gross mixed income excluding imputed contributions. That share increased from 59.2 p.c. of GDP in 2000 to 60.6 p.c. of GDP in 2002, before dropping back to 60.3 p.c. of GDP in 2003 and 59.3 p.c. of GDP in 2004. Among the measures to reduce the fiscal and parafiscal burden on earned incomes, the personal income tax reform and the reduction in employers' social security contributions obviously had the greatest impact in 2004.

First, continuation of the personal income tax reform reduced the levies due from taxpayers in 2004 by 482 million euro, or 0.2 p.c. of GDP. The bulk of this reduction, or 315 million, came from measures which took effect from the year under review; however, their main impact will not be felt until the time of the assessments. When fully operational, the measures will cost a total of 0.8 p.c. of GDP. Altogether, taking account of the measures implemented in previous years, the global impact of the personal income tax reform will thus come to 1.4 percentage point. The measures relating to incomes in 2004 concern the extension of the tax credit for taxpayers on low incomes, the raising of the ceilings on incomes taxable at marginal rates of 30 and 40 p.c. and a set of measures to ensure that the tax position is unaffected by marital status. In principle, the self-employed benefited from the new measures immediately, since they were able to reduce their advance payments, but other taxpayers were unaffected in 2004 except by the measure to align the married person's tax allowance with that of cohabitants,

TABLE 29 REVENUE OF GENERAL GOVERNMENT (1)

(Percentages of GDP)

	2000	2001	2002 (2)	2003	2004 e (2)
Fiscal and parafiscal revenue	45.0	45.2	45.6	44.8	45.0
Levies weighing chiefly on earned income	26.9	27.6	27.7	27.2	26.5
Personal income tax (3)	12.6	12.9	12.8	12.5	12.2
Social contributions (4)	14.4	14.7	14.9	14.7	14.3
Taxes on company profits (5)	3.3	3.2	3.1	2.9	3.2
Levies on other incomes and on assets (6)	3.5	3.5	3.5	3.6	3.8
Taxes on goods and services	11.4	11.0	11.3	11.1	11.5
of which:					
VAT	6.9	6.6	6.8	6.7	6.9
Excise duties	2.3	2.2	2.3	2.3	2.4
Non-fiscal and non-parafiscal revenue (7)	4.4	4.7	4.7	6.5	4.4
Total revenue	49.4	49.9	50.3	51.3	49.4

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) Between 2001 and 2002, fiscal and parafiscal revenue and total revenue were augmented by around ¼ p.c. of GDP by accounting factors: first, the reclassification of the public radio and television broadcasting companies from the non-financial corporations sector to the general government sector, and second, the shift between VAT and GNI resources following the EU financing reform. That reform also increased revenue in 2004 by 0.1 p.c. of GDP. 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. In 2003 this includes the capital transfer of 1.9 p.c. of GDP made by Belgacom in return for the government's assumption of its pension liabilities.

which was partly incorporated in the withholding tax on earned income. The proceeds from the tax were also affected by the residual impact on the assessments of the measures concerning incomes in previous years, such as the introduction of the tax credit for taxpayers on low incomes and the provisions to make better allowance for dependent children. For wage earners, the programme law of 27 December 2004 replaced the above tax credit with the "work bonus", which will be introduced gradually from 2005 and consists of a cut in personal social security contributions. Apart from the personal income tax reform, a reduction in the withholding tax on earned income from shift work was also introduced.

In contrast to 2003, the shifts in timing between amounts collected via the withholding tax on earned incomes and those collected via the assessments increased tax revenues by around 300 million in the year under review. Thus, the rate of the additional local taxes charged by the federal authority via the withholding tax on earned incomes was raised for the second consecutive year from 6.7 to 7 p.c. in 2004. In addition, a withholding tax on earned incomes was introduced in respect of various social security benefits, such as the disability benefit and the career break allowance. These measures boosted the revenue raised by the withholding tax on earned incomes in 2004, but they will have an adverse effect on the assessments in future years.

The measures concerning the additional percentages on personal income tax charged by local authorities had a neutral impact on revenue in the year under review, in contrast to previous years. The increases in the rate of the additional percentages on personal income tax broadly offset the mechanical effects on local revenues of the federal personal income tax reform.

In parallel with the fiscal measures concerning the levies on labour, significant cuts were also made in social security contributions. Apart from the simplification and harmonisation of the existing systems reducing employers' contributions, various new measures were introduced in 2004, as explained in detail in chapter 4 on the labour market and labour costs, particularly within the

TABLE 30 **MAIN FISCAL AND PARAFISCAL MEASURES**

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

	2002	2003	2004 e
Fiscal measures	–1,553	–689	697
Structural measures	–1,333	–579	182
Federal government and social security (1)	–741	–709	107
Personal income tax	–741	–997	–548
Personal income tax reform	–309	–687	–482
Abolition of the complementary crisis contribution	–431	–303	0
Other	0	–8	–66
Taxes on goods and services	0	288	580
Levies on other incomes and on assets	0	0	75
Communities and regions	–783	35	–68
Abolition or reform of the radio and television licence fee	–517	–19	0
Reform of registration fees in the Flemish Region	–367	0	0
Withholding tax on immovable property	0	0	–68
Other	101	54	0
Local authorities	191	95	143
Additional percentages on personal income tax	31	45	–4
Endogenous effect of the federal reform	0	–4	–32
Rate increase	31	49	28
Additional percentages on the withholding tax on immovable property	135	51	32
Elia tax	0	0	115
Shifts between withholding tax on earned income and assessments	0	–330	314
Non-recurring measures	–220	220	200
Reduction in personal income tax in the Flemish Region	–220	220	0
One-off tax regulation	0	0	200
Parafiscal measures	–144	–345	–471
Employers' contributions	–144	–283	–533
Employees' contributions	0	–61	63
Total	–1,697	–1,033	226
p.m. Percentages of GDP	*–0.6*	*–0.4*	*0.1*

Sources: budgets, NBB.
(1) The corporation tax reform implemented in 2003 is not included in this table since, according to official sources, its budgetary effect is neutral.

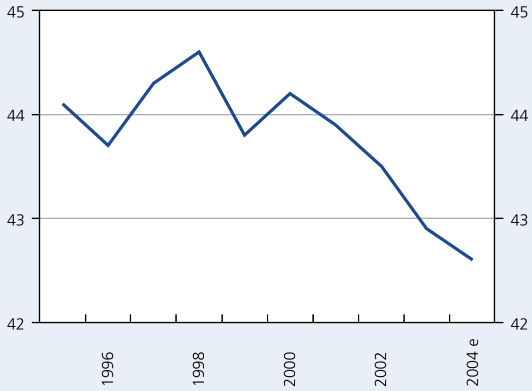
framework of the Employment Conference in September and October 2003. The overall cost to the budget of these measures – calcultated on a transaction basis, in line with the ESA 95 – came to 533 million euro, or 0.2 p.c. of GDP, in 2004.

Between 2000 and 2004, the implicit tax rate on earned incomes – i.e. the fiscal and parafiscal levies as a percentage of the wages calculated on the basis of the national accounts – contracted by 1.6 percentage point, falling from 44.2 to 42.6 p.c. According to the latest figures available from the EC, it nonetheless seems that, in 2002, the implicit rate of tax on earned incomes in Belgium was still 7.2 percentage points above the EU-15 average. With the exception of Sweden, where the implicit tax rate was significantly higher still, and Finland which had a comparable tax rate, it was lower in the other countries, sometimes considerably so: in Ireland and the United Kingdom, that rate was around 18 percentage points lower than in Belgium.

CHART 52 **AVERAGE IMPLICIT TAX RATE ON WAGES (1)**

(Percentages of labour costs)

TREND IN BELGIUM



TREND IN THE EU-15

	Change between 1995 and 2000	Change between 2000 and 2002	*p.m. Level in 2002*
SE	0.9	–2.7	*46.6*
FI	0.1	–0.1	*43.9*
BE	**0.1**	**–0.7**	***43.5***
FR	0.9	–1.3	*41.8*
IT	3.5	–0.2	*41.1*
DK	1.1	–1.9	*39.9*
DE	0.7	–0.3	*39.9*
AT	1.0	–0.5	*39.2*
GR	4.1	–0.4	*37.8*
PT	2.2	0.5	*33.7*
NL	0.3	–3.5	*31.9*
ES	–0.3	1.4	*30.0*
LU	0.5	–2.0	*28.0*
IE	–1.5	–2.4	*25.9*
GB	0.0	–1.1	*24.6*
Average EU-15 (2)	–0.1	–0.9	*36.3*

Sources: EC, NBB.
(1) Calculated on the basis of the national accounts.
(2) Weighted by wages.

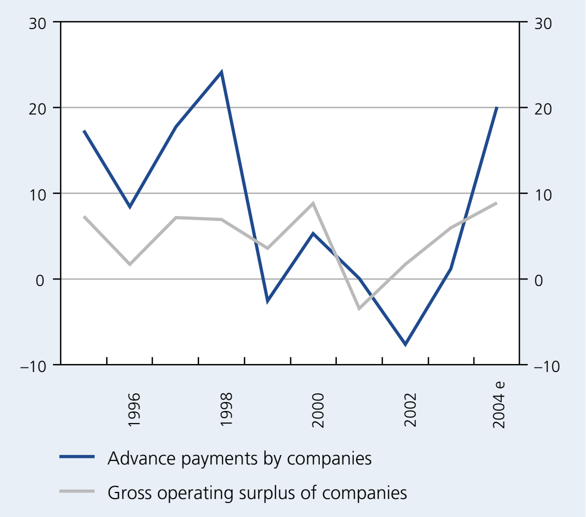
The difference between the implicit tax rate on earned incomes in Belgium and in the EU-15 hardly varied between 1995 and 2002 : as in the EU-15 in general, it remained more or less steady between 1995 and 2000, and declined to a comparable extent in the two subsequent years. The implicit tax rate in the majority of these countries has fallen since 1995, the only marked increases having occurred in the Southern European countries.

Taxes on company profits expressed as a proportion of GDP had fallen from 3.3 p.c. in 2000 to 2.9 p.c. in 2003. Conversely, they went up by a substantial 0.3 percentage point of GDP in 2004. Advance payments by companies increased particularly sharply, by around 20 p.c. in nominal terms, against the background of improvements in their gross operating surplus.

The levies on other incomes and on assets grew by 0.2 percentage point of GDP during the year under review. Apart from the expansion in some categories of tax, such as inheritance taxes, registration fees and gift taxes – the reduction in the rates applicable to movable property on 1 January 2004 in the Flemish Region encouraged the transfer of assets in the form of gifts, so that revenues increased significantly despite the rate reduction – a number of measures also had a favourable impact on revenues. This essentially concerned the one-off tax regulation, a non-recurring measure whereby taxes which had been avoided could be regularised by a contribution of 9 p.c., or just 6 p.c. in certain circumstances, discussed in more detail in box 16 on the European directive concerning tax on savings. In the end, the proceeds, which had initially been estimated at 0.3 p.c. of GDP when the budget was drawn up, would seem to total around 0.1 p.c. of GDP. Furthermore, various changes were made to a number of taxes on financial transactions. Thus the tax on UCIs was increased and the tax on the delivery of bearer securities was tripled, bringing it to 0.60 p.c., in order to discourage the use of such securities. On 15 July 2004 the Court of Justice of the European Communities decided that the tax on stock market transactions and that on the delivery of bearer securities at the time of the issue of new securities were contrary to the European directive concerning indirect taxes on the raising of capital. Since that date, persons subscribing to new securities no longer have to pay this tax, and part of the tax on securities previously levied can be reclaimed, which will entail expenditure for the government.

CHART 53 ADVANCE PAYMENTS AND GROSS OPERATING SURPLUS OF COMPANIES

(Percentage changes compared to the previous year)

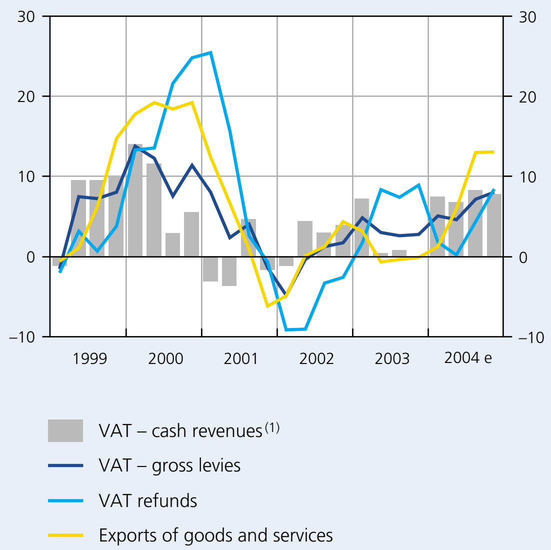


Sources : NAI, FPS Finance, NBB.

Taxes on goods and services increased by 0.4 p.c. of GDP in 2004 ; this was due to three main factors. First, the trend in VAT revenues was very favourable. During the year under review, they grew by almost 7 p.c. in nominal terms. This rise came from an increase in gross levies parallel to the expansion of economic activity in general and consumer spending in particular, but also from the low increase in the refunds which normally follow exports and investments with a certain time lag. While these refunds had increased significantly in 2003, their growth was limited in 2004, probably because of the sluggishness of exports and investments in 2003. Secondly, the proportion of VAT revenues levied in Belgium and accruing to the Belgian State was increased by 0.1 p.c. of GDP as a result of the reform in the method of financing the EU, approved at the Berlin summit in March 1999, which provided for a shift from the VAT resource to the GNI resource, by reducing the percentage of the VAT contribution accruing to the EU from 1 to 0.75 p.c. in 2002 and to 0.50 p.c. in 2004. Thirdly, various measures led to an increase in excise duties totalling 0.1 p.c. of GDP. Thus, the August 2003 increase in the energy contribution levied on electricity, heating oil, coal, petrol and diesel, continued to have an impact of 128 million euro in 2004. Also, the excise duty on tobacco was raised at the beginning of 2004, and the ratchet system increased the excise duty on petrol and diesel during the first half year, generating revenue totalling around 150 and 200 million euro respectively. Furthermore, certain minor taxes such as the excise compensatory levy and the motor vehicle registration tax were reduced. Finally, as regards social security, the advance payable by the pharmaceutical industry to finance the overspend on the drugs budget was raised from 2.55 to 7.44 p.c. of the turnover achieved in 2003

CHART 54 **DETERMINANTS OF THE MOVEMENT IN VAT REVENUES**

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



Sources : NAI, FPS Finance, NBB.

(1) These are cash revenues as collected by the FPS Finance. They differ from the revenues recorded in the general government accounts according to the ESA 95, which are stated on a transaction basis and from which the revenues transferred to the EU are deducted.

by this sector, generating an additional 135 million euro in revenue.

The Flemish Region and the Walloon Region reformed their withholding tax on immovable property. In Flanders, the regional element of the withholding tax on immovable property of enterprises was abolished ; in Wallonia, the reform consisted mainly in replacing the proportional reduction for dependent children and the disabled with a higher flat-rate reduction. Furthermore, the local authorities raised the rate of the additional percentages on the withholding tax on immovable property by a smaller amount than in previous years.

During the year under review, the "Elia tax" generated revenue totalling 115 million euro. This levy on electricity supplies came into force with retroactive effect from May 2004. It was introduced by the federal government, but the proceeds go to the local authorities, in partial compensation for the negative effects on their revenues of the liberalisation of the electricity market.

The impact of the fiscal and parafiscal measures – including the one-off tax regulation – was more or less neutral in 2004, in contrast to 2002 and 2003 when it had helped to reduce the tax wedge. However, in 2004 there was a marked tendency towards a reduction in the burden on labour, the burden being shifted towards other sources of taxation, mainly consumption. This trend should continue, as a result of the still impending effects of the personal income tax reform and the planned reductions in social security contributions, as well as the scheduled increase in certain indirect taxes.

There was a sharp fall in non-fiscal and non-parafiscal revenues in 2004, whereas in 2003 they had been swollen by the capital transfer equivalent to 1.9 p.c. of GDP received from Belgacom in return for the government's assumption of its pension commitments. In 2004, a similar but considerably smaller operation was effected, when the government took over the 151 million euro pension fund of BIAC, the company which owns and operates the Brussels national airport. The sale in 2003 of the portfolio of mortgage loans managed by Credibe – the institution created in 2001 out of the former Central Mortgage Loan Office – and the partial repayment by the regional housing companies of the bulk of their debt to SHLAF have also led to a decrease in interest income during the year under review of 0.1 p.c. of GDP. Finally, the liberalisation of the energy market in Flanders had an adverse effect in 2004 on the dividends paid to local authorities by the intermunicipal associations, amounting to around 0.1 p.c. of GDP.

Primary expenditure

The growth of primary expenditure at constant prices, which had been particularly sustained in 2002 and 2003, slowed down in 2004. This deceleration led to a 0.9 percentage point reduction in this expenditure as a percentage of GDP, to 44.6 p.c., offsetting only a very small part of the increase recorded in previous years.

During the year under review, the real expansion of primary expenditure totalled 0.9 p.c., a particularly modest rate compared to the two preceding years. However, the actual movement in this expenditure is not a good indicator of the government's structural policy on the matter, since it is greatly influenced by non-recurring factors, cyclical developments and any time lags between the indexation of certain expenditure and the increase in the national consumer price index. The underlying trend in primary expenditure can be assessed by neutralising the impact of these three factors.

TABLE 31 PRIMARY EXPENDITURE OF GENERAL GOVERNMENT

(Deflated by the national consumer price index, percentage changes compared to the previous year, unless otherwise stated)

	2000	2001	2002	2003	2004 e	Average 1995-2004 e
Level recorded (1)	42.5	42.8	44.2	45.6	44.6	
Real growth recorded	1.2	0.6	4.6	4.7	0.9	2.3
Influence of non-recurrent and cyclical factors						
Non-recurrent factors (2) (3)	–0.1	–1.2	1.2	1.1	–1.4	0.1
Unemployment spending, excluding measures (2)	–0.2	0.0	0.1	0.3	0.1	0.0
Real growth adjusted for non-recurrent and cyclical factors	1.5	1.9	3.2	3.3	2.2	2.2
Effect of indexation (2) (4)	–0.7	0.0	0.7	–0.2	–0.5	–0.1
Real growth adjusted for non-recurrent and cyclical factors and for the effects of indexation	2.2	1.9	2.5	3.5	2.8	2.4

Sources : NAI, NBB.

(1) Percentages of GDP.

(2) Contribution to real recorded growth of primary expenditure.

(3) The increase in primary expenditure between 2001 and 2002 is inflated by 0.3 p.c. of GDP, by accounting factors, namely the reclassification of the public radio and television companies from the non-financial corporations sector to the general government sector, and the shift between VAT and GNI resources following the EU financing reform. This last effect recurred between 2003 and 2004, and amounted to 0.1 p.c. of GDP. These factors inflated both revenue and expenditure, without any significant impact on the overall balance.

(4) Effect caused by the difference between the actual indexation of public sector wages and social security benefits and the rise in the national consumer price index.

In 2004, non-recurrent factors made a significant contribution towards limiting the volume of expenditure, at 1.4 percentage points, whereas they had inflated expenditure substantially in 2003. First of all, expenditure was affected by the recording in 2003 of the investment grants and part of the operating subsidies which the BNRC was, in principle, only entitled to receive in 2004. Thus, a sum of 1,051 million euro was added to expenditure in 2003, reducing the 2004 figure by a corresponding amount. Next, buildings were sold off not only by the federal government, raising around 200 million euro, or practically the same amount as in 2003, but also – in the sum of just over 200 million – by the Flemish Community which had not engaged in such transactions in the recent past. According to the ESA 95, these transactions are recorded as negative expenditure.

Conversely, two major factors boosted expenditure in 2004. Thus, as already mentioned, the GNI resource was augmented by 290 million euro in 2004, offsetting a smaller EU levy on the VAT revenues collected in Belgium. The expenditure now also includes the pensions which the State has to pay to retired Belgacom officials, having taken over the company's obligations in that respect in 2003 : these pensions entailed disbursements totalling around 200 million euro in 2004. However, this amount was more than offset at the level of the overall balance by larger contributions paid by Belgacom under the general pensions system and by gains relating to interest charges generated by the reduction in the debt following the capital transfer of 5 billion euro, effected by Belgacom in favour of the Treasury in 2003, to ensure the actuarial neutrality of the operation as a whole for the general government budget.

Finally, following the decision of the Court of Justice of the European Communities on 15 July 2004, mentioned above, ordering the Belgian State to repay the amounts unlawfully collected by way of the tax on stock market transactions and that on the delivery of bearer securities, subscribers will be filing applications for refunds ; under the ESA 95, the resulting expenditure, estimated at 75 million euro, must be accounted for in 2004, the year of the ruling against Belgium, whatever the actual date of disbursement.

The primary expenditure growth rate is also influenced by fluctuations in economic activity, via the movement in unemployment benefits, which generally lags to some extent behind the economic cycle. Following a very steep rise in unemployment spending in 2003, totalling 5.8 p.c. in real terms, the steady recovery of activity kept the growth of this expenditure down to 2.2 p.c. in 2004, so that the contribution to the growth of primary expenditure was reduced from 0.3 percentage point in 2003 to 0.1 percentage point.

During the year under review, the growth of primary expenditure was also curbed, by around 0.5 percentage point, by the mechanism of index-linking social security benefits and civil service pay. This expenditure, which accounts for almost 60 p.c. of the primary expenditure of general government, is linked to the health index which, in 2004, rose less than the national consumer price index because, unlike the latter, it was not influenced by the sharp increase in petrol and diesel prices, nor by a whole series of measures to increase indirect taxes, detailed earlier. Furthermore, the indexable spending is not adjusted until the reference index, obtained after smoothing, exceeds a threshold value of the index. Since that did not happen until September in 2004, social security benefits and civil service pay were increased by 2 p.c. in October and November respectively, or four months later than in 2003. In view of the rise in inflation recorded in 2004, the difference between the indexation and inflation rates rose to 0.8 percentage point, against just 0.3 percentage point in 2003.

Following adjustment for the effects of all the non-recurrent and cyclical factors and the effects of indexation, the increase in primary expenditure came to 2.8 p.c. in 2004, which is below the rate recorded in 2003 but higher than the trend GDP growth rate and the average increase in primary expenditure of 2.4 p.c. for the past ten years. That rate was higher from 2000 to 2004, rising to an average of 2.6 p.c., than between 1995 and 1999 when it had averaged 2.1 p.c. per annum.

The movement in the primary expenditure of general government was relatively variable, depending on the sub-sectors composing it. Thus, there was a substantial rise in spending by the social security authorities and the communities and regions, while the growth of federal government spending was only modest, and local authority spending was in an intermediate position.

The adjusted primary expenditure of the federal government grew by 1.2 p.c. in real terms in 2004. Hence, that growth was slightly lower than the average, relatively weak rise observed over the past ten years.

The increase in the volume of the primary expenditure of social security, adjusted for the effects mentioned above, remained strong, at 2.9 p.c., though below the 4.3 p.c. recorded in 2003. The high rate of the growth seen in recent years is due almost exclusively to the steep rise in health care spending and, to a lesser extent, the success of the career break schemes according entitlement to social security benefits. Health care spending has a large, structural influence on the movement in social security expenditure, as well as adding to the primary expenditure of general government. In fact, with a real growth rate averaging 3.7 p.c. since 1981, health care spending has shown the largest increase among the main categories of primary expenditure. Thus, expenditure on health care represented almost one-third of social security expenditure in 2004, against less than 20 p.c. in 1980.

The real growth of public expenditure on health care is highly volatile. Calculation of a moving average can attenuate the part of the annual fluctuations due to shifts, accounting delays or short-term measures. This reveals that the growth of this expenditure at constant

TABLE 32 PRIMARY EXPENDITURE BY GENERAL GOVERNMENT SUB-SECTOR (1)

(Deflated by the national consumer price index, percentage changes compared to the previous year)

	2000	2001	2002	2003	2004 e	Average 1995-2004 e	Sub-period	
							Average 1995-1999	Average 2000-2004 e
Adjusted real growth (2)	2.2	1.9	2.5	3.5	2.8	2.4	2.1	2.6
Federal government	2.3	0.5	1.4	3.5	1.2	1.4	1.0	1.8
Social security	2.3	3.5	2.0	4.3	2.9	2.5	1.8	3.0
Communities and regions	0.5	2.2	3.9	3.1	2.9	2.1	1.7	2.5
Local authorities	4.8	–1.8	2.5	3.3	2.3	2.7	3.3	2.2

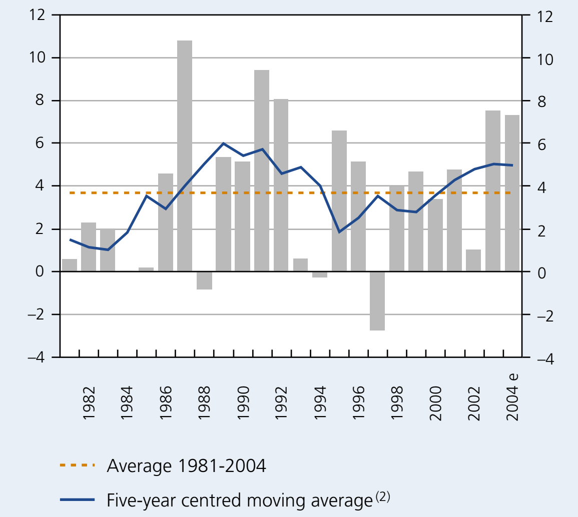
Sources : NAI, NBB.

(1) The expenditure of the sub-sectors includes mutual transfers, except for the federal government's assumption of the social security debt in 2001 and the payment of the capital transfer, effected by the federal government to the regions in 2004 in respect of the repayment by the regional housing companies of part of their debt to SHLAF.

(2) Real growth adjusted for non-recurrent and cyclical factors and for the effects of indexation.

CHART 55 HEALTH CARE EXPENDITURE [1]

(Deflated by the national consumer price index, 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.

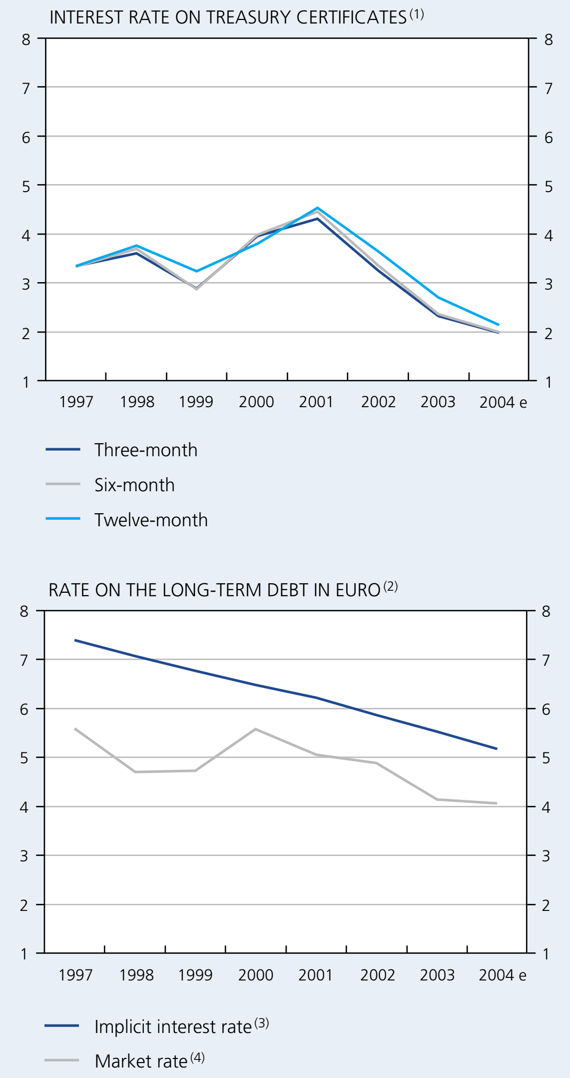
(2) For the purpose of calculating the moving average for 2003 and 2004, real growth of 4.5 p.c. in 2005 and 2006 was assumed.

prices has been well above the trend rise in recent years, and that an acceleration occurred during the most recent period. The rise was particularly strong in 2003 and 2004, totalling 7.5 and 7.3 p.c. respectively. In the first of these two years, there were shifts from one year to another, but that does not apply in the case of the year under review. The fact that the target set in the July 2003 coalition agreement, namely a real annual increase of 4.5 p.c. from 2004 to 2007, was used for the purpose of drawing up the 2004 budget therefore did not suffice to keep expenditure within the planned limits.

Despite these factors, the growth of social security expenditure slowed down in 2004 by more than one percentage point compared to 2003, the main reason being the very modest growth of pensions, but also the deceleration in the majority of the other social security benefit categories. The lessening of the budgetary impact of the social provisions, which had been particularly significant in 2003, also reduced the rate of increase in spending, despite new measures introduced in 2004.

Of those new measures, mention can be made of the ones concerning the lowest replacement incomes and totalling 115 million euro in 2004, supplementing the adjustments already made in 2003, which amounted to over 180 million. Thus, the minimum amounts of self-employed persons' pensions have been gradually increased since 2003, and that process will continue until 2007. The oldest pensions are also being gradually adjusted in line with prosperity, to compensate for the spontaneous decline in the relative affluence of the oldest

CHART 56 INTEREST RATES ON THE PUBLIC DEBT



Sources : NAI, FPS Finance, NBB.

(1) Average rate due 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 like short-term rates.

(3) Ratio between the interest charges (including issue premiums) and the average monthly outstanding amount of the debt.

(4) Average interest rate on public loans with a maturity of six years or more.

pensioners : from 1 April 2004, pensions of employees and self-employed persons which had commenced in 1996 were increased by 2 p.c. Other measures, of less budgetary significance, have also been passed, such as the extra 66 million added to the budget for the service voucher system, introduced at the beginning of 2003 and reformed at the time of the Employment Conference in September and October 2003, or the 2 p.c. adjustment in line with prosperity applicable to disability benefits which were paid for the first time before 1998.

As regards the communities and regions, the growth of the volume of primary expenditure was still sustained in 2004, though it was slightly less rapid than in the preceding two years. In the case of local authorities, real primary expenditure grew at below the average pace of the past ten years.

Interest charges of general government

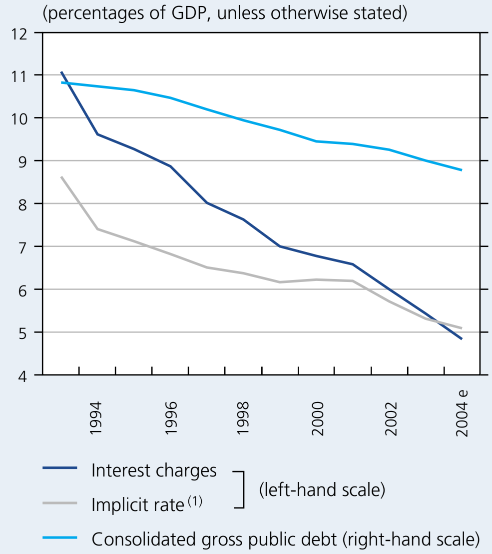
During the year under review, a further fall, equivalent to 0.6 p.c. of GDP, was recorded in the interest charges of general government, bringing them down to 4.8 p.c. of GDP. This decline was due both to the debt reduction – in 2003 and 2004 the consolidated gross debt of general government contracted by 5.4 and 4.3 p.c. of GDP respectively – and to the downward trend in the implicit interest rate on the public debt, which dropped by 0.2 percentage point during the year under review (see also box 15).

Given that the composition of the Treasury debt, which represents over 90 p.c. of the public debt, has remained practically unchanged in recent years, the movement in the implicit rate is attributable almost exclusively to the

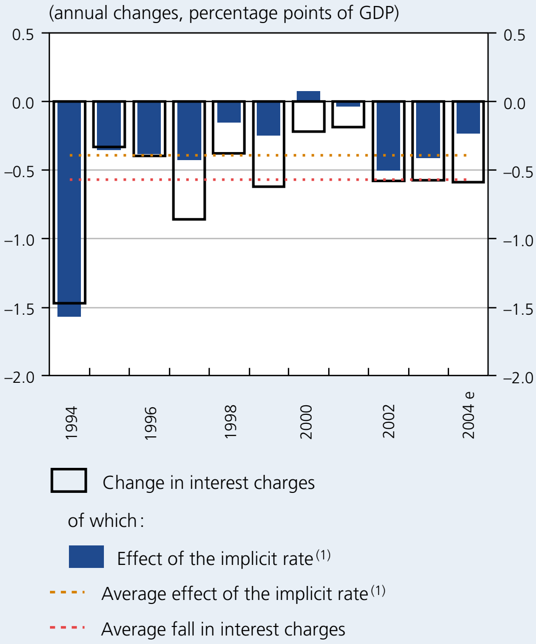
Box 15 – Trend in interest on the public debt

INTEREST CHARGES, DEBT RATIO AND IMPLICIT INTEREST RATE

TREND FROM 1993 TO 2004
(percentages of GDP, unless otherwise stated)



DECLINE IN INTEREST CHARGES AND EFFECT OF THE IMPLICIT INTEREST RATE
(annual changes, percentage points of GDP)

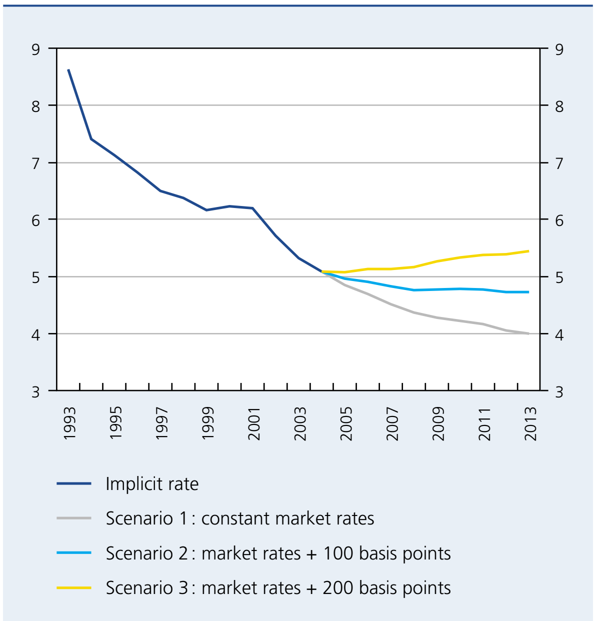


Sources : NAI, FPS Finance, NBB.
(1) Ratio between interest charges during the current year and the debt at the end of the previous year.

Between 1993 and 2004, general government's interest charges dropped from 11.1 to 4.8 p.c. of GDP. This reduction was brought about by the contraction in the debt ratio, averaging 3.7 p.c. of GDP per annum, and by the steady reduction in the implicit rate on the public debt, averaging 0.3 percentage point per annum. Of the average annual decline in interest charges, amounting to 0.6 p.c. of GDP, 0.4 percentage point is attributable to the reduction in the implicit rate on the public debt. The possibility of refinancing at lower market rates loans which matured or were repaid early, thus permitted the creation of a substantial budget margin during the past decade for an amount equal to the fall in interest charges.

However, nominal market interest rates reached historically low levels during the year under review. Any continuing reduction in the implicit interest rate is therefore likely to proceed more slowly than in the past. There is also a possibility that a rise in market interest rates could stabilise or increase the implicit rate on the public debt.

IMPLICIT INTEREST RATE ON THE PUBLIC DEBT (1) (2)



Sources : NAI, FPS Finance, NBB.

(1) Ratio between interest charges in the current year and the debt at the end of the preceding year.

(2) On the technical assumption that the level of debt remains constant and the debt structure remains unchanged.

By way of illustration, three interest rate scenarios were examined: in the first, short- and long-term market interest rates remain constant at the average level of 2004, in the second, market interest rates increase by 100 basis points at the beginning of 2005, then remain steady, and finally, in the third scenario, this increase is put at 200 basis points. In the first scenario, the implicit rate on the public debt continues to decline, but more slowly than in the past. In the second scenario, the decline in the implicit interest rate is halted after just a few years, so that the reduction in interest charges via the interest rate channel would disappear entirely. A 200 basis points rise in market interest rates leads to an almost immediate increase in the implicit interest rate, so that – in contrast to what has happened in the past – that would exert upward pressure on the interest charges.

change in the rates on the various debt components. The Eurosystem made no change to the minimum bid rate on the main refinancing operations during the year under review, but the reduction in its key rate in 2003, totalling 75 basis points altogether, continued to produce an effect. The implicit short-term rates therefore continued to fall, though more slowly than in earlier years. Long-term loans reaching maturity could be refinanced at significantly lower rates in 2004, so that the implicit rate on the long-term debt maintained its downward trend.

Overall balance of general government

Having recorded a surplus of 0.3 p.c. of GDP in 2003, the transactions of general government ended 2004 more or less in balance, according to the data compiled in accordance with the ESA 95. Since interest charges showed a further marked fall in 2004, this movement was accompanied by a reduction in the primary surplus, which dropped from 5.7 p.c. of GDP in 2003 to 4.7 p.c. The main reason for this development is the reduced importance of non-recurrent factors.

The movement in the budget balance of general government is the outcome of developments which vary between sub-sectors. Thus, the federal government recorded a deficit of 0.3 p.c. of GDP, whereas it had managed to produce a surplus of 0.4 p.c. of GDP in 2003. This substantial deterioration is due to the disappearance of the non-recurrent factors already mentioned – particularly the one concerning Belgacom – which had made a major contribution to the improvement in the budget result in 2003. The amount paid by the federal government to social security, essentially in the form of alternative funding, was also stepped up substantially during the year under review. In 2004, the expenditure was also increased by the non-recurrent capital transfer, equivalent to 0.2 p.c. of GDP, paid by the federal government to the regions in respect of the regional housing companies' repayment of the bulk of their debt to SHLAF. This was a one-off payment to compensate for the fact that the regions no longer had the possibility of using loans conferring tax concessions for refinancing the liabilities which SHLAF was managing on their behalf. Finally, the reduction in interest charges had a favourable impact of 0.5 p.c. of GDP on the federal government balance.

Social security recorded a deficit for the second year running. This deterioration is due, in particular, to the decline in social security contributions, down by 0.7 percentage point of GDP between 2002 and 2004, owing to the fall in the proportion of GDP represented by gross wages, recorded since 2003, and the reductions in social security contributions. In addition, there was a large increase in expenditure on health care during this period. Spending in fact rose from 5.9 p.c. of GDP in 2002 to 6.5 p.c. of GDP in 2004, an increase of 0.6 percentage point. The impact

TABLE 33 FINANCING REQUIREMENT (–) OR CAPACITY BY GENERAL GOVERNMENT SUB-SECTOR
(Percentages of GDP)

	2000	2001	2002	2003	2004 e
Primary balance	6.9	7.2	6.1	5.7	4.7
Federal government	5.9	5.3	5.4	5.4	4.2
Social security	0.6	0.7	0.4	–0.5	–0.2
Communities and regions	0.6	1.1	0.1	0.4	0.5
Local authorities	0.0	0.1	0.3	0.5	0.4
Interest charges	6.8	6.6	6.0	5.4	4.8
Financing requirement (–) or capacity	0.2	0.6	0.1	0.3	–0.1
Federal government	–0.4	–0.8	–0.2	0.4	–0.3
Social security	0.6	0.7	0.3	–0.5	–0.2
Communities and regions	0.3	0.8	–0.1	0.2	0.3
Local authorities	–0.3	–0.1	0.1	0.3	0.2
p.m. Financing requirement or capacity according to the EDP (1)	*0.2*	*0.6*	*0.1*	*0.4*	*0.0*

Sources: NAI, NBB.
(1) 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. However, in the framework of the excessive deficit procedure (EDP) no account is taken of this adjustment, which is also disregarded in the EC's assessment of the stability programmes.

TABLE 34 SOCIAL SECURITY ACCOUNTS (1)

(Percentages of GDP)

	2002	2003	2004 e	Movement between 2002 and 2004 e
Total revenues	19.6	19.4	19.5	–0.1
Social security contributions	14.1	13.8	13.4	–0.7
Other revenues	5.5	5.6	6.2	0.6
Total expenditure	19.3	19.9	19.8	0.5
of which :				
Health care	5.9	6.2	6.5	0.6
Financing requirement (–) or capacity	0.3	–0.5	–0.2	–0.6

Sources : NAI, NBB.

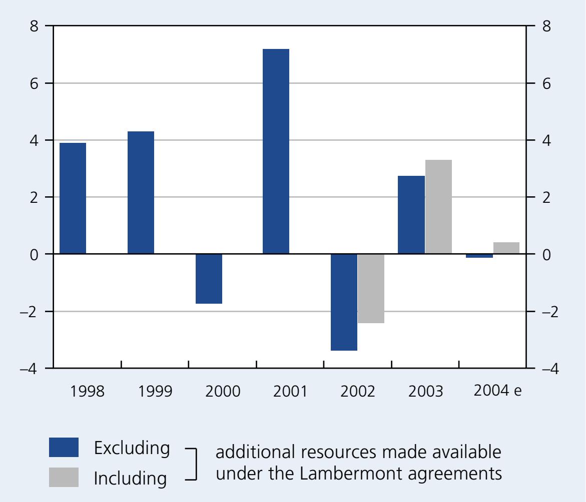
(1) Adjusted for the effect on expenditure of the transfer to social security in 2004 of part of the daily cost of hospitalisation which had previously been paid by the federal government, and the effect on revenues of the corresponding increase in the alternative funding of social security.

of these two factors was partly absorbed by the increase in transfers from the federal government.

During the year under review, the communities and regions increased their surplus to 0.3 p.c. of GDP. However, the part of the proceeds generated by personal income tax and VAT which is transferred to the communities and regions under the Finance Act increased by only 0.4 p.c. in real terms. Three factors account for the improvement in the balance of these entities : first, the movement in certain regional taxes, such as registration fees, inheritance taxes and gift taxes, was highly favourable ; next, revenues were boosted by the non-recurrent capital transfer effected as part of the transaction already mentioned between the regional housing companies and SHLAF ; finally, the Flemish Community sold off some assets in the form of real estate.

CHART 57 PERSONAL INCOME TAX AND VAT REVENUES TRANSFERRED TO THE COMMUNITIES AND REGIONS UNDER THE SPECIAL FINANCES ACT (1)

(Deflated by the national consumer price index, percentage changes compared to the previous year)



Sources : State revenue and resources budget, NBB.

(1) Excluding the impact of regional taxes transferred.

Finally, as regards the local authorities, the surplus was down by 0.1 p.c. of GDP against 2003. This fall was due to a contraction in revenues combined with an increase in investment spending.

Cyclically adjusted and structural budget balances

The primary balance and the overall balance of general government give only an imperfect indication of the actual orientation of fiscal policy, as they are determined not only by that policy but also – and to a significant extent – by the general economic situation, which is beyond the direct influence of the government. In order to assess the fiscal policy stance, it is therefore better to use indicators from which the influence of the economic cycle has been eliminated. For that purpose, the ESCB uses a harmonised method which adjusts the actual budget balances to take account both of the discrepancy between the actual increase in activity and the trend growth rate, and of non-trend fluctuations in the composition of GDP.

TABLE 35 CYCLICALLY ADJUSTED [1] AND STRUCTURAL BUDGET BALANCES

(Percentages of GDP)

	Primary balance			Overall balance		
	2002	2003	2004 e	2002	2003	2004 e
Level observed	6.1	5.7	4.7	0.1	0.3	–0.1
p.m. Idem, according to the EDP [2]	*6.1*	*5.7*	*4.7*	*0.1*	*0.4*	*0.0*
Change observed		–0.3	–1.0		0.2	–0.4
Cyclical change		–0.2	0.0		–0.2	0.0
GDP growth		–0.5	0.4		–0.5	0.4
Composition effects		0.3	–0.4		0.3	–0.4
Cyclically adjusted change		–0.2	–1.0		0.4	–0.4
Cyclically adjusted level	6.2	6.0	5.0	0.2	0.6	0.2
Impact of non-recurrent factors [3]	0.2	1.5	0.7	0.2	1.5	0.7
of which:						
Reduction in personal income tax in the Flemish Region	0.1	0.0	0.0	0.1	0.0	0.0
Shifts between the withholding tax on earned incomes and assessments	0.1	0.0	0.1	0.1	0.0	0.1
Sales of real estate	0.1	0.1	0.2	0.1	0.1	0.2
Capital transfers in return for taking over pension commitments	0.0	1.9	0.1	0.0	1.9	0.1
Shifts in the funding of the BNRC	0.0	–0.4	0.4	0.0	–0.4	0.4
One-off tax regulation	0.0	0.0	0.1	0.0	0.0	0.1
Structural level	6.0	4.5	4.3	–0.1	–0.9	–0.5
Structural change		–1.5	–0.2		–0.9	0.4

Sources: NAI, NBB.

(1) According to the methodology described in Bouthevillain C., Cour-Thimann P., van den Dool G., Hernández de Cos P., Langenus G., Mohr M., Momigliano S. and Tujula M. (2001), *Cyclically adjusted budget balances: an alternative approach*, ECB Working Paper Series, No 77 (September). A less technical description of this methodology is given in box 6 *Cyclically adjusted budget balances: calculation method used by the ESCB* in the NBB's Report 2003 (Part 1), pp. 83-84.

(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. However, in the framework of the excessive deficit procedure (EDP) no account is taken of this adjustment, which is also disregarded in the EC's assessment of the stability programmes.

(3) I.e. the impact of non-recurrent factors on revenue or on primary expenditure.

The indicators constructed by this method show that, in contrast to previous years, the business cycle did not have any adverse effect on the movement in the budget balances during the year under review. The expansion of activity far outstripped the trend GDP growth at constant prices, but it was also sustained essentially by income and expenditure components which have a relatively limited impact on public revenues. The favourable effects of the relatively robust economic growth were therefore entirely negated by shifts in the composition of GDP which were unfavourable to public finances. The cyclically adjusted primary surplus therefore fell in the same proportion as the actual primary surplus, namely by 1 p.c. of GDP.

Thanks to the further fall in interest charges, the deterioration in the cyclically adjusted overall balance was less marked than the decline in the cyclically adjusted primary balance. Following adjustment for the influence of the business cycle, the budget surplus was down from 0.6 to 0.2 p.c. of GDP. Nonetheless, it must be said that the method of cyclical adjustment used here – like almost all the variants applied – does not eliminate from the budget figures any cyclical influences on interest rate levels and hence on interest charges. When economic activity is lower than the trend level, that may therefore slightly flatter the cyclically adjusted budget balance.

Cyclically adjusted balances should not be confused with structural balances from which are eliminated not only cyclical movements but also, as far as possible, all other non-recurring factors. In 2003 such factors had improved the budget balances by 1.5 p.c. of GDP. During the year under review, the budget once again benefited from non-recurring factors, but in much smaller proportions. Owing to the above-mentioned switch to 2003, the finance provided by the federal government for the BNRC thus stood at an exceptionally low level in 2004, reducing primary expenditure by around 0.4 p.c. of GDP. New sales of real estate by both the federal government and certain federated entities also exerted a negative influence on investment expenditure, amounting to more than 0.2 p.c. of GDP. Furthermore, capital revenues were increased by the non-recurring payment effected by BIAC and by the proceeds of the one-off tax regulation. Finally, various shifts between the withholding tax on earned incomes and the tax ultimately payable led to a non-recurring increase in tax revenues totalling almost 0.1 p.c. of GDP. Overall, the non-recurring factors improved the budget balances by around 0.7 p.c. of GDP in the year under review.

The sharp fall mentioned earlier in the cyclically adjusted primary surplus was therefore due to a very great extent to the halving of the favourable impact of the non-recurring factors. The structural primary surplus showed a less marked deterioration, of around 0.2 p.c. of GDP. In general, public revenues had a relatively neutral influence on the movement in the structural primary surplus, since the limited net impact of the structural measures to reduce the burden of taxes and parafiscal levies was more than counterbalanced by the increase in the yield of certain taxes, which was greater than might have been expected in the light of the macroeconomic environment, especially as regards the tax on company profits and VAT. The further contraction in the structural primary surplus was therefore due essentially to the movement in primary expenditure which, at constant prices and adjusted for cyclical variations and other non-recurring factors, grew by almost 3 p.c., which was well above the trend growth of activity.

Insofar as the contraction of the structural primary surplus was more than offset by the decline in interest charges, the structural deficit was reduced slightly during the year under review, falling to 0.5 p.c. of GDP.

TABLE 36 CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT

(Percentages of GDP, unless otherwise stated)

	1993	Average 1994-2000	2001	2002	2003	2004 e	Movement between 1993 and 2004 e
Level of the debt (end of period)	136.7	123.4	108.0	105.4	100.0	95.6	
Change in the debt		–4.0	–1.1	–2.6	–5.4	–4.3	–41.1
Endogenous change (1)		–2.9	–3.3	–3.0	–3.6	–4.9	–35.1
Primary balance required to stabilise the debt (1)		3.0	3.9	3.1	2.1	–0.2	
Implicit interest rate on the debt (2)		6.6	6.1	5.7	5.3	5.0	
Growth of nominal GDP (2)		4.3	2.5	2.7	3.2	5.2	
Actual primary balance		5.9	7.2	6.1	5.7	4.7	
Change resulting from other factors		–1.1	2.2	0.4	–1.8	0.5	–6.0
Transactions with the NBB (including capital gains on gold)		–0.5	0.0	–0.1	–0.1	0.0	
Privatisation operations and other financial transactions		–0.4	0.0	0.0	–2.3	–0.4	
Net formation of financial assets outside the public sector		–0.4	–0.3	–0.2	0.2	0.0	
Other (3)		–0.3	2.6	0.7	0.4	0.9	

Sources: NAI, NBB.

(1) The endogenous change in the public debt is determined by the difference between the primary balance required to stabilise the debt – i.e. the balance equal to the difference between the implicit interest rate on the debt and the rate of growth of nominal GDP, multiplied by the ratio between the debt at the end of the previous year and the GDP of the period in question – and the actual primary balance.

(2) Percentages.

(3) Mainly lending, equity investment, the impact of exchange differences and of issue and repurchase premiums, statistical discrepancies and, in 2001, the incorporation of CREDIBE in the general government sector.

Debt of general government

At the end of 2003, the debt ratio stood at 100 p.c. of GDP. While the public debt had risen from a level just below GDP in 1982 to a peak of almost 137 p.c. of GDP in 1993, the debt level has fallen continuously since then, at an average rate of 3.7 percentage points per annum. During the year under review, the consolidated gross debt contracted by 4.3 p.c. of GDP to 95.6 p.c. of GDP.

The debt contraction between the end of 1993 and the end of the year under review was largely endogenous. This endogenous debt reduction, or reverse snowball effect, occurs when the primary surplus is higher than required just to keep the public debt stable taking account of nominal economic growth and the implicit interest rate on the public debt. The endogenous debt reduction came to 4.9 p.c. of GDP in 2004, mainly as a result of the vigour of nominal economic growth – 5.2 p.c. against barely 2.8 p.c. on average, in the three preceding years – and the further fall in the implicit interest rate.

A small fraction – around one-seventh – of the debt reduction recorded since 1993 is due to factors which have no impact on the budget balance, such as transactions with the Bank – notably the allocation of capital gains on gold – privatisations, or the reduction in financial assets held outside the public sector. While these exogenous factors made a substantial contribution towards reducing the public debt between 1995 and 1998, they tended to curb the contraction of the debt in the following years, owing to lending, equity investments and, above all, the incorporation of Credibe in the general government sector in 2001. In 2002, the effect of these exogenous factors had been negligible overall, while they had amplified the endogenous debt reduction in 2003, essentially by the effect of the regional housing companies' repayment of a large part of their debt to SHLAF, the sale of the portfolio of mortgage loans managed by Credibe and, to a lesser extent, the payment made by the Bank to the Treasury in return for the Belgian franc banknotes not exchanged for euros.

During the year under review, exogenous factors augmented the debt by 0.5 p.c. of GDP. At the end of 2003, the federal government had recorded in advance the payment to the BNRC of the investment grants and part of the operating subsidies which were, in principle, intended for payment in 2004, totalling 1,051 million euro. Insofar as this expenditure, which had been imputed to the year 2003, did not give rise to any actual cash disbursements until the beginning of 2004, it increased the debt for the year under review by a corresponding amount. During the year under review, the government reduced its stake in BIAC, cutting it back from 64 to 30 p.c. and thus raising 352 million euro. It also sold off some of the shares held in the capital of Belgacom, for a total of 539 million euro. Furthermore, Belgocontrol paid the Treasury 191 million euro in compensation for the State's coverage of the pensions of that company's former officials. These three transactions generated around 0.4 p.c. of GDP in financial revenues, which were used to reduce the public debt.

6.2 The finances of the communities and regions

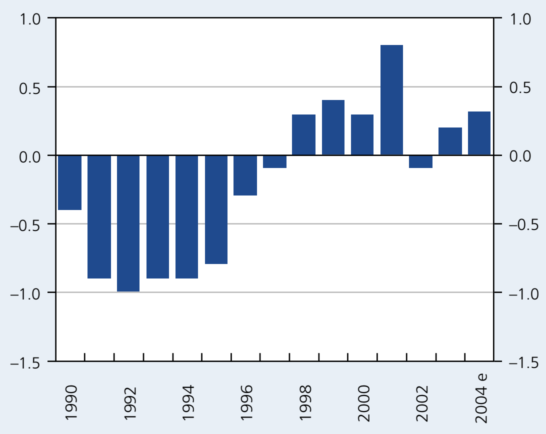
During the successive phases of the State reform, powers have been increasingly devolved from the federal level to the communities and regions. The revenue and expenditure of those entities represented around a quarter of general government revenue and expenditure in 2004.

The overall balance of the communities and regions has improved systematically over the past decade. At the beginning of the 1990s, these entities were still recording deficits of around 1 p.c. of GDP, but in recent years they have generally closed their accounts in balance or even in surplus. During the year under review they achieved a surplus of 0.3 p.c. of GDP.

The improvement can be explained by the fact that, in real terms, their primary expenditure was growing more slowly than their revenues, which in fact increased sharply. The major part of the resources of the communities and

CHART 58 FINANCING REQUIREMENT (–) OR CAPACITY OF THE COMMUNITIES AND REGIONS

(Percentages of GDP)



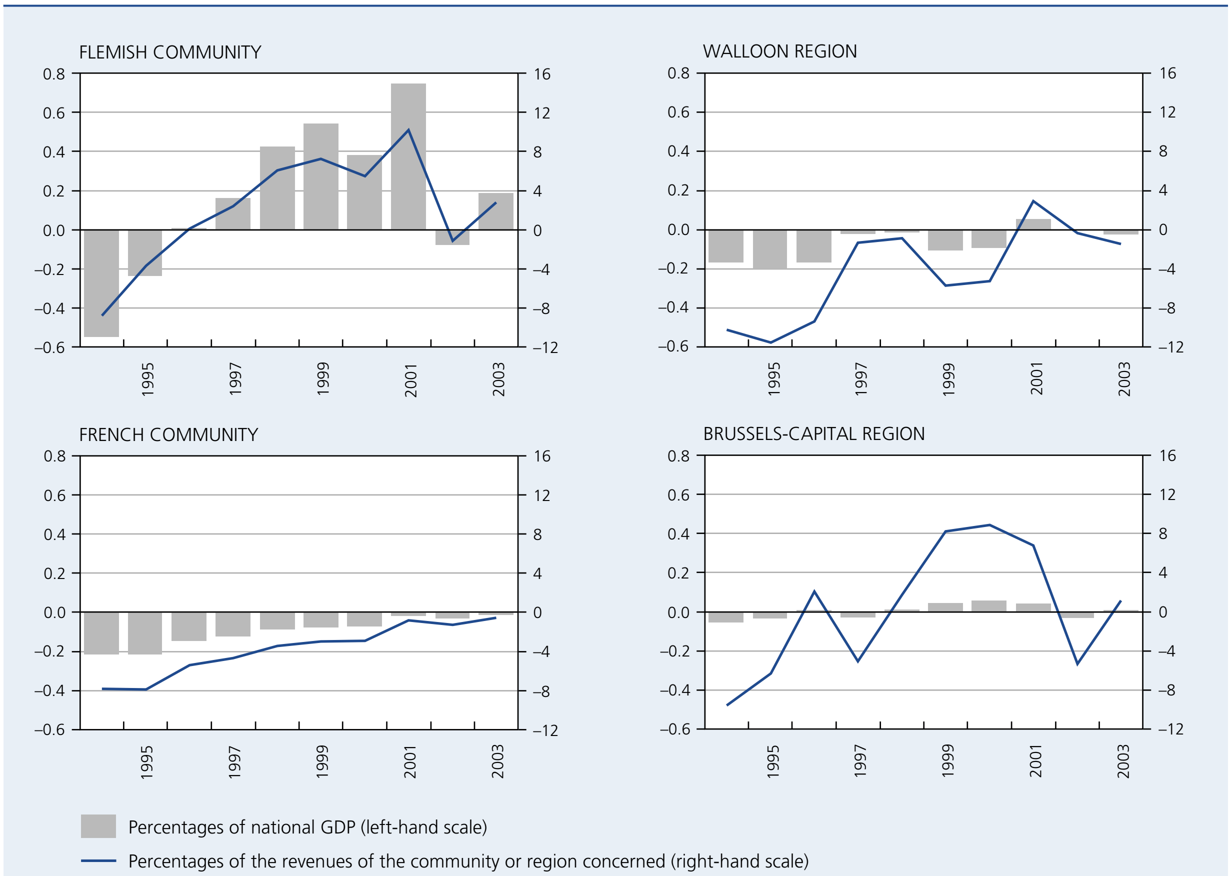
Sources : NAI, NBB.

regions – over 70 p.c. of total revenues – consists of the part of personal income tax and VAT resources transferred to them in accordance with the parameters defined by the 1989 Finances Act. During the so-called transitional period which ended in 1999, specific Finances Act mechanisms in fact contributed towards particularly strong growth of the resources allocated in the form of personal income tax revenues. The funds obtained in the form of VAT resources – which corresponded to the education powers devolved in 1989 and constitute the communities' main financial resources – were for the most part only adjusted to the movement in consumer prices and to 80 p.c. of the rise in the number of persons under the age of 18 years in the community recording the largest increase or smallest reduction in the number of young people. Following the Lambermont agreements, additional flat-rate resources in the form of VAT resources were granted to the communities from 2002 onwards, namely 198 million euro in 2002, 149 million euro in 2003 and 2004, 372 million euro in 2005, 124 million euro in 2006 and 25 million euro per annum for the period from 2007 to 2011. Furthermore, from 2007 onwards the total amount of the VAT resources will be 91 p.c. linked to the real growth of GNI.

Following the Lambermont agreements, the regions were also granted greater fiscal autonomy, and the amount of their own tax revenues increased significantly from 2002 onwards. The budgetary impact of this change was neutralised by a reduction in the personal income tax transferred under the Finances Act.

The communities and regions of greatest significance from the point of view of the budget all achieved a systematic improvement in their balance. The Flemish Community, which still showed a deficit of 0.6 p.c. of GDP in 1994, recorded a budget surplus from 1996 onwards, which actually increased to 0.7 p.c. in 2001. Subsequently, the surplus declined to 0.2 p.c. in 2003. By strict control over expenditure, the French Community managed to eliminate almost the whole of its deficit, which had stood at

CHART 59 OVERALL BALANCE OF THE MAIN COMMUNITIES AND REGIONS



Sources : NAI, NBB.

just over 0.2 p.c. of GDP in 1994, so that by 2003 only a very small deficit was still recorded. The Walloon Region achieved much the same: the deficit of almost 0.2 p.c. of GDP in 1994 was cut substantially in subsequent years. By 2003, the region recorded only a small deficit. The Brussels-Capital Region – which represents a relatively small share of revenues and expenditure, in comparison with the other main communities and regions – succeeded in converting its deficit into a surplus, which peaked in 2000; it still recorded a small surplus in 2003.

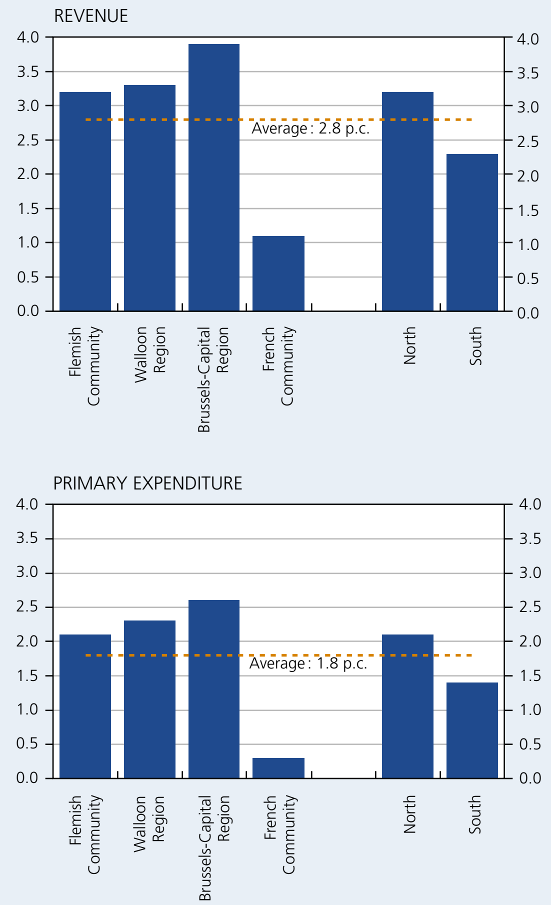
For these communities and regions taken together, revenues increased by an average of 2.8 p.c. per annum between 1994 and 2003, while the growth of primary expenditure came to 1.8 p.c. In the Flemish Community, the Walloon Region and the Brussels-Capital Region, the real growth of revenues and that of primary expenditure were above these average figures. In contrast, during this period the French Community saw a small increase in revenues and real growth of primary expenditure which averaged only 0.3 p.c.

A method which makes it possible to neutralise the influence of the institutional differences and compare more similar entities – the Flemish Community exercises the powers of both the community and the region – involves making a distinction between the north and the south of the country. By taking the formula used in the Finances Act to divide the personal income tax of the Brussels-Capital Region between the communities, the north is equivalent to the Flemish Community plus 20 p.c. of the Brussels-Capital Region, and the south consists of the French Community, the Walloon Region, the German-speaking Community and 80 p.c. of the Brussels-Capital Region. The north accounts for just under 60 p.c. of the revenue and expenditure of the communities and regions as a whole, against just over 40 p.c. for the south.

The gradual transition, in regard to the part of personal income tax allocated to the communities and regions, to an allocation formula based on the proceeds of the personal income tax levied in each entity – the allocation formula applied until 1988 was based on the population, the land area and the personal income tax in each federated entity – led to a larger increase in these resources in the north of the country than in the south. This enabled the Flemish Community to implement substantial tax cuts recently, such as the introduction of a zero rate for the radio and television licence fee and the reduction in registration fees in 2002. In the other entities, the tax reforms were rather neutral in their budgetary effect.

CHART 60 **REVENUE AND EXPENDITURE OF THE COMMUNITIES AND REGIONS DURING THE PERIOD 1994-2003** (1) (2)

(Deflated by the national consumer price index, averages of the annual percentage changes)



Sources: NAI, NBB.

(1) The Joint Community Commission was divided between north and south in ratios of 20 and 80 p.c. respectively, while the German-speaking Community and the French Community Commission come under the south, and the Flemish Community Commission comes under the north.

(2) The national accounts data have been adapted to avoid breaks in the series and to adhere more closely to the reality of the budget. An adjustment has been made to neutralise the effect of the reclassification, in 2002, of the public radio and television broadcasting companies, transferred from the non-financial corporations sector to the general government sector, and the effect of the assumption by the Brussels-Capital Region, in 1995, of the powers of the Brussels Conurbation. The imputed pensions and social security contributions were not taken into account. These adjustments, which affect the movement in revenues and expenditure, have no effect on the balance.

Despite the tax reductions mentioned, the real increase in revenue in the north of the country came to 3.2 p.c. between 1994 and 2003. This relatively favourable trend in resources during that period provided scope for relatively rapid growth of primary expenditure, at 2.1 p.c., and also contributed towards a relatively substantial improvement in the balance, amounting to 0.8 p.c. of GDP. In the south, where real revenues increased by 2.3 p.c. during this period, the improvement in the balance of 0.4 p.c. of

GDP was only possible because the real growth of primary expenditure came to just 1.4 p.c.

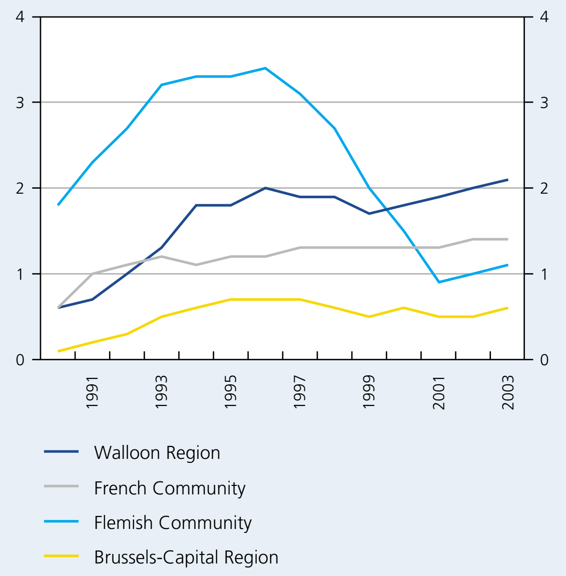
The debt of the communities and regions represents only a small part of the consolidated gross debt of general government. Having risen from 3.2 p.c. of GDP in 1990 to 7.4 p.c. of GDP in 1996, that debt has since pursued a favourable trend. In 2003, the debt of the communities and regions came to 5.2 p.c. of GDP.

This decline as a percentage of GDP is attributable to the Flemish Community, which managed to reduce its debt as a result of the budget surpluses achieved since 1996. Its debt was in fact brought down from 3.4 p.c. of GDP in 1996 to 1.1 p.c. of GDP in 2003. Thus, the debt of the Flemish Community fell below the levels recorded by the French Community (1.4 p.c. of GDP) and the Walloon Region (2.1 p.c. of GDP). The debt of the Brussels-Capital Region came to 0.6 p.c. of GDP in 2003.

In the future, there could be continuing differences in the movement in expenditure between federated entities, in view of the foreseeable growth of revenues. Thus, by making a number of technical assumptions, it is possible to calculate the increase in primary expenditure compatible with the targets which the HCF recommends that the

CHART 61 CONSOLIDATED GROSS DEBT OF THE MAIN COMMUNITIES AND REGIONS (1)

(Percentages of GDP)



Source : NBB.

(1) Consolidated gross debt of the communities and regions, minus the part of the debt of the other sub-sectors of general government held by those entities.

TABLE 37 DERIVED GROWTH OF PRIMARY EXPENDITURE OF THE COMMUNITIES AND REGIONS BETWEEN 2004 AND 2010 (1) (2)

(Deflated by the national consumer price index; averages of the percentage annual change, unless otherwise stated)

	Flemish Community	French Community	Walloon Region	Brussels-Capital Region	North	South	Total
Real growth of revenue	1.9	1.5	1.6	2.0	1.9	1.6	1.8
of which :							
Finance Act funds	1.9	1.5	1.6	2.2	1.9	1.5	1.8
Real growth of primary expenditure (3)	2.3	1.4	1.3	2.1	2.3	1.4	2.0
p.m. Movement in the balance (percentages of GDP) (3)	*–0.2*	*0.1*	*0.1*	*0.0*	*–0.2*	*0.1*	*0.0*

Sources : NAI, NBB.

(1) These projections are based on the following assumptions : real GNI and GDP growth of 2 p.c., and an annual rise in the national consumer price index of 1.75 p.c. They are also based on the demographic projections of the NSI and the Federal Planning Bureau. For the number of pupils, the current proportions have been adopted, while for the movement in personal income tax, it is assumed that growth will be the same in the three regions. Finally, the calculations are based on the assumption that own tax revenues and other revenues will track the movement in GDP, except for the drawing rights in respect of unemployed persons returning to work, for which nominal amounts apply, and the allowances for foreign students, which are only adjusted in line with inflation.

(2) The Joint Community Commission was divided between the north and south in ratios of 20 and 80 p.c. respectively, while the German-speaking Community and the French Community Commission come under the south, and the Flemish Community Commission comes under the north.

(3) Growth necessary to achieve the HCF targets for 2010, i.e. a surplus limited to expenditure on lending and equity investments. In the case of the French Community, allowance was made for progress towards a surplus of 100 million euro in 2010, as laid down in its debt reduction plan (decree of 19 December 2002).

communities and regions should pursue, namely to achieve at least a balanced budget by 2010. In the exercise below, the main assumption is that real GNI growth will average 2 p.c. over the period between 2004 and 2010. It is also assumed that the movement in personal income tax will be the same in the three regions. Finally, the calculations are based on the assumption that the movement in own tax revenues and other revenues will correspond to GDP growth. It is mainly in the Brussels-Capital Region that the proportion of these revenues is relatively large. However, movements deviating from these assumptions cannot be ruled out, especially as the Lambermont agreements give the regions greater fiscal autonomy. If the movements in the parameters differ from the assumptions made, the results obtained will also change. The projection results are therefore intended purely as an illustration.

In order to attain the target of a balanced budget in 2010, formulated by the HCF, the increase in primary expenditure for the communities and regions as a whole should not exceed GDP growth. The expenditure growth could probably be slightly higher in the north than in the south of the country, partly because the north has scope for gradually reducing its surplus, while in the south the deficits – albeit small – need to be eliminated.

For the period 2004-2010, the derived growth of primary expenditure is relatively substantial for the communities and regions as a whole, in comparison with the scope available to the other sub-sectors of general government. Taking account of the surplus of 0.6 p.c. of GDP aimed at by the stability programme for 2008 and the reductions in taxes and social security contributions which have already been decided, the increase in primary expenditure of general government should be around 0.8 percentage point lower than GDP growth, in the absence of new measures to reduce fiscal and parafiscal revenues. According to these assumptions, the primary expenditure of the entity constituted by the federal government and social security can only grow in real terms at a rate of 1.1 p.c. per annum.

7. Financial accounts and financial markets

7.1 Structure of finance and investments in the Belgian economy

Households, who possessed financial assets of around 564 billion euro at the end of 2003, constitute the Belgian economy's only creditor sector; therefore they finance, directly or indirectly, the other two resident non-financial sectors and the rest of the world. Despite the relative reduction in its debt level in recent years, general government, whose net debt amounted to some 253 billion, was again the largest resident debtor sector, ahead of non-financial corporations. The net financial liabilities of the latter came to around 209 billion euro at the end of 2003, but totalled only about 26 billion if shares and other capital participating interests were excluded. Non-financial corporations currently constitute the resident non-financial sector with the highest gross assets and liabilities.

Financial institutions continue to play a key role in the Belgian financial world: individuals place the bulk of their financial assets with these institutions, which are also their main source of finance, just as they are for the government. Moreover, the financial institutions are the main holders of foreign assets and liabilities. It was only the non-financial corporations that held the bulk of their assets and liabilities outside of the financial institutions.

TABLE 38 FINANCIAL ASSETS AND LIABILITIES BY SECTOR
(Outstanding amount at the end of 2003, billions of euro)

	Financial assets of					Total financial liabilities
	Households	Non-financial corporations	General government	Financial institutions (1)	Rest of the world	
Financial liabilities of						
Households	–	–	6.3	109.4	–	115.7
Non-financial corporations	71.6	424.2 (2)	10.9	129.0	320.4	956.1
General government	14.9	6.7	26.6	132.9	127.3	308.5
Financial institutions (1)	430.4	93.4	10.2	236.3	435.4	1,205.7
Rest of the world	162.7	222.9	1.2	598.0	–	984.9
Total financial assets	679.6	747.2	55.3	1,205.7	883.1	3,570.9
Net financial assets	563.8	–208.9	–253.2	–	–101.7	

Source: NBB.
(1) Financial institutions comprise the NBB, credit institutions and institutional investors. These institutions are treated as pure financial intermediaries: by construction, the total of their financial assets is equal to that of their financial liabilities.
(2) Apart from shares and fixed-income securities, only loans between non-financial corporations are currently recorded as intrasectoral transactions of this sector. Nonetheless, these transactions do not cover commercial loans, for which no intrasectoral data are available.

TABLE 39 STRUCTURE OF THE FINANCIAL ASSETS AND LIABILITIES OF RESIDENT NON-FINANCIAL SECTORS
(Billions of euro)

	Households		Non-financial corporations		General government	
	Outstanding amount at the end of 2003	Flows of the first nine months of 2004	Outstanding amount at the end of 2003	Flows of the first nine months of 2004	Outstanding amount at the end of 2003	Flows of the first nine months of 2004
Financial assets	679.6	14.5	747.2	18.0	55.3	3.8
Notes, coins and deposits	221.5	10.0	70.5	2.4	4.9	7.6
Fixed-income securities	123.4	–14.6	13.3	2.3	17.6	–7.0
Loans	0.0	0.0	304.4	8.3	9.1	3.7
Shares and other equity	96.8	3.7	346.7	4.1	8.1	0.0
Units of UCIs	105.9	2.0	–	–	0.6	0.5
Insurance technical reserves (1)	130.0	12.2	5.7	0.5	–	–
Other	1.8	1.1	6.5	0.5	14.8	–1.0
Financial liabilities	115.7	3.2	956.1	19.5	308.5	8.6
Notes, coins and deposits	–	–	–	–	0.7	0.1
Fixed-income securities	–	–	33.7	2.4	259.7	8.4
Loans	107.8	4.0	362.5	16.2	34.8	3.9
Shares and other equity	–	–	529.4	2.7	–	–
Other	7.9	–0.8	30.6	–1.8	13.3	–3.8
Financial balance	563.8	11.3	–208.9	–1.6	–253.2	–4.7

Source : NBB.
(1) This item consists mainly of the net claims of households on life insurance reserves and pension funds.

Since the formation of new financial assets by households far exceeded the new liabilities incurred, their net financial assets grew by just over 11 billion euro in the first nine months of the year. Conversely, the financial transactions of the two resident debtor sectors led to an increase in their net debts of almost 5 billion in the case of the government and 2 billion for non-financial corporations.

7.2 Households

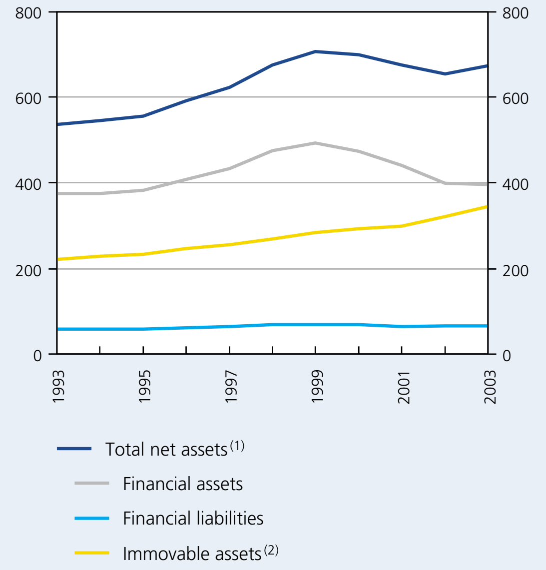
The gross financial assets of households fell sharply between 1999 and 2002, mainly as a result of the slump in stock market prices. Since then, they have stabilised at around four times the level of gross disposable income. In contrast, in the case of immovable assets, the growth rate which had been moderate until 2001 quickened significantly during the ensuing two years, mainly as a result of the rise in the prices of housing and building plots. At the end of 1999, gross financial assets represented roughly 63 p.c. of total gross assets, but by the end of 2003 that proportion had fallen to 53 p.c. On that date, after deduction of their financial liabilities – consisting largely of mortgage loans – households had total net assets of 1,156 billion euro, or almost seven times their gross disposable income.

In the past ten years, shifts have taken place between the counterparties with whom individuals hold assets. Thus, the share of the financial institutions gradually increased from 55.9 p.c. at the end of 1993 to 63.1 p.c. at the end of September 2004. Changes also took place among these institutions, so that the share of the MFIs gradually declined in favour of institutional investors, primarily insurance companies followed by non-monetary UCIs.

The growth of the overall market share of the financial institutions took place at the expense of that of the non-financial corporations which, by the end of September 2004, accounted for only 11.7 p.c. of the assets held by individuals, compared to 15.1 p.c. at the end of 1993. Between the end of 1993 and the end of September 2004, the share of the government declined from 3.7 to 1.8 p.c. The proportion of financial assets which individuals hold abroad initially increased, from 25.3 p.c. at the end of 1993 to 30.3 p.c. at the end of 1997, before declining to 23.4 p.c. at the end of September 2004.

CHART 62 ASSETS OF HOUSEHOLDS

(End of period, percentages of gross disposable income)



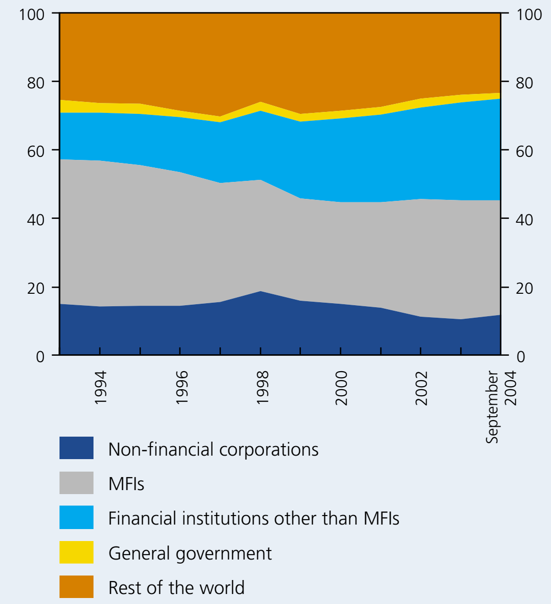
Sources : NSI, Stadim, NBB.

(1) Total net assets are the sum of the financial and immovable assets less the financial liabilities.

(2) The immovable assets recorded here refer exclusively to housing and building plots. The stock is valued on the basis of the average annual selling prices of housing and building plots.

CHART 63 FINANCIAL ASSETS OF HOUSEHOLDS : BREAKDOWN BY COUNTERPARTY SECTOR

(End of period, percentages of the outstanding total)



Source : NBB.

This fall is undoubtedly attributable in part to capital losses, particularly on foreign shares. Tax considerations may also have been a factor. The chance to avoid the withholding tax on income from movable assets has certainly encouraged Belgians to build up financial assets abroad on a massive scale in recent decades. There will probably be much less chance of doing that in the near future, following the likely implementation in mid 2005 of the European directive on the taxation of savings (for more details, see box 16). This may be one of the factors motivating individuals to scale down their foreign assets in anticipation, during the year under review.

Box 16 – The European directive on the taxation of savings

It has long been recognised that the continuing integration and liberalisation of the financial markets could not lead to a level playing field so long as the Member States had tax rules which, being designed solely to attract economic and financial activities from other Member States, distort that competition. This applies to tax rules which permit the collection of income from movable assets in a neighbouring country while avoiding the payment of tax.

There have been several moves to abolish these systems. Thus, in the 1990s, the European Commission devised a "tax package" containing not only a proposal for a uniform tax treatment of interest income, but also measures to eliminate forms of business taxation commonly described as harmful.

Gradually, a compromise was reached. When the discussions began, it was still thought that the exchange of information would be combined with deduction at source, but the European Council held in Santa Maria de Feira on 19 and 20 June 2000 finally decided in favour of the exchange of information. Under that arrangement, the tax authority of the country in which a non-resident has received income from movable assets automatically forwards all relevant information to the authority of that person's country of origin. Belgium, Luxembourg and Austria may temporarily replace that exchange of information with deduction at source for non-residents (15 p.c. from 1 July 2005; 20 p.c. from 1 July 2008; 35 p.c. from 1 July 2011). However, once agreement on the exchange of information has been reached with third countries – starting with Switzerland – being an agreement which the Member States deem equivalent to the established system of automatically exchanging information, Belgium, Luxembourg and Austria will also be required to adopt that system. The Member States which apply deduction at source keep 25 p.c. of the revenue collected and transfer 75 p.c. to the Member State of residence of the person actually receiving the interest.

This agreement was embodied in Directive 2003/48/CE of 3 June 2003 (Official Journal of 26 June 2003) on the taxation of savings income in the form of interest payments. The directive was initially intended to come into force on 1 January 2005. However, this was conditional upon the conclusion of appropriate agreements with third countries (Switzerland, Liechtenstein, San Marino, Monaco and Andorra) and with dependent or associated territories (the Channel Islands, the Isle of Man and the dependent or associated Caribbean territories). These agreements have since been concluded, but Switzerland has been unable to guarantee that it will be ready, owing to the uncertainty caused by the possibility of a referendum. The entry into force of the directive has therefore been postponed to 1 July 2005. If a referendum is in fact held in Switzerland, a further delay cannot be ruled out.

The new rules apply to all investors who are natural persons – companies are not affected – from the twenty-five EU Member States who receive interest income in another EU Member State. There is no change in the case of investors who collect their interest income in their own country.

All investment incomes which can be classed as interest are covered by these new regulations:
- interest on sight deposits, savings accounts and term accounts;
- interest on savings notes and bonds, including zero coupon bonds, issued after 1 March 2001. Bonds issued before 1 March 2001 are covered by the "grandfathering clause" (historical precedence) and are not covered by the new regulations;
- coupons – or capital gains – on funds investing more than 40 p.c. of their assets in interest-bearing instruments.

The following are among the items not covered by the new regulations:
- dividends and capital gains on equities and funds in which equities form 60 p.c. or more of the assets;
- insurance contract incomes.

This directive could have important implications for the investment behaviour of Belgian individuals who, compared with the residents of other Member States in the euro area, hold proportionately more assets abroad. Since the political agreement on the main points of the directive had already been drawn up in 2000, many individuals may have adjusted their financial asset portfolio in advance, despite the uncertainty over the date of entry into force of the directive.

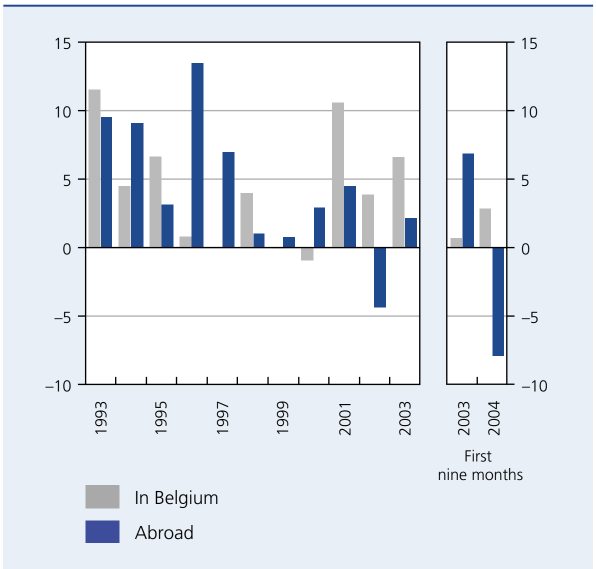
The one-off tax regulation may also have encouraged some individuals to rearrange their assets before the actual introduction of the directive. The law introducing the one-off tax regulation came into force on 16 January 2004 and gave all taxpayers, resident or not, permission to regularise their tax position by paying a single contribution which would confer exemption from all fiscal charges and guarantee immunity from prosecution. This measure was aimed primarily at incomes from movable assets on which the tax due in Belgium had not been paid. Formally, the one-off tax regulation concerned sums of money, capital and securities placed on an account abroad before 1 June 2003, and securities not placed in an account but also held before that date. Taxpayers had until 31 December in the year under review to submit their declarations to banks, investment firms and insurance companies, or to the FPS Finance when choosing to keep these assets abroad. The penalty charged on the amounts declared was 9 p.c. However, declarants could ask to pay a reduced rate charge of 6 p.c. if they decided to invest the corresponding funds for a minimum of three years in certain categories of assets. To take advantage of this offer, an additional 6 p.c. had to be frozen by way of guarantee ; that sum will accrue to the Treasury on 1 July 2008 if the investment obligation is not respected.

It is difficult to identify how the possible anticipation of the entry into force of the directive has influenced the investment behaviour of Belgian individuals, as other factors may also have played a role. Apart from the appraisal of financial market opportunities, there are also technical or tax factors that determine the decisions of individuals : the development of tax-free domestic products, a possible preference for dematerialised securities, the effectiveness of measures to control tax evasion or avoidance, the application of inheritance tax rules which vary in strictness, etc. It must be said that, for several years now, a number of developments concerning these factors have been tending to make it less attractive for individuals to hold financial assets abroad.

Comparison of the transactions of Belgian individuals investing – in Belgium and abroad – in asset categories covered by the directive may be instructive. Examination of the pattern of Belgian individuals' interest-bearing investments reveals that the formation of foreign assets by those individuals has slowed down significantly since 1998, and that their preponderance over the formation of domestic interest-bearing assets has diminished. In 2002, for the first time during the period under review, individuals reduced their foreign assets while their domestic assets continued to grow at a modest rate. In 2003, the formation of assets abroad recovered slightly, but a further marked decline in those assets occurred during the first nine months of 2004, while demand for

FORMATION OF INTEREST-BEARING ASSETS (1) BY INDIVIDUALS

(Billions of euro)



Source : NBB.

(1) Deposits, fixed-income securities and units in monetary and bond UCIs.

domestic assets remained positive. These opposing movements by foreign and domestic interest-bearing assets could reflect the anticipation of the European directive on the taxation of savings, which would thus have influenced the savings behaviour of Belgian individuals even before it actually comes into force.

As already mentioned in the 2003 Report, the figures on foreign assets held by households should nevertheless be interpreted with caution because, in the Belgian financial accounts, the assets of households are usually estimated as a balance, which implies that any error in the recording of financial assets of other sectors inevitably affects the data on individuals. Furthermore, the data concerning outstanding amounts are chiefly compiled on the basis of the cumulative flows of the balance of payments, with subsequent revaluation based on various assumptions. However, the records do not pick up asset conversions which take place directly in another country.

According to the methodology of the financial accounts compiled by the Bank, an asset is classed as foreign solely on account of the debtor's residence, not the currency in which the asset is denominated or the place where it is held. Thus, for instance, a dollar deposit in an account with a Belgian bank will be regarded as a domestic asset, while American bonds deposited with the same bank will be classified among foreign assets. Furthermore, the units of Belgian UCIs are recorded as domestic assets even if those UCIs have a portfolio of foreign securities.

Thus, deposits, fixed-income securities and units in monetary UCIs or UCIs investing essentially in bonds are regarded as subject to the new European regulations. However, that is still only an approximation of the interest-bearing assets actually governed by the savings directive. Thus, all fixed-income securities have been taken into consideration, including bonds issued before 1 March 2001 which do not fall within the scope of the directive. On the other hand, transactions concerning mixed funds which invest more than 40 p.c. of their assets in bonds are not covered by the definition adopted in this box in respect of interest-bearing assets.

Formation of financial assets

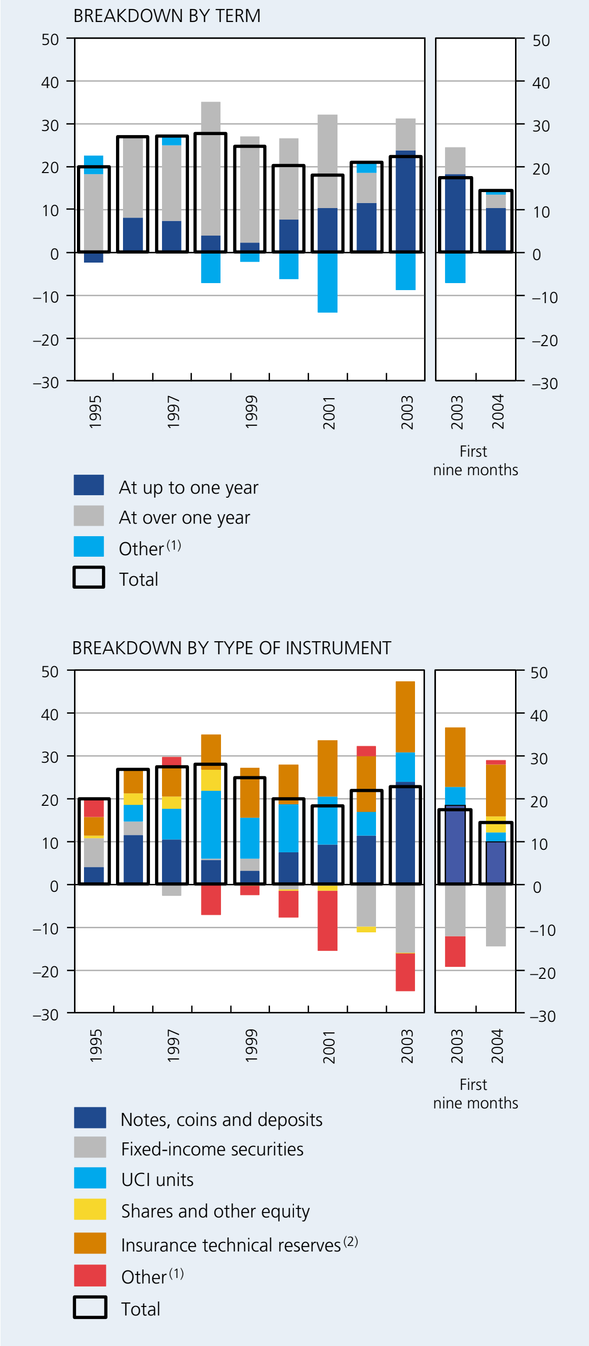
The formation of financial assets by individuals slowed down slightly during the first nine months of 2004, totalling 14.5 billion euro against 17.4 billion during the corresponding period of the previous year. For the third consecutive year, Belgian households displayed a preference for short-term investments, although it was less marked than in 2003 : over two thirds of their new financial investments concerned assets at up to one year. The attractiveness of liquidity is due largely to the low opportunity cost of holding cash, but also to the uncertainty regarding the economic outlook and financial market performance. Thus, the proportion of short-term investments in the financial portfolio of households increased from 26.7 p.c. at the end of 2001 to 32.8 p.c. at the end of September 2004.

In particular, during the year under review, individuals formed assets worth 10 billion euro in the form of notes, coins and deposits. This asset formation, representing a substantial percentage of new investments, is nonetheless more modest than the 18.6 billion increase recorded in the previous year. The bulk of this asset category comprises savings deposits, where movements are closely linked to changes in interest rates. Thus, the difference between the interest rate on regulated savings accounts and the five-year net yield on linear bonds, which was almost zero in the first half of 2003, subsequently widened slightly in favour of government loans. These conditions tempered the enthusiasm of individuals for savings deposits : whereas in the first nine months of 2003 the volume of savings deposits had increased by 12.1 billion euro, that growth declined to 7.6 billion over the corresponding period of the year under review.

Although they exceeded the interest rates on savings deposits, bond yields were not high enough to encourage investments in fixed-income securities. The decline in the volume of bonds and savings notes held by households – already very marked in 2003 – accelerated in 2004 : as at 30 September in the year under review, the portfolio of households contained 16.7 p.c. fewer fixed-income securities than a year earlier. This lack of enthusiasm is probably due to the persistent weakness of the long-term return on this type of investment : the yield on ten-year benchmark government loans has averaged only 4.1 p.c. over the past two years.

CHART 64 FORMATION OF FINANCIAL ASSETS BY HOUSEHOLDS

(Billions of euro)

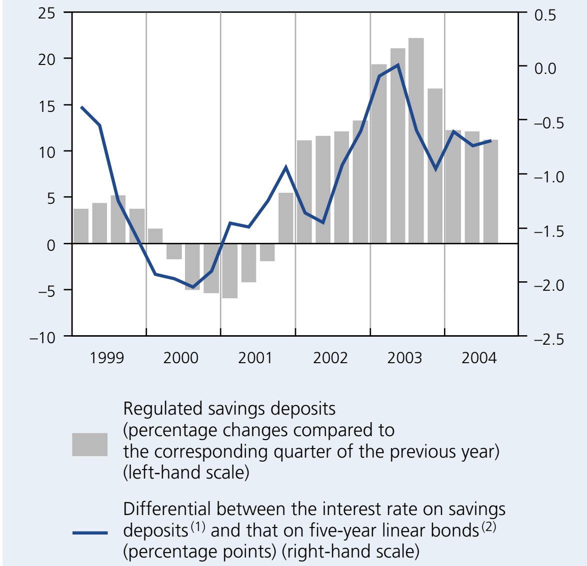


Source : NBB.

(1) Includes transitional items and statistical adjustments.

(2) This item essentially comprises the net claims of households on life insurance reserves and pension funds.

CHART 65 SAVINGS DEPOSITS OF HOUSEHOLDS AND INTEREST RATE DIFFERENTIAL



Source : NBB.

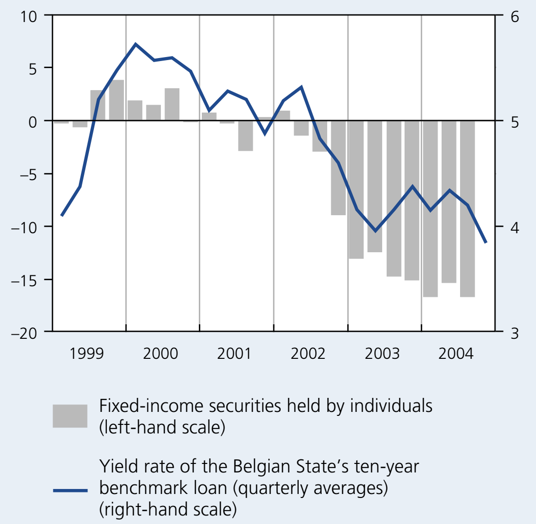
(1) Implicit interest rate on regulated savings deposits as indicated by the profit and loss accounts of credit institutions ; quarterly averages.

(2) Net yield on the secondary market in linear bonds with a residual term of five years, the movement in which is taken as an indicator of the movement in the interest rate on investments competing with savings deposits ; quarterly averages.

During the year under review, households appear to have switched part of their savings to riskier investments, as net acquisitions of equities – totalling 3.7 billion euro during the first nine months of 2004 – were recorded for the first time since 1998. Part of this revival of enthusiasm is related to the recent performance of shares listed on Euronext Brussels. Apart from these acquisitions, that performance also accounts for much of the rise in the volume of equities in the household portfolio : increases in share values represented 12.5 billion euro during the first three quarters. The assets invested with insurance companies and pension funds expanded by a total of 12.2 billion euro during the first nine months of 2004, a slightly smaller rise than that recorded over the same period of the previous year. Finally, new investments in UCI units totalled 2 billion euro. Once again, individuals demonstrated their preference for index UCIs with capital protection : these funds received a total net inflow of more than 3 billion euro, at the expense of equity and bond UCIs, which saw negative investment flows.

CHART 66 FIXED-INCOME SECURITIES HELD BY HOUSEHOLDS AND LONG-TERM YIELD RATES

(Percentage changes compared to the corresponding quarter of the previous year, except for the yield rate)



Source : NBB.

New financial liabilities

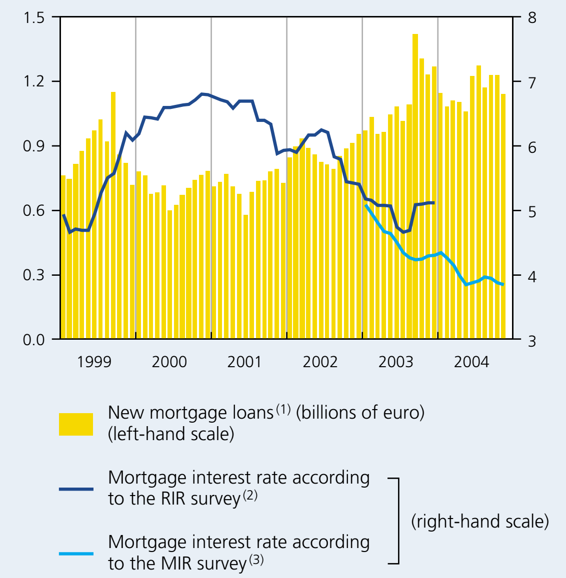
During the first nine months of the year under review, the new financial liabilities of individuals totalled 3.2 billion euro, a figure comparable to that recorded over the corresponding period of the previous year. As in 2003, home loans represented the major part of the debts contracted by households. The gross amount of mortgage loans taken out during the first eleven months of 2004 increased by more than 5 p.c. against the corresponding period of the previous year – when growth was already exceptional – thus reaching a total of 12.8 billion euro. There was in fact a renewed fall in mortgage interest rates, encouraging decisions to invest in the acquisition of property : during the first eleven months of the year under review, the weighted average interest rate on mortgage loans was only 4 p.c., according to the latest results of the MIR survey, analysed in greater depth in box 17. In addition to the movement in capital market interest rates, the low level of mortgage rates is also due to the competition between the lender institutions. In the fourth quarter, in particular, the leading banks made substantial cuts in their advertised rates. The aim was to preserve their market shares, which had for some time been eroded by smaller banks. While this move did not necessarily lead to a reduction in the rates actually charged, it does promote the transparency of rates on the mortgage loan market, while also attenuating the effect of the unequal bargaining position between households.

Two factors contributed to the growth of the volume of mortgage loans : while the low level of interest rates undeniably affected the number of borrowers, it also influenced the average amount borrowed, as did the rise in prices on the housing market. Between 2002 and 2003, the average amount of the mortgage loans granted increased by almost 21 p.c., mirroring the rise in the average selling price of a home.

Households seem to be increasingly inclined to reduce the burden of charges on their loans at the start of a contract. That is demonstrated by the exponential growth of the market share of all new lending represented by loans at annually variable rates, for which the initial period of fixity is generally less than three years. In August 2004, that proportion totalled 68 p.c., against barely 4 p.c. five years earlier. Conversely, the share of fixed-rate contracts, which peaked at over 73 p.c. in 1999, represented just 30 p.c. of loans contracted during the first eight months of the year under review. However, this new trend calls

CHART 67 NEW MORTGAGE LOANS TO HOUSEHOLDS AND INTEREST RATES

(Monthly data)



Sources : PLU, NBB.

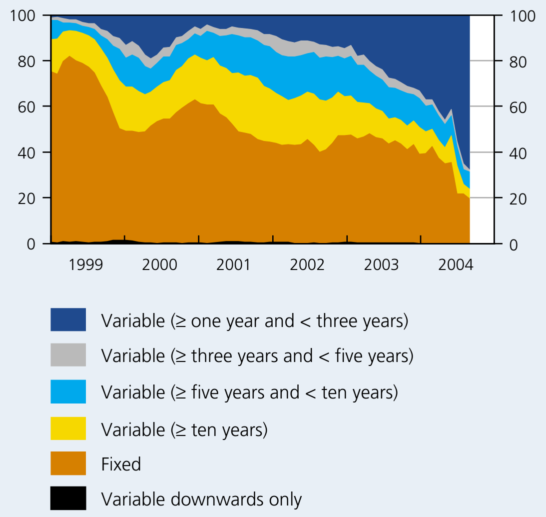
(1) Seasonally adjusted gross flows, excluding those relating to the refinancing of existing loans.

(2) Rate for a twenty-year loan, subject to five-yearly revision and wholly covered by a mortgage.

(3) 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.

CHART 68 BREAKDOWN OF NEW MORTGAGE CONTRACTS BY TYPE OF RATE (1)

(Monthly data, percentages of total)



Source: PLU.
(1) The wording in brackets refers to the period for which the rate is initially fixed.

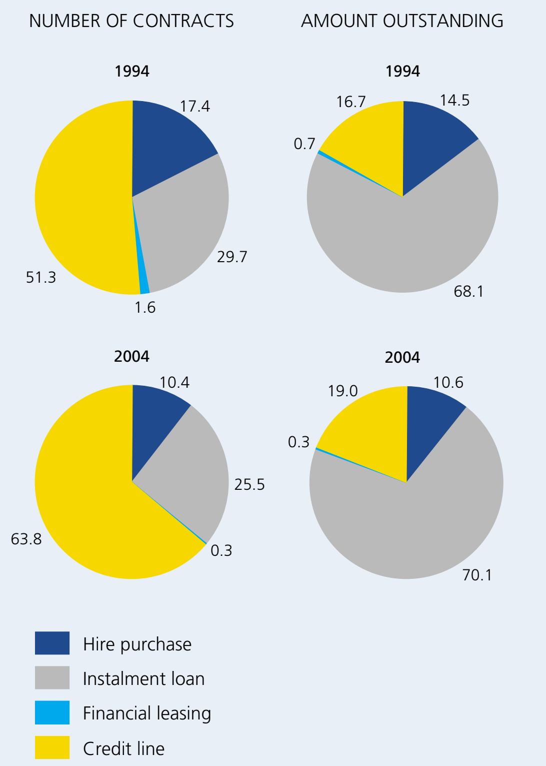
for special vigilance, as variable rate contracts expose individuals to future fluctuations in credit terms. Recently, thanks to the low level of interest rates and despite the constant rise in mortgage debt levels, the proportion of household disposable income devoted to the payment of monthly instalments during the first year of the loan repayment has remained steady at around 30 p.c. If borrowing became more expensive, the situation would be different.

Nonetheless, there are safeguards limiting the risks incurred by households contracting a variable rate mortgage loan. On the one hand, there are contractual limits restricting the degree to which the interest rate may vary, up or down, from its initial value. In all cases, there is a legal maximum on the increase in the initial rate, set at 1 percentage point in the second year and 2 percentage points in the third year, provided the initial fixed rate period is less than three years. Also, if interest rates rise, the borrower can generally avoid the increase in the monthly payments by opting for an extension of the loan period. Thus, the Central Office for Credits to Individuals will probably continue, in the future, to record a low and relatively constant default rate on mortgage loans: it is estimated that payment default concerns only 2 p.c. of home loans.

Over the first six months of 2004, outstanding consumer credit grew by 2.6 p.c., or 355 million euro, a more substantial rise than during the corresponding period of 2003 (209 million euro). This acceleration could stem from the improvement in the economic situation as well as from the modest level of interest rates. Instalment loans make up the bulk of the total borrowed for consumption. As at 30 June 2004, they represented 70 p.c. of the outstanding consumer loans, but only 26 p.c. of the number of existing contracts. Conversely, the market share of credit lines was just 19 p.c. of the volume of loans, whereas it accounted for 64 p.c. of the number of contracts. This paradox can be explained by the larger average amounts involved in instalment loans, and by the limited actual use of the credit lines granted. Over the past ten years, both the number and the amount of credit lines have risen in terms of their relative share. This trend coincides with the growing power of non-bank lenders on the credit market, at the expense of the financial institutions. The non-bank lenders, comprising mainly supermarket chains, mail order companies and finance companies, accounted for 18 p.c. of the outstanding amounts due on consumer

CHART 69 CONSUMER CREDIT: BREAKDOWN BY FORM

(Data as at 30 June, percentages of total)



Source: NSI.

loans in mid 2004, against 12 p.c. ten years earlier. The proportion is even higher in the case of defaulting loans: 26 p.c. of the amount of consumer loans in default concerned contracts concluded with non-bank lenders. Altogether, around 10 p.c. of consumer loans were recorded as defaulting by the Central Office for Credits to Individuals. Against that background, the entry into force on 1 January 2004 of a series of provisions under the law of 24 March 2003 aimed at improving consumer protection should help to curb excessive debt levels. Some of the provisions of the legislation specify that, from now on, the lender institution must supply a prospectus containing financial information on the loans offered and give the option of full or partial repayment at any time.

Box 17 – The new harmonised survey of interest rates in the euro area[1]

At the end of 2003, the interest rate survey which ascertained the advertised rates offered by Belgian credit institutions on standard contracts (RIR), was terminated and replaced by a new survey harmonised at European level (MIR). Since January 2003, this survey has recorded a wide range of contractual rates which MFIs charge their customers throughout the euro area. The categories listed by this survey contain products with similar characteristics, though there may be marked differences in commercial terms. This survey therefore no longer permits comparisons of rates between specific banking products. On the other hand, the conditions granted on the main categories of bank loans and deposits are easier to compare at euro area level.

The results recorded during the first eleven months of 2004 reveal that the interest rates charged on sight deposits and term deposits at up to one year, held by individuals, differ little between Belgian banks and banks in the euro area. On the other hand, more substantial differences are found for the other deposit categories. Term accounts at over one year in fact attract a higher rate of interest in Belgium, whereas traditional savings deposits, included in the category of deposits redeemable at less than three months' notice, enjoy higher rates in the euro area. In this connection, the exemption from the withholding tax on income from movable assets, applicable to interest on savings deposits up to a certain maximum in Belgium, does to some extent attenuate the difference recorded in relation to the euro area, if comparison is made between the incomes actually received.

As regards loans to households, while the mortgage lending rates in Belgium are very similar to the average rates in the euro area, overdrafts are more expensive. In the case of consumer loans, there are divergences in varying directions, but the annual percentage rate of charge (APRC), which represents an average of all the rates charged, weighted according to new business, and also takes account of the charges associated with borrowing, is similar to the average for the euro area.

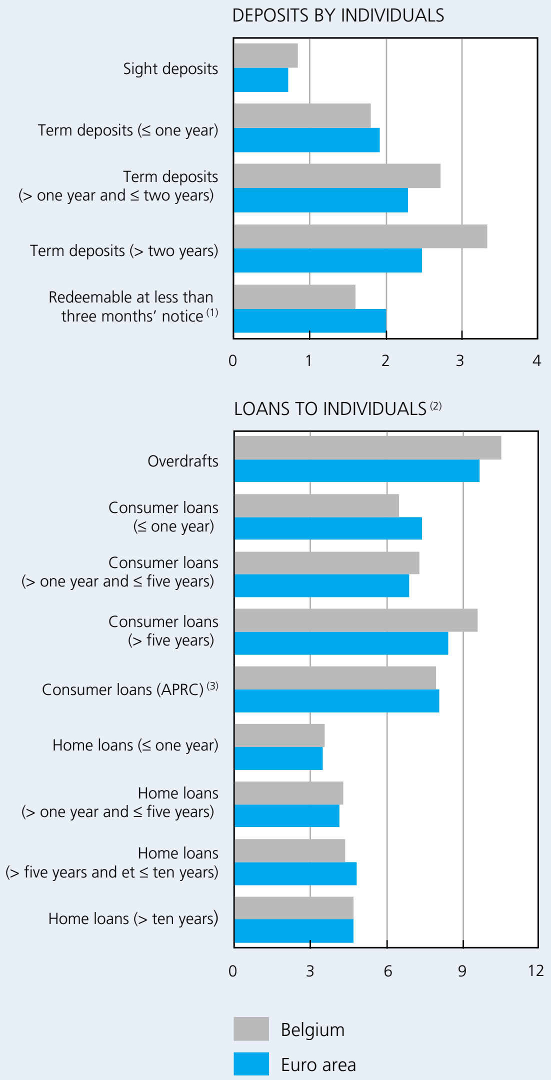
In the case of loans to non-financial corporations[2], the rate hierarchy shows effects concerning amounts, duration and risk in both Belgium and the euro area. Thus, the contractual rates are in inverse proportion to the size of the loan, owing to the existence of overheads, but they may also reveal a negative correlation between the size of the borrower enterprise and the assessment of the risk. The rates charged increase with the duration of the loan, as one would expect from the positive slope of the risk-free yield curve over the period considered, but it is also possible that the credit providers associate a higher risk with longer term loans. With the exception of overdrafts, which are considerably more expensive in Belgium, it seems that the rates which Belgian banks charge their customers are similar overall to those of their colleagues in the euro area. At the level of the categories which were most representative in terms of activity during the first eleven months of 2004 in Belgium and in the euro area – namely, loans on which the rate was initially fixed for a period of less than one year – the rates charged by Belgian banks were slightly below the European average.

(1) For more information on the new survey, cf. *Determinants of Belgian bank lending interest rates*, Baugnet V. and Hradisky M. (2004), Economic Review, NBB, 3rd quarter, pp. 43-58.

(2) The harmonised survey also compiles the rates on deposits placed with banks by non-financial corporations, which are not discussed in this box.

INTEREST RATES ON DEPOSITS BY AND LOANS TO INDIVIDUALS

(Averages over the first eleven months of 2004, new contracts)



Sources: ECB, NBB.

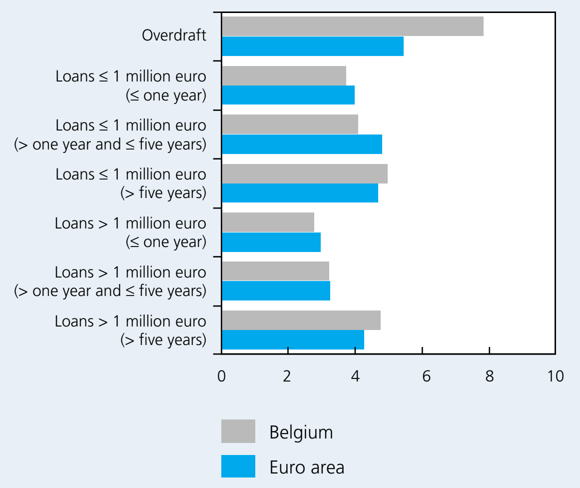
(1) In Belgium, this category includes regulated savings deposits.

(2) The wording in brackets refers to the period for which the rate is initially fixed.

(3) Annual percentage rate of charge, taking account of all the credit terms: the pace of repayment of the capital, the payment of interest and any charges connected with the granting or administration of the loan.

INTEREST RATES ON LOANS TO NON-FINANCIAL CORPORATIONS [1]

(Averages over the first eleven months of 2004, new contracts)



Sources: ECB, NBB.

(1) The wording in brackets refers to the period for which the rate is initially fixed.

7.3 Non-financial corporations

During the first nine months of 2004, the new financial liabilities of non-financial corporations totalled 19.5 billion euro, a sizeable increase on the 9.9 billion euro recorded in the corresponding period of the previous year. As in earlier years, the major part of these new liabilities took the form of loans between non-financial corporations, while little use was made of other sources of finance.

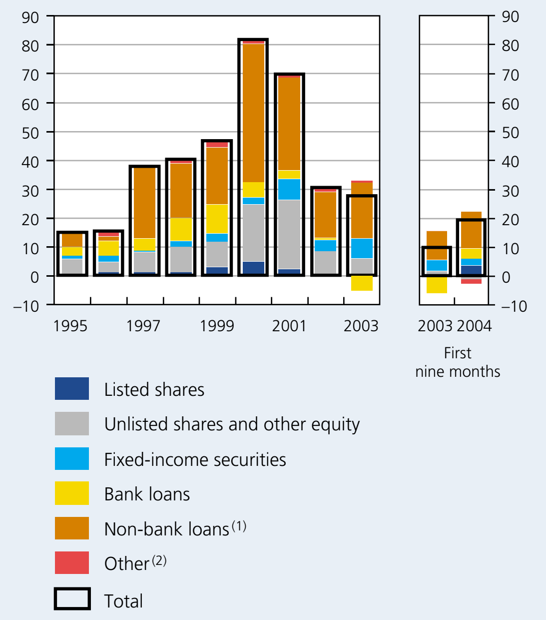
Financing between non-financial corporations

In order to obtain a more exhaustive set of information, it was decided that the financial accounts should henceforward include intra-sectoral loans by non-financial corporations. This term covers loans concluded between two separate Belgian enterprises, most of them being arranged between entities belonging to the same group, particularly via coordination centres or holding companies. This methodological adjustment does not affect the financial balance of non-financial corporations, but it does influence the respective share of each instrument in their financial balance sheet.

Intra-sectoral loans are a key source of finance for Belgian non-financial corporations, since they have represented, on average, one third of their new financial liabilities over the past ten years. The financial links between Belgian enterprises, which are not confined to loan transactions but also consist of equity investments, were already considerable at the end of 1993, representing 27 p.c. of the liabilities of non-financial corporations. They have continued to expand over the past ten years, and by the end of 2003 they amounted to over 44 p.c. of the liabilities of non-financial corporations. Furthermore, this trend was not confined to transactions between residents, but also had an international dimension. Thus, out of the growing share of the finance which Belgian firms received from abroad, up from 23 p.c. at the end of 1993 to 34 p.c. at the end of 2003, the major part came from non-banks. The development of closer financial links between Belgian firms and their Belgian or foreign colleagues took place to the detriment of direct financing by individuals and credit granted by Belgian banks.

CHART 70 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.
(2) Technical reserves of non-autonomous pension funds and transitory items.

Bank loans

While the outstanding amount of bank loans to Belgian non-financial corporations had contracted sharply in 2003, it recovered somewhat during the first nine months of the year under review. In real terms, however, with adjustment for the effect of exchange rate fluctuations and sectoral reclassifications, it remained more or less steady, ending the third quarter of 2004 at a level 0.2 p.c. below the figure achieved a year earlier. The brighter economic outlook and the still historically low level of interest rates were probably the reasons for the turnaround in bank lending to non-financial corporations.

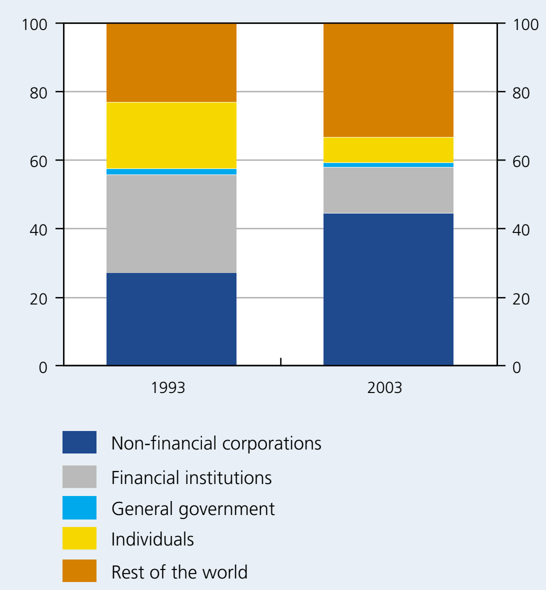
The Central Credit Office data – which permit a distinction according to the size of the debtors but differ from those of the financial accounts since, in particular, they cover only loans granted by Belgian banks and include loans to non-monetary financial intermediaries excluding insurance companies and pension funds – present a picture which varies for firms of different sizes. Thus, the contraction in lending which has been in progress for some years appears to have affected mainly large and medium-sized enterprises, while the amounts of credit used by small firms continued to expand. During the first nine months of 2004, however, the rate of expansion in the use of credit by small firms slowed down slightly, while large and medium-sized enterprises recorded a small rise in the amount of credit used.

The percentage of credit lines used, which compares the amounts borrowed with the credit lines authorised, offers some information on the scale of the effects of supply and demand on the pattern of bank lending. The percentage of credit lines used shows a negative link with the size of the enterprise. Moreover, during the last three years, small firms have made steadily increasing use of credit facilities, bringing the usage rate close to 85 p.c. in 2004.

In order to ensure optimum treatment of the question of SME finance in Belgium and to increase the transparency of the link between banks and SMEs, a code of conduct was signed during the year under review between the main protagonists, namely the Belgian Bankers' Association and the main organisations representing businesses and small firms and traders (FEB, Agoria, Unizo, UCM). In practice, by signing this code the banks have undertaken to pursue a policy of transparency when deciding whether to grant credit, and to inform firms of

CHART 71 FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS : BREAKDOWN BY COUNTERPARTY SECTOR

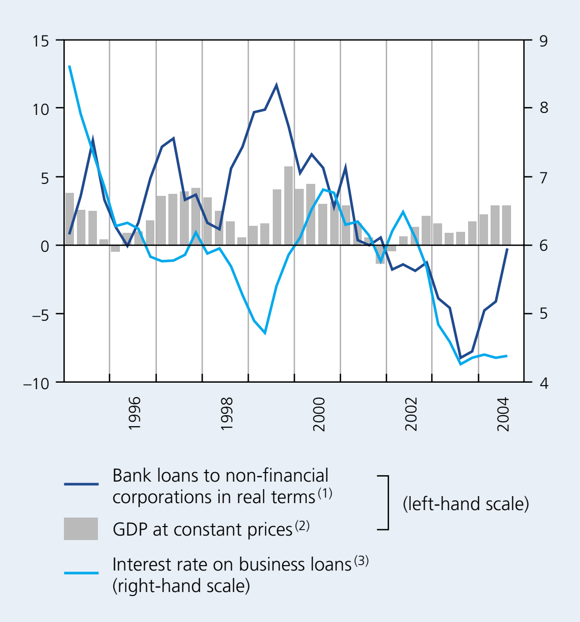
(End of period, percentages of the outstanding total)



Source : NBB.

CHART 72 BANK LOANS TO NON-FINANCIAL CORPORATIONS, GDP AND INTEREST RATES

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



Source : NBB.

(1) Loans by Belgian and foreign credit institutions, end-of-quarter data adjusted for the effects of exchange rate movements and sectoral reclassifications, and divided by the deflator of GDP.

(2) Data adjusted for seasonal variations and calendar effects.

(3) Weighted quarterly average of interest rates on loans to non-financial corporations, taken from the RIR survey (up to 2002) and the MIR survey (from 2003). The weighting is based on the share of the various loans in the total outstanding amount of loans granted to non-financial corporations.

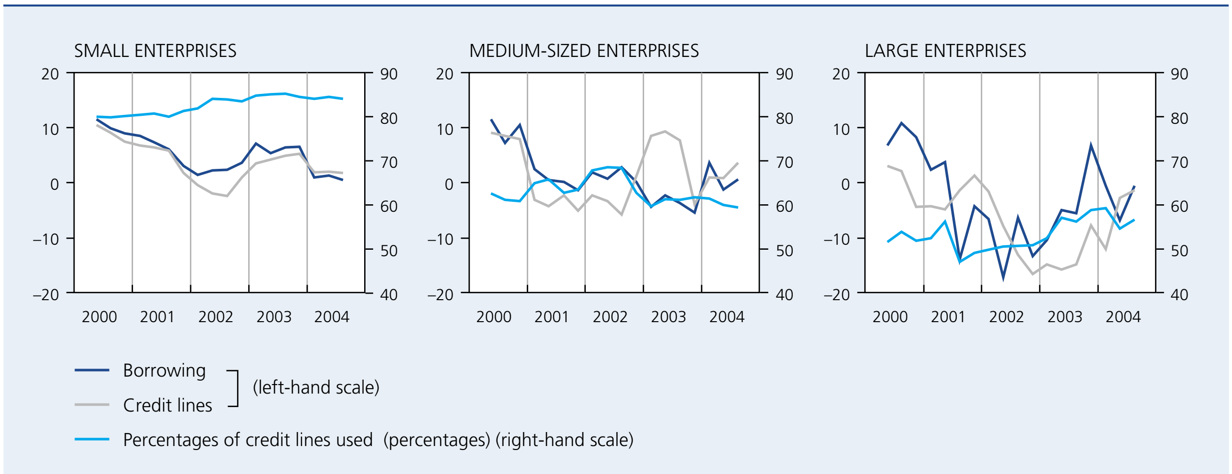
the existence of public financial aid systems. In addition, a "Contact Point" which was opened on 1 November 2004 is available to receive complaints from SMEs against their credit providers, to examine whether the complaints are admissible and to pass the matter on to the banks concerned, which must then justify their decision. Analysis of these complaints should permit a collective assessment of the problems facing SMEs in the process of obtaining credit, so that appropriate solutions can be provided.

As in 2003, large and medium-sized enterprises did not take maximum advantage of their credit options, which suggests that demand factors dominated the movement in bank lending. The same thing emerges from the Eurosystem's bank lending survey, which is a source of information on the credit supply and demand conditions. Both Belgian banks and their counterparts in the euro area stated that they had kept their credit standards unchanged, or even relaxed them slightly during the year under review. The Belgian banks also stated that they had faced fluctuating demand in 2004, which recovered strongly in the second quarter before contracting and finally stabilising. Demand from enterprises in the euro area seems to have been more stable.

In all, the very modest improvement in demand for loans in 2004, while the economic recovery which had begun in mid 2003 was gathering strength, is due to the delayed revival in business investment and the marked rise in corporate profits. By increasing the internal resources

CHART 73 LOANS GRANTED BY BELGIAN CREDIT INSTITUTIONS TO CORPORATIONS, BY SIZE OF ENTERPRISE (1), ACCORDING TO THE CENTRAL CREDIT OFFICE

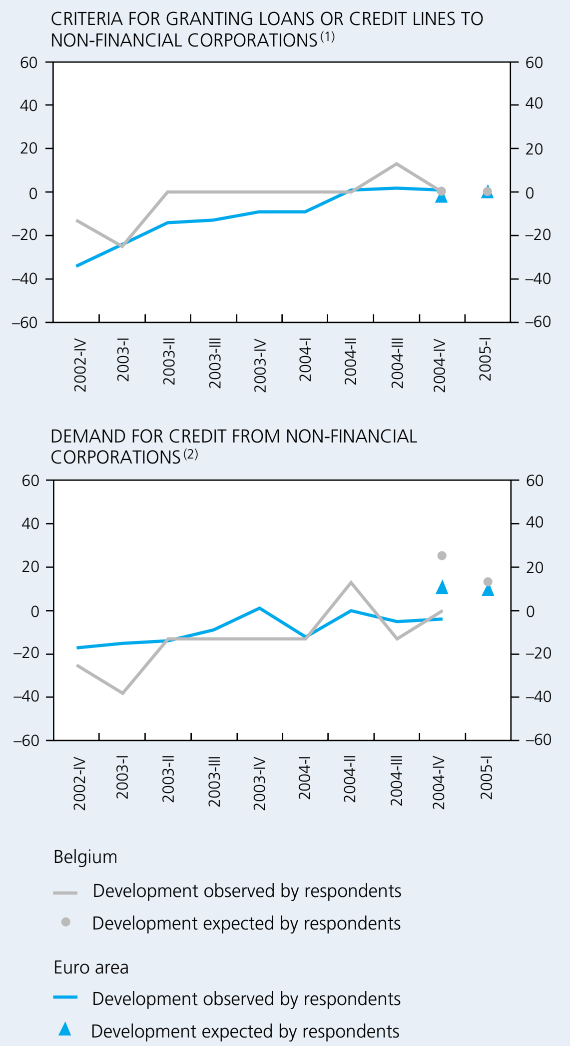
(Percentage changes in amounts outstanding compared to the corresponding quarter of the previous year, unless otherwise stated)



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.

CHART 74 RESULTS OF THE EUROSYSTEM'S BANK LENDING SURVEY



Sources : ECB, NBB.
(1) Balance of replies indicating the degree of easing or tightening (–) of the credit standards applied to the approval of loans or credit lines.
(2) Balances of replies indicating the degree of increase or decrease (–) in demand for credit.

of firms, this rise reduces demand for external sources of finance. In addition, in view of the high debt levels attained in the recent past, some firms probably allocated part of their profits to debt restructuring or reduction.

As regards the first quarter of 2005, the Belgian banks stated that they expected to see stronger demand for business loans, and planned to leave their credit standards unchanged.

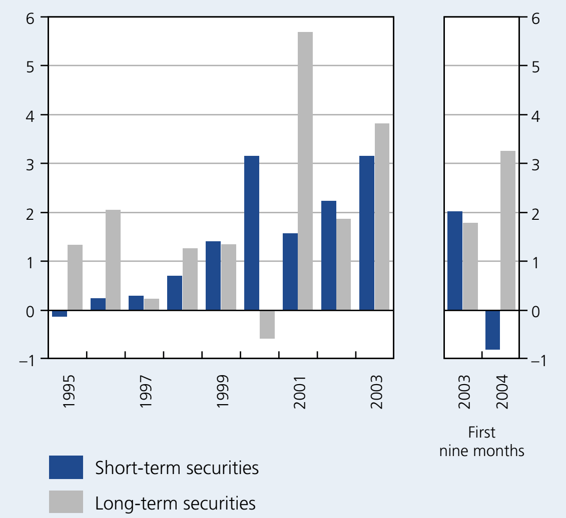
Shares

The Belgian and European stock market indices maintained their upward trend which had begun in 2003. The performance recorded by the Euronext Brussels broad index, namely a rise of 36.5 p.c. between December 2003 and December 2004, outstripped that seen in the comparable index for the euro area by a substantial 26 percentage points. The buoyancy of the Belgian stock market is due mainly to a process of catching up with the other European stock markets in terms of price-earnings and price-dividend ratios, and was also influenced by the size and sectoral focus of Belgian companies included in the stock market indices (see also box 18). However, it did not lead to any increase in net issues of quoted shares. In fact, leaving aside the transaction which gave rise to the establishment of the Inbev group and boosted net issues by 3.3 billion euro, net issues of quoted shares totalled only 400 million euro during the first nine months of 2004.

Fixed-income securities

In Belgium as in the euro area as a whole, European monetary unification led to a rise in direct issues of fixed-income securities by non-financial corporations on the money and capital markets. Thus, in Belgium, these liabilities grew strongly, their volume having more than

CHART 75 NET ISSUES OF FIXED-INCOME SECURITIES BY NON-FINANCIAL CORPORATIONS
(Billions of euro)



Source : NBB.

Box 18 – Decoupling of Belgian and European stock market indices

The divergence between the performance of the Belgian stock market and that of other European stock markets is nothing new. In fact, from 1999 onwards the Belgian index ceased to be affected by the euphoria which had begun in the second half of the 1990s on the American and European markets, and the scale of the ensuing correction in 2000 and 2001 was not as great.

In consequence of their moderate price movements, Belgian firms had recorded a below-average price-earnings ratio for the 1973-2004 period from mid 2000 onwards. On the basis of this criterion, Belgian equities were more than 11 p.c. undervalued at the start of the year 2004; the under-valuation amounted to 17 p.c. if calculated in relation to the average price-earnings ratio for the euro area. On the other hand, since euro area shares had experienced only a brief episode of undervaluation between mid 2002 and mid 2003, they recorded a price-earnings ratio which was about 4 p.c. higher than its long-term average at the beginning of 2004. On the basis of comparison of price-earnings ratios, Belgian shares remained more attractive than European shares until October 2004.

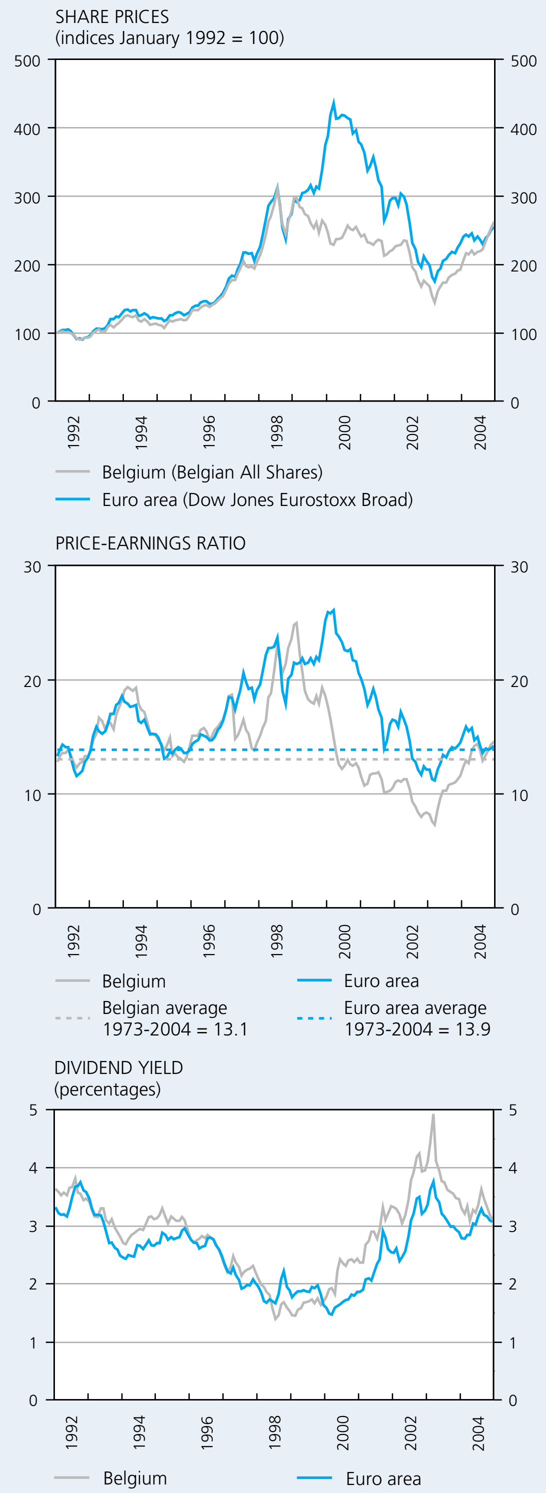
Together with a lower valuation, Belgian shares had for some years recorded a dividend yield well above the European average, produced by the combination of the more moderate price rise in recent years and a more generous policy of rewarding shareholders. It seems that, following the recent stock market turbulence, the dividend yield has become a more important factor influencing the purchase decisions of investors, particularly foreign ones. In December 2003 the average dividend yield on Belgian shares stood at 3.46 p.c., against 2.89 p.c. for European shares. By December 2004, price rises had lowered the dividend yield on Belgian shares to a level equivalent to that of European shares.

It is evident from the two factors mentioned above that the Belgian stock market's outperformance of its European counterparts in 2004 must be regarded mainly as a process of making up the leeway, following weaker results in the past.

Thirdly, the low level of capitalisation of Belgian firms worked in their favour. The Eurostoxx broad index includes only five Belgian firms among the two hundred largest companies in the euro area, and there are only eight in the next two hundred companies, listed as medium-sized enterprises. In 2004, international investors seem to have expressed a preference for enterprises of more modest size, generally focusing more on domestic markets and being less sensitive to the international macroeconomic climate. That hypothesis is confirmed by the better results achieved by other low capitalisation stock markets. In sectoral terms, it seems that financial stocks outperformed the market in general in 2004 in the euro area. In this connection, the large weight of the banking sector in the Belgian stock market index had a favourable impact on performance.

Finally, and in general, the Bel 20 companies achieved excellent results in 2004. Some of them were also involved in promising mergers or acquisitions, while others were the subject of persistent rumours on that subject, giving rise to speculative activity in the shares of the companies concerned.

STOCK MARKET PRICES IN BELGIUM AND IN THE EURO AREA
(Monthly averages)



Sources : Thomson Financial Datastream, Euronext Brussels.

tripled between the end of 1998 and the end of the third quarter of 2004. However, they still represent only a very small fraction – 3.5 p.c. at the end of September 2004 – of the total liabilities of non-financial corporations. Issues of fixed-income securities by non-financial corporations in Belgium are mainly private issues, though it is true that financial institutions may subscribe to them. On the whole, they have represented a form of funding reserved for the largest enterprises, which may help to explain the low level of bank lending to those enterprises in recent years.

During the first nine months of 2004, net issues of long-term securities were sustained while the short-term segment, consisting almost exclusively of treasury bills, recorded a negative flow, reflecting a volume of redemptions which outweighed the volume of issues.

7.4 General government

During the first nine months of the year under review, the financial position of general government deteriorated by 4.7 billion euro, a larger deficit than that recorded over the corresponding period of 2003. Both the formation of financial assets, totalling 3.8 billion euro, and the new liabilities of general government, amounting to 8.6 billion, significantly exceeded the flows recorded in the previous year. This expansion was due mainly to the transfer to the Ageing Fund, in 2004, of the money received by the Belgian State in 2003 when it took over the pension liabilities of Belgacom : that revenue, totalling 5 billion euro, was invested by the said Fund in "Ageing Fund Treasury Bonds", the instrument in which it is legally required to invest its assets. This transaction thus caused a simultaneous increase in the financial assets and liabilities recorded in the financial accounts of general government.

New issues

The new financial liabilities of general government essentially took the form of net issues of euro-denominated securities by the Treasury, for a cumulative total of 7.9 billion euro at the end of September, against 4 billion a year earlier. However, over 2004 as a whole, taking account of the decline in net issues by the Treasury at the end of the period, the outstanding total of debt securities was probably down.

In the segment comprising medium- to long-term financial instruments, the Treasury issued linear bonds totalling 22.4 billion euro in 2004, an amount comparable to the funds raised in the previous year. As in 2003, a new ten-year linear bond line was issued by syndication at the beginning of the year, then offered at each tender.

TABLE 40 FINANCIAL ASSETS AND LIABILITIES OF GENERAL GOVERNMENT
(Billions of euro)

	1999	2000	2001	2002	2003	2004	First nine months 2003	First nine months 2004
Formation of financial assets (1)	1.6	1.3	5.1	4.3	–4.4	n.	–2.0	3.8
New financial liabilities	2.6	2.0	4.8	5.3	–5.2	n.	1.7	8.6
Securities denominated in euro	2.0	4.4	5.6	5.8	–2.1	n.	3.1	8.2
of which :								
Treasury	2.9	5.2	8.5	5.4	–0.9	–1.5	4.0	7.9
At up to one year	–7.3	–4.0	1.7	–0.5	–0.3	–0.2	3.7	–0.1
At over one year	10.2	9.3	6.7	5.9	–0.6	–1.3	0.2	8.0
Other liabilities denominated in euro (1)	0.7	–0.6	0.6	0.7	–1.8	n.	–2.2	0.2
Liabilities in foreign currencies	–0.1	–1.8	–1.4	–1.2	–1.3	–1.2	0.7	0.1
of which :								
Treasury	–0.1	–1.8	–1.4	–1.2	–1.3	–1.2	0.7	0.1
Financial balance	–1.0	–0.7	0.3	–1.0	0.8	n.	–3.7	–4.7

Source : NBB.
(1) Including "Ageing Fund Treasury Bonds".

In addition, the year 2004 saw the launch of a new thirty-year benchmark loan. More than twice oversubscribed, the issue generated a great deal of interest among professional investors: the initial syndication raised around 5 billion euro for the Treasury, and the subsequent tranches allocated by tender brought in 1.8 billion. This new line of linear bonds extended the yield curve of the Belgian State's benchmark loans beyond the five, ten and fifteen year maturities, and beyond the previous very long-term linear bond maturing in 2028.

Public debt instruments reserved for private investors are usually issued in smaller quantities. In 2004, the Treasury's borrowings from Belgian households totalled under a billion euro. State notes represent the major part of these subscriptions. However, from March onwards the Treasury had offered individuals the chance to acquire linear bonds on the primary market, hitherto reserved mainly for professional investors. Each issue of traditional linear bonds was followed by a subscription period of five working days, intended for individuals. The latter were able to buy the linear bond, called the "OLOP" (linear bond for retail investors), at the weighted average tender price (or at the re-offer price in the case of syndication), plus a commission payable to the financial institution granted approval to distribute this product. The OLOP took account of the interest already accrued at the time of issue: it offered a short coupon, covering only the period between the acquisition date and the coupon date. From the first coupon date, any existing OLOP is fungible with the corresponding traditional linear bond.

The launch of the OLOP did not visibly dent the success of the State notes. As at 31 December, the cumulative total of OLOP subscriptions represented barely 30 million euro, whereas the Treasury issued State notes totalling 850 million euro in 2004. The experiment will therefore not be repeated in 2005. However, the linear bonds offered gross yields which were generally higher than those on State notes of a similar maturity. Moreover, they comprised a range of investment horizons; in contrast, State notes were only issued for five and eight years in 2004. Despite the OLOPs' attractive characteristics, a number of factors may explain their lack of success. Their novelty and the distribution costs claimed by the banks undoubtedly operated to their detriment. The dematerialisation of the OLOP is also a two-edged sword for the investor. In contrast to physical delivery, authorised for State notes, the registration of linear bonds in a securities account protects their holder against the risk of loss or theft, but makes it impossible to pass them on quietly to other people. The Securities Regulation Fund regulates the secondary market in OLOPs and ensures its liquidity, as it already does for linear bonds. Thus, private investors can buy or sell a linear bond on the securities market at any time, at the market price set by the Securities Regulation Fund.

TABLE 41 FINANCING REQUIREMENTS AND RESOURCES OF THE FEDERAL STATE
(Billions of euro)

	2003	2004
Gross balance to be financed	23.3	24.0
Gross financing requirements	15.3	19.5
Budget deficit or surplus (–) (1)	–2.4	–1.6
Medium- and long-term debt maturing during the year	17.7	21.1
In euro	17.1	20.1
In foreign currencies	0.5	1.1
Redemptions and exchanges (securities maturing the next year or later)	7.9	4.5
Other financing requirements	0.1	0.0
Means of financing	24.6	23.3
Medium- and long-term issues in euro	24.6	23.3
Linear bonds (OLOs)	23.3	22.4
State notes, OLOPs and others (2)	1.3	0.9
Medium- and long-term issues in foreign currencies	0.0	0.0
Net change in the short-term debt in foreign currencies	–0.8	–0.1
Net change in the short-term debt in euro and in financial assets	–0.5	0.9

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".

In contrast to 2003, the gross balance to be financed exceeded the amount of medium- and long-term issues, as the Treasury reduced its portfolio of assets while also making a small reduction in the outstanding amount of treasury certificates.

Management of the public debt

The budget balance has no need of funding from the Treasury, since it ended in a surplus, as in 2003. On the other hand, a sum of 21.1 billion euro was used to buy back or redeem loans maturing during the year under review. Also, the Treasury bought back securities maturing in 2005 or later for a total of 4.5 billion euro. This type of operation is intended to respect the guidelines limiting the risks associated with refinancing: the aim is to adjust the maturity of the public debt so that the amounts to be refinanced on expiry of the loans are similar from one year to the next. Thus, at the end of the year under review, by means of buying back securities, the proportion of the euro-denominated debts needing to be refinanced within twelve months was kept down to 19 p.c. (the limit being set at 22.5 p.c.) and the fraction of euro loans maturing within five years was held at 55 p.c. (the limit being 60 p.c.).

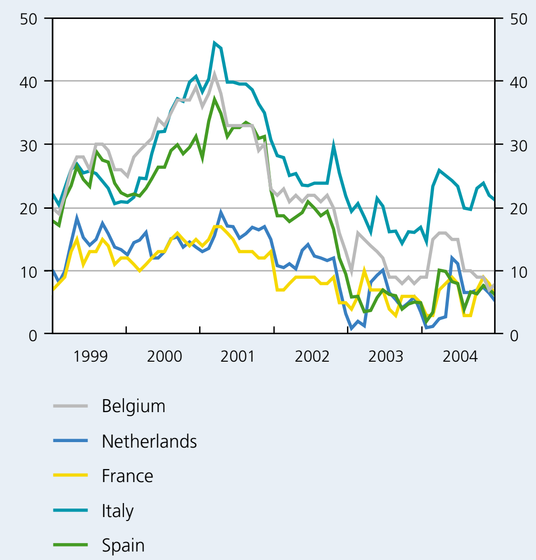
There were no issues at all of medium- and long-term loans in foreign currencies during the year under review. Foreign currency loans maturing in 2004 were refinanced by debts denominated in euro. This measure forms part of the policy aimed at limiting the currency risk by progressively dismantling the debt denominated in foreign currencies. In this connection, the Treasury also took advantage of exchange rates favourable to the euro to buy back debts in foreign currencies and thus to reduce their already minimal share in the outstanding total of State loans. As at 31 December 2004, that proportion was down to just 0.9 p.c.

The relative cost of the debt is a key variable for the managers of the public debt, and can be measured by the yield spread in relation to the German Bund. After two consecutive years of a generalised fall, the yield differentials remained steady overall in 2004 in relation to the previous year: this applied not only to Belgian loans but also to French and Dutch instruments; in contrast, the financing conditions of Italian and Spanish loans deteriorated slightly on average during the year under review. The differential between the yield on the Belgian ten-year benchmark loan and the German bond of a similar maturity averaged 12 basis points in 2004. As a result of the launch of a new German ten-year benchmark loan, the spread actually diminished to 7 basis points in November. Apart from the relative improvement in Belgium's public finances compared to the situation prevailing in Germany, the downward trend in the yield spread is also due to the efforts made to improve the operational management of the debt.

The increasing diversification of the counterparties holding the debt is part of this policy. While the volume of outstanding loans contracted in foreign currencies is tending to decline, quite the opposite applies to the proportion of the debt denominated in euro held by non-residents. That ratio is constantly rising as a result of ever more cosmopolitan new issues. For example, just 7 p.c. of investors subscribing to the new thirty-year loan were

CHART 76 YIELD DIFFERENTIALS ON TEN-YEAR GOVERNMENT BONDS IN RELATION TO THE GERMAN *BUND*

(Monthly averages, basis points)



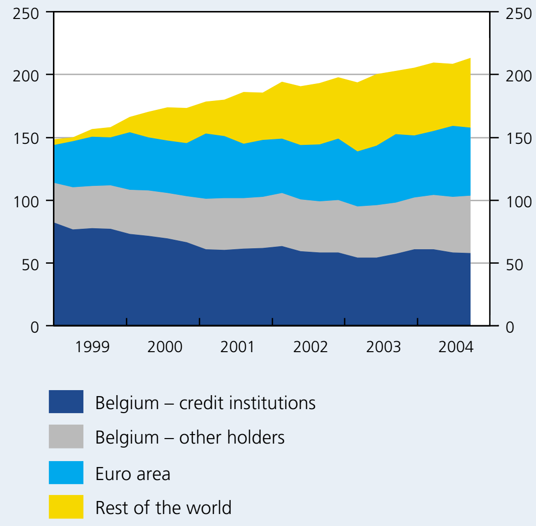
Source: BIS.

resident in Belgium, while 58 p.c. of them came from the rest of the euro area. Just over half of linear bonds are now held abroad; as at 30 September in the year under review, Belgian residents owned 48.5 p.c. of the linear bond debt. Over the years, Belgian residents in general have seen a decline in their relative share of the total held. Belgian credit institutions have even reduced the absolute volume of linear bonds held in their portfolios.

Internationalisation of the clientele investing in debt securities has been fostered by the sustained liquidity of the secondary market. The latter in fact consists of several separate markets. On the Euronext Brussels fixing segment, the liquidity of the loans is maintained by the Securities Regulation Fund. Every day, and for every security listed, it determines a price at which it will always act as counterparty, guaranteeing participants the volume of securities required at the right price. The Securities Regulation Fund is also responsible for monitoring and supervising the regulated off-exchange market in linear bonds, split securities and treasury certificates, which accounts for the majority of the transactions. It also ensures the transparency of the off-exchange market by publishing the guide prices and rates as well as the volumes traded. Transactions there take place through a

CHART 77 LINEAR BOND HOLDINGS: GEOGRAPHICAL BREAKDOWN

(End-of-quarter data, billions of euro)



Source: NBB.

market member, and the primary dealers ensure adequate liquidity. Finally, there is a third – informal market – for transactions concluded outside the first two.

There was a noteworthy development on the secondary market during the year under review. It concerns "strips" (Separate Trading of Registered Interest and Principal of Securities), i.e. securities created by separating the capital rights from the right to the interest payments on a bond. Since 1992, this process has been authorised for certain linear bond lines. To promote stripped bonds among investors, there were plans for implementing measures to increase the liquidity and transparency of the secondary market in strips. In this connection, MTS Belgium, the main electronic platform for transactions where linear bonds, in particular, are quoted, extended its product range in January 2004 to include public debt strips. This launch increased the transparency of price-setting, exercising an undeniable effect on the market's liquidity. During the year under review, the total volume of transactions in strips on the secondary off-exchange market came to 6.5 billion euro, almost five times the figure recorded in 2003.

8. Financial stability

8.1 International financial markets

Despite the highly favourable environment for the equity markets in 2004 – with sustained global economic growth, low interest rates and robust expansion of corporate earnings – the stock market indices fluctuated within a narrow range for much of the year. However, at the end of the year, following the surge in prices in the fourth quarter, they recorded appreciable gains in the United States and in the euro area, totalling 11.5 and 16.6 p.c. respectively against the end of 2003.

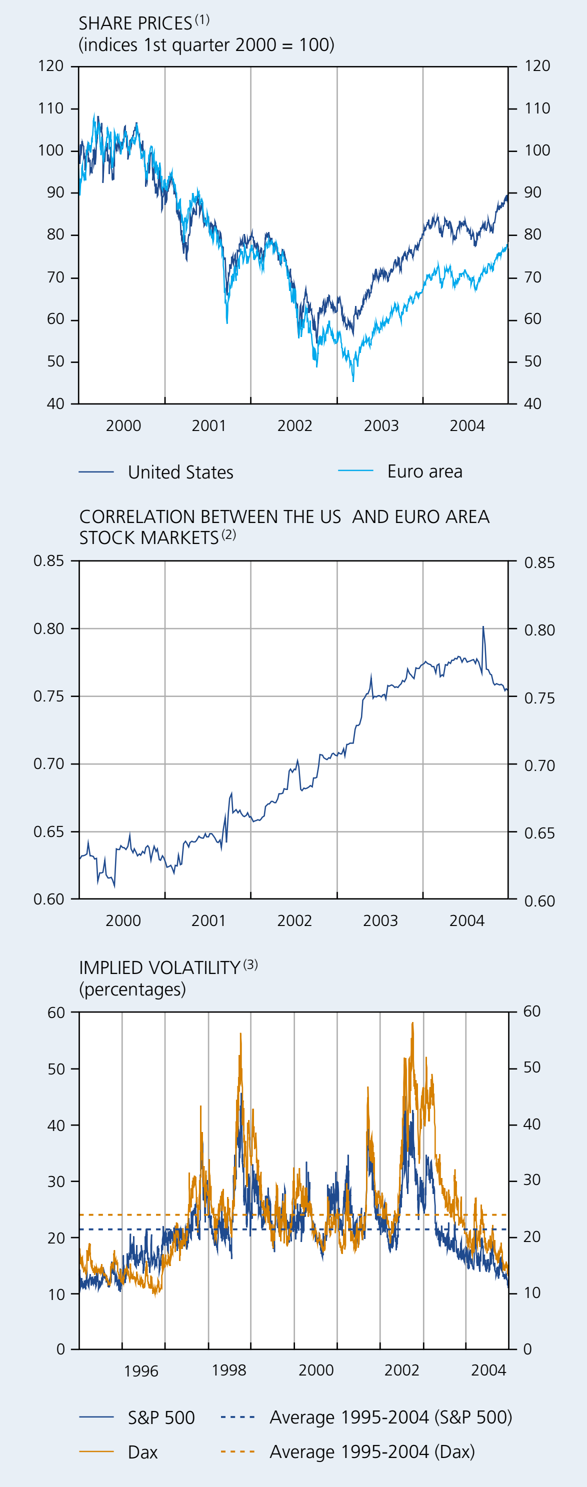
In general, the profile of price movements remained very similar in Europe and the United States, further increasing the correlation between the two markets, on average, over the year. Starting at less than 0.5 prior to 1998, the correlation coefficient between the weekly returns on these markets, calculated over a moving three-year period, has increased sharply in recent years to exceed 0.75 in 2004. Apart from reflecting the parallelism between the economic recovery in the United States and in the euro area since 2001, this increase is probably also due to a more structural factor. The continuing integration of the international financial markets is evident in the increased alignment of price movements, but – by the same token – it is reducing the potential benefits of international portfolio diversification.

Notwithstanding this synchronisation, there were still certain divergences between the two markets. While stock market prices expressed in local currency remained well below their early 2000 levels in both cases, the US stock market index recouped a greater proportion of the losses incurred between March 2000 and March 2003 than did the equivalent euro area index. This greater robustness of the transatlantic stock market may be explained by the more vigorous growth of the American economy, but is probably also due to the dollar's depreciation against the euro, which affected the relative performance of US and European exporters. Nevertheless, in view of the weakness of the dollar, the weaker performance of European shares needs to be seen very much in perspective, since – if the gains are converted into US dollars – it is clear that in 2004 they significantly outpaced those recorded by American shares, namely by 13.5 percentage points.

The relative calm of the international stock markets in 2004 was accompanied by a further decline in the implied volatility of options on the stock market indices, which recorded a level well below the average for the past ten years. A fairly similar pattern emerged on the bond markets, where the maintenance of prices within a narrow corridor was accompanied by a fall in the indicators measuring anticipated volatility. These developments seem in turn to have prompted changes in the behaviour and risk attitudes of investors, reflected in particular in the expansion, on a number of financial markets, of investments with a leverage effect, such as the financing of long positions by short-term loans (carry trades) or in investors' growing appetite for speculative funds (hedge funds), the total volume of which reportedly exceeded 1,000 billion dollars in 2004. This greater enthusiasm for riskier investment strategies reflects the fact that investors were searching for yield in a context of persistently low interest rates and ample liquidity. At the same time, their enthusiasm was fuelled by the low levels of volatility, which enabled investors to take greater risks for the same amount of required capital as calculated by the "value at risk" models.

CHART 78 STOCK MARKET DEVELOPMENTS

(Daily data, unless otherwise stated)



Sources : Chicago Board Options Exchange, Deutsche Börse, Thomson Financial Datastream.

(1) Indices defined by Thomson Financial Datastream, expressed in local currency.

(2) Coefficient of correlation between weekly returns on the US and European markets, calculated over a moving three-year period ; indices expressed in US dollars ; weekly data.

(3) Measures of expected volatility based on the prices of a basket of options on the S&P 500 and Dax stock market indices.

The quest for returns helped to compress risk premiums on the fixed-income security markets. Although the spreads on high yield bonds issued by the private sector and emerging economies had already shrunk significantly in 2003, new lows were reached in the second half of 2004, despite the admittedly widely anticipated reversal of US monetary policy. This would tend to suggest that the rise in the prices of speculative bonds was due not only to a desire to achieve higher yields, but was also supported by an improvement in the creditworthiness of private companies and the emerging economies.

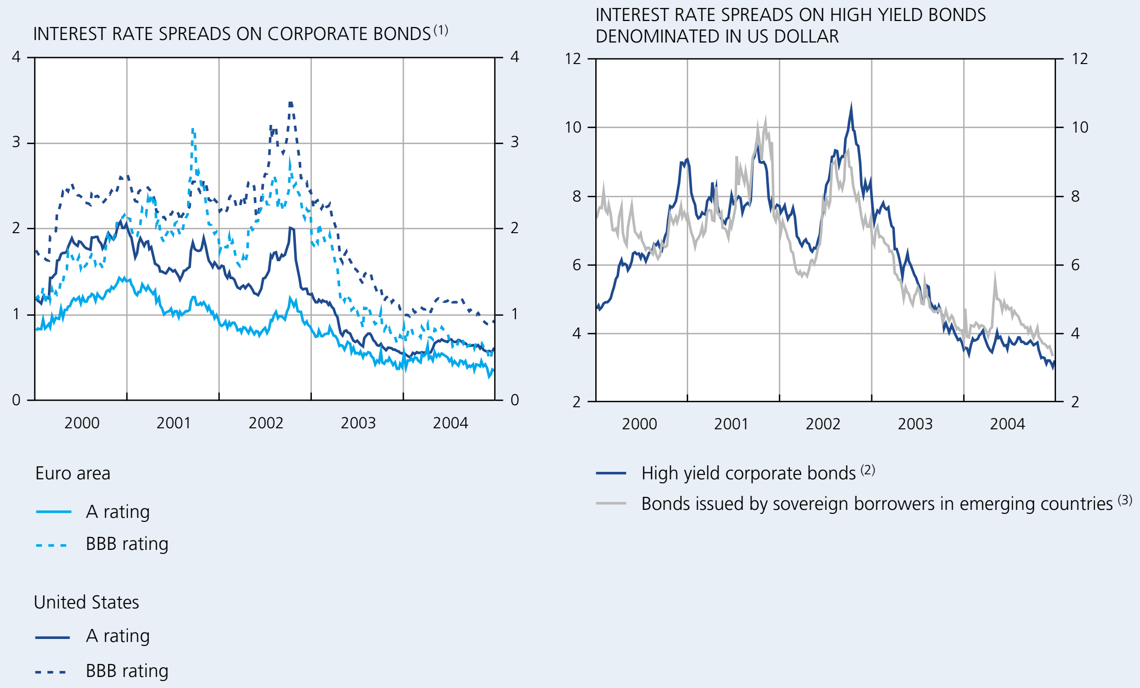
Thus, the decline in the differential on the composite EMBIG index of emerging country bonds, from around 9 percentage points in the autumn of 2002 – when uncertainty over Brazil's solvency reached its peak – to less than 4 percentage points in 2004, was accompanied by a large number of upgrades in borrowers' ratings. In countries such as Brazil and Turkey, the macroeconomic indicators indeed showed a marked improvement in 2003 and 2004, as a result of the favourable international environment and the efforts made by the national authorities to remedy the internal and external vulnerability by means of tighter fiscal and monetary policies and structural reforms. In this connection, the firm commitment of the governments of the two countries mentioned to the maintenance of substantial primary budget surpluses seems to have played a key role in lowering the risk premiums on their debts.

In view of the persistent doubts surrounding the strength of the global economic recovery, American and European non-financial corporations took advantage of the historically low level of the cost of borrowing and their strong earnings growth primarily to eliminate the financial imbalances which they had accumulated during the latter half of the 1990s. This process of balance sheet restructuring was reflected in high levels of self-financing, lower investment in real and financial assets, and debt refinancing in order to cut the costs or extend the average maturity of the financial liabilities. These improvements in the creditworthiness of firms led to a further fall in the default rate, while towards the end of the year under review, the number of upgrades of private sector bond ratings once again exceeded the number of downgrades.

This decline in corporate credit risks was also one of the main factors behind the continuing improvement in the profitability of banks in the euro area in 2004. Combined with the vigorous growth of household lending and cost control, the sharp decline in provisions for non-performing assets in fact offset the mixed results of market trading activities and the downward pressure on

CHART 79 BOND MARKET RISK PREMIUMS

(Weekly data, percentage points)



Sources : Bloomberg, JP Morgan, Merill Lynch, Thomson Financial Datastream.

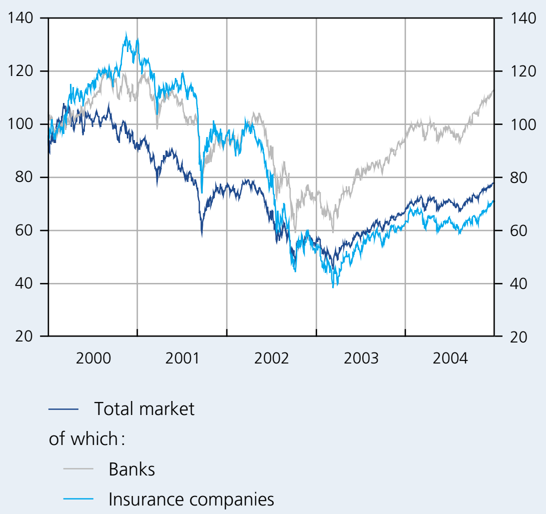
(1) Spreads relative to the interest rates on ten-year government bonds.

(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.

(3) EMBIG index ; spread relative to the interest rate on US Treasuries with a corresponding maturity.

CHART 80 FINANCIAL SECTOR SHARE PRICES IN THE EURO AREA

(Indices January 2000 = 100)



Source : Thomson Financial Datastream.

interest margins due to the low rates. However, it was for insurance companies that the low level of long-term interest rates posed the greatest challenge, in view of the high guaranteed returns which many of these companies had offered on their life insurance policies in the past. When the stock market bubble burst, the sector was, moreover, suffering from serious financial imbalances owing to its heavy dependence on financial investment income. That situation is probably also the reason why insurance sector shares took much longer than those in the banking sector to recover from the losses suffered since 2000.

8.2 Belgian credit institutions

Overview of performance

In 2004, Belgian credit institutions did not only benefit from a favourable international financial environment. They were also able to take advantage of the fairly sustained growth of the domestic economy and the buoyancy of the Belgian stock market. The gross operating result, which had produced a marked fall in 2001 and 2002 before stagnating in 2003, thus grew by 12.6 p.c. during the first three quarters of 2004 compared to the corresponding period of the previous year, while the net operating result increased by 33.8 p.c.

In regard to expenses, the banks continued their efforts to save on operating costs. This was particularly apparent in the personnel costs. In addition, the improvement in the financial situation of corporations was confirmed, which translated into a further reduction in value adjustments on credit portfolios.

The most notable change took place at the level of banking income, however. After two consecutive years of decline, the Belgian banks once again succeeded in boosting their income, which grew by 4.6 p.c. during the first nine months of 2004, driven mainly by a strong rise in net interest income.

While the aggregate growth of the other income sources was much smaller, this was due exclusively to the steep fall in the results on the sale of investment securities. As these securities are booked at their acquisition cost, the capital gains achieved as a result of the fall in long-term interest rates are not recorded unless the securities are sold. It is therefore possible to adjust the rate at which these capital gains are realised according to market opportunities and the movement in other results. In 2004, the improvement in profitability probably encouraged the banks to limit the realisation of capital gains. Leaving aside this source of income, non-interest income grew by 7.7 p.c. during the first three quarters of 2004.

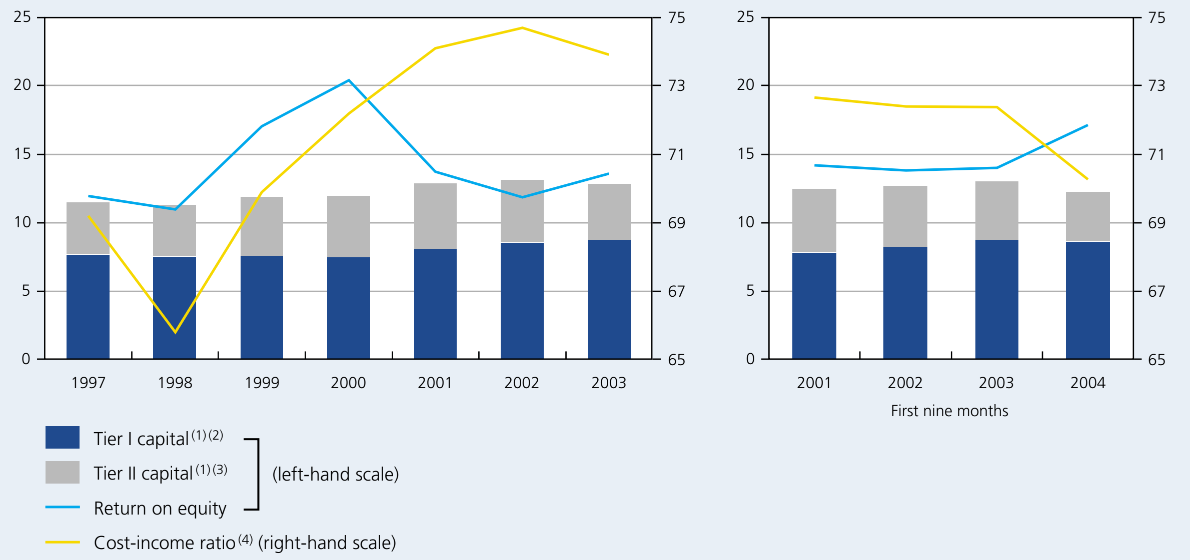
TABLE 42 PROFIT AND LOSS ACCOUNT OF BELGIAN CREDIT INSTITUTIONS [1]

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

	2000	2001	2002	2003 [2]	First nine months 2003 [2]	First nine months 2004	*p.m. Results for 2003, billions of euro*
Banking income	15.3	1.4	–4.6	–0.5	–1.9	4.6	*22.8*
Net interest income	3.0	4.6	3.2	0.3	–3.6	6.9	*12.2*
Non-interest income	28.5	–1.2	–11.7	–1.4	–0.1	2.2	*10.6*
of which:							
Net result on the realisation of investment securities	–46.6	43.5	–5.4	12.6	16.3	–33.8	*1.2*
Operating expenses (–)	19.0	4.1	–3.8	–1.2	–1.9	1.6	*16.9*
Personnel costs	11.7	6.7	–0.5	2.3	–0.3	0.3	*7.7*
Other operating expenses	24.9	2.3	–6.3	–4.0	–3.2	2.6	*9.2*
Gross operating result	6.8	–5.6	–6.9	1.3	–1.9	12.6	*6.0*
Value adjustments (–)	–9.6	4.6	36.2	–17.0	–23.0	–73.1	*1.5*
Net operating result	12.3	–8.3	–20.2	9.9	6.8	33.8	*4.5*

Sources: BFIC, NBB.
(1) Including the results on a territorial basis of the Belgian branches of foreign banks.
(2) These figures were adjusted for the impact of the removal of Dexia BIL from the scope of consolidation Dexia Bank Belgium.

CHART 81 PROFITABILITY AND SOLVENCY INDICATORS OF CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW
(Consolidated data, percentages)



Sources : BFIC, NBB.
(1) End-of-period data as a percentage of the risk-weighted assets.
(2) Own funds in the strict sense, consisting essentially of paid-up capital, reserves, the fund for general banking risks, minority interests and, as the main deduction item, positive consolidation differences.
(3) Mainly subordinated loans.
(4) Including the results on a territorial basis of the Belgian branches of foreign banks.

The improvement in the results was reflected in the main profitability indicators. The return on equity exceeded 17 p.c. for the first nine months of 2004, while the cost-income ratio dropped from 72 p.c. in 2003 to 70 p.c.

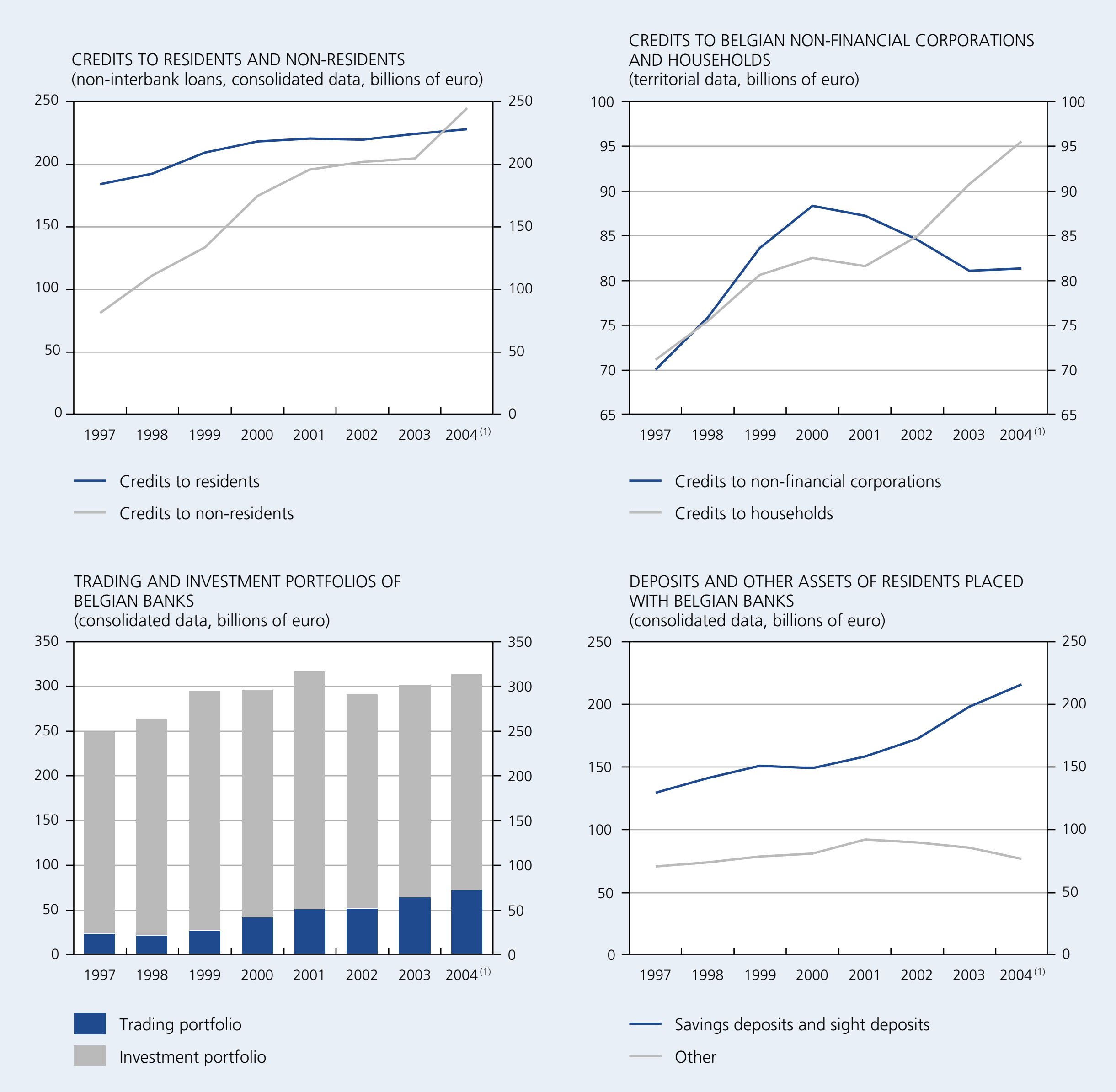
The solvency ratio, which had risen more or less continuously since 1998, dipped slightly during the first nine months of 2004, dropping to 12.3 p.c. at the end of September. The main reason for this fall was the repayment of subordinated loans, as the solvency ratio in the strict sense (tier I) remained steady. Moreover, the solvency of Belgian banks remained above both the average for the other EU Member States and the regulatory requirements. It is probably worth remembering that these requirements are to be amended shortly with the entry into force of the new Basel Accord, which is described in box 19.

Impact of recent changes in the structure of activities on profitability and risks

In recent years, various developments have progressively contributed towards changes in the structure of the Belgian banks' activities. Some are due to decisions taken by the credit institutions themselves. In this perspective, diversification and the extension of operations beyond the national market have led to strong growth in lending to non-residents. Since business expanded far less rapidly on the domestic market, the consolidated amount of the outstanding claims of Belgian banks on foreign non-bank debtors exceeded the corresponding claims on Belgian customers in 2004. While the great majority of these debtors are located in western Europe, Belgian banks also hold substantial claims on the United States and central European countries.

At the same time, for more cyclical reasons, bank credits granted to private sector residents were concentrated more on households than on non-financial corporations.

CHART 82 RECENT DEVELOPMENTS IN THE ACTIVITIES OF BELGIAN CREDIT INSTITUTIONS



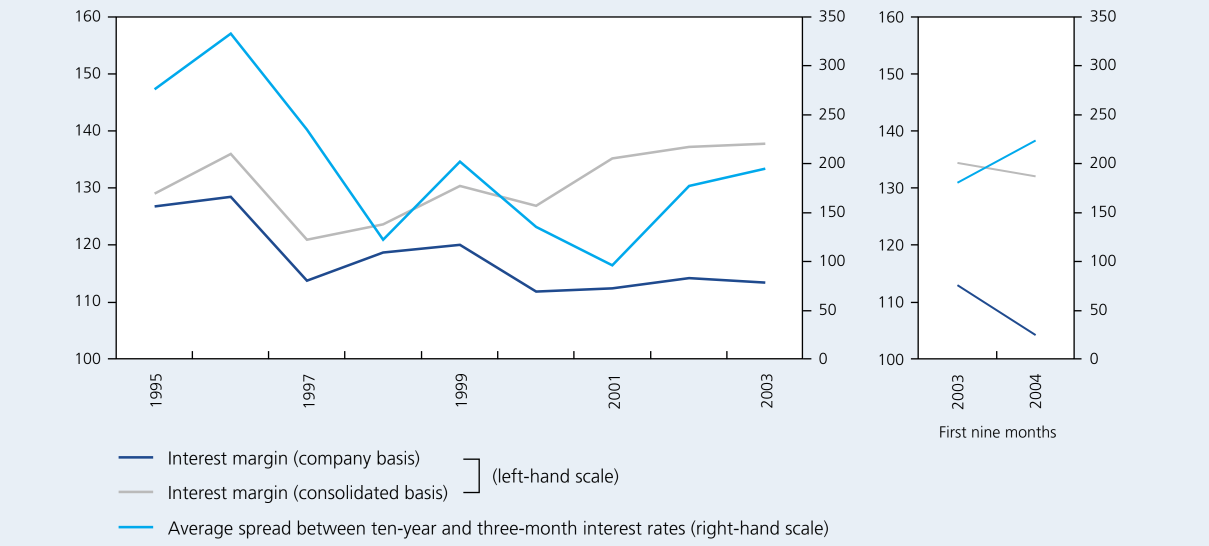
Source : BFIC.
(1) Data as at end of September 2004.

As discussed in more detail in chapter 7 on the financial accounts and the financial markets, households continued to express a strong demand for mortgage loans, while businesses tended to limit their debt levels in order to consolidate their financial position. Furthermore, in the case of the largest companies, they focused more on market financing.

While the Belgian banks still hold substantial securities portfolios, they now tend to manage their positions far more actively, as can be inferred from the increase in the share of the portfolio held for trading purposes rather than for long-term investment, which went up from 9.6 p.c. at the end of 1997 to 23.2 p.c. at the end of September 2004.

CHART 83 INTERMEDIATION MARGIN OF BELGIAN BANKS

(Basis points)

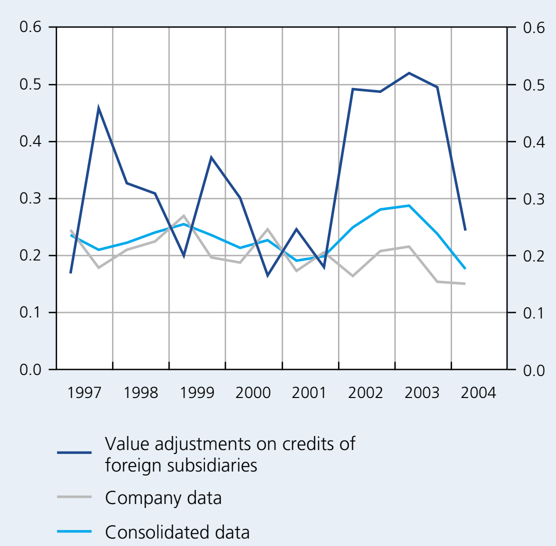


Sources : BFIC, NBB.

On the liabilities side, the low level of interest rates encouraged individuals to prefer savings deposits to savings notes when investing with Belgian credit institutions.

CHART 84 NET VALUE ADJUSTMENTS ON CREDITS

(Seasonally adjusted half-yearly data, percentages of total credits)



Sources : BFIC, NBB.

The overall share represented by sight deposits and savings deposits in the assets placed with banks by Belgian residents came to 73.7 p.c. of the total at the end of September 2004, against 64.6 p.c. at the end of 1997.

These multiple changes were not neutral for the decisions which Belgian banks have to make when weighing returns against risks in the course of their activities.

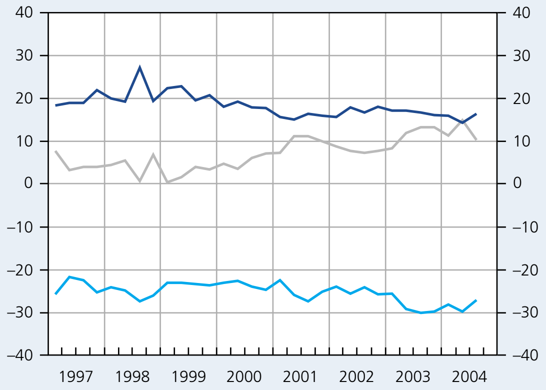
The development of new markets, particularly in a number of countries which have just joined the EU, has brought a fairly considerable improvement in the interest margin, up from a low of 121 basis points in 1997 to 138 basis points in 2003. True, the banks have also benefited from the movement in the yield curve, the widening spread between short and long-term interest rates having been favourable to maturity transformation activities, but this positive effect mainly influenced the margin calculated on a consolidated basis, which includes the intermediation income of foreign subsidiaries of Belgian banks. The margin on an individual company basis, which depends essentially on the intermediation activity on the domestic market, hardly changed between 2000 and 2003, and even showed a marked fall in the first nine months of 2004.

However, the default rate on the foreign loans of Belgian banks is higher on average, since some of the loans are granted in countries with a higher level of risk. A good approximation of the size of the provisions which credit institutions have had to constitute to cover this credit risk category can be obtained by calculating the difference between the value adjustments for non-performing assets on a consolidated basis and on a company basis. This difference, which should in principle correspond to the credit risk provisions of foreign subsidiaries of Belgian banks, has fluctuated fairly widely in recent years. It increased sharply in 2002, following the constitution of provisions for loans granted by the Dutch subsidiary of a Belgian credit institution and, in 2003, when another Belgian banking group made substantial value adjustments on loans granted by its subsidiary in Poland. Since these exceptional operations helped to rationalise the credit portfolio, a sharp decline in provisions could be recorded in 2004.

In contrast, there were only fairly minor variations in the value adjustments on a company basis, which have shown, since 2000, a certain tendency to decline. At first sight this is surprising in a period when economic growth has tended to slow. It can be related to the shift which has taken place, among resident customers, away from business loans and towards loans to households which, on average, have a lower risk profile.

CHART 85 NET POSITIONS OF BELGIAN BANKS BY MAIN MATURITY CATEGORY (1)

(Quarterly data on a company basis, percentages of the balance sheet total)



Source : BFIC.
(1) Including net positions in derivatives.

Box 19 – The New Basel Accord

On 26 June 2004 the Basel Committee on Banking Supervision approved the publication of the revised framework for the international convergence of the rules concerning minimum capital requirements and the methods of calculating them, commonly known as the “New Basel Accord” or “Basel II”. The preparation of this accord has entailed a lengthy process of consultation with banking sector representatives, which had begun in June 1999 with the presentation of an initial series of proposals for revising the previous accord, known as “Basel I”. Numerous discussions with the sector on additional proposals and the completion of three quantitative impact studies preceded the finalisation of this new regulatory framework.

The new framework confirms the basic philosophy of Basel I. An adequate level of capitalisation should serve as the basis for the future growth of credit institutions and provide a buffer against unexpected losses. However, the new accord aims to match the capital requirements for credit transactions more closely with the risks which banks actually incur, and introduces specific requirements for operational risks.

To attain this objective, the Committee has taken account of the progress made in developing techniques and instruments to measure and control risks. It has drawn heavily on the best practices which were developed in the market, with a view to their adoption by a larger number of banks. To take account of the differences in the nature of the activities and the degree of sophistication of the internal control procedures of individual credit institutions, the Basel II Accord offers three options for calculating capital requirements. In addition to a standardised approach, which permits the use of external credit risk measurement instruments, such as the ratings of independent agencies, provision is made for two approaches based on the banks' internal ratings models, one called the foundation approach, in which the prudential authorities define a number of parameters, and the other called the advanced approach in which the banks are permitted to define these parameters themselves.

The new regulatory framework does not aim only to refine the calculation of capital requirements, but is also intended to encourage banks to improve the quality of their control procedures. To that end, the new accord introduces a structure comprising three mutually reinforcing pillars. While the first pillar corresponds to the imposition of capital requirements geared more closely to the actual risks, a second pillar foresees the possibility for the prudential authorities to take account of the specific risk profile of each institution, and a third pillar is intended to encourage market discipline by imposing greater transparency in the disclosure of information by credit institutions.

In order to finalise the accord, various adjustments had to be made in the last few months. The main one concerns the distinction between expected losses, which are in principle covered by provisions, and unexpected losses, which should be the sole criterion used for calculating the capital requirements. Other changes concerned the treatment of securitisation operations, credit card liabilities and certain credit risk mitigation techniques.

The standardised approach and the foundation approach, based on internal ratings models, for the calculation of the capital requirements are scheduled to enter into force on 1 January 2007, but the Committee has decided to delay the implementation date for the advanced approach until 1 January 2008. The Committee has also announced that, before the introduction of the new rules, it will determine or clarify appropriate treatments for taking account of double default, for implementing a number of points relating to trading activities and for estimating the loss parameter in the event of default in the advanced approach.

The Committee also reiterated its basic objective of introducing a system which keeps the overall level of the minimum capital requirements unchanged, while encouraging the banks to adopt approaches based on internal ratings models. This general calibration is achieved by introducing a conversion factor applicable to the requirements covering credit losses. For the time being, this factor has been set at 1.06, but its final value will be adjusted on the basis of a new calibration exercise taking account of all the elements of the new accord.

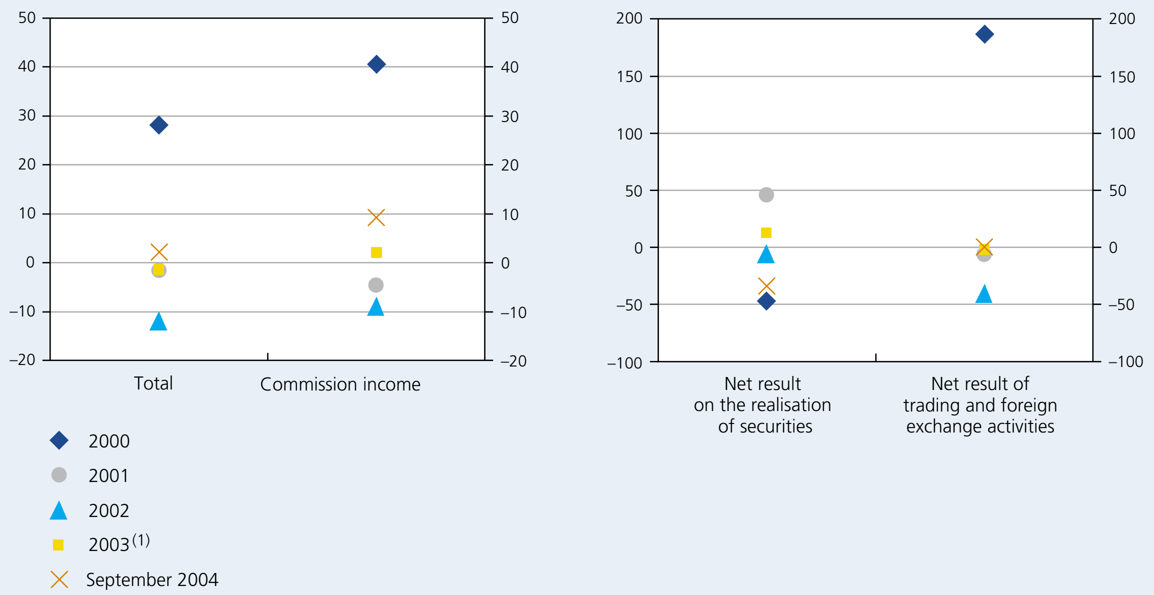
In June 2004 the Committee confirmed its commitment to the promotion and development of coordination between the various supervisory authorities, in order to ensure the effective and efficient implementation of the new rules. For its part, the European Commission submitted a proposal for a directive amending the directive on the capital adequacy of investment firms and credit institutions, which is intended to transpose the new Basel Accord into European law.

The new accord was designed by taking a dynamic view of solvency supervision, which is likely to change over time. Two areas in which the Committee will need to extend its activities can already be identified. The first concerns the definition of the capital qualifying for the calculation of requirements, while the second relates to credit risk modelling, in particular as regards taking account of the correlations between sectors of activities and geographical regions.

While the changes in the composition of the assets affected the nature of the credit risks, the alterations to the structure of the liabilities mainly influenced the management of the interest rate risks. Since the banks obtain the bulk of their resources on a short-term basis or for an indeterminate period, they are traditionally net borrowers for the positions with no fixed maturity or maturing within one month. The success of the savings deposits has increased the relative size of the net debit balance for this range of maturities in the past few years.

CHART 86 ANNUAL RATE OF CHANGE IN THE NON-INTEREST INCOME OF BELGIAN BANKS

(Consolidated data, percentages)



Source : BFIC.
(1) Figures adjusted for the impact of the removal of Dexia BIL from the scope of consolidation of Dexia Bank Belgium.

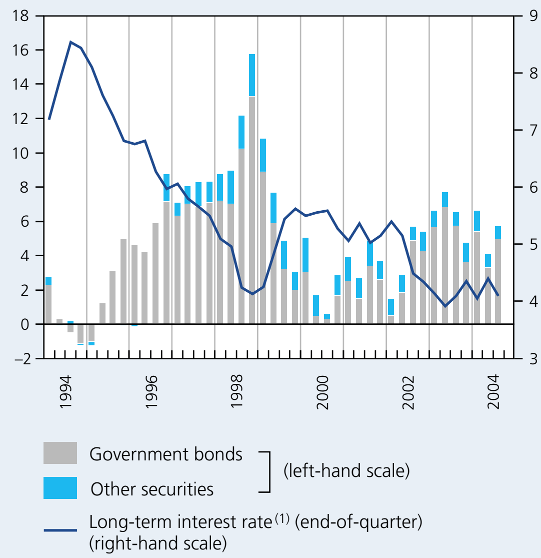
The basis available to the banks for maturity transformations has therefore become larger. However, these additional net resources have not been used to increase the relative share of the long positions at over one year which, in contrast, declined between the end of 1997 and the end of September 2004, from 21.9 to 16.3 p.c. of the balance sheet total. The counterpart took the form of net credit positions with a maturity of one month to one year.

The banks' sensitivity to fluctuations in the longer term segment of the yield curve has thus diminished. This outcome is due in part to the development of variable rate loan formulas for both corporate finance and mortgage loans to households. It is also attributable to a more intensive use of interest rate derivatives to hedge long-term positions.

This fits into the broader framework of the development of market transactions by credit institutions, either for their own account or for that of customers. Non-interest income sources, received in the form of commissions or profits on trading activities, now constitute a substantial part of total banking income. However, these income sources appear highly volatile, from one year to another and between institutions during the same period.

CHART 87 UNREALISED CAPITAL GAINS ON THE INVESTMENT PORTFOLIO

(Consolidated quarterly data, billions of euro, unless otherwise stated)



Sources : BFIC, NBB.
(1) Yield on the secondary market of Belgian ten-year government bonds.

Managing the volatility of their profits, and hence their equity capital, is a particular point of interest for credit institutions. As stated earlier, the current method of booking the securities portfolios provides some scope for profit smoothing. However, this option will soon cease to be available, since the introduction of the International Financial Reporting Standards (IFRS) – discussed in more detail in box 20 – will make it compulsory to apply market price valuation not only to virtually the whole of the securities portfolio but also to a number of other asset, liability and off-balance-sheet items.

At this stage, it is difficult to determine what will be the exact impact of the implementation of these new rules on the accounting situation of Belgian banks. The movement in the unrealised capital gains on their investment portfolio offers a partial indication. These unrealised capital gains, which totalled 5.7 billion euro at the end of September 2004, seem to be highly sensitive to movements in long-term interest rates. The new IFRS accounting rules will mean that changes in these gains will have to be almost entirely recorded in the banks' own funds.

Box 20 – Introduction of the International Financial Reporting Standards

Accounting information is essential to the proper operation of a market economy. So long as it faithfully reflects the underlying economic reality, it is an aid to well-informed decisions and more efficient investment. It also enables the financial markets to impose discipline and to send out reliable price signals.

Financial instruments have become much more complex in the past few decades, particularly with the development of derivatives, securitisation and structured portfolio products. Traditional accounting standards, based largely on historical cost, are becoming increasingly unsuitable for this new environment and for modern risk management techniques. In particular, derivative positions are recorded off balance sheet at their notional value, preventing measurement of the underlying risk. The development of the financial markets is creating a need to implement accounting rules that rely more on the market value of financial instruments.

The new international accounting rules (IFRS – International Financial Reporting Standards) are intended to fulfil this need. Their simultaneous application in the various countries would also offer the advantage of increasing the comparability of financial information, facilitating companies' access to the international capital markets and reducing the cost of accounting formalities for firms working in a cross-border environment. The European Commission has therefore, quite naturally, become one of the driving forces behind the introduction of international accounting standards in the EU Member States.

By a regulation dated 19 July 2002, the EU made the application of the IFRS standards compulsory, from 2005 onwards, for the consolidated annual accounts of listed companies; this concerns around 7,000 enterprises in the EU. On the other hand, the implementation of the new rules is optional for the consolidated annual accounts of unlisted companies. By means of a royal decree, Belgium extended the compulsory application of the IFRS standards to the consolidated accounts of unlisted banks from January 2006.

While there are undeniable microeconomic and macroeconomic advantages in switching to the IFRS, that still leaves a mixed system combining valuations based on historical cost with those based on market value. The rules relating to financial instruments (IAS 32 and 39), in particular, have come in for criticism from the banking sector, since they result in the use of different methods of accounting for assets and liabilities which are affected in similar ways by changing market conditions. They are therefore likely to create artificial volatility in capital and profits.

However, these disparities relating purely to accounting methods and not to economic reality are inevitable, in that the choice of a single accounting method can hardly be justified. While the historical cost approach is not suitable for derivatives and marketable securities, for which the only relevant value is the market price, an exclusive use of the full fair value criterion, as implicitly intended by the original wording of standard IAS 39, raises conceptual problems which were pointed out both by the ECB and by the Basel Committee on Banking Supervision. On the one hand, there is no reliable market reference for many banking assets and liabilities, particularly on the financial markets of continental Europe. On the other hand, in a situation where an institution was becoming less financially sound, measuring the liabilities at market value would, paradoxically, increase the level of that institution's own funds.

In that context, the discussions are currently focusing on hedge accounting techniques, which entail linking the gains and losses on a hedging instrument with those recorded on the items being hedged. Various methods are available for that purpose, but to leave the financial institutions too much free choice would impair the comparability of financial statements, as the same transaction could be recorded differently depending on the hedging technique used. Conversely, strict application criteria would in practice make it impossible to use some of the hedging techniques commonly employed by many financial intermediaries, particularly in order to manage risks on the basis of a portfolio of positions, rather than position by position.

Since the various parties involved have been unable to reach agreement so far, it was decided to maintain the entry into force of the new accounting standards but to adapt standard IAS 39. The provisional solution adopted is to permit the application of the fair value option for the assets side of the balance sheet while not allowing it for items on the liabilities side, particularly deposits for an indefinite period. The EC has asked the IASB (International Accounting Standards Board), the prudential authorities and the banks to resolve the controversies concerning the IAS 39 as soon as possible.

8.3 Belgian insurance companies

Interactions between insurance companies and credit institutions

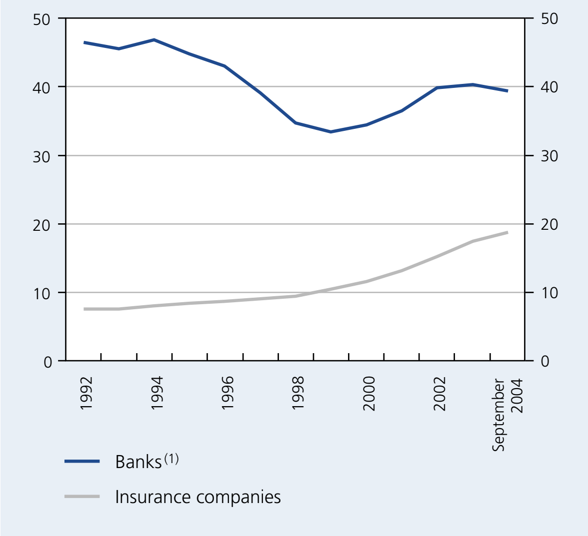
In the past few years, insurance companies have come to play a growing role on the financial markets. In Belgium, in particular, owing to the development of life insurance products, the portion of the financial assets of individuals formed via insurance companies has more than doubled since 1992. It increased from 8 p.c. in 1992 to 19 p.c. in September 2004, while the market share of resident and non-resident credit institutions dropped from 46 to 39 p.c. over the same period.

The systemic importance of the insurance sector compared to that of the banks is determined not only by the volume but also by the nature of the liabilities of the two sectors. Credit institutions collect the bulk of their resources on a very short-term basis, part of their liabilities actually being used directly as means of payment. They therefore perform a very specific role in the financial system, and are exposed to a liquidity risk which hardly applies to insurance companies, whose liabilities are generally long term. However, since they use the major part of their liabilities for the acquisition of securities, insurance companies have become key players on the securities markets and their operations may therefore have a direct effect on the liquidity of those markets.

The interdependencies between the two sectors are not purely indirect, but also operate via the large banc-assurance groups which now hold a commanding position on the Belgian financial market.

CHART 88 SHARE OF BANKS AND INSURANCE COMPANIES IN THE FINANCIAL ASSETS OF INDIVIDUALS

(Percentages)



Source : NBB.

(1) Financial assets formed by Belgian individuals with resident and non-resident credit institutions.

TABLE 43 SHARE OF THE MAIN GROUPS ACTIVE IN BANKING AND INSURANCE ON THE BELGIAN MARKET AT THE END OF 2003 (1)

(Data on a consolidated basis, percentages)

Group	Insurance market	of which:		Banking market
		Life insurance market	Non-life insurance market	
Fortis	20.3	23.0	14.6	32.0
Dexia	8.0	9.9	3.8	15.9
KBC	10.3	11.1	8.6	22.0
ING	8.1	10.1	3.8	12.0
Sub-total	46.7	54.1	30.8	81.9
AXA	13.7	12.2	17.1	2.7
Ethias	15.8	17.7	11.9	0.1
Total	76.2	84.0	59.8	84.7

Sources: Assuralia, BFIC, NBB.

(1) The market shares for insurance activities were calculated as a percentage of the total premiums collected. In the case of banking, this share is defined as a percentage of the total deposits constituted by residents.

At the end of 2003, four large bancassurance groups dominated the financial market in Belgium, with a market share of almost 82 p.c. in banking activities and around 47 p.c. for insurance activities as a whole. These groups are mainly active in life insurance, since diversification in this branch offers greater scope for synergy at the level of both costs and income. This strategy also meets the demand of investors seeking financial products which offer higher returns and longer maturities. The market share of the four groups in life insurance was over 54 p.c., against just under 31 p.c. for non-life insurance.

These large financial groups also adapted their risk management to the structure of their activities. It now tends to be conducted at aggregate level, merging the positions of the banking and insurance arms. The merger of the Banking and Finance Commission with the Insurance Supervision Office on 1 January 2004 made it possible to adapt the organisational structure of the microprudential supervision of the Belgian financial system in line with this new environment.

The formation of integrated groups also calls for greater emphasis on systemic risks, in order to prevent the widespread occurrence of situations hindering all financial institutions and markets from fulfilling the essential functions which they perform in the allocation of financial resources. This macroprudential task has quite naturally become one of the key areas of activity for central banks. The Bank has responded to this development, both by expanding its analysis and research on the subject of financial stability, particularly in connection with the publication of its Financial Stability Review, and at a more institutional level, by reinforcing the links with the BFIC. In particular, in 2004 the two institutions jointly formulated recommendations aimed at strengthening the ability of the Belgian financial system to cope with events which could affect the continuity of operations without any prolonged interruption of its functioning.

Solvency and profitability

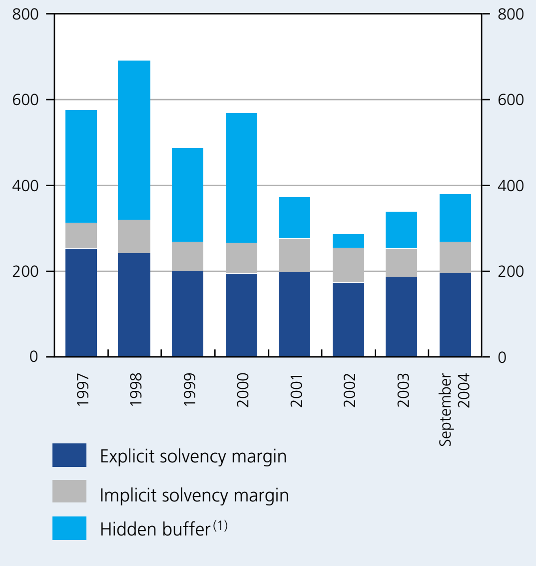
The solvency margin constituted by insurance companies has remained relatively steady in recent years at around 260 p.c. of the minimum requirement. This margin comprises an explicit component, consisting mainly of the own funds, and an implicit component which includes, at the company's request and after the approval of the BFIC, part of the unrecorded, unrealised capital gains, plus part of the future profits on life insurance activities. The losses suffered by the sector in 2002 had led to a deterioration in the solvency margin of insurance companies, with the explicit margin dropping from 197 to 173 p.c. of the minimum requirement, while the implicit margin remained stable. The composition of the margin subsequently improved: the explicit margin was restored to 186 p.c. at the end of 2003 and 195 p.c. at the end of September 2004, while over the same period the implicit margin declined, mainly because of the fall in profits expected from life insurance activities, owing to the low level of interest rates.

The main impact of the decline in share prices was felt in the level of the hidden buffer, which comprises the part of the unrealised capital gains neither recorded on the balance sheet nor included in the implicit margin. Following the decline in the market value of insurance companies' stock market investments, this buffer fell from 304 p.c. of the required solvency margin in 2000 to just 33 p.c. in 2002. The stock market recovery in 2003 and 2004 entailed a new increase in this hidden buffer, which climbed back to 86 p.c. at the end of 2003 and 112 p.c. at the end of September 2004.

The profitability of insurance companies, like their solvency, recovered in 2003 and 2004. After four years of decline, the investment returns increased in 2003 from 12.5 to 16.4 p.c. of net premiums. Since the underwriting results also continued to improve, recovering from –14.6 to –12.5 p.c. of net premiums thanks to better pricing in relation to the risks incurred, the overall net result of the companies was back in the black in 2003. This progress will probably have continued in 2004, supported by further growth in the financial results, as suggested by the estimated increase in the return on a typical portfolio, similar in composition to that of the Belgian insurance sector. However, the return calculated on the basis of a typical portfolio constitutes only an approximate indicator of the performance of insurance companies' investments.

CHART 89 SOLVENCY MARGIN CONSTITUTED BY INSURANCE COMPANIES

(Percentages of the minimum requirement)

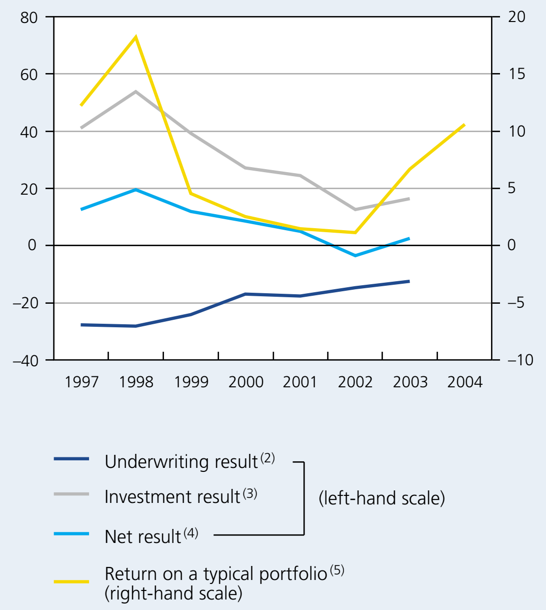


Sources: BFIC, NBB.

(1) For more detailed information on the accounting rules relating to the hidden buffer, see box 5 *Rules for the valuation of insurance companies' investments* in the NBB's Financial Stability Review 2004, pp. 56-58.

CHART 90 COMPOSITION OF THE RESULTS OF INSURANCE COMPANIES

(Percentages of net premiums (1), unless otherwise stated)



Sources: BFIC, NBB.

(1) Insurance premiums net of paid reinsurance premiums.

(2) Corresponds to the balance of the technical accounts of life and non-life insurance activities, excluding the investment results, with adjustment for the constitution of provisions owing to changes in the value of investments covering class 23 contracts.

(3) Includes all net income from investments except for net investment income relating to changes in the value of investments covering class 23 contracts.

(4) Also includes, besides the investment and underwriting results, the balance of other residual transactions.

(5) Return in per cent of the outstanding amount of a typical portfolio comparable in structure to that of Belgian insurance companies.

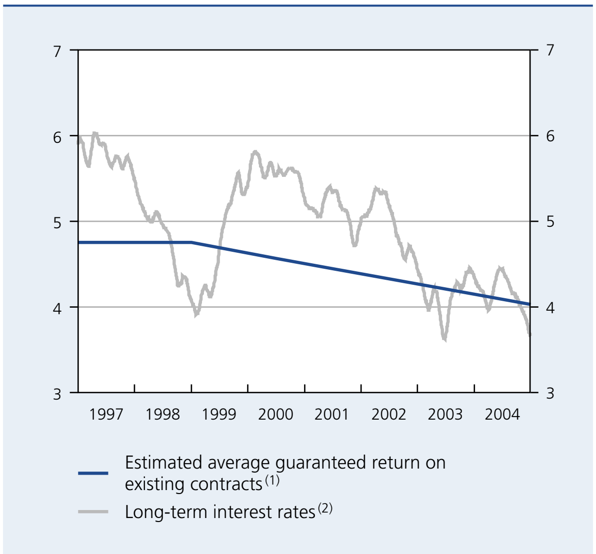
In fact, it incorporates all capital gains, whereas the accounting rules stipulate that the investment result must only record the gains actually realised. As was already the case in 2003, the return on the investments recorded in the accounts should therefore remain below the return on the typical portfolio in 2004.

Interest rate sensitivity of insurance companies

The downward trend in interest rates since the early 1990s has enabled insurance companies to collect substantial capital gains on their large bond portfolios. Interest rates on the secondary market in Belgian ten-year government bonds, which had already fallen below the 4 p.c. threshold in 1999, have oscillated between 3.5 and 4.5 p.c. since the beginning of 2003.

CHART 91 AVERAGE GUARANTEED RETURN ON CLASS 21 LIFE INSURANCE CONTRACTS AND LONG-TERM INTEREST RATES

(Percentages)



Sources : BFIC, NBB.

(1) To calculate the guaranteed return, it was estimated that, in 1999, all contracts offered a guaranteed return of 4.75 p.c. and, at the end of 2003, 45 p.c. of contracts still offered a guaranteed return of 4.75 p.c., 40 p.c. gave a return of 3.75 p.c. and 15 p.c. a return of 3 p.c. The values relating to the intermediate and the subsequent period were obtained by linear interpolation.

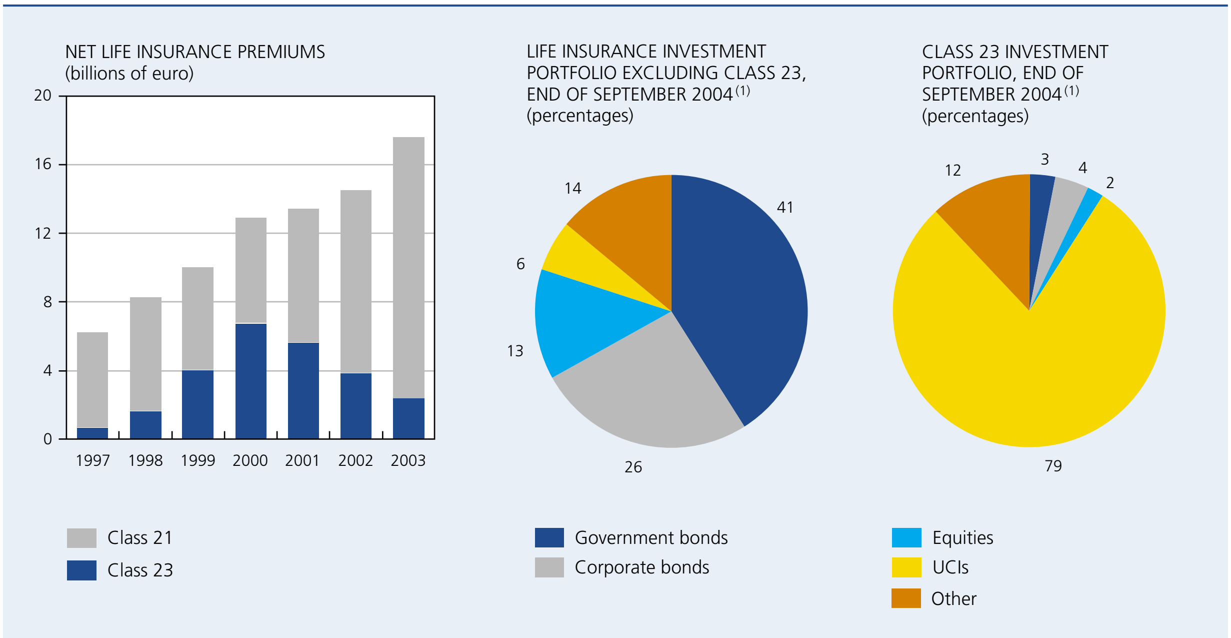
(2) Interest rates on the secondary market for Belgian ten-year government bonds ; daily data as one-month moving averages.

The low level of long-term interest rates has, however, made it difficult to manage life insurance contracts offering a guaranteed return (class 21). In fact, until recently, Belgian insurers guaranteed returns equivalent to the legal maximum, namely 4.75 p.c. for the entire duration of contracts concluded before 1999 and 3.75 p.c. for that of later contracts. While market developments have induced insurance companies over the past two years to reduce the guaranteed return to rates hovering around 3 p.c., the average guaranteed return of all class 21 contracts was estimated at around 4 p.c. at the end of 2004, a level above the long-term market interest rate.

Insurance companies are still able to cover the guaranteed returns thanks to bonds acquired up to 1998, or between 2000 and 2002, when long-term interest rates were significantly above those returns. If long-term interest rates were to be maintained at the levels of the year under review, the risks incurred by insurance companies could fairly quickly materialise as the bonds in their portfolio mature.

The insurance companies have taken various measures in anticipation of this eventuality. First, they have increased the percentage of private sector bonds in their portfolio, thus seeking to offset the decline in interest rates by accepting credit risk which enabled them to benefit

CHART 92 NET PREMIUMS AND INVESTMENT PORTFOLIOS OF CLASS 21 AND 23



Sources : BFIC, NBB.

(1) On the basis of the covering assets.

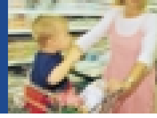
from the interest rate differential between private and government bonds.

Insurance companies have also offered alternative products, known as class 23 contracts, in which the investment risk and income both rest entirely with the policyholder. That is reflected in the composition of the class 23 investment portfolio. At the end of September 2004, bonds made up 67 p.c. of the portfolios covering contracts for which the insurance companies take on the investment risk, against 13 and 6 p.c. respectively for equities and UCI shares, whereas the latter, and in particular UCIs investing in equities, form a dominant proportion of the portfolio associated with class 23 contracts.

However, the respective success of class 21 and 23 products is determined essentially by investor demand. While subscriptions to class 23 contracts increased sharply towards the end of the 1990s, as a result of the soaring stock markets, this movement was reversed following the decline in share prices, causing investors to switch their allegiance back to life insurance contracts with a guaranteed return. While the premiums received in class 23 contracts had represented more than half of all life insurance premiums in 2000 (6.8 billion euro), that share had dropped to 14 p.c. in 2003 (2.4 billion euro). During the final months of the year under review, however, investors showed renewed interest in class 23 products, especially these in the form of contracts offering a capital guarantee.

A third measure adopted by most insurance companies involved structural modifications to class 21 contracts. Thus, the guaranteed interest rate is now generally determined at the time of the payment of each of the premiums, and can therefore be adjusted according to market conditions, whereas previously the rate fixed at the time of entry into force of the contract applied to all subsequent premiums. In a number of cases, insurance companies now also reserved the right to adjust the guaranteed return relating to the premiums already paid in line with market conditions. Furthermore, the guaranteed return relating to new contracts is generally lower than the average return on all current contracts. Finally, a large number of new contracts have shorter maturities, which permits better matching of asset and liability durations.

Annexes



Statistical annex

TABLE I SUMMARY OF MACROECONOMIC DEVELOPMENTS IN SOME EURO AREA COUNTRIES

	Belgium		Germany		France		Italy		Spain		Netherlands		Austria	
	2003	2004 e	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004
Expenditure at constant prices (1)	*(Percentage contributions to the change in GDP)*													
Final consumption expenditure of households	1.2	1.2	0.0	–0.4	0.9	1.3	0.8	0.8	1.7	1.9	–0.5	0.0	0.4	0.8
Public expenditure	0.6	0.8	–0.2	–0.1	0.8	0.6	0.5	0.2	0.7	0.8	0.4	0.1	0.1	0.0
Gross fixed capital formation of the private sector	–0.1	0.3	–0.2	–0.3	–0.2	0.6	–0.5	0.7	0.8	0.7	–0.6	0.1	1.3	0.4
of which:														
Gross formation of non-residential fixed capital	–0.3	0.2	–0.1	–0.1	–0.2	0.5	–0.6	0.5	0.5	0.5	–0.4	0.0	1.5	0.4
Total domestic expenditure	1.6	3.0	0.5	0.3	1.4	3.2	1.3	1.2	3.3	3.5	–0.5	0.3	1.9	1.0
Exports	1.5	5.2	0.7	3.0	–0.8	1.0	–1.1	1.2	0.8	1.6	0.0	4.4	0.7	4.0
Imports	–1.7	–5.5	–1.3	–2.1	–0.1	–2.1	0.2	–1.2	–1.6	–2.5	–0.4	–3.4	–2.2	–3.4
p.m. Net exports	*–0.3*	*–0.3*	*–0.6*	*0.9*	*–0.8*	*–1.2*	*–0.9*	*0.1*	*–0.8*	*–0.9*	*–0.4*	*1.1*	*–1.5*	*0.7*
	(Percentage changes compared to the previous year)													
GDP	1.3	2.7	–0.1	1.2	0.5	2.1	0.4	1.3	2.5	2.6	–0.9	1.2	0.8	1.8
Inflation	*(Percentage changes compared to the previous year)*													
Harmonised index of consumer prices	1.5	1.9	1.0	1.8	2.2	2.3	2.8	2.3	3.1	3.1	2.2	1.4	1.3	2.0
Unemployment (2)	*(Percentages of the labour force)*													
Number of unemployed (EC data)	8.0	7.8	9.6	9.8	9.5	9.6	8.6	8.2	11.3	10.8	3.8	4.6	4.3	4.5
Public finances	*(Percentages of GDP)*													
Financing balance of general government (3)	0.4 (4)	0.0	–3.8	–3.9	–4.1	–3.7	–2.4	–3.0	0.4	–0.6	–3.2	–2.9	–1.1	–1.3
Balance of payments	*(Percentages of GDP)*													
Balance of current transactions	4.4	3.4	2.3	3.3	0.4	0.2	–1.4	–0.5	–2.8	–4.2	2.9	4.2	–0.4	–0.1

Sources: EC, OECD, NAI, NBB.
(1) Calendar adjusted data.
(2) Average for twelve months in 2004, except Italy (six months) and the Netherlands (eleven months).
(3) Concept according to the excessive deficit procedure (EDP), the result of which is not identical with that of the ESA 95 owing to the different treatment of interest payments arising from swaps and forward rate agreements.
(4) Including the capital transfer of 1.9 p.c. of GDP made by Belgacom in return for the government's assumption of its pension liabilities.

TABLE II GDP AND MAIN CATEGORIES OF EXPENDITURE AT 2000 PRICES

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

	1997	1998	1999	2000	2001	2002	2003	2004 e
Final consumption expenditure of households	2.2	3.1	2.3	3.4	0.7	0.3	2.2	2.1
Housing	10.4	0.2	5.7	1.0	−3.4	−3.3	2.6	1.5
Gross fixed capital formation by enterprises	8.5	5.2	2.3	4.4	3.6	−3.8	−1.9	1.5
Expenditure of general government	0.4	1.0	4.7	2.3	1.5	2.1	2.6	3.3
Final consumption	0.4	1.1	3.5	2.3	2.7	2.3	2.7	3.4
Gross fixed capital formation	1.1	−0.6	20.2	1.9	−11.4	−0.6	1.0	0.8
p.m. Total gross fixed capital formation (1)	*8.3*	*3.5*	*4.5*	*3.4*	*0.6*	*−3.4*	*−0.6*	*1.5*
Change in stocks (2)	−0.2	0.5	−0.5	0.5	−0.9	0.7	−0.1	0.8
Total domestic expenditure	2.8	3.2	2.5	3.6	0.2	0.6	1.6	3.1
Exports of goods and services	6.2	5.7	5.3	8.2	1.8	1.3	1.7	6.0
Total final expenditure	4.3	4.3	3.7	5.7	0.9	1.0	1.6	4.4
Imports of goods and services	5.0	7.3	4.5	8.3	1.0	1.0	2.1	6.5
p.m. Net exports of goods and services (2)	*1.1*	*−1.0*	*0.8*	*0.2*	*0.6*	*0.3*	*−0.3*	*−0.3*
GDP	3.8	2.1	3.2	3.7	0.9	0.9	1.3	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 III GNI AND MAIN CATEGORIES OF EXPENDITURE AT 2000 PRICES

(Percentage changes compared to the previous year)

	1997	1998	1999	2000	2001	2002	2003	2004 e
Final consumption expenditure of households	2.0	3.1	2.3	3.5	0.6	0.3	2.2	2.3
Housing	10.5	0.1	5.7	1.0	–3.4	–3.3	2.7	1.4
Gross fixed capital formation by enterprises	6.7	4.9	2.1	6.0	3.1	–4.1	–2.3	2.4
Expenditure of general government	0.3	0.9	4.8	2.3	1.6	2.1	2.6	3.2
Final consumption	0.2	1.1	3.6	2.3	2.8	2.3	2.7	3.3
Gross fixed capital formation	1.1	–0.6	20.3	1.9	–11.4	–0.6	1.0	1.2
p.m. Total gross fixed capital formation (1)	*7.1*	*3.3*	*4.4*	*4.4*	*0.3*	*–3.7*	*–0.9*	*2.0*
Change in stocks (2)	0.1	0.2	–0.5	0.3	–0.6	0.6	0.1	0.3
Total domestic expenditure	2.7	2.9	2.5	3.8	0.4	0.5	1.7	2.8
Exports of goods and services	5.9	6.0	5.1	8.4	1.3	1.5	1.7	6.8
Total final expenditure	4.1	4.3	3.6	5.9	0.8	1.0	1.7	4.7
Imports of goods and services	5.1	7.3	4.2	8.5	1.0	1.0	2.3	6.8
p.m. Net exports of goods and services (2)	*0.8*	*–0.8*	*0.8*	*0.2*	*0.3*	*0.4*	*–0.4*	*0.2*
GDP	3.5	2.0	3.2	3.9	0.7	0.9	1.3	2.9
Trade surplus or deficit (–) resulting from the change in the terms of trade (3)	–0.4	0.9	–0.5	–1.7	0.1	0.8	–0.1	–0.7
Net primary incomes received from the rest of the world (3)	0.0	0.2	0.0	–0.1	–0.1	0.6	–0.5	–0.4
GNI	3.0	3.0	2.6	1.9	0.7	2.3	0.6	1.7

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.
(3) Contribution to the change in GNI.

TABLE IV DEFLATORS OF GNI AND THE MAIN CATEGORIES OF EXPENDITURE

(Percentage changes compared to the previous year)

	1997	1998	1999	2000	2001	2002	2003	2004 e
Final consumption expenditure of households	1.8	0.9	1.2	2.3	2.5	1.7	1.8	2.2
Housing	0.7	1.7	0.9	2.7	4.0	4.4	1.2	1.6
Gross fixed capital formation by enterprises	0.6	1.3	2.1	1.8	–0.5	–2.3	0.9	1.8
Expenditure of general government	2.2	2.2	1.5	2.5	2.3	3.2	2.3	2.1
Final consumption	2.4	2.2	1.5	2.3	2.4	3.3	2.5	2.2
Gross fixed capital formation	0.1	1.9	1.2	4.2	0.8	1.5	–0.6	1.2
p.m. Total gross fixed capital formation (1)	*0.6*	*1.4*	*1.7*	*2.2*	*0.6*	*–0.4*	*0.9*	*1.7*
Total domestic expenditure (2)	1.7	1.3	1.4	2.3	2.0	1.7	1.8	2.1
Exports of goods and services	4.8	–1.3	0.0	9.6	1.4	–1.1	–1.2	2.2
Total final expenditure (2)	3.0	0.1	0.8	5.5	1.7	0.3	0.4	2.1
Imports of goods and services	5.5	–2.2	0.7	12.0	1.3	–2.1	–1.0	3.1
p.m. Terms of trade	*–0.7*	*1.0*	*–0.7*	*–2.2*	*0.1*	*0.9*	*–0.2*	*–0.9*
GDP	1.4	1.7	1.4	1.3	1.8	1.8	1.9	2.2
GNI	1.9	0.8	1.9	3.0	1.7	1.0	2.1	2.9

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 V GNI AND THE MAIN CATEGORIES OF EXPENDITURE AT CURRENT PRICES

(Millions of euro)

	1997	1998	1999	2000	2001	2002	2003	2004 e
Final consumption expenditure of households	117,534	122,347	126,683	134,194	138,358	141,174	146,779	153,489
Housing	11,009	11,202	11,949	12,400	12,464	12,578	13,071	13,456
Gross fixed capital formation by enterprises	29,724	31,592	32,919	35,513	36,419	34,095	33,628	35,034
Expenditure of general government	49,630	51,180	54,436	57,059	59,297	62,487	65,597	69,122
Final consumption	46,025	47,529	49,995	52,347	55,090	58,244	61,336	64,755
Gross fixed capital formation	3,605	3,650	4,441	4,713	4,207	4,243	4,261	4,367
p.m. Total gross fixed capital formation (1)	*44,338*	*46,444*	*49,308*	*52,626*	*53,091*	*50,915*	*50,960*	*52,857*
Change in stocks	–312	–694	–521	1,158	–1,098	–813	271	3,210
Total domestic expenditure	207,585	215,627	225,465	240,325	245,441	249,520	259,346	274,312
Exports of goods and services	162,241	169,816	178,453	211,999	217,879	218,522	219,701	239,829
Total final expenditure	369,826	385,443	403,918	452,323	463,319	468,042	479,047	514,141
Imports of goods and services	152,680	160,212	168,235	204,399	209,166	206,918	209,501	230,669
p.m. Net exports of goods and services	*9,561*	*9,604*	*10,218*	*7,600*	*8,713*	*11,603*	*10,200*	*9,160*
GDP	217,146	225,231	235,683	247,924	254,153	261,124	269,546	283,472
Net primary incomes received from the rest of the world	4,297	4,804	4,858	4,668	4,547	6,242	5,114	4,044
GNI	221,442	230,035	240,541	252,593	258,700	267,366	274,660	287,516

Sources: NAI, NBB.
(1) Housing, gross fixed capital formation by enterprises and gross fixed capital formation by general government.

TABLE VI VALUE ADDED OF THE VARIOUS BRANCHES OF ACTIVITY AT 2000 PRICES

(Percentage changes compared to the previous year)

	1997	1998	1999	2000	2001	2002	2003	*p.m. Percentages of the 2003 GDP*
Agriculture, hunting, forestry and fisheries	2.9	3.4	5.1	1.0	–11.3	12.7	–3.2	*1.2*
Industry	6.6	0.7	1.2	5.0	–0.3	–0.2	–0.3	*19.6*
Mineral-extracting industry	9.4	–11.1	–4.5	12.3	–19.4	–1.9	–5.6	*0.1*
Electricity, gas, water	7.7	–4.6	10.9	6.1	–1.4	–2.7	–8.1	*2.1*
Manufacturing industry	6.5	1.5	0.0	4.8	0.0	0.1	0.8	*17.5*
of which:								
Non-metallic minerals	4.6	–8.1	6.8	–1.3	–2.4	0.7	–2.3	*0.9*
Iron, steel, and non-ferrous metals	9.4	1.1	4.5	7.1	0.1	3.2	3.2	*2.7*
Metal-working industry	8.2	5.1	–0.4	13.7	–4.3	–0.3	–8.9	*3.6*
Paper, printing, publishing	5.7	–0.6	7.0	–0.5	–3.4	–1.1	9.4	*1.4*
Chemicals and rubber	12.2	–1.3	3.7	6.3	1.9	3.0	3.1	*4.2*
Textiles, clothing and footwear	11.8	5.1	–7.4	–10.7	0.2	–1.8	–9.5	*0.8*
Food, beverages, tobacco	–4.0	4.5	–1.5	–1.6	10.4	–3.9	9.3	*2.5*
Building industry	4.3	–1.8	3.5	7.7	1.2	–1.5	–0.4	*4.4*
Market services	2.9	2.7	3.1	2.8	1.8	1.5	2.0	*54.1*
Trade and repairs	1.4	1.1	1.3	0.5	1.8	6.1	0.3	*11.1*
Financial services	9.9	1.3	0.7	–7.4	–7.8	4.6	–2.1	*5.1*
Real estate, renting and business services	4.0	4.1	3.6	5.3	4.2	–1.0	4.3	*21.3*
Transport and communications	–1.4	6.3	4.9	6.3	4.7	0.0	3.8	*6.6*
Health care and social services	0.5	–1.4	8.0	4.6	2.6	2.4	3.1	*6.3*
Hotels and restaurants and miscellaneous services to households	1.2	3.5	–0.1	4.1	–3.0	–1.0	–4.4	*3.7*
Non-market services	0.2	1.1	2.2	1.7	1.4	0.7	1.6	*13.3*
Value added of branches, at basic prices	3.4	1.8	2.6	3.3	1.1	1.0	1.3	
Financial intermediation services indirectly measured and taxes net of subsidies on products (1)	0.3	0.3	0.8	0.8	–0.3	0.0	0.1	
GDP	3.5	2.0	3.2	3.9	0.7	0.9	1.3	*100.0*

Source: NAI.
(1) Contribution to the change in GDP.

TABLE VII LABOUR MARKET

(Annual averages, thousands of units)

	1997	1998	1999	2000	2001	2002	2003	2004 e
Population of working age [1]	6,706	6,709	6,715	6,724	6,743	6,774	6,805	6,828
Labour force	4,504	4,547	4,568	4,613	4,668	4,677	4,727	4,797
National employment	3,934	4,006	4,060	4,138	4,198	4,186	4,189	4,220
Frontier workers (balance)	48	49	49	50	50	50	50	51
Domestic employment	3,886	3,956	4,011	4,088	4,148	4,136	4,138	4,169
Self-employed persons	702	697	693	688	683	679	677	681
Employees	3,184	3,259	3,319	3,400	3,466	3,457	3,462	3,488
Private sector	2,471	2,534	2,578	2,653	2,715	2,690	2,685	2,702
Public sector	713	725	740	747	751	767	777	786
Unemployment [2]	570	541	508	474	470	491	538	577

Sources: NAI, NSI, NEMO, NBB.

(1) Persons aged 15 to 64.

(2) 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 VIII **UNEMPLOYMENT RATE**

(Percentages of the corresponding labour force aged 15 to 64 (1), annual averages)

						Second quarter	
	1999	2000	2001	2002	2003	2003	2004
Total	8.6	7.0	6.6	7.6	8.2	7.8	7.4
According to sex							
Women	10.4	8.7	7.5	8.7	8.9	8.1	8.3
Men	7.2	5.8	6.0	6.7	7.7	7.5	6.7
According to age							
15 to 24	21.1	17.4	16.9	17.7	21.7	19.0	17.5
25 to 49	7.6	6.4	6.0	6.9	7.4	7.4	7.0
50 and over	5.4	3.7	3.3	4.3	3.9	3.2	3.8
According to region							
Brussels	15.9	14.0	13.0	14.7	15.7	15.0	n.
Flanders	5.4	4.3	4.0	4.9	5.7	5.3	n.
Wallonia	12.7	10.3	10.0	10.6	10.9	10.5	n.
According to educational level							
Lower secondary education or less	13.6	11.1	10.0	11.7	12.4	11.7	12.1
Upper secondary education	8.0	6.8	6.7	7.3	8.4	8.0	7.4
Higher education	3.8	3.3	3.5	4.1	4.4	3.8	3.7

Sources: EC, NSI.
(1) These unemployment rates are calculated on the basis of the harmonised data from the labour force survey.

TABLE IX HARMONISED INDEX OF CONSUMER PRICES FOR BELGIUM

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

	Total							*p.m.* *National index of consumer prices*	*p.m.* *"Health" price index* [3]
		Energy	Unprocessed food [1]	Underlying trend in inflation [2]					
					Processed food	Non-energy industrial goods	Services		
1997	1.5	3.1	2.7	1.1	2.3	0.1	1.7	*1.6*	*1.3*
1998	0.9	–3.6	2.2	1.4	1.4	0.7	2.1	*1.0*	*1.3*
1999	1.1	2.0	0.0	1.1	0.6	0.8	1.8	*1.1*	*0.9*
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	2.1	*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*
2004 January	1.4	–1.5	2.9	1.7	2.2	0.7	2.3	*1.6*	*1.6*
February	1.2	–4.4	1.4	1.8	2.4	0.8	2.4	*1.3*	*1.3*
March	1.0	–4.2	1.2	1.6	2.5	0.7	2.1	*1.1*	*1.1*
April	1.7	3.5	1.9	1.4	2.4	0.7	1.9	*1.9*	*1.6*
May	2.4	10.1	2.8	1.5	2.3	0.4	2.2	*2.6*	*1.9*
June	2.0	8.6	1.4	1.3	2.0	0.4	1.9	*2.3*	*1.6*
July	2.1	9.5	0.7	1.4	2.3	0.0	2.3	*2.4*	*1.7*
August	2.0	10.0	–0.8	1.4	2.2	0.4	2.1	*2.3*	*1.6*
September	1.8	10.4	–3.1	1.3	2.1	0.1	2.3	*2.0*	*1.4*
October	2.7	16.0	0.0	1.3	1.9	0.0	2.2	*2.9*	*2.1*
November	2.3	12.7	1.0	1.2	2.0	0.1	1.9	*2.5*	*1.9*
December	1.9	10.2	1.8	1.1	2.1	0.0	1.7	*2.3*	*1.7*

Sources: EC; FPS Economy, SMEs, Self-employed and Energy.
(1) Fruit, vegetables, meat and fish.
(2) HICP excluding unprocessed food and energy.
(3) National index of consumer prices excluding products considered harmful to health, namely tobacco, alcoholic beverages, petrol and diesel.

TABLE X INCOMES OF THE VARIOUS SECTORS AT CURRENT PRICES [1]

(Millions of euro)

	1997	1998	1999	2000	2001	2002	2003	2004 e
Households								
Gross primary income	170,647	176,324	182,988	191,929	201,998	206,714	210,267	215,789
Wages and salaries [2]	114,237	118,119	124,260	129,789	137,188	141,942	145,700	150,785
Incomes from movable property [3]	20,583	21,800	21,296	23,411	25,107	24,950	23,639	22,719
Gross mixed income	25,255	25,496	26,074	26,883	27,508	27,468	28,170	29,164
Gross operating surplus	10,573	10,909	11,357	11,845	12,196	12,354	12,758	13,120
Current transfers [3]	–30,361	–32,310	–33,865	–36,275	–38,241	–39,977	–38,702	–39,243
Transfers received	49,385	50,622	51,343	52,691	55,616	58,221	60,356	62,423
Transfers paid (–)	–79,746	–82,932	–85,209	–88,966	–93,857	–98,198	–99,059	–101,666
Gross disposable income	140,286	144,014	149,123	155,653	163,757	166,737	171,565	176,545
p.m. At constant prices [4]	*146,710*	*149,210*	*152,599*	*155,653*	*159,832*	*159,954*	*161,721*	*162,829*
(Percentage changes compared to the previous year)	*(0.8)*	*(1.7)*	*(2.3)*	*(2.0)*	*(2.7)*	*(0.1)*	*(1.1)*	*(0.7)*
Companies								
Gross primary income	37,333	39,251	40,622	42,429	38,577	40,044	42,300	46,499
Gross operating surplus [5]	39,757	42,525	44,048	47,921	46,293	47,078	49,903	54,344
Incomes from movable property [3]	–2,424	–3,274	–3,426	–5,493	–7,716	–7,034	–7,603	–7,845
Current transfers [3]	–5,330	–7,109	–6,782	–7,110	–6,795	–5,861	–5,975	–7,371
Gross disposable income	32,004	32,142	33,840	35,319	31,782	34,183	36,325	39,128
General government								
Gross primary income	13,462	14,460	16,931	18,235	18,124	20,608	22,092	25,229
Current transfers [3]	33,661	37,051	38,188	40,983	43,109	43,132	41,334	43,049
Gross disposable income	47,123	51,511	55,120	59,218	61,233	63,740	63,426	68,278
Rest of the world								
Gross disposable income	2,030	2,369	2,459	2,402	1,928	2,706	3,344	3,565
GNI	221,442	230,035	240,541	252,593	258,700	267,366	274,660	287,516

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 deflator of the final consumption expenditure of households, at 2000 prices.
(5) Including the negative value of the gross operating surplus of financial intermediation services indirectly measured.

TABLE XI SUMMARY OF THE TRANSACTIONS OF THE MAIN SECTORS OF THE ECONOMY AT CURRENT PRICES [1]

(Millions of euro)

	1997	1998	1999	2000	2001	2002	2003	2004 e
1. Households								
1.1 Gross disposable income	140,286	144,014	149,123	155,653	163,757	166,737	171,565	176,545
p.m. Gross adjusted disposable income	*169,435*	*174,310*	*180,655*	*188,347*	*198,454*	*203,098*	*210,250*	*217,761*
1.2 Change in net equity of households in pension funds reserves	1,401	1,166	1,258	1,156	1,536	2,465	2,108	2,373
1.3 Final consumption expenditure	117,534	122,347	126,683	134,194	138,358	141,174	146,779	153,489
p.m. Actual final consumption	*146,683*	*152,643*	*158,216*	*166,887*	*173,055*	*177,535*	*185,464*	*194,705*
1.4 Gross savings (1.1 + 1.2 – 1.3)	24,153	22,833	23,698	22,616	26,935	28,029	26,894	25,429
p.m. Percentages of gross disposable income [2]	*17.0*	*15.7*	*15.8*	*14.4*	*16.3*	*16.6*	*15.5*	*14.2*
p.m. Percentages of gross adjusted disposable income [2]	*14.1*	*13.0*	*13.0*	*11.9*	*13.5*	*13.6*	*12.7*	*11.6*
1.5 Capital transfers [3]	201	14	87	–324	–668	–579	–920	–1,289
1.6 Gross capital formation	13,281	13,777	14,301	15,008	14,732	15,057	15,634	15,918
1.7 Financing balance (1.4 + 1.5 – 1.6)	11,073	9,071	9,483	7,283	11,535	12,394	10,340	8,222
2. Companies								
2.1 Gross disposable income	32,004	32,142	33,840	35,319	31,782	34,183	36,325	39,128
2.2 Change in net equity of households in pension funds reserves	–1,401	–1,166	–1,258	–1,156	–1,536	–2,465	–2,108	–2,373
2.3 Gross savings (2.1 + 2.2)	30,602	30,976	32,582	34,163	30,246	31,717	34,217	36,755
2.4 Capital transfers [3]	1,935	1,745	1,602	1,669	843	152	–4,134	1,032
2.5 Gross fixed capital formation	27,410	29,044	30,528	32,852	34,108	31,514	30,962	32,256
2.6 Change in stocks	–272	–726	–492	1,218	–1,043	–738	357	1,122
2.7 Financing balance (2.3 + 2.4 – 2.5 – 2.6)	5,399	4,403	4,148	1,762	–1,976	1,094	–1,236	4,410
3. General government								
3.1 Gross disposable income	47,123	51,511	55,120	59,218	61,233	63,740	63,426	68,278
p.m. Gross adjusted disposable income	*17,974*	*21,215*	*23,587*	*26,525*	*26,536*	*27,379*	*24,741*	*27,062*
3.2 Final consumption expenditure	46,025	47,529	49,995	52,347	55,090	58,244	61,336	64,755
p.m. Actual final consumption	*16,876*	*17,234*	*18,462*	*19,653*	*20,393*	*21,883*	*22,651*	*23,539*
3.3 Gross savings (3.1 – 3.2)	1,099	3,981	5,125	6,872	6,143	5,496	2,090	3,523
3.4 Capital transfers [3]	–1,744	–1,829	–1,623	–1,790	–501	–1,044	3,023	296
3.5 Gross fixed capital formation	3,605	3,650	4,441	4,713	4,207	4,243	4,261	4,367
3.6 Change in stocks	2	6	10	–6	–11	28	18	18
3.7 Financing balance (3.3 + 3.4 – 3.5 – 3.6)	–4,253	–1,504	–949	375	1,447	181	834	–566
4. Total of domestic sectors								
4.1 Financing balance (1.7 + 2.7 + 3.7)	12,219	11,970	12,683	9,420	11,007	13,669	9,939	12,065

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 claims of households on 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.

TABLE XII REVENUE, EXPENDITURE AND FINANCING BALANCE OF GENERAL GOVERNMENT [1]

(Millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 e
Revenue [2]	98,075	101,589	107,427	112,790	117,100	122,573	126,876	131,364	138,285	139,949
Fiscal and parafiscal revenue	88,978	91,840	97,232	102,522	106,369	111,614	114,883	119,067	120,806	127,600
Levies weighing chiefly on earned incomes	55,408	56,142	58,979	61,765	63,506	66,765	70,037	72,294	73,344	75,246
Personal income tax [3]	25,240	25,439	27,040	28,379	29,032	31,131	32,741	33,440	33,670	34,719
Social security contributions [4]	30,168	30,703	31,939	33,386	34,475	35,634	37,296	38,854	39,674	40,527
Taxes on profits of companies [5]	4,881	5,630	6,264	7,762	7,703	8,090	8,092	8,087	7,906	9,094
Levies on other income and in respect of property [6]	7,143	7,058	7,623	8,019	8,048	8,568	8,794	9,192	9,613	10,670
Taxes on goods and services	21,546	23,009	24,366	24,977	27,111	28,192	27,960	29,494	29,943	32,591
Non-fiscal and non-parafiscal revenue [7]	9,097	9,750	10,195	10,268	10,731	10,959	11,993	12,297	17,479	12,349
Expenditure excluding interest charges	88,198	91,068	94,285	97,108	101,535	105,382	108,680	115,494	122,812	126,563
Social insurance benefits	45,718	47,429	48,364	49,761	51,293	53,249	55,948	59,129	62,757	65,770
Replacement incomes	26,752	27,580	28,461	29,138	29,686	30,318	31,608	33,683	35,301	36,763
Pensions	17,541	18,079	18,876	19,450	19,925	20,538	21,354	22,338	23,243	24,133
Private sector pensions	12,724	13,110	13,458	13,810	14,149	14,549	15,110	15,723	16,286	16,713
General government pensions [8]	4,818	4,969	5,418	5,640	5,776	5,988	6,244	6,615	6,957	7,420
Old persons' guaranteed income	235	231	233	231	227	249	258	258	264	278
Early retirement pensions	1,294	1,305	1,308	1,254	1,215	1,163	1,165	1,158	1,189	1,244
Unemployment benefits	4,219	4,422	4,462	4,515	4,492	4,381	4,623	5,333	5,731	5,983
Career breaks and time credit	132	130	138	160	197	236	275	360	437	493
Sickness and disability insurance benefits	2,482	2,543	2,547	2,635	2,722	2,840	3,023	3,206	3,403	3,560
Industrial accidents and occupational diseases	513	502	489	494	485	486	489	495	497	507
Integration allowance	336	368	409	399	424	426	420	536	536	563
Other social insurance benefits [9]	18,966	19,849	19,903	20,623	21,607	22,931	24,340	25,445	27,457	29,007
of which:										
Health care	11,155	11,973	11,831	12,420	13,145	13,934	14,960	15,361	16,777	18,382
Family allowances	3,961	4,105	4,179	4,241	4,261	4,324	4,433	4,566	4,677	4,773
Other primary expenditure	42,480	43,639	45,921	47,347	50,242	52,134	52,732	56,366	60,055	60,793
Compensation of employees	24,128	24,611	25,476	26,210	27,367	28,324	29,590	31,394	32,671	33,857
Current purchases of goods and services	5,547	5,872	6,264	6,646	7,079	7,488	8,062	8,861	9,206	9,668
Subsidies to enterprises	2,974	3,176	2,978	3,258	3,411	3,645	3,953	3,998	4,349	4,441
Current transfers to the rest of the world	892	1,305	1,506	1,673	1,781	1,841	1,851	2,112	2,433	2,824
Other current transfers	3,167	3,000	3,054	3,069	3,072	3,067	3,161	3,298	3,534	3,695
Gross fixed capital formation	3,771	3,563	3,605	3,650	4,441	4,713	4,207	4,243	4,261	4,367
Other capital expenditure	2,001	2,112	3,037	2,841	3,092	3,056	1,909	2,460	3,601	1,941
Net amount excluding interest charges	9,876	10,522	13,142	15,682	15,565	17,191	18,196	15,870	15,474	13,386
Interest charges	18,745	18,368	17,395	17,186	16,514	16,816	16,749	15,689	14,639	13,709
Financing balance	–8,868	–7,847	–4,253	–1,504	–949	375	1,447	181	834	–324

Sources: NAI, NBB.

(1) From 2002, the data incorporate the effects of the reclassification of the public radio and television companies from the non-financial corporations sector to the general government 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. Including in 2003 the capital transfer of 5 billion euro made by Belgacom in return for the government's assumption of its pension liabilities.

(8) Including pensions of Post Office staff and, from 2004, pensions of Belgacom officials.

(9) 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.

TABLE XIII FINANCING BALANCE OF GENERAL GOVERNMENT, BY SUBSECTORS

(Millions of euro)

	Entity I			Entity II			General government
	Federal government	Social security	Total	Communities and regions	Local authorities	Total	
1995	–7,761	–135	–7,897	–1,535	563	–972	–8,868
1996	–7,035	–476	–7,511	–724	389	–335	–7,847
1997	–5,264	860	–4,404	–112	263	151	–4,253
1998	–3,594	1,097	–2,497	771	222	993	–1,504
1999	–3,578	1,629	–1,948	963	37	1,000	–949
2000	–1,034	1,413	379	672	–677	–5	375
2001	–2,040	1,800	–240	2,047	–360	1,687	1,447
2002	–544	913	369	–371	183	–188	181
2003	1,041	–1,316	–275	407	702	1,110	834
2004 e	–991	–674	–1,664	863	478	1,341	–324

Sources: NAI, NBB.

TABLE XIV **CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT** [1]

(End-of-period outstanding amounts, millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Official debt of the Treasury	236,230	238,121	243,082	241,903	246,755	251,061	257,163	262,752	263,018	265,518
In national currency [2]	209,325	219,923	223,637	224,523	236,314	242,455	250,085	257,288	259,295	263,074
At up to one year	43,093	46,420	47,894	41,888	36,553	33,310	34,851	31,115	30,222	30,355
At over one year	166,232	173,504	175,743	182,635	199,762	209,144	215,234	226,173	229,073	232,719
In foreign currencies	26,905	18,198	19,444	17,380	10,441	8,606	7,079	5,464	3,724	2,444
2. Components of the official debt of the Treasury not included in the consolidated gross debt [3]	2,707	2,767	3,274	3,321	4,595	5,429	4,572	4,234	3,727	433
3. Other federal government liabilities [4]	12,717	11,953	11,785	11,555	11,821	10,288	12,656	12,105	6,414	n.
4. Consolidation between federal government units [5]	925	3,047	2,156	2,167	2,696	3,108	6,501	11,347	15,486	n.
of which:										
Ageing Fund assets [6]	–	–	–	–	–	–	374	1,087	4,266	12,492
5. Consolidated gross debt of federal government (1 – 2 + 3 – 4)	245,315	244,261	249,437	247,970	251,285	252,812	258,746	259,276	250,220	n.
6. Consolidated gross debt of communities and regions	18,196	18,943	19,319	18,705	17,629	16,395	16,049	15,990	14,736	n.
7. Consolidated gross debt of local authorities	12,380	12,370	11,769	12,121	12,163	13,213	13,686	14,011	14,481	n.
8. Consolidated gross debt of social security	2,608	1,879	2,117	1,774	1,429	1,237	0	103	90	n.
9. Consolidation between the general government subsectors [7]	9,561	9,778	12,945	12,590	12,640	13,300	14,032	14,263	10,113	n.
10. Consolidated gross debt of general government [1] (5 + 6 + 7 + 8 – 9)	268,937	267,675	269,698	267,980	269,866	270,358	274,448	275,117	269,414	271,015 e

Sources: FPS Finance, NBB.

(1) Concept used for the implementation of the convergence criteria defined in the Treaty on European Union.

(2) In Belgian franc up to the end of 1998 and in euro thereafter.

(3) Treasury certificates presented to the IMF (up to 2003), capitalised interest on traditional loans, exchange variations on operations concerning the management of the foreign currency debt, and accruals and deferrals relating to the financial Post Office.

(4) Mainly the debudgeted Treasury debt, the SHLAF and CREDIBE debts, and coins in circulation.

(5) Federal government debt, the counterpart of which is an asset of a federal government unit.

(6) Including the capitalised interest on "Ageing Fund Treasury Bonds".

(7) Debt of a general government subsector, the counterpart of which is an asset of another general government subsector.

TABLE XV CURRENT AND CAPITAL TRANSACTIONS OF BELGIUM ON A TRANSACTION BASIS

(Millions of euro)

	2002			2003			2004 (First nine months)		
	Credits	Debits	Balances	Credits	Debits	Balances	Credits	Debits	Balances
1. Total current transactions on a transaction basis	263,418	248,453	14,965	259,780	247,987	11,793	205,905	199,740	6,165
Goods and services	218,329	206,792	11,537	220,010	209,284	10,726	175,595	168,980	6,615
Goods	178,255	168,921	9,334	180,319	171,297	9,022	145,123	139,286	5,837
General merchandise	162,240	154,703	7,537	166,225	159,169	7,056	135,253	130,999	4,254
Goods for processing	14,569	13,438	1,131	12,682	11,361	1,321	8,687	7,690	997
Repairs to goods	294	251	43	219	174	45	165	140	25
Purchases of goods in ports	1,045	395	650	1,137	426	711	956	333	623
Non-monetary gold	107	134	–27	56	167	–111	62	124	–62
Services	40,074	37,871	2,203	39,691	37,987	1,704	30,472	29,694	778
Transport	9,115	8,106	1,009	8,664	7,896	768	7,231	6,409	822
Travel	7,313	10,730	–3,417	7,209	10,743	–3,534	5,672	8,792	–3,120
Communications	1,746	1,360	386	1,630	1,280	350	1,183	890	293
Building	1,360	751	609	1,700	867	833	1,007	709	298
Insurance	513	475	38	654	558	96	522	357	165
Financial services	2,329	2,442	–113	2,235	2,381	–146	1,761	1,893	–132
Data-processing and information services	1,920	1,484	436	1,862	1,396	466	1,392	1,026	366
Fees and licence dues	720	842	–122	779	947	–168	564	635	–71
Other services to enterprises	12,973	10,674	2,299	13,006	10,835	2,171	9,810	8,307	1,503
of which:									
Merchanting (net)	1,510	–	1,510	1,447	–	1,447	1,023	–	1,023
Personal, cultural and leisure services	302	402	–100	316	388	–72	254	294	–40
Services provided or received by general government, not included elsewhere	1,783	605	1,178	1,636	696	940	1,076	382	694
Incomes	39,492	31,472	8,020	34,073	27,075	6,998	26,134	21,870	4,264
Earned incomes	4,747	1,446	3,301	4,853	1,513	3,340	3,703	1,120	2,583
Income from direct and portfolio investment	34,745	30,026	4,719	29,220	25,562	3,658	22,431	20,750	1,681
Current transfers	5,597	10,189	–4,592	5,697	11,628	–5,931	4,176	8,890	–4,714
General government	1,691	5,405	–3,714	1,648	6,048	–4,400	1,264	4,682	–3,418
Other sectors	3,906	4,784	–878	4,049	5,580	–1,531	2,912	4,208	–1,296
2. Total capital transactions	206	902	–696	221	981	–760	217	275	–58
Capital transfers	178	815	–637	210	897	–687	183	181	2
Acquisitions and sales of non-produced non-financial assets	28	87	–59	11	84	–73	34	94	–60
3. Net lending to the rest of the world (1 + 2)	263,624	249,355	14,269	260,001	248,968	11,033	206,122	200,015	6,107

Source: NBB.

TABLE XVI FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF HOUSEHOLDS

(Millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	First nine months 2003	First nine months 2004 e	*p.m. Outstanding amount at the end of September 2004 e*
Formation of financial assets	19,988	26,973	27,096	27,766	24,688	20,199	18,081	21,040	22,386	17,407	14,475	*707,136*
At up to one year	–2,433	8,016	7,225	3,914	2,230	7,604	10,274	11,491	23,812	18,191	10,203	*232,061*
Notes, coins and sight deposits	567	253	1,289	1,236	3,775	2,117	–3,606	4,383	3,553	2,604	2,996	*42,412*
Savings deposits	9,987	10,719	7,881	4,520	3,422	–5,129	5,554	11,543	17,934	12,134	7,579	*132,924*
Time deposits	–7,976	294	1,053	300	–3,772	10,953	7,151	–4,107	3,070	4,373	–227	*52,773*
Fixed-income securities	–4,135	–2,344	–853	–484	–135	252	575	–1,258	–357	–286	–152	*599*
Units of monetary UCIs	–877	–906	–2,145	–1,660	–1,060	–589	601	930	–388	–634	7	*3,353*
At over one year	18,140	18,645	17,646	31,023	24,741	18,877	21,799	7,066	7,466	6,369	3,220	*472,947*
Time deposits	1,528	167	271	–279	–279	–467	223	–506	–629	–540	–308	*3,721*
Fixed-income securities	10,786	5,583	–1,834	658	2,885	–1,447	–804	–8,585	–15,593	–11,759	–14,398	*107,180*
Shares and other equity	562	2,689	2,750	4,916	–232	–277	–1,309	–1,412	–53	–12	3,730	*113,034*
Units of non-monetary UCIs	929	4,732	9,282	17,558	10,760	11,822	10,440	4,606	7,264	4,793	2,014	*105,775*
Insurance technical reserves (1)	4,336	5,474	7,178	8,172	11,607	9,246	13,249	12,962	16,477	13,887	12,182	*143,238*
Other assets (2)	4,280	312	2,224	–7,171	–2,283	–6,282	–13,992	2,483	–8,891	–7,154	1,052	*2,127*
New financial liabilities	2,197	4,222	5,877	6,454	5,202	2,107	–1,984	4,079	5,524	2,841	3,155	*118,911*
Loans at up to one year	–245	362	–35	573	1,585	–698	–1,224	241	–1,100	–679	–208	*4,280*
Loans at over one year	2,168	4,019	5,601	5,305	2,907	3,223	707	4,373	6,508	4,528	4,194	*107,522*
Mortgage loans	2,115	2,916	3,636	2,874	5,532	2,632	621	5,258	6,153	4,384	4,601	*87,757*
Instalment loans	–102	414	593	1,258	139	328	248	59	–164	–183	–600	*8,164*
Other	154	689	1,372	1,174	–2,763	263	–162	–944	518	326	193	*11,601*
Other liabilities (3)	274	–159	311	577	709	–418	–1,467	–535	116	–1,008	–831	*7,110*
Financial balance (4)	17,791	22,750	21,219	21,312	19,487	18,092	20,066	16,961	16,862	14,566	11,320	*588,225*

Source: NBB.

(1) This item essentially comprises the net claims of households on insurance technical reserves and on pension funds.

(2) Instruments whose maturity is not known and errors and omissions.

(3) This item comprises other accounts payable within the meaning of the ESA 95.

(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, to the statistical adjustments or to the errors and omissions. Thus, for example, the financial accounts cannot, for lack of data, record most of the trade credits and advances.

TABLE XVII FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

(Millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	First nine months		*p.m. Outstanding amount at the end of September 2004 e*
										2003	2004 e	
Formation of financial assets	16,199	11,842	33,838	32,972	40,972	73,814	60,597	28,217	20,143	6,773	17,954	*789,669*
At up to one year	8,701	3,863	12,210	31,272	28,895	49,297	41,573	6	26,998	19,552	1,509	*275,950*
Notes, coins and sight deposits	2,110	2,016	1,656	3,421	1,215	–390	354	959	1,819	2,534	3,594	*32,720*
Other deposits	1,993	3,777	–1,283	2,108	7,495	–2,136	1,326	4,449	843	–2,871	–1,161	*43,183*
Other (1)	4,598	–1,929	11,836	25,743	20,186	51,823	39,892	–5,402	24,336	19,889	–924	*200,048*
At over one year	2,846	2,532	10,690	8,863	6,505	29,333	12,774	23,956	5,449	1,195	15,990	*518,956*
Shares and other equity	67	1,043	–1,727	6,886	–788	14,942	3,908	1,904	–4,693	–6,956	4,059	*380,371*
Fixed-income securities	853	–74	1,807	1,011	–979	–623	1,213	3,252	–1,497	555	1,912	*11,866*
Other (1)	1,925	1,562	10,610	966	8,271	15,014	7,653	18,800	11,640	7,596	10,019	*126,718*
Other assets (2)	4,652	5,448	10,939	–7,163	5,572	–4,816	6,251	4,255	–12,305	–13,974	455	*–5,237*
New financial liabilities	15,133	15,591	37,947	40,249	46,780	81,823	69,957	30,517	27,856	9,923	19,511	*1,037,838*
At up to one year	5,407	4,279	16,203	24,401	19,388	39,192	27,065	–3,100	8,831	5,206	2,496	*210,325*
Loans granted by credit institutions	3,006	3,804	1,832	5,780	5,626	513	–792	–876	–714	–1,174	1,188	*57,310*
Other loans (1)	2,542	222	14,078	17,916	12,354	35,528	26,292	–4,451	6,392	4,360	2,124	*141,615*
Fixed-income securities	–140	253	292	706	1,408	3,151	1,565	2,227	3,153	2,020	–817	*11,400*
At over one year	9,212	9,211	21,384	14,452	24,916	41,030	41,469	32,169	18,059	4,326	18,824	*796,302*
Loans granted by credit institutions	32	1,144	2,362	2,099	4,324	4,745	3,786	1,515	–4,480	–4,832	2,213	*59,500*
Other loans (1)	1,936	1,269	10,581	1,012	7,387	12,264	5,822	20,328	12,656	5,546	10,696	*124,087*
Shares and other equity	5,915	4,754	8,219	10,070	11,865	24,614	26,175	8,459	6,066	1,830	2,659	*587,892*
Fixed-income securities	1,330	2,043	222	1,271	1,341	–592	5,687	1,868	3,816	1,782	3,257	*24,822*
Other liabilities (3)	514	2,101	360	1,397	2,476	1,601	1,422	1,449	966	391	–1,809	*31,210*
Financial balance (4)	1,066	–3,749	–4,109	–7,278	–5,808	–8,009	–9,359	–2,300	–7,713	–3,150	–1,557	*–248,168*

Source : NBB.
(1) Including intrasectoral loans of non-financial corporations.
(2) See note 2 to table XVI.
(3) This item comprises the technical reserves of the non-autonomous pension funds and the other accounts payable within the meaning of the ESA 95.
(4) See note 4 to table XVI.

TABLE XVIII FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF GENERAL GOVERNMENT

(Millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	First nine months 2003	First nine months 2004	*p.m. Outstanding amount at the end of September 2004*
Formation of financial assets	–2,645	–4,824	–1,240	–887	1,585	1,298	5,097	4,322	–4,397	–2,016	3,826	*61,956*
Deposits, loans and securities other than shares	–2,541	1,765	141	54	1,380	1,497	3,374	4,927	–3,922	–233	4,412	*36,152*
With general government	648	2,544	2,096	–100	369	1,168	4,239	5,172	1,418	–2,030	–3,474	*22,258*
With other sectors	–3,189	–778	–1,955	154	1,011	329	–864	–245	–5,340	1,797	7,887	*13,893*
Other assets (1)	–104	–6,589	–1,381	–941	206	–199	1,722	–606	–475	–1,783	–586	*25,805*
New financial liabilities	5,057	3,658	3,651	1,176	2,581	1,961	4,796	5,313	–5,187	1,730	8,562	*317,092*
In national currency (2)	11,545	11,939	3,680	3,245	2,686	3,810	6,172	6,527	–3,905	983	8,422	*313,177*
At up to one year	–10,077	5,435	718	–5,045	–5,372	–4,662	–553	104	–549	1,663	–5,185	*42,821*
of which:												
Treasury Certificates	–9,373	3,883	550	–5,832	–6,807	–3,483	1,383	57	–840	3,400	461	*26,625*
Other securities	661	352	723	1,147	–221	–795	–1,959	–82	594	635	–678	*2,323*
At over one year	21,623	6,504	2,962	8,291	8,058	8,472	6,726	6,423	–3,356	–680	13,608	*270,356*
of which:												
Linear bonds	16,315	8,072	4,329	8,552	14,455	15,073	12,570	11,628	7,790	5,529	8,369	*213,515*
Other securities	6,652	–1,266	347	318	–5,415	–6,427	–6,442	–5,778	–9,662	–6,418	83	*21,752*
In foreign currencies	–6,488	–8,281	–29	–2,069	–105	–1,849	–1,377	–1,214	–1,282	747	140	*3,916*
At up to one year	–8,004	–5,179	–604	–887	1,517	–397	372	–164	–762	780	881	*1,849*
At over one year	1,515	–3,102	575	–1,183	–1,622	–1,452	–1,748	–1,050	–520	–32	–741	*2,067*
Financial balance (3)	–7,702	–8,482	–4,891	–2,064	–996	–663	301	–991	790	–3,746	–4,736	*–255,136*

Source: NBB.
(1) Shares and other equity, units of UCIs, financial derivatives and other accounts receivable.
(2) In Belgian franc up to the end of 1998 and in euro thereafter.
(3) See note 4 to table XVI.

TABLE XIX FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF MONETARY FINANCIAL INSTITUTIONS (1)

(Data on a territorial basis, millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	First nine months 2003	First nine months 2004 e	*p.m. Outstanding amount at the end of September 2004 e*
Formation of financial assets												
Interbank claims	22,434	13,678	–2,675	–508	5,848	–47,768	698	15,582	59,204	10,629	23,155	*276,686*
Belgian MFIs	11,899	14,981	–5,923	2,083	4,291	–26,420	–5,420	–7,154	8,098	–352	735	*48,216*
Foreign MFIs	10,535	–1,303	3,248	–2,591	1,557	–21,348	6,118	22,736	51,106	10,981	22,420	*228,470*
Loans (2)	29	2,593	3,576	6,512	15,448	12,484	14,280	21,091	14,907	3,187	18,462	*306,581*
of which:												
Households	2,020	4,316	5,146	4,913	4,999	2,051	76	3,284	5,615	3,808	4,591	*96,588*
Non-financial corporations	1,667	3,220	1,387	3,026	5,607	2,425	1,558	–1,874	–7,380	–5,080	–1,876	*79,810*
Fixed-income securities	13,733	19,046	8,201	1,622	13,461	–12,488	27,806	–11,355	1,700	423	7,530	*227,944*
of which:												
General government	8,094	7,200	519	1,276	–13,240	–18,719	–9,800	–7,812	–8,415	–6,094	–2,031	*70,487*
Rest of the world	5,462	6,346	8,551	3,428	25,291	5,917	38,209	–2,421	9,753	6,106	9,934	*152,173*
Other assets	5,477	3,979	6,172	5,504	13,133	7,654	14,916	–1,466	6,526	11,071	17,804	*123,124*
Total	41,673	39,297	15,274	13,131	47,891	–40,119	57,701	23,851	82,336	25,311	66,951	*934,334*
Households	2,024	4,222	5,153	4,940	5,261	1,803	–1,778	3,081	5,659	3,725	4,562	*98,039*
Non-financial corporations	1,900	3,550	2,727	3,736	5,641	3,587	1,282	–4,529	–5,859	–4,011	–3,041	*84,687*
General government	889	2,501	–2,435	965	–13,506	–19,423	–11,683	–9,281	–8,132	–5,701	–2,145	*97,520*
Financial institutions	14,192	22,014	–5,067	329	12,675	–25,072	6,274	–3,462	22,009	10,576	12,050	*132,249*
Rest of the world	22,668	7,011	14,896	3,160	37,819	–1,014	63,605	38,042	68,659	20,722	55,525	*521,839*
New financial liabilities												
Interbank liabilities	25,906	13,980	–5,665	3,230	17,685	–57,802	17,599	535	57,682	15,227	36,057	*335,405*
Belgian MFIs	11,899	14,981	–5,923	2,083	4,291	–26,420	–5,420	–7,154	8,098	–352	735	*48,216*
Foreign MFIs	14,007	–1,001	259	1,147	13,394	–31,381	23,019	7,689	49,584	15,579	35,322	*287,188*
Cash and deposits (2)	11,501	18,181	17,452	19,013	15,284	5,528	28,247	22,388	21,880	5,672	23,887	*383,827*
of which:												
Households	4,516	7,954	8,464	7,595	3,927	303	5,820	7,216	10,599	6,500	7,012	*175,361*
Non-financial corporations	1,465	5,449	1,780	2,753	2,894	–1,699	1,065	5,109	1,292	–1,349	–3,421	*54,851*
Fixed-income securities	–213	4,179	–7,517	–12,447	–706	4,790	–5,682	–4,170	–8,879	–9,090	–7,143	*59,632*
Savings notes	256	–3,303	–8,532	–7,332	–5,905	–3,051	–4,790	–4,033	–6,976	–5,586	–6,096	*39,582*
Other fixed-income securities	–469	7,482	1,014	–5,115	5,199	7,841	–892	–136	–1,903	–3,504	–1,047	*20,050*
Other liabilities and statistical adjustments (3)	4,479	2,957	11,004	3,335	15,627	7,365	17,537	5,097	11,654	13,502	14,150	*155,471*
Total	41,673	39,297	15,274	13,131	47,891	–40,119	57,701	23,851	82,336	25,311	66,951	*934,334*
Households	4,510	4,892	–2,474	626	722	–933	–1,003	4,353	4,441	364	–88	*237,746*
Non-financial corporations	1,097	8,981	6,863	–14,859	10,370	–4,875	3,743	8,596	–157	–3,715	–6,906	*54,294*
General government	–3,395	–7,553	–1,367	–1,837	196	306	155	–1,466	22	1,130	949	*6,678*
Financial institutions	15,196	25,718	–1,742	23,704	15,847	–19,767	9,851	–5,987	21,596	10,412	19,532	*185,057*
Rest of the world	24,266	7,260	13,993	5,496	20,755	–14,850	44,955	18,355	56,434	17,120	53,464	*450,559*

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 financial liabilities, Belgian MFIs being treated as pure financial intermediaries.

TABLE XX FORMATION OF ASSETS AND NEW LIABILITIES OF FINANCIAL INSTITUTIONS OTHER THAN MONETARY INSTITUTIONS

(Millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	First nine months 2003	First nine months 2004 e	*p.m. Outstanding amount at the end of September 2004 e*
Non-monetary UCIs												
Formation of financial assets	1,359	2,981	6,106	13,709	14,850	18,524	12,110	3,886	4,029	2,098	4,787	*88,384*
Deposits	429	1,320	2,649	5,091	5,131	1,600	2,950	3,404	2,711	1,472	1,319	*27,140*
Fixed-income securities	797	953	1,604	2,278	2,024	4,298	1,568	128	–540	–1,091	4,203	*22,391*
Shares and other equity (1)	–54	15	962	3,749	5,768	9,630	5,444	1,753	338	345	–1,787	*27,941*
UCI units	219	161	662	1,770	2,255	3,336	1,963	–2,657	199	161	–93	*6,899*
Other assets	–31	531	229	821	–328	–340	187	1,259	1,320	1,211	1,143	*4,013*
New financial liabilities	1,359	2,981	6,106	13,709	14,850	18,524	12,110	3,886	4,029	2,098	4,787	*88,384*
UCI units held by Belgian households	1,129	2,667	5,472	12,503	11,859	12,809	9,375	5,370	4,671	2,824	2,376	*71,018*
UCI units held by other investors	231	314	633	1,206	2,991	5,715	2,735	–1,483	–642	–726	2,410	*17,366*
Insurance companies and pension funds												
Formation of financial assets	3,010	4,776	6,205	6,880	10,793	7,480	12,342	12,727	15,636	13,428	12,021	*154,976*
Deposits	177	377	327	–573	–54	642	319	649	2,247	35	–178	*5,819*
Fixed-income securities	2,722	3,020	2,797	3,496	3,295	1,727	4,320	4,635	11,638	11,667	11,475	*77,334*
Loans	–94	–307	–427	–604	–278	266	873	700	–312	–253	–169	*6,238*
Shares and other equity	1,219	1,335	3,271	4,100	3,369	202	3,201	3,282	–1,422	–789	–873	*21,515*
UCI units	–245	331	369	729	3,957	3,531	3,462	1,595	3,398	2,567	3,127	*25,279*
Other assets and statistical adjustments (2)	–768	20	–132	–268	503	1,112	167	1,867	87	202	–1,362	*18,791*
New financial liabilities	3,010	4,776	6,205	6,880	10,793	7,480	12,342	12,727	15,636	13,428	12,021	*154,976*
Net claims of households on life insurance reserves and pension funds reserves	2,411	3,958	5,366	6,250	9,550	7,088	10,699	10,465	14,682	12,268	9,665	*114,638*
Other insurance technical reserves	531	945	721	666	638	202	1,356	634	80	452	1,564	*22,244*
Other liabilities	68	–127	118	–36	605	190	287	1,629	874	708	792	*18,093*
Other (3)												
Formation of financial assets	289	5,610	3,254	29,722	17,037	6,207	6,080	7,611	4,555	3,522	–6,125	*128,879*
Deposits	191	1,009	–1,043	340	737	261	701	–289	3,584	2,725	–337	*3,020*
Loans	70	656	1,759	1,691	131	1,923	1,326	3,230	1,312	357	–1,094	*22,723*
Shares and other equity	149	2,941	2,699	27,153	16,102	3,131	2,099	3,671	–1,619	–45	–2,511	*95,840*
Other assets and statistical adjustments (2)	–121	1,004	–161	537	67	892	1,954	1,000	1,278	485	–2,183	*7,297*
New financial liabilities	289	5,610	3,254	29,722	17,037	6,207	6,080	7,611	4,555	3,522	–6,125	*128,879*
Loans	–249	106	403	–306	1,235	2,137	3,575	1,359	8,182	7,208	–3,834	*18,411*
Shares and other equity	211	4,814	872	27,945	12,938	4,624	1,177	2,901	–82	–383	–143	*101,862*
Other liabilities and statistical adjustments (2)	327	689	1,979	2,083	2,864	–554	1,329	3,351	–3,544	–3,303	–2,147	*8,607*

Sources: Belgian Asset Managers Association, Belgian Association of Pension Institutions, BFIC, NBB.

(1) Including real estate certificates.

(2) The statistical adjustments are due to the equalisation of the total of financial assets and financial liabilities, Belgian financial institutions being treated as pure financial intermediaries.

(3) Financial holding corporations, 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, securities dealers, portfolio management companies, financial instruments broking companies and companies for the placing of orders in financial instruments.

TABLE XXI NET ISSUES OF SECURITIES (1) BY FINANCIAL (2) AND NON-FINANCIAL CORPORATIONS AND GENERAL GOVERNMENT

(Millions of euro)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	First nine months 2003	First nine months 2004 e	*p.m. Outstanding amount at the end of September 2004 e*
Fixed-income securities	16,819	10,355	816	–474	3,823	9,386	6,338	5,275	–7,608	–2,977	3,491	*368,068*
Financial and non-financial corporations	1,003	1,089	–5,661	–2,565	2,598	6,844	1,457	664	–4,205	–6,860	–4,889	*99,937*
Securities at up to one year	–4,469	–679	115	1,093	5,845	7,759	–1,212	1,388	631	–1,263	–1,850	*18,085*
Securities at over one year	5,472	1,768	–5,776	–3,658	–3,247	–916	2,669	–724	–4,836	–5,598	–3,039	*81,852*
General government	15,816	9,266	6,477	2,091	1,225	2,542	4,881	4,611	–3,403	3,884	8,380	*268,131*
Securities at up to one year	–8,712	5,562	1,226	–5,597	–6,194	–4,652	501	–189	–1,011	4,805	669	*30,797*
Securities at over one year	24,528	3,704	5,251	7,688	7,419	7,194	4,380	4,800	–2,392	–921	7,711	*237,334*
Shares	6,128	9,729	9,757	39,035	24,945	28,979	26,707	11,030	3,939	–583	2,184	*738,751*
Listed shares	254	2,959	2,662	12,503	9,367	7,939	5,711	1,048	818	405	3,996	*167,425*
Unlisted shares	5,874	6,770	7,095	26,531	15,578	21,040	20,996	9,982	3,122	–988	–1,812	*571,326*
p.m. Recourse by financial and non-financial corporations to the securities market	*7,131*	*10,818*	*4,096*	*36,470*	*27,543*	*35,822*	*28,164*	*11,694*	*–266*	*–7,444*	*–2,705*	*838,688*

Sources: BFIC, Euronext Brussels, NBB.
(1) Excluding derivatives, real estate certificates and units of UCI's.
(2) Excluding the Eurosystem.

TABLE XXII 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 reference linear bond
					At one year	At two years	At five years	
2000	I	3.75	3.83	3.72	4.16	4.52	5.11	5.52
	II	4.75	4.55	4.41	4.90	5.05	5.33	5.56
	III	4.91	5.00	4.72	5.08	5.17	5.40	5.61
	IV	5.16	4.86	4.70	4.63	4.65	4.85	5.28
2001	I	4.85	4.56	4.47	4.23	4.33	4.65	5.09
	II	4.72	4.44	4.35	4.24	4.39	4.85	5.37
	III	3.83	3.66	3.52	3.36	3.58	4.32	5.05
	IV	3.91	3.29	3.17	3.22	3.69	4.57	5.13
2002	I	3.39	3.45	3.33	3.80	4.29	4.99	5.41
	II	3.49	3.44	3.36	3.62	3.97	4.64	5.16
	III	3.42	3.30	3.14	2.96	3.18	3.82	4.51
	IV	3.44	2.87	2.73	2.61	2.78	3.56	4.32
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

Sources: ECB, NBB.

(1) The weighted average overnight interest rate for the euro on the interbank market of the euro area (Eonia).

(2) The average interest rate offered on the interbank market of the euro area for three-month loans in euro (Euribor).

TABLE XXIII MAIN INTEREST RATES OF THE EUROSYSTEM

(Annual percentages)

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	–			

Source: ECB.

(1) Until the operation to be settled on 21 June 2000, fixed rate of the weekly allotments of two-week credits. From the transaction to be settled on 28 June 2000, minimum bid rate at the tenders for the weekly 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 XXIV **EXCHANGE RATES** (1)

(National monetary units per ecu or euro, annual averages)

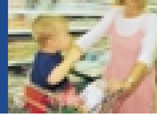
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
US dollar	1.308	1.270	1.134	1.121	1.066	0.924	0.896	0.946	1.131	1.244
Japanese yen	123.0	138.1	137.1	146.4	121.3	99.5	108.7	118.1	131.0	134.4
Swiss franc	1.546	1.568	1.644	1.622	1.600	1.558	1.511	1.467	1.521	1.544
Korean won (2)	999.7	1,007.9	1,069.8	1,568.9	1,267.3	1,043.5	1,154.8	1,175.5	1,346.9	1,422.6
Hong Kong dollar (2)	10.011	9.684	8.750	8.695	8.269	7.198	6.986	7.375	8.808	9.688
Singapore dollar (2)	1.833	1.765	1.678	1.876	1.806	1.592	1.604	1.691	1.970	2.102
Canadian dollar	1.795	1.731	1.569	1.665	1.584	1.371	1.386	1.484	1.582	1.617
Norwegian dollar	8.286	8.197	8.019	8.466	8.310	8.113	8.048	7.509	8.003	8.370
Australian dollar	1.765	1.623	1.528	1.787	1.652	1.589	1.732	1.738	1.738	1.691
Pound sterling	0.829	0.814	0.692	0.676	0.659	0.610	0.622	0.629	0.692	0.679
Swedish krona	9.332	8.515	8.651	8.916	8.807	8.445	9.255	9.161	9.124	9.124
Danish krone	7.328	7.359	7.484	7.499	7.435	7.454	7.452	7.431	7.431	7.440
Cyprus pound	0.592	0.592	0.583	0.577	0.579	0.574	0.576	0.575	0.584	0.582
Czech koruna	34.70	34.46	35.93	36.32	36.88	35.60	34.07	30.80	31.85	31.89
Estonian kroon	14.99	15.28	15.72	15.75	15.65	15.65	15.65	15.65	15.65	15.65
Hungarian forint	164.6	193.7	211.7	240.6	252.8	260.0	256.6	243.0	253.6	251.7
Lithuanian litas (2)	5.232	5.079	4.536	4.484	4.264	3.695	3.582	3.459	3.453	3.453
Latvian lats (2)	0.690	0.700	0.659	0.660	0.626	0.559	0.560	0.581	0.641	0.665
Maltese pound (2)	0.461	0.458	0.437	0.435	0.426	0.404	0.403	0.409	0.426	0.428
Polish zloty	3.170	3.422	3.715	3.918	4.227	4.008	3.672	3.857	4.400	4.527
Slovenian tolar	154.9	171.8	181.0	186.0	194.5	206.6	218.0	226.0	233.8	239.1
Slovak koruna (2)	38.86	38.92	38.11	39.54	44.12	42.60	43.30	42.69	41.49	40.02
p.m. Effective euro exchange rate (3) (index 1st quarter 1999 = 100)	*106.1*	*106.7*	*98.6*	*100.7*	*95.9*	*86.1*	*86.7*	*89.2*	*99.9*	*103.8*

Source: ECB.

(1) Ecu exchange rate until 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) 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 describe the development of various important economic data relating to Belgium in the year 2004 as a whole, it was necessary to make estimates, as the statistical material for that year is inevitably still very fragmentary. In the tables and charts these estimates, which were finalised in early February 2005, 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 2004, the data in the Report are those of the official national accounts. On the other hand, the comments on the international environment and the international comparisons are based on data from international institutions, which for the year under review were closed a few months earlier.

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 countries except Greece, for which it replaced the national currency on 1 January 2001. The amounts relating to the periods prior to its introduction are converted at the irrevocable euro conversion rates. The euro area is defined in this Report as consisting of the twelve EU countries which adopted the single currency. Apart from Belgium, the area consists of Austria, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. 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. This new system gives a more accurate and complete picture of economic developments.[(1)] It also provides a better guarantee of the international comparability of the macroeconomic data.

As far as possible, the Report incorporates the new definitions and methods resulting from ESA 95. However, it still expresses the data in gross terms, as under the ESA 79, although the new system presents the 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,

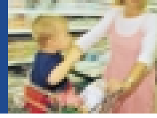
(1) For fuller information concerning the new system of national accounts according to ESA 95, see the NAI publication entitled *Comptes nationaux 1998 – Partie 1 : Estimation des agrégats annuels.* The changes caused by the switch to this new system for the account of general government are specified in more detail in another publication from the same source, entitled *Comptes nationaux 1998 – Partie II : Comptes des administrations publiques*.

under the heading "households", individuals 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 Belgian public radio and television broadcasting companies are included in the non-financial corporations sector until 2001, and in the general government sector from 2002 onwards. Where this change of sector has a significant impact on the movement in a key aggregate between those two years in any tables in the Report, its influence is mentioned in a footnote. The change of sector is due to the Lambermont agreement in Belgium, which modified the funding of the regions and communities. Under this agreement, the radio and television licence fee is collected by the regions, instead of by the communities, from 2002 onwards. A detailed presentation of how the change affects the various national accounts aggregates was supplied as an annex to the article *The Belgian economy in 2002* in the Bank's Economic Review for the second quarter of 2002.

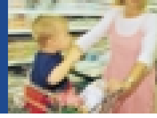
In the chapter devoted to the international environment, the presentation has also been adapted to the introduction of ESA 95 or its equivalent, the United Nations System of National Accounts (SNA 1993). Nevertheless, the statistics from the sources to which reference is made in the Report, principally the EC and the OECD, have still not been made completely uniform, because the period for which the conversion of the national accounts from one system to the other has been carried out still varies greatly from one country to another. In general, references to the EU mean all twenty-five member countries for the whole period covered, unless otherwise stated.

The breakdown of the financial accounts between households and companies is largely based on the data from 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
n.	not available
p.c.	per cent
p.m.	pro memoria
e	estimate by the Bank



List of abbreviations

COUNTRIES

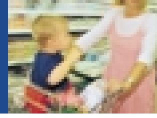
BE	Belgium
DE	Germany
GR	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
LU	Luxembourg
NL	Netherlands
AT	Austria
PT	Portugal
FI	Finland
EA	euro area
DK	Denmark
SE	Sweden
GB	United Kingdom

OTHER

BEA	Bureau of Economic Analysis
BFIC	Banking, Finance and Insurance Commission
BIAC	Brussels International Airport Company
BIS	Bank for International Settlements
BITC	Brussels Intermunicipal Transport Company
BLEU	Belgian-Luxembourg Economic Union
BLS	Bureau of Labor Statistics
BNRC	Belgian National Railway Company
BREO	Brussels Regional Employment Office
CCE	Central Council for the Economy

Dmfa	Multifunctional declaration
EC	European Commission
ECB	European Central Bank
ECOFIN	European Council of Ministers of Economic Affairs and Finance
EDP	Excessive Deficit Procedure
EMBIG	Emerging Market Bond Index Global
EMU	Economic and Monetary Union
ERM	European Exchange Rate Mechanism
ESA	European System of Accounts
ESCB	European System of Central Banks
ESRI	Economic and Social Research Institute, Cabinet Office for the Government of Japan
EU	European Union
EU15	European Union excluding the ten countries which joined in 2004
FISIM	Financial Intermediation Services Indirectly Measured
FOREM	Office communautaire et régional de la formation professionnelle et de l'emploi (Community and regional vocational training and employment office)
FPS	Federal Public Service
FSAP	Financial Sector Assessment Program
G7	Group of Seven
GDP	Gross Domestic Product
GNI	Gross National Income
HCF	High Council of Finance
HICP	Harmonised index of consumer prices
HWWA	Hamburgisches Welt-Wirtschafts-Archiv
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICT	Information and Communication Technologies
IEA	International Energy Agency
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
MFI	Monetary Financial Institution
MIR	Monetary Financial Institutions Interest Rates
MTS	Mercato telematico dei titoli di Stato
NAI	National Accounts Institute
NAIRU	Non-accelerating inflation rate of unemployment
NAS	National Accounting System
NBB	National Bank of Belgium
NEMO	National Employment Office
NSDII	National Sickness and Disability Insurance Institute
NSI	National Statistical Institute
NSSO	National Social Security Office
OECD	Organisation for Economic Co-operation and Development
OLO	Linear bond
OPEC	Organisation of Petroleum Exporting Countries

PLU	Professional Lenders' Union
RIR	Retail Interest Rates
S&P	Standard & Poor's
SDR	Special Drawing Rights
SHLAF	Social Housing Loan Amortisation Fund
SITC	Standard International Trade Classification
SME	Small and Medium-sized Enterprises
TFP	Total Factor Productivity
UCI	Undertaking for Collective Investment
UMTS	Universal Mobile Telecommunications Systems
VAT	Value Added Tax
VDAB	Vlaamse dienst voor arbeidsbemiddeling en beroepsopleiding (Flemish employment exchange and vocational training service)
WTO	World Trade Organisation



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