

Main findings

Recent developments in inflation and purchasing power

- Inflation accelerated in Belgium, rising from 1.2 p.c. in August 2007 to 3.5 p.c. in January 2008. The rate of price increases in energy and processed food products came to 13.3 and 8.5 p.c. respectively in January 2008. Together these products represent around 22 p.c. of consumption expenditure. The movement in the prices of these product categories, which is examined in detail below, mainly reflects the impact of the increase in crude oil and food prices on the global market. A similar acceleration was observed in the euro area, although it was less marked. According to the Eurostat Flash estimate, inflation there came to 3.2 p.c. in January 2008. Conversely, inflation remained moderate for unprocessed food, non-energy industrial goods and services.
- Since the indexation mechanism only cuts in after a certain delay, in the short term an acceleration in inflation is reflected in some erosion of purchasing power. However, this delay mechanism is essentially neutral since it operates in the opposite direction when inflation slows down. Thus, in overall terms, indexation prevents the erosion of purchasing power. However, price rises are keenly felt when inflation accelerates.
- The application of the health index (which excludes petrol and diesel, in particular) provides only partial protection for purchasing power in the present circumstances, causing a relative loss of purchasing power compared to a situation in which oil prices had not increased. In practice, purchasing power continued to rise in 2007 from a macroeconomic point of view, principally as a result of job creations, but also because of the continuing rise in real hourly wages.
- Since crude oil is imported, an increase in its price – all other things being equal – leads to collective impoverishment of the Belgian economy. The application of the health index contributes to ensure that the consequences of that impoverishment are evenly distributed and helps preventing the start of a price-wage spiral. In order to prevent such a spiral from occurring, most European countries have abolished their formal indexation mechanisms. In Belgium, the health index, combined with the application of the law on the promotion of employment and the safeguarding of competitiveness, offers protection against such a spiral.
- The loss of purchasing power is greater for certain groups, such as households receiving benefits which are hardly linked – if at all – to prosperity, and consuming more products which have seen a much bigger than average price rise. Thus, in the present circumstances, the aggregate price increase corresponding to the consumption pattern of the population comprising the 10 p.c. lowest incomes is greater than that based on average consumption patterns, on which the inflation measure is based. All other things being equal, the purchasing power of this population group thus declined (by 1.1 percentage points) during the period 2004-2007 compared to the average household. That gap could widen further during 2008.
- The general perception of purchasing power erosion may be reinforced by the gap between perceived inflation and real inflation. That gap appears to be larger in Belgium than in the euro area, one possible reason being that the inflation figure takes no account of the accommodation costs of owner occupiers. However, it is very difficult to

incorporate those costs accurately in the inflation measure. Moreover, the structural growth in the number of groups of products which have gone up in price – though the number of products which have fallen sharply in price has increased in approximately the same proportions over the past five years – may have played a role, more particularly if the consumer is more aware of price increases rather than reductions. Such variations in relative prices prompt consumers to adjust their spending patterns. There is probably more resistance to such adjustment if it is necessary to reduce the consumption of certain goods and services.

- Nonetheless, that adjustment helps consumers to preserve their level of welfare and permits a more efficient allocation of resources. The authorities should therefore not oppose it by intervening at the level of pricing, be it via indirect taxation or otherwise. However, the authorities, and more particularly the competition authorities or the sectoral regulator, if appropriate, must ensure that the markets operate efficiently in order to avoid distortions in pricing, particularly to the detriment of consumers, but also in order to augment the dynamic efficiency of the economy. In addition, they can resort to indirect taxation to take account of certain externalities such as climate change. They may also address the purchasing power problems specific to certain population groups by adopting appropriate, targeted social policy measures.

Inflation over the past five years

- In the past five years (2003-2007), inflation in Belgium has averaged 2 p.c. per annum. It has therefore been slightly below the figure recorded in the euro area (2.1 p.c.). Also since the advent of monetary union, inflation in Belgium has been slightly lower than that in the euro area. The divergences in relation to the three main neighbouring countries mainly reflect cyclical differences.
- However, in Belgium inflation often diverges, albeit briefly, from that in the euro area in either direction. These differences are due essentially to the effect of variations in primarily administrative prices and the greater sensitivity of Belgian inflation to crude oil price fluctuations (cf. below).
- The implementation of a macroeconomic policy which conforms to the smooth operation of monetary union explains why Belgian inflation has not deviated significantly from that in the euro area. Pursuit of such a policy is therefore necessary to ensure that this performance is perpetuated. A fiscal policy geared to stability and moderate growth of all incomes is particularly important in this context.

Petroleum products: inflation and price levels

- Inflation in petroleum product prices accelerated in Belgium, rising from –4.7 p.c. in August 2007 to 15.9 p.c. in December 2007. The acceleration was stronger than in the euro area, where inflation increased from –3.4 p.c. to 15.3 p.c.
- Petroleum products are also the only important product category for which the price rise was significantly more pronounced in Belgium than in the euro area over the past five years, namely by 10 percentage points. The price rise was also steeper in Belgium than in each of the three main neighbouring countries. Heating oil was the main product for which the differences were substantial.
- Nevertheless, the level of heating oil prices is lower in Belgium than in the euro area (and in each of the three main neighbouring countries). That is due to the low level of flat-rate taxes (essentially excise duty) on this product. However, that also implies that the percentage of the price rise attributable to the movement in crude oil prices is higher.
- The low level of excise duty also explains why the diesel price is lower in Belgium than in the euro area, while the price of petrol is higher owing to heavier excise duty. The reverse ratchet system which came into force in mid 2005 has had the effect of reducing the Belgian excise duty on biodiesel to the EU minimum by the end of 2007. Up to February 2008 the reverse ratchet system was not activated for petrol. Belgium is the only country where the rise in crude oil prices was offset to a small degree by reductions in excise duty.

- The effect of the higher percentage increase in the price of heating oil, in particular, was further augmented by the greater weight of that product in Belgium. That means that Belgian inflation is traditionally more sensitive to fluctuations in crude oil prices. Since the price of crude oil essentially rose since 2002, this factor has penalised Belgium in the past five years. That also means that Belgian consumers have been harder hit by the rise in crude oil prices.
- The programme contract has not caused any significant distortions in pricing. Nonetheless, the automatic indexation of the distribution margins places the sector in a comfortable position. On the other hand, in recent years the actual consumer prices have increasingly dropped below the maximum prices, indicating that the margins have been cut. That could also be a sign of greater competition in the distribution of petroleum products, although the fact that some service stations grant much bigger discounts than others seems to indicate that this market is still highly segmented and that imperfect competition still prevails.

Electricity and natural gas: inflation and price levels

- Inflation in the prices of electricity and natural gas accelerated in Belgium, rising from – 6.3 p.c. in July 2007 to 1.3 p.c. in December 2007. The acceleration was stronger than in the euro area (from 1.9 p.c. in July to 2 p.c. in December 2007), but inflation was higher in the euro area throughout that period.
- Liberalisation of the residential segment of the electricity market had no significant impact on the part of the electricity price which is subject to competition.
- Nonetheless, the consumer price of electricity has increased by only 6 p.c. in the past five years, compared to a rise of 18 p.c. in the euro area. Consequently, by mid 2007 the pre-tax price of electricity was lower than in Germany and the Netherlands. However, it remained higher than in France. These differences are due partly to the size of the nuclear capacity used to generate electricity. Despite the higher VAT rate in Belgium, the price after tax was also lower in Belgium than in Germany and the Netherlands in mid 2007. This did not apply in relation to France. That indicates that other fiscal levies are relatively more substantial in the neighbouring countries, mainly Germany and the Netherlands.
- The major part of the relatively favourable movement in electricity prices is attributable to the price reductions which were first imposed on the regulated market by the Electricity and Gas Control Board (CCEG) and later by the Electricity and Gas Regulation Board (CREG). The price reductions imposed by the CREG concerned only the transport and distribution prices which are still subject to monopolies. The downward influence of these tariff reductions was only partly offset by the fact that the liberalisation was also accompanied by a series of new levies. Since the liberalisation, distribution tariffs have varied between regions: these tariffs are higher in Brussels and Wallonia than in Flanders. These differences are largely due to objective factors, but their precise exact impact is difficult to determine.
- In the past five years, the consumer price of natural gas has risen more sharply than electricity prices, mainly because the actual energy input is greater since there is not really any production process. Moreover, fewer tariff reductions were imposed for natural gas than for electricity. Nonetheless, the rise in natural gas prices during the period 2003-2007 was also less pronounced in Belgium (15 p.c.) than in the euro area (34 p.c.).
- In the case of natural gas, pricing underwent an important change in 2007. Henceforth, the movement in the actual energy cost is determined not only by the somewhat smoothed movement in petroleum product prices but also by the movement in the reference prices of natural gas at Zeebrugge. The natural gas price is now much more volatile than it used to be, owing to the introduction of a spot price in the consumer price indexation formulas for this product. The impact of this last aspect was further reinforced by the fact that, since January, the natural gas price index has reflected the movement in the monthly tariffs.
- The structurally greater volatility is probably largely neutral for the medium-term picture, but combined with the integration of the monthly tariffs in the price index that could cause a difference between the assessment by households of changes in the amounts invoiced, on the one hand, and the movement in the price index, on the other; in fact, as a general rule, households continue to pay a fixed amount for one year by way of an intermediate invoice.

- In mid 2007, Belgium was in a very favourable position in an international comparison of the pre-tax consumer prices of natural gas. Despite a higher VAT rate, that was also the case for the price after tax, although to a lesser extent. This situation is due, in particular, to the decline in the price of gas in the first half of 2007, which was more marked in Belgium than in the euro area. In the second half of 2007, the price of natural gas nevertheless rose sharply in Belgium, so that Belgium's position at the end of 2007 was probably less favourable, though data on that subject are not yet available.
- Prices of electricity and natural gas will continue to increase significantly in 2008. This is due partly to the increases in the price of the actual energy component. However, the major part of the increase is due to higher charges for transport (electricity) and distribution (electricity and gas). The reason for this situation is that the justification for the tariff reductions previously imposed by the CREG was subjected to a legal challenge by the intermunicipal associations, and the court ruled that the CREG had exceeded its powers in this case. The tariff increases will largely cancel out the tariff reductions previously imposed, and in consequence an international price comparison will be less favourable to Belgium in the future.
- However, the lawmaker could extend the CREG's powers, which seems appropriate for a market segment which is still a de facto monopoly.
- Price setting by competing suppliers does not appear to pose any major problems. However, the tariff indexation principle sometimes lacks transparency and the regulator does not have the necessary powers to judge whether or not changes to suppliers' tariffs or indexation parameters are fair. As competition develops, that should reduce the risk of abuse, but the existence of dominant operators is a factor in favour of some supervision.

Processed food: inflation and price levels

- Since mid 2006 the pace of processed food price increases has been considerably higher in Belgium than in the euro area. In the past few months it has accelerated further, from 4 p.c. in June to 7.6 p.c. in December, while a more or less parallel movement was seen in the euro area, although starting from a lower level. There the pace of processed food price increases came to 5.1 p.c. in December 2007. In Belgium, this pace increased further in January to 8.5 p.c.; the comparable figure for the euro area is not yet available.
- However, the cumulative rise in food prices over the past five years has been hardly any higher than that recorded in the euro area, being 14.5 p.c. in Belgium against 14.4 p.c. in the euro area.
- It is not so much the strong acceleration in processed food price inflation in the second half of 2007 that is atypical, but rather the fact that processed food prices had already risen sharply in the second half of 2006 and the first half of 2007. That movement is to a large extent totally unconnected with the increase in food commodity prices, which is more recent. It was also a more or less general phenomenon, affecting most categories of processed food products.
- The effects of the food commodity price increase recorded since mid 2007 have been substantial, by historical standards. The main reason is that the common agricultural policy no longer smoothes out world market price fluctuations.
- The price of a number of basic products prevailing on the internal market of the EU has been the main factor driving the recent rise in consumer prices of milk, cheese and eggs, oils and fats, and bread and cereals in both Belgium and the euro area. Consumption patterns specific to Belgium (more bread and butter, less olive oil) have been somewhat unfavourable. However, the transmission has been systematically weaker in France, but it is too soon to say whether that is only a sign of slower transmission or whether it also means that the total scale of the transmission will be smaller. Indirect pieces of evidence also suggest that the main reason for the price adjustment was the effect of the cost increases. The price adjustments were in fact biggest and speediest in the case of low-priced products. Since the margins on those products are smaller, in principle, the pressure exerted by costs is more noticeable.

- It is mainly for bread and cereals that there are signs of supplementary price increases. That also applies to the euro area, albeit to a slightly lesser extent than in Belgium. Furthermore, the rise in bread and cereal prices has been consistently stronger in Belgium than in the euro area over the past four years. That is not due solely to a (short-lived) catching-up process following the deregulation of bread prices in July 2004. It is perhaps due to inefficiencies in this sector, in view of the large number of small firms operating there. To some degree, that situation reflects the consumer's preference for the "artisan baker".
- In line with this picture of rapid reaction, the latest data (January 2008) show that the price adjustments for the products considered are beginning to slow down. However, for other products, such as meat, that has only partly begun as yet.
- According to Eurostat, food prices level in Belgium were 6 p.c. above the level recorded in the euro area in 2006. They were also higher than in each of the main three neighbouring countries. The difference is particularly large in relation to the Netherlands, where there was a "price war" in the distribution sector between late 2003 and mid 2006. Eurostat classes Belgium, France and Germany in a group where the level of food prices is comparable, taking account of the margin of uncertainty in these statistics. A more detailed classification is not possible without an in-depth analysis. Differences in VAT rates account for little if any of the observed differential.
- According to OECD data currently available, the Belgian distribution sector is the most highly regulated, more particularly as regards the establishment of new supermarkets, opening hours, and discounting (period in which clearance sales are prohibited). However, these indicators date from 2003, and Belgium has made progress in many areas in recent years. Belgian supermarkets are smaller, on average, than those in Germany and France, where hypermarkets are more numerous. The number of supermarkets has recently expanded at a faster pace, and the number of "hard discounters" has also risen steadily.
- Keener competition, increased efficiency and relaxation of the regulations in the distribution sector could help to reduce price levels and foster greater dynamism in the economy.