INTERNATIONAL MONETARY FUND

Belgium—2010 Article IV Consultation
Concluding Statement of the Mission

Brussels, December 13, 2010

The Belgian economy is recovering from the financial crisis and global recession. Although the economy has good fundamentals, the financial market turbulence in the euro area poses risks to the recovery. An encompassing strategy to better control public spending pressures, including from population aging, and to increase employment is urgently needed. Therefore, it is important for the authorities to focus on macroeconomic policy priorities, in particular measures to proceed with fiscal consolidation, contain risks in the financial sector, and push ahead with structural reforms to boost job creation and growth.

A gradual recovery continued …

Economic performance in 2010 has been better than foreseen. Real GDP growth is set to reach 2 percent, above the euro area average, while the external current account surplus increased. As in other European countries, the expansion has been driven by strong exports and stock-building. Employment started to expand again while the unemployment rate has increased somewhat to 8½ percent in 2010, remaining below that in the euro area as a whole. Core inflation remained subdued but headline inflation picked up briskly to almost 2½ percent, due to the high pass-through of world energy price increases in Belgium. The overall budget deficit is on track to fall as planned from almost 6 percent of GDP in 2009 to 4.8 percent in 2010, while the increase in the public debt continued at a slower pace than foreseen.

The rebound is expected to slow in the period ahead and longer-term growth prospects are weighed down by demographic factors. In the coming quarters, export growth is projected to decline with the softening of external demand while relatively high labor costs and supply rigidities continue to hamper the penetration into fast-growing export markets. Moreover, the inventory cycle seems about to run its course, while consumption growth is constrained by the rise in unemployment and withdrawal of fiscal stimulus. Real GDP is projected to increase by 1.7 percent in 2011 and, reflecting the impact of population aging, would remain moderate over the medium term.

… But is exposed to the financial market turbulence …

The outlook is uncertain and risks are predominantly on the downside. Belgium has a strong track record of public debt reduction prior to the global financial crisis, high household savings, and a strong external position. Nevertheless, the country has been affected by the recent turbulence on financial markets as evidenced by higher interest rate spreads. Financial market concerns about sovereign risks in the euro area, Belgium's high public debt and political uncertainty, could dampen confidence, increase financing costs for the economy, and undermine the recovery. Banks have made progress in restructuring but possible spillovers from foreign exposures and sovereign debt holdings could lead to higher funding costs and depress credit growth.

… Requiring a strong and rapid policy response …

Under current circumstances, it is crucial to develop and communicate a clear and comprehensive strategy without delay. Specific measures at all levels of government are needed to help ensure the reduction of the overall budget deficit to 3 percent of GDP by 2012 and achieve a balanced budget by 2015, as appropriately set forth in Belgium's Stability Program. A significant effort, including reforms in entitlement programs and fiscal federalism arrangements, is needed to deal with rising aging costs while reducing the public debt over the longer term. In the financial sector, a clear plan is needed to contain contagion from abroad while strengthening banking supervision and preparing for Basel III implementation. Sustained growth and job creation are crucial for fiscal consolidation and therefore it is essential to push ahead with structural reforms in labor and product/services markets.

… Especially credible fiscal consolidation …

In order to reduce the overall deficit to 3 percent of GDP by 2012, significant additional tightening measures are needed starting in 2011. Under current policies, the overall deficit is projected at around 4.7 percent of GDP in 2011, while the public debt is bound to rise further over the medium term. To give a strong signal of the resolve of the authorities in restoring fiscal soundness, all levels of government should aim at reducing the overall deficit to below 4 percent of GDP in 2011. A key element would be the submission of a draft 2011 budget for the federal government to parliament. Regional and local governments should implement additional measures in 2011 to contain their deficit at ½ percent of GDP as set forth in the Stability Program. Reaching the fiscal objectives will require limiting spending growth, notably by starting growth-friendly entitlement reforms while continuing the social protection of the poor, as well as additional revenue measures:

- Containing the wage bill by strictly limiting nominal wage increases, not replacing a sizable part of retiring civil servants, and significantly reducing the overlap of public services at sub-national levels of government.
- Curbing the rise in pension costs by eliminating fiscal incentives for early retirement and introducing actuarial neutral discounts for pensions granted before the legal retirement age of 65 years. It is also urgent to hold a national dialogue to prepare a comprehensive pension reform as in other European countries. An increase of the effective retirement age by 1 year is estimated to yield structural savings of more than ½ percent of GDP.
- Reducing federal transfers to the healthcare system (estimated at 1 percent of GDP in 2011) by tightening the overly loose real healthcare spending growth norm and by strengthening cost-saving incentives to healthcare providers and customers.
- Strengthening fiscal discipline at the local government level by setting up a forum for regional-local fiscal coordination at all stages of the budget cycle and by applying transparent norms on the size and composition of local investment and

borrowing to prevent municipalities from accumulating excessive or excessively risky liabilities.

- Broadening the tax base and improving revenue collection. There is also considerable scope to reduce the large federal and regional tax expenditures on personal and corporate income taxes, VAT, and excises, while using part of the gains to lower statutory tax rates.

… Supported by viable institutional reform …

Reforming the existing fiscal federalism arrangement is a priority to start bringing down the public debt. Key issues to be addressed are: (i) the lack of adequate incentives to contain real spending growth in line with trend economic growth; and (ii) the off-loading on the federal government of revenue shortfalls, higher-than-foreseen social security outlays, and spending decisions by regional or local governments. The assignment of public services to different levels of government can be based on various considerations (such as economies of scale and voter preferences, including on sub-national fiscal autonomy and national solidarity), but should ultimately be governed by the need to preserve the financial viability of the general government as a whole. Regarding the current negotiations on state reform and a revision of the Special Financing Act, the following key macroeconomic considerations should be taken into account:

- Adopting a rule-based fiscal framework that ensures the credibility of the envisaged consolidation efforts, in line with the ongoing strengthening of fiscal governance in the euro area. Such a framework should comprise a binding multi-year budgetary framework based on realistic macroeconomic assumptions; a cap on spending growth for each level of government and social security; and a revenue rule that excludes any unforeseen additional revenue from distribution between different levels of government and assigns it directly to public debt reduction.

- Determining the share in tax revenues of each level of government in a consistent manner, in order to safeguard sufficient revenues to honor debt service and social security obligations.

- Avoiding moral hazard by precluding decisions by sub-national governments that create unplanned fiscal liabilities for the federal government.

- Promoting transparency and accountability at all levels of government by establishing a clear and close link between costs and benefits of public services.

- Limiting tax competition between sub-national jurisdictions to avoid distortions in the efficient working of the internal common market.

… While further strengthening financial sector resilience …

Continued progress in implementing bank restructuring plans is needed. The ongoing deleveraging and refocusing on core markets and activities needs to continue to enable the banks to gradually dispense of public support and comply with regulatory requirements that are set to tighten with the implementation of the Basel III regulatory framework. The banking sector remains exposed to adverse external shocks and impaired structured assets (the losses on the latter are capped by public guarantees), while nonperforming loans are edging up, albeit generally from a low base. It is important to ensure that banks have sufficient capital and liquidity buffers, taking into account bank-specific circumstances. Larger capital buffers will enhance banks' ability to raise longer-term funds at reasonable costs and maintain adequate credit supply to the private sector. Supervisors also need to keep up the pressure on banks to develop transparent organizational structures and robust new funding models based upon a sound mix of simpler and more transparent instruments, and a larger deposit base.

The authorities should remain vigilant and manage public support to the banking system flexibly. It is important to continue to closely monitor possible spillovers while preparing contingency plans to address possible renewed market tensions. Preserving market confidence in Belgian sovereign debt based on credible fiscal consolidation is critical for sound bank balance sheets and stable funding conditions.

Continued emphasis on proactive financial sector supervision is an important policy priority. The integration of the micro- and macro-prudential supervision should facilitate better understanding of macro-financial linkages in the Belgian economy. To ensure its effectiveness, the supervisory integration should proceed as scheduled without interruption of supervisory activities. The recent launch of the Committee for systemic risks and systemically-relevant financial institutions is welcome. At the same time, the remaining challenges of better integration of micro- and macro-prudential supervision should be addressed to ensure intensive and intrusive supervision as well as monitoring of cross-border exposures. Setting up effective cooperation and information exchange between the two new supervisory authorities, including through formalized cooperation agreements, is a critical task. The authorities should also closely coordinate their regular stress testing efforts with the next round of EU-wide stress tests, based on credible and stringent scenarios, subject to intensive supervisory scrutiny, and benchmarked against sufficiently high capital levels.

The June 2010 law on financial sector crisis management is welcome but more needs to be done to strengthen resolution mechanisms. The crisis management law provides the authorities with important tools to facilitate effective resolution of systemic banks and insurance companies while addressing moral hazard considerations. Additional work, including at the international level, is required to facilitate the timely resolution of complex, cross-border financial institutions if needed. In view of the high interconnectedness of the Belgian financial sector with those in neighboring countries, continued close cooperation with foreign regulators and central banks, notably within the EU, is critical to develop a shared understanding of the risk profile and activities of Belgian financial institutions as well as robust contingency plans.

… And implementing decisive reforms in labor and product markets.

A renewed momentum in labor market reform is needed to expand employment, lift trend growth, and restore sound public finances. Increasing the Belgian employment rate to the euro area average could boost trend output growth by about ½ percent per year over the medium term. To this end, the following measures are important:

- Phasing out temporary unemployment programs to avoid lasting damage to incentives and labor allocation during the recovery and further mitigating the wage trap.
- Strengthening incentives for individuals to find a job by enhancing the monitoring of search activities and increasing sanctions on inadequate efforts, including in case of refusal of suitable employment; expanding job counseling and training opportunities; gradually limiting the duration of unemployment benefits; and increasing performance incentives for employment agencies.
- Reducing incentives for workers to leave the labor force temporarily or permanently before having reached the legal retirement age.
- Improving labor market participation for younger workers and immigrants by stepping up targeted language and other training, and reconsidering the employment protection legislation.

To strengthen competitiveness, it is crucial to moderate wage increases and reconsider automatic wage indexation. In the context of the current negotiations between employer organizations and trade unions, further efforts are needed to strengthen the competitiveness of the Belgian economy. This requires boosting innovation, investment in human capital, and containing costs. Labor costs need to be kept in line with those in trade partners in the context of the euro zone monetary union. Given Belgium's high labor costs, there is little room for wage increases. In order to increase the flexibility in wage negotiations to take account of varying circumstances in different sectors and avoid second-round effects of energy price volatility, the automatic wage indexation mechanism should be reconsidered, including in the public sector.

Continued progress in enhancing competition is necessary. The new law on market practices has eased regulation in the retail sector and the EU Services Directive has been transposed into Belgian legislation. Further steps should ensure that the liberalization in the services sector is effectively implemented; enhance transparency, regulation, and competition in energy markets; and provide the Competition Council with sufficient resources while further strengthening its independence.

In conclusion, the IMF mission team would like to thank the authorities for their generous hospitality and frank discussions.