

The inflation gap between Belgium and the three main neighbouring countries and likely repercussions on competitiveness

L. Aucremanne
N. Cordemans
D. Cornille
M. Dossche

Introduction

This article focuses on the inflation differential between Belgium and the three main neighbouring countries and the implications of this gap for competitiveness. In a monetary union, differences in inflation rates between participating countries actually have direct repercussions on their competitiveness in terms of prices and costs. Relative price and cost developments are of course only one factor among many different elements that determine the competitive position of an economy. This is nevertheless an important aspect, as the Belgian experience from the end of the 1970s and beginning of the 1980s showed only too well. Furthermore, political circles have recently been taking a keener interest in this competitiveness factor, after the recession had shown the extent to which competitive handicaps and the external imbalances that some countries in the monetary union have built up can ultimately harm their economic development. Given these circumstances, it was deemed appropriate to set up a new framework for monitoring Europe's macroeconomic policy, covering not only fiscal policy, but also macroeconomic imbalances and divergences in competitiveness in the euro area. This new framework was endorsed by the European Council at its meeting on 28 and 29 October 2010.

This article is structured as follows. The first part looks at the implications of inflation differentials within a

monetary union – and more specifically within the euro area – and attempts to prove that participation in monetary union can only succeed if the Member States pay sufficient attention to changes in their competitive position. The second part discusses the institutional framework for monitoring competitiveness in Belgium and raises the question of whether it is still advisable to focus particularly on the three neighbouring countries (i.e. Germany, France and the Netherlands), as is currently the case, rather than on the euro area as a whole. Since the answer to this question is in the affirmative, the third section analyses the inflation differential with the three neighbouring countries and examines the resultant implications for the Belgian economy's competitive position. A series of conclusions wrap up the article.

1. Inflation differentials in a monetary union

Since, in a monetary union, there is no longer any nominal exchange rate between the countries in it – because they all use the same currency –, differences in inflation automatically imply a change in the real exchange rate of these member countries. So, a positive inflation differential of one member vis-à-vis the whole of the monetary union results in a real appreciation, while a negative inflation differential induces a real depreciation. As a general rule,

a real currency appreciation (higher inflation) is associated with a loss of competitiveness and a real depreciation (lower inflation) with a gain in competitiveness. However, this is not always the case, since the repercussions of fluctuations in real exchange rates on competitiveness vary according to their origin. It is nevertheless quite clear that, in a monetary union, a loss of competitiveness can no longer be corrected by an exchange rate adjustment. Effectively, this monetary policy instrument is no longer available to steer competitive relations between Member States. Therefore, maintaining – and with stronger reason re-establishing – a competitive edge depends largely on the ability to keep movements in domestic prices and costs under control.

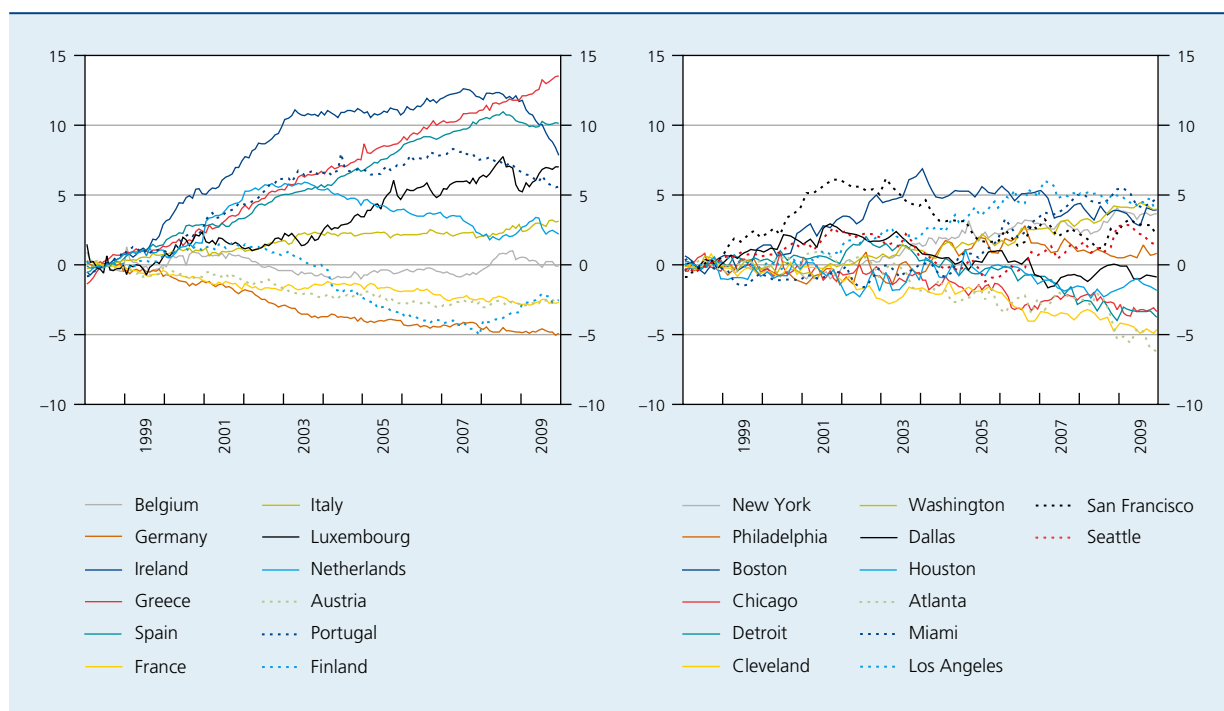
As mentioned above, the relationship between inflation differentials and competitiveness is relatively complex. Indeed, in some cases, the inflation differential has no implications for competitiveness. Thus, a divergent aggregate trend in prices between two countries may be attributable to differences in consumption habits and/or production structures. In a given country, proportionally higher consumption of goods and services whose prices are rising rapidly effectively leads to a more pronounced increase in consumer prices. While this situation does actually have implications for purchasing power in the

country in question, in principle the same does not hold true for competitiveness. Moreover, changes in indirect taxation have a direct impact on inflation, but they are generally less significant for competitiveness. And, finally, it is quite normal for the member countries of a monetary union starting out from a lower level of economic development to have higher inflation during their catching-up process, owing to the “Balassa-Samuelson”⁽¹⁾ effect.

However, in many other cases (different stages of the business cycle, national economic institutions operating differently – for example, differences in wage formation –, varying speed of implementation of structural reforms in the members of a monetary union, etc.), the associated divergences in inflation do have implications for competitiveness. In some cases, the very existence of such divergences is an integral part of a normal adjustment process. Thus, a positive inflation differential and some loss of competitiveness may cause an overheating

(1) Generally speaking, in countries that are going through a catching-up phase, faster growth in productivity in the tradable goods and services sector is observed, on top of which come higher movements in wages. These wage developments remain neutral for the sector's competitive position, as long as the two trends continue to move in parallel. Furthermore, in the non-tradable goods and services sector, which does not enjoy the same productivity growth, wages nevertheless tend to rise just as quickly. This obviously leads to higher inflation in this sector and, consequently, a stronger increase in the aggregate level of prices compared with countries with more advanced economic development. However, such divergence has no impact on competitiveness.

CHART 1 CUMULATIVE INFLATION DIFFERENTIALS IN THE EURO AREA AND THE UNITED STATES
(HICP and inflation measured by the CPI; period from 1998 to 2009; 1998 = 100, seasonally adjusted data)



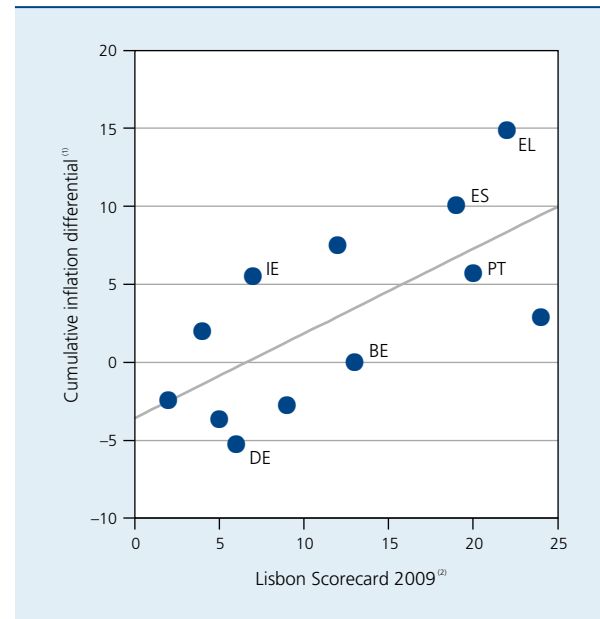
Sources : EC, Bureau of Labor Statistics.

economy to slow down, while a negative inflation differential can stimulate a sluggish economy. In other cases, however, (unsuitable macroeconomic policy, inappropriate trend in wage costs, excessively slow implementation of structural reforms, etc.), these inflation gaps and the related losses in competitive position are problematical. This is what happens when a country accumulates losses of competitiveness over a long period of time. Recurrent losses of competitiveness are not sustainable.

So, it is not the actual existence of inflation gaps in the EMU that poses a problem, but the fact that, over a long period, inflation in some countries has systematically tended to be higher than for the euro area as a whole, while in others, it was systematically lower. So, if European monetary union is taken as a starting point, Ireland, Greece, Portugal and Spain show a significant cumulative positive inflation differential, whereas Germany, Austria and Finland have a cumulative negative gap. In this respect, Belgium takes a neutral position: during its time in the monetary union, inflation there has neither been systematically higher, nor systematically lower than in the euro area as a whole. The fact that the cumulative inflation differentials between Member States in the euro area since 1999 have been a lot higher than those between regions in the United States⁽¹⁾ points up the seriousness of the problem of persistent divergences in inflation within the euro area and the shifts in competitiveness associated with them. This situation seems to suggest that, in this field, market mechanisms play a weaker stabilising role in the euro area, undoubtedly because product and labour markets are less flexible and there is less mobility in the workforce. The need to monitor these developments and, if necessary, put corrective policies into practice is therefore felt to be greater in the euro area.

It also appears that cumulative inflation differentials during the monetary union period can only in small part be attributed to the Balassa-Samuelson effect that goes hand in hand with the catching-up process⁽²⁾. In contrast, inflation differentials are quite clearly correlated with the implementation of structural reforms. The closer a country to the Lisbon targets, the more inflation falls. Greece, Portugal and Spain turn out to be the least advanced with regard to the Lisbon objectives⁽³⁾, while Germany is highly advanced. Here, too, Belgium occupies a middle-of-the-road position. The fact that the Balassa-Samuelson effect is less relevant and that there is a link with structural reforms would suggest that the inflation differentials observed in EMU do actually have some implications for shifts in competitiveness between the Member States and can be partly explained by the differences between national economic policies, especially as far as implementing structural reforms is concerned.

CHART 2 INFLATION DIFFERENTIALS AND IMPLEMENTATION OF STRUCTURAL REFORMS



Sources: EC, Centre for European Reform.

(1) HICP, from January 2000 to December 2009.

(2) Measures implementation of the Lisbon objectives. A high score means that the targets have not been met.

Looking at a few other indicators confirms the above finding whereby several countries are confronted with major competitive handicaps owing to the accumulation of positive differentials for inflation, underlying inflation, movements in the GDP deflator and trends in wage costs per unit produced in the economy as a whole. The signals sent out in this respect by the various indicators are quite convergent. It is mainly Greece, Spain, Portugal and Ireland that have seen their competitive edge systematically blunted. At the other end of the scale is Germany which clocked up gains in competitiveness, regardless of the indicator analysed; and the same goes for Austria and Finland. For each of the indicators analysed, Belgium occupies a neutral position in relation to the whole euro area, which implies that it has sharpened its competitive edge, notably over Greece, Spain, Portugal and Ireland, but also that it has lost some competitiveness vis-à-vis Germany. The other two main neighbouring countries, France and the Netherlands, are in a quite similar position

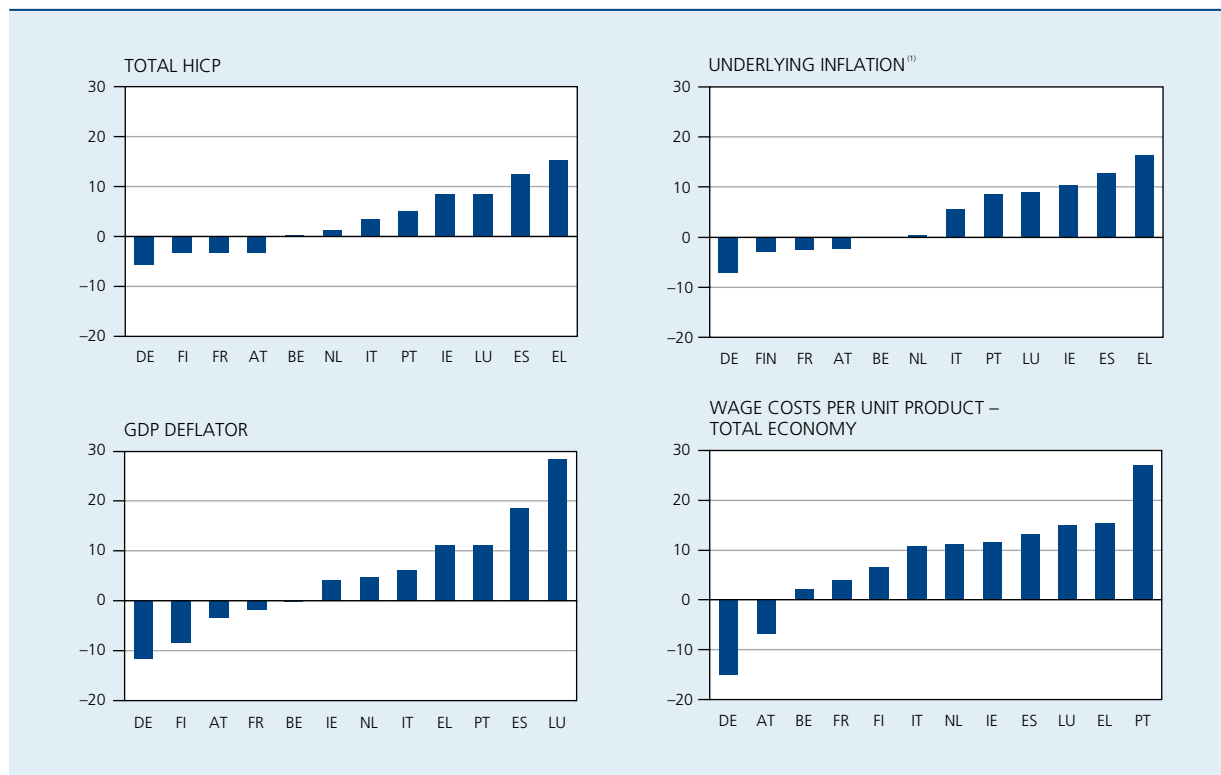
(1) The fourteen Metropolitan Statistical Areas for which the American Bureau of Labor Statistics calculates a consumer price index. A Metropolitan Statistical Area includes a large city and the region that depends on it.

(2) Cumulative inflation differentials are actually only weakly correlated with differences in productivity growth between the goods and services sectors, even though this factor may have played a greater role in the case of Slovenia and Slovakia. The Balassa-Samuelson effect is undoubtedly more relevant in the new Member States of the EU which have not yet adopted the euro.

(3) The Lisbon European Council in 2000 set the goal of making the EU "the most dynamic and competitive knowledge-based economy in the world" by carrying out structural reforms to boost competitiveness and innovation while completing the internal market.

CHART 3 A SELECTION OF COMPETITIVENESS INDICATORS

(cumulative evolution between 1999 and 2009, differential vis-à-vis the euro area)



Source: EC.

(1) Total HICP, excluding energy and unprocessed food products.

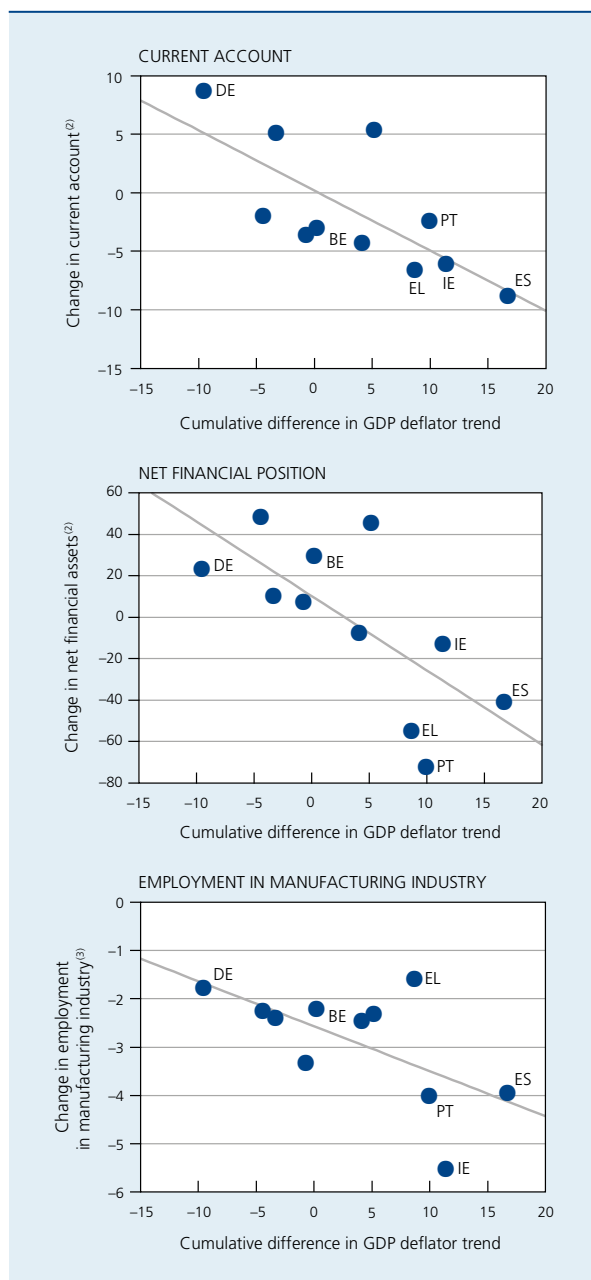
to Belgium, with France tending to show a slight gain in competitiveness in relation to the latter, while the Netherlands would appear to have lost a bit of ground.

In these circumstances, it is not surprising to find that the cumulative inflation differentials that have built up in the monetary union are strongly correlated with trends in the trade balance and the current account balance. In countries with a large positive inflation differential, the trade balance and current account positions have deteriorated sharply, while the opposite can be observed in countries with lower inflation. However, this situation is not just a direct consequence of a deterioration (an improvement) in competitiveness, but it also reflects differences in domestic demand trends. Effectively, demand has been buoyant in countries showing strong wage growth. In addition, divergences in inflation in a monetary union not only influence the member countries' real exchange rate, but also their real interest rates. In cases where the nominal short-term rate is the same for all members (common monetary policy), a positive (negative) inflation differential results in a lower (higher) real interest rate. This mechanism is pro-cyclical and can therefore be

potentially destabilising: in an overheating economy, the real interest rate is lower because of the higher rate of inflation, which in principle stimulates domestic demand even further. These differences between real interest rates also seem to be closely correlated with the growth in loans granted to the private sector and the rise in property prices during the period preceding the recession. In the first instance, this growth presumably boosted domestic demand in the countries in question. However, these developments were also behind the emergence of financial vulnerability, since the bursting of the property market bubble in several countries later proved that they were not sustainable.

The movement in the current account balance has not been without impact on the Member States' net financial position. Deficit countries have been forced to turn increasingly to foreign creditors. Initially, the founding of monetary union made it easier to fund external deficits, but the outbreak of the crisis brought a sudden turnaround in the propensity to finance these deficits. Since the beginning of monetary union, there are also indications of a much sharper fall in employment in manufacturing

CHART 4 INFLATION DIFFERENTIALS AND CURRENT ACCOUNT, NET FINANCIAL POSITION AND EMPLOYMENT IN INDUSTRY DURING THE PERIOD FROM 1999 TO 2007⁽¹⁾



Sources: EC, OECD.

(1) Cumulative difference in GDP deflator vis-à-vis the euro area, on the basis of the twelve original member countries of EMU, excluding Luxembourg. Greek figures are based on data from 2000 onwards.

(2) Percentages of GDP.

(3) Percentages of total employment.

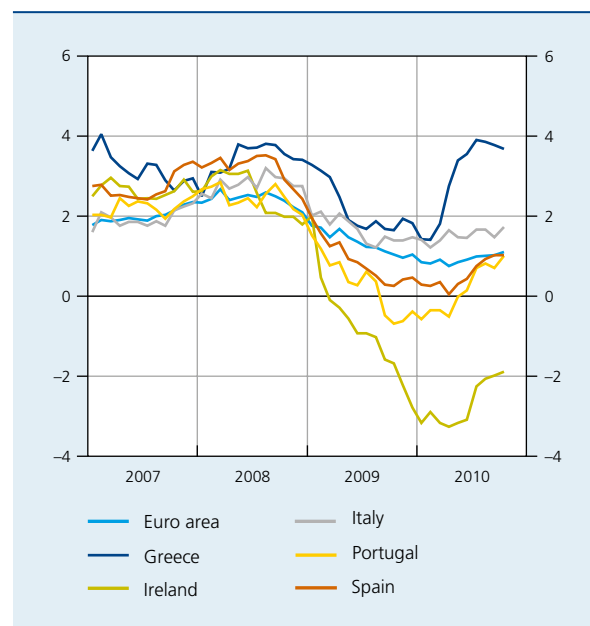
industry in the countries with large positive inflation gaps than in those where the gap is negative. This fall in employment can be explained more directly by shifts in competitiveness. It is hard to stop this decline; and besides, the initial compensatory effect working through

domestic demand, as discussed above, has meanwhile tapered off in most of the countries where inflation differentials were positive.

As mentioned above, the exchange rate instrument can no longer be used to eliminate the competitive handicaps that have built up. These handicaps have to be corrected by moderation in domestic price and cost increases (or even a downward trend). This kind of "domestic devaluation" is generally a difficult process because it comes up against downward nominal rigidity, essentially in wage formation. It should nevertheless be pointed out that this process is currently underway in several of the countries mentioned above: underlying inflation in Ireland, Spain and Portugal is actually growing more slowly than in the euro area as a whole, a situation that is in sharp contrast with the period preceding the recession. In Ireland's case, quite significant declines in prices have even been observed. Spain recently carried out a major reform of its labour market, so as to make it more flexible and to reduce the dualisation in the market. On top of a large section of fiscal policy measures, the Greek recovery programme put together with the EC and IMF includes a package of structural reforms aimed at making the economy more dynamic and more competitive. The rise in inflation in Greece, Spain and Portugal in the second

CHART 5 UNDERLYING INFLATION IN SELECTED EURO AREA COUNTRIES

(percentage changes compared to the corresponding month of the previous year)⁽¹⁾



Source: EC.

(1) Total HICP, excluding energy and unprocessed food products.

and third quarters of 2010 is attributable to the sharp increases in indirect taxes stemming from their respective fiscal consolidation plans. So it is not an indication of any further deterioration in competitiveness nor any reversal of the ongoing adjustment process.

The common monetary policy does not permit any off-setting of inappropriate divergences of this kind in the euro area. The only contribution that it can make in this respect is to ensure price stability throughout the whole euro area. As a result of medium-term inflation in the euro area stabilising at a high enough level – less than, but close to, 2% –, deflationary pressures have been avoided in the current circumstances in the euro area as a whole and the process of adjustment underway in countries that had been faced with major losses of competitiveness has been made easier. These considerations are among the reasons why the monetary policy strategy

was clarified in 2003 by adding the words “close to 2%” in the definition of price stability.

The main challenges ahead are therefore on the national economic policy front. Suitable domestic policy instruments have to be developed in order to tackle the problematic divergences in the euro area, i.e. in the field of fiscal policy, structural reforms, income policy, macro-prudential policy aiming to curb pro-cyclicality, etc. The recession triggered a growing awareness that countries cannot, at one and the same time, be part of a monetary union and follow an unsuitable or excessively short-term-orientated domestic economic policy with impunity. There is thus a need to strengthen coordination and monitoring of macroeconomic policies conducted in the euro area Member States. A new framework for this purpose was proposed by the Van Rompuy Task Force and endorsed by the European Council held on 28 and 29 October 2010.

Box 1 – The action plan for European economic governance

Bearing in mind that the recession pointed up the flaws in economic governance in Europe, the March 2010 European Council set up a working group, under the leadership of European Council President Herman Van Rompuy, with the task of drawing up recommendations designed to guarantee greater fiscal discipline, to introduce a new system of macroeconomic surveillance and to provide an improved framework for crisis management. The proposals put forward by this Task Force on European economic governance were endorsed by the heads of State and government at the European Council of 28 and 29 October. The objective is for an agreement between the Council and the European Parliament on implementing the proposals to be reached by the summer of 2011. This box endeavours to set out the action plan adopted by the European Council, by focusing on measures designed to correct macroeconomic imbalances and competitiveness gaps.

In this key policy area, the action plan provides, on the one hand, for wider macroeconomic surveillance, beyond what is currently prescribed by the Stability and Growth Pact and, on the other hand, for a deepening of national economic policy coordination.

The new surveillance framework expected to be adopted is based on two pillars. The first is preventive action involving regular assessments of the risks of macroeconomic imbalances. In particular, it includes setting up a scoreboard based on a small number of key indicators and putting an early-warning procedure into place for pointing up serious competitiveness gaps or major risks such as a property bubble forming. In the event of an excessive imbalance, whether potential or real, an in-depth analysis of the country concerned would be carried out by the Commission, possibly in conjunction with the ECB. The second pillar is corrective. If the policies chosen by a Member State were to prove out of line with the broad economic policy guidelines or if they might potentially jeopardise the smooth functioning of Economic and Monetary Union, the Commission would be allowed to address an early warning to the Member State in question. In the event of profound imbalances, however, the Council would be able to place a member country in an “excessive imbalances position” and thus trigger a corrective procedure against it. A series of policy recommendations should then be put to the country in question and if no satisfactory measures were to emerge, sanctions could be imposed on any Member State belonging to the euro area.



On the policy coordination front, the plan is to introduce a “European Semester” to examine how the EU dimension has been taken into consideration when preparing domestic economic and fiscal policies. This strengthened round of policy coordination will run from March to the moment when budgets are presented to national parliaments and will cover all aspects of economic surveillance, including fiscal, growth and macroeconomic stability policies. It will come into force on 1 January 2011.

Alongside the elements concerning macroeconomic imbalances and competitiveness gaps, the action plan adopted by the European Council intends to toughen up the Stability and Growth Pact, notably by bringing in sanctions earlier on in the process and by making them more automatic. It also involves establishing a permanent crisis resolution system with a view to safeguarding the financial stability of the euro area as a whole. In order to improve the efficiency of fiscal governance, the plan also requires national budgetary frameworks to be adapted to comply with a number of minimum requirements, most notably a national accounting and statistical plan. A set of non-binding standards will be drawn up as well, particularly on the role of national public bodies tasked with providing independent analysis, assessments and forecasts related to domestic fiscal policy matters.

2. Monitoring competitiveness in Belgium

In Belgium, monitoring competitiveness is a practice that existed well before the advent of EMU. Because it is a small, open economy, the development of Belgium’s economic activity and employment is highly dependent on international trade. The experience of the end of the 1970s and beginning of the 1980s shows only too well that a wage drift is not without impact on the economy and therefore forces the authorities to take draconian measures. At that time, competitiveness had been restored thanks to a devaluation of the national currency, combined with a series of radical measures revolving around wage moderation. Economic activity and employment were nevertheless hit very badly until competitiveness could be restored. When the Belgian franc was pegged to the German mark in 1990, the Belgian authorities effectively gave up the right to use the exchange rate instrument, something that turned out to be of crucial importance in 1982. Since joining the European monetary union in 1999, the exchange rate instrument has disappeared altogether. In such circumstances, competitive positions can only be maintained by suitably adjusted developments in domestic prices and costs.

This is why the Law of 1996 on the promotion of employment and the preventive safeguarding of competitiveness includes a large section on monitoring changes in competitiveness, measured by developments in wage costs in the private sector compared with that observed in the three neighbouring countries, namely Germany, France and the Netherlands. The choice of these three reference countries had been dictated by the fact that Belgium was

already *de facto* part of a monetary union with them at the time (1996). On this subject, the explanatory note to the 1996 Competitiveness Law states that: “Germany, France and the Netherlands have been chosen as reference countries because they are in fact countries with which Belgium already has stable exchange rates and monetary convergence”. In principle, closer monitoring of competitiveness trends and imbalances in the euro area should therefore not require any major changes in the policy followed in this field in Belgium.

However, the question has to be asked whether the choice of the three neighbouring countries as benchmarks for comparing changes in competitiveness is still relevant today, given that Belgium is now part of a much bigger monetary union. A whole series of basic arguments nevertheless plead in favour of continuing to align Belgium’s competitiveness primarily with that of its three main neighbouring countries.

It should first of all be pointed out that the reference countries singled out by the 1996 legislation are also Belgium’s three main trading partners, so price and cost developments in relation to these countries have a huge effect on competitiveness. In addition, these nations have a comparable level of economic development. If changes in competitiveness are to be accurately estimated, it is better to compare Belgium with three similar countries. Any comparison with a wider reference zone, which would also include countries in the catching-up phase, could conceal a loss of competitiveness, because inflation and wage cost developments in these countries are (upwardly) influenced by the Balassa-Samuelson effect described above. Although the impact of this effect has

clearly not been very significant during the first twelve years of monetary union, this aspect can nevertheless become more important as new member countries join the euro area. Moreover, largely as result of this law, Belgium has managed to keep its competitive edge vis-à-vis the euro area as a whole, even if it has incurred a loss of competitiveness against Germany. By comparing its own performance with countries that also have ambitious programmes for structural reforms on the labour and product markets, Belgium also has the potential to take measures that could inject substantial dynamism into its economy. Lastly, keeping on an institutional framework that has worked relatively well and which enjoys a broad social consensus has undeniable advantages, too. This enables efforts to be concentrated on making sure the institutional set-up works efficiently, whereas putting together a new framework is a long drawn-out process with an uncertain outcome into the bargain.

The importance of the 1996 law in the efforts to maintain Belgium's competitive edge also stems from the fact that it gives explicit encouragement to the social partners to avoid the undesirable effects of automatic wage indexation. In this respect, the objective is to reconcile this index-linking system with a moderate overall wage trend that has to be aligned on movements in nominal hourly wage costs in the private sector in the three neighbouring countries. To do this, on the one hand, the anticipated impact of indexation has to be deducted *ex ante* from the margin available for real wage increases. On the other hand, this piece of legislation requires any possible overshoots of the wage norm, for instance as a result of unexpected effects of indexation, to be corrected *ex post*, by deducting them from future wage rises. Together with the introduction in 1994 of the health index (which excludes changes in the price of petrol, diesel, tobacco and alcoholic drinks from the consumer price basket) as the reference for indexation in Belgium, the 1996 law is a cornerstone of the policy for keeping the consequences of indexation under control.

Belgium's inflation gap with the three neighbouring countries is therefore a valuable tool for assessing competitiveness, both present and future, and for two reasons. Firstly, an analysis focusing on inflation divergences can either strengthen or weaken the signal coming from relative changes in wage costs. Movements in wages act as a key determinant in price trends, so the relative change in inflation may be perceived as an alternative competitiveness criterion. Secondly, in a country, like Belgium, where wage costs are index-linked, fluctuations in relative consumer price trends can cause fluctuations in relative labour cost developments and, hence, determine any change in competitiveness. Emphasising this dual perspective, the next

section of this article concentrates on Belgium's inflation gap vis-à-vis its three main neighbouring countries.

3. Belgium's inflation differential with the three main neighbouring countries

The following section focuses first of all on movements in the inflation differential over the last four years. A more in-depth analysis of this period is of particular interest since it has seen very marked fluctuations in the inflation gap. Moreover, a systematic sequence seems to have formed during this period. To begin with, changes in prices of energy and food products following on from fluctuations in commodity prices on international markets were the main factor fuelling the inflation differential before they began to have a more general influence on the underlying inflation trend, measured here as the change in prices of non-energy industrial goods and services. So, while the recent period clearly raises questions about energy and food price-setting in Belgium, it also shows that the impact of the mechanism for index-linking not just wages but also prices of certain services can trigger so-called related second-round effects and put a strain on competitiveness. The second part of the analysis, which looks at changes in the inflation gap since 1996, the year when the Competitiveness Law came into force, clearly highlights the crucial importance of the link between relative wage cost developments and movements in the inflation gap.

3.1 Increased volatility of the inflation gap between Belgium and its three main neighbouring countries since 2007

In recent months, the inflation gap between Belgium and its three neighbouring countries has widened considerably. In October, inflation as measured by the harmonised index of consumer prices (HICP) came to 3.1 % in Belgium, compared with 1.3 % in Germany, 1.8 % in France and 1.4 % in the Netherlands. The average rate of inflation in these three countries thus works out at 1.5 %, which is 1.6 percentage points less than in Belgium. In 2008, too, Belgium had a clearly positive inflation differential, which had exceeded the 2 percent mark in the summer. During the course of the year 2009, however, the inflation gap turned into a significantly negative differential. Consequently, in June 2009, a negative differential of 1.5 percentage points was recorded, exclusively due to the negative contribution of energy products. Such wide fluctuations had never been observed before and are evidence of much greater volatility since 2007. Between

January 2007 and September 2010, the standard deviation of inflation in Belgium from that of the three neighbouring countries actually reached 1 percentage point, whereas it had only hovered around half a percentage point between January 1996 and December 2006.

The widening of the inflation gap observed in 2010 bears many similarities to its evolution in 2008. Against a backdrop of rising crude oil prices expressed in euro, the differential was once again first fuelled by movements in relative prices of petroleum products, before gas and electricity triggered a positive differential after a few months (this has been the case since June 2010). In 2008, moreover, these developments had been accompanied by a very sharp increase in prices of (processed) food products, in a context of surging food commodity prices. Besides unprocessed food, processed food products again contributed to widening Belgium's inflation gap with the three main neighbouring countries from the summer of 2010 onwards. It remains to be seen whether, like in 2008, this contribution will get any bigger in the near future under the influence of the recent rise in food commodity prices. Finally, in the previous phase where a positive inflation gap had been recorded, a positive contribution from services and non-energy industrial goods had

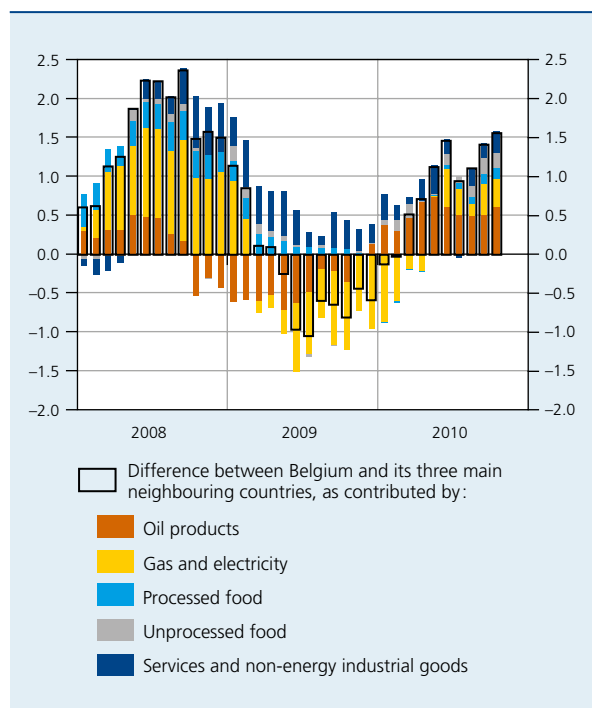
been observed from June 2008, which points up the fact that the greater impact on prices of shocks resulting from movements in raw material prices had ultimately triggered second-round effects. This positive contribution from the above-mentioned components to the inflation gap narrowed in 2009, a downward movement that has recently come to a halt, especially when one considers that the decline recorded in July 2010 is largely due to a one-off and rather artificial effect, namely the bigger weighting given to the group of discounted products in the HICP as of 2010 following a change in the weighting system⁽¹⁾. So, it will be interesting to see whether the positive contribution from services and non-energy industrial goods will widen again in the future as a result of second-round effects. In fact, the pace of price increases for products used in calculating the health index (heating oil, electricity and natural gas are included, unlike petrol and diesel) has already accelerated to reach 2.6% in October, whereas it had still been negative in the second half of 2009.

The next part of the article will look in turn at unprocessed and processed food products, and energy, before referring to the underlying inflation trend.

UNPROCESSED FOOD

In the case of unprocessed food products, the analysis is complicated by the change in the method for compiling price indices for fruit and vegetables used for calculating the Belgian HICP from January 2010 onwards. This change in methodology, requested by Eurostat, concerns the way in which the seasonal nature of these products, which are not necessarily available all year round, is taken into account. Consequently, the inflation profile for unprocessed food products will be affected throughout the year 2010. Without this methodological change, a smaller positive inflation differential would have been recorded for unprocessed food. Thus, the average inflation rate for this component over the first ten months of 2010 was as high as 3.3% according to the HICP, as against 2.7% under the domestic index (which is not affected by the above-mentioned changes). That said, there is no doubt that the pace of price increases has gained momentum in 2010, rising from 1.6% in the first quarter to 4.8% in October. This acceleration is basically due to less favourable supply conditions during the summer of 2010, which enjoyed an exceptionally warm and dry July that was followed by a particularly wet month of August, while the favourable weather conditions seen a year earlier had enabled fruit and vegetable prices to be kept at very low levels. Both in Belgium and the three neighbouring

CHART 6 INFLATION GAP BETWEEN BELGIUM AND ITS THREE NEIGHBOURING COUNTRIES
(contribution of the main components to the inflation gap, in percentage points)



Sources: EC, NBB.

(1) This change of method alters the seasonal profile of the HICP, which has brought about a non-recurring fall in annual inflation in the months of January and July 2010.

countries, sharp fluctuations in supply conditions usually cause a volatile, but nonetheless synchronous, movement in prices of unprocessed food products. While this volatility is no more marked in Belgium, unprocessed food inflation was higher on average in Belgium between 1996 and September 2010, where they posted an annual inflation rate of 2.2%, compared with 1.7% in the three main neighbouring countries.

PROCESSED FOOD

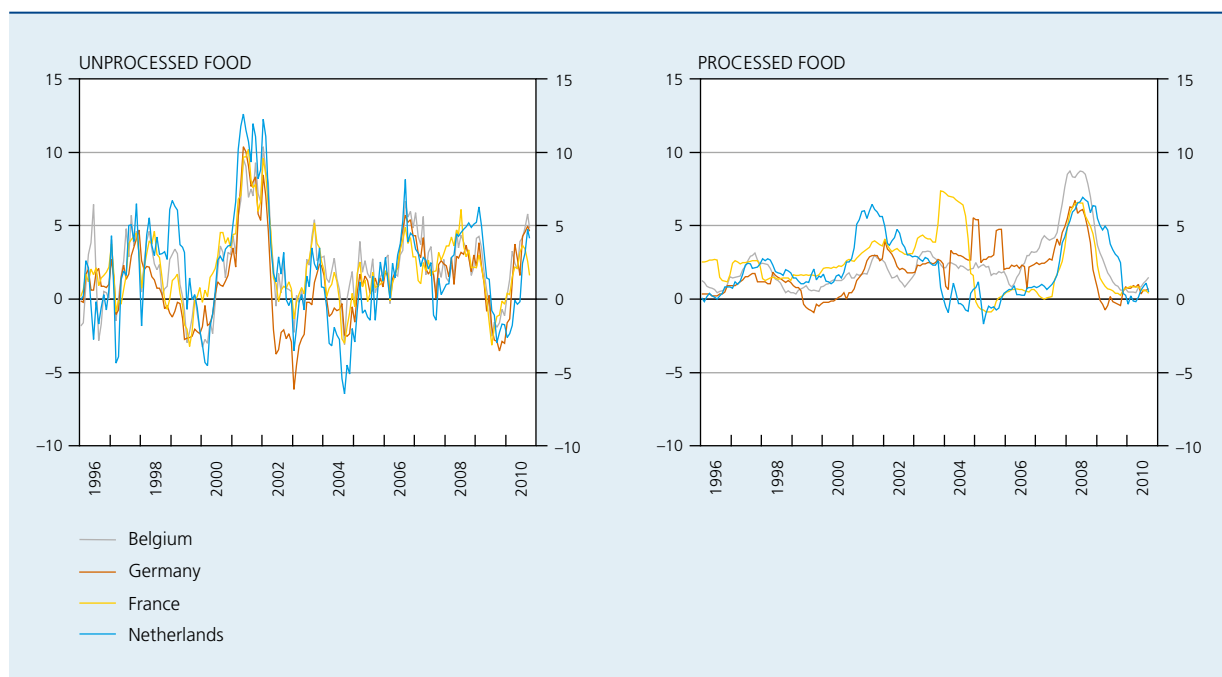
As far as processed food products are concerned, they were found to make a major contribution to the unfavourable inflation gap observed in 2008, when food commodity prices had risen sharply. Considered over a longer period, processed food prices have shown no systematic tendency to rise faster in Belgium than in the three neighbouring countries. However, this is what happened between mid-2006 and the end of 2008. From mid-2007 onwards, marked increases in processed food prices can be linked to the strong increase in prices of agricultural commodities over this period. However, a high degree of transmission of upward cost pressures is not necessarily evidence of uncompetitive price-setting. It can just as easily be an indication of the opposite, because in a fiercely competitive environment, it is hard for the

various stakeholders in the food chain, from production to distribution, not to pass on the rise in costs, given that their margins are, in principle, already narrow. This is why the symmetry (or lack of symmetry) between the initial upward phase and the downturn phase is generally the best indicator for assessing the degree of competition. However, no negative gap appeared during the period following the drop in food commodity prices. This finding suggests some degree of asymmetry in price-fixing, at least in the short term, as pointed out in the 2009 annual reports from the Bank and the Price Observatory⁽¹⁾.

During the course of 2009 and more particularly in 2010, prices on international markets started rising again, albeit at varying paces from one product to another. The rise in prices of raw materials was initially concentrated on sugar, cocoa or coffee, before going on to affect commodities like wheat, maize and milk from the summer of 2010 onwards. From July, higher consumer prices were first of all observed in the "sugar confectionery" and "coffee,

(1) In the absence of sufficient data, it has not been possible to find out in which phase of the agri-food production and distribution chain this asymmetry emerged. However, as regards the more specific case of milk, the Price Observatory pointed out that the asymmetry seems to result from price-fixing by both the food production and distribution sectors. At the same time, in several market segments – notably that of premium milk – it has transpired that prices were fixed more evenly and, therefore, more competitively.

CHART 7 CONSUMER PRICES OF FOOD
(percentage changes compared with the corresponding month of the previous year)



Source : EC

CHART 8 FOOD COMMODITY PRICES IN EURO
(index 2005 = 100)



Sources: IMF, NBB.

tea and cocoa” components, and then for products like bread and butter, too. In recent months, price rises for these products have been more marked than in the three main neighbouring countries. As the 2007-2008 experience showed, price increases like this can have major consequences. It is therefore important that the way in which rises in food commodity prices are passed on is carefully monitored over the next few months for all food products, a major task for the Price Observatory.

ENERGY

Energy products have a tendency to contribute positively to the inflation differential when raw materials prices rise (as in 2008 and again in 2010) and to contribute negatively to this differential when they fall (as in 2009). This suggests that Belgian inflation is more sensitive to fluctuations in the price of energy raw materials. Judging from several recent publications in the Bank’s Economic Review⁽¹⁾, three factors give an explanation for this greater sensitivity: higher energy consumption by households, a lower average level of excise duties on energy products than in other countries, and certain features of pre-tax energy price-setting in Belgium, notably a particularly swift transmission of energy commodity prices to consumer gas and electricity prices.

Turning to Belgian households’ comparatively higher consumption of energy products than households in

neighbouring countries, this increases their weight in the consumer price index and therefore makes it more sensitive to energy prices. Factors helping to explain this situation are put forward in Bagniet and Dury (2010). Controlling and, as far as possible, reducing the energy intensity of the Belgian consumption profile is a major challenge, not just for the sake of the environment, but also from a macroeconomic point of view. An increase in excise duties on energy products could help here. In addition, any such increase would automatically weaken the link between consumer prices and energy commodity prices (see below). But since it would also have an upward influence on the health index, it risks having adverse effects on wage cost developments.

At the same time, the weight of energy consumption varies according to the source used: it is higher in the national accounts than in the household budget survey. Since 2010, the HICP has switched from a weighting system based on this survey – as is still the case with the national consumer price index from which the health index is also derived – to a system based on the national accounts, which has pushed up the share of energy compared with the national index⁽²⁾. According to these data, it is mainly consumption of motor fuels and heating oil that is stronger in Belgium. Although this new weighting system is not yet being used to calculate the national index and the health index – because the Index Commission still has to examine its relevance – it is nevertheless useful to assess the impact that switching over to this new weighting system could have on the health index. As regards the share of energy products included in this index (i.e. excluding motor fuels), there is virtually no difference at all from the current system, but the composition is different: heating oil would see its relative share grow, while the share of gas and electricity would shrink.

The second factor explaining the higher short-term sensitivity of inflation to oil shocks in Belgium is the fairly low level of excise duties and related taxes on diesel, natural gas, electricity and, above all, heating oil compared with the country’s three main neighbours. By way of example, these differences in excise duties are illustrated in the article by Bagniet and Dury (2010) mentioned above. The mechanism at work here can be summed up as follows: taking account of the relatively low excise duties, the (implicit) weight of energy commodities in consumer prices for energy products is higher and any given

(1) See Cornille (2009), Bagniet and Dury (2010), Coppens (2010) and Swartenbroekx (2010).

(2) This difference has accounted for more than half of the gap between inflation rates measured using the two concepts since the beginning of 2010. Over the first nine months of 2010, this difference came to 0.2 of a percentage point, while during the same period, the average inflation rate measured by the HICP was 2.1 % compared to 1.9 % under the national index.

TABLE 1 **WEIGHTING FOR ENERGY PRODUCTS IN BELGIUM AND THE THREE MAIN NEIGHBOURING COUNTRIES**
(per thousand)

	Average over the period 2000-2010		Weightings in 2010		
	Three main neighbouring countries	Belgium	Three main neighbouring countries	Belgium	<i>p.m. Belgium (national index)⁽¹⁾</i>
Energy	96	105	102	112	101
of which:					
Motor fuels	40	42	41	50	39
Heating oil	8	15	8	17	12
Gas	15	20	16	17	21
Electricity	23	28	27	27	29
Other ⁽²⁾	9	1	10	1	1
<i>p.m. Energy, excluding motor fuels</i>	55	64	61	62	62

Sources: EC, NBB.

(1) Adjusted for relative price variations between the reference year 2004 and 2009.

(2) Especially the purchase of direct heat via the district heating networks in Germany and France and coal in Belgium.

percentage change in the price of the raw material will trigger a more pronounced percentage change in the prices charged to the consumer (and will therefore have a greater impact on inflation).

In order to analyse the third explanatory factor, the mechanism for setting pre-tax prices needs to be studied carefully. The results of such an analysis vary from one product to another.

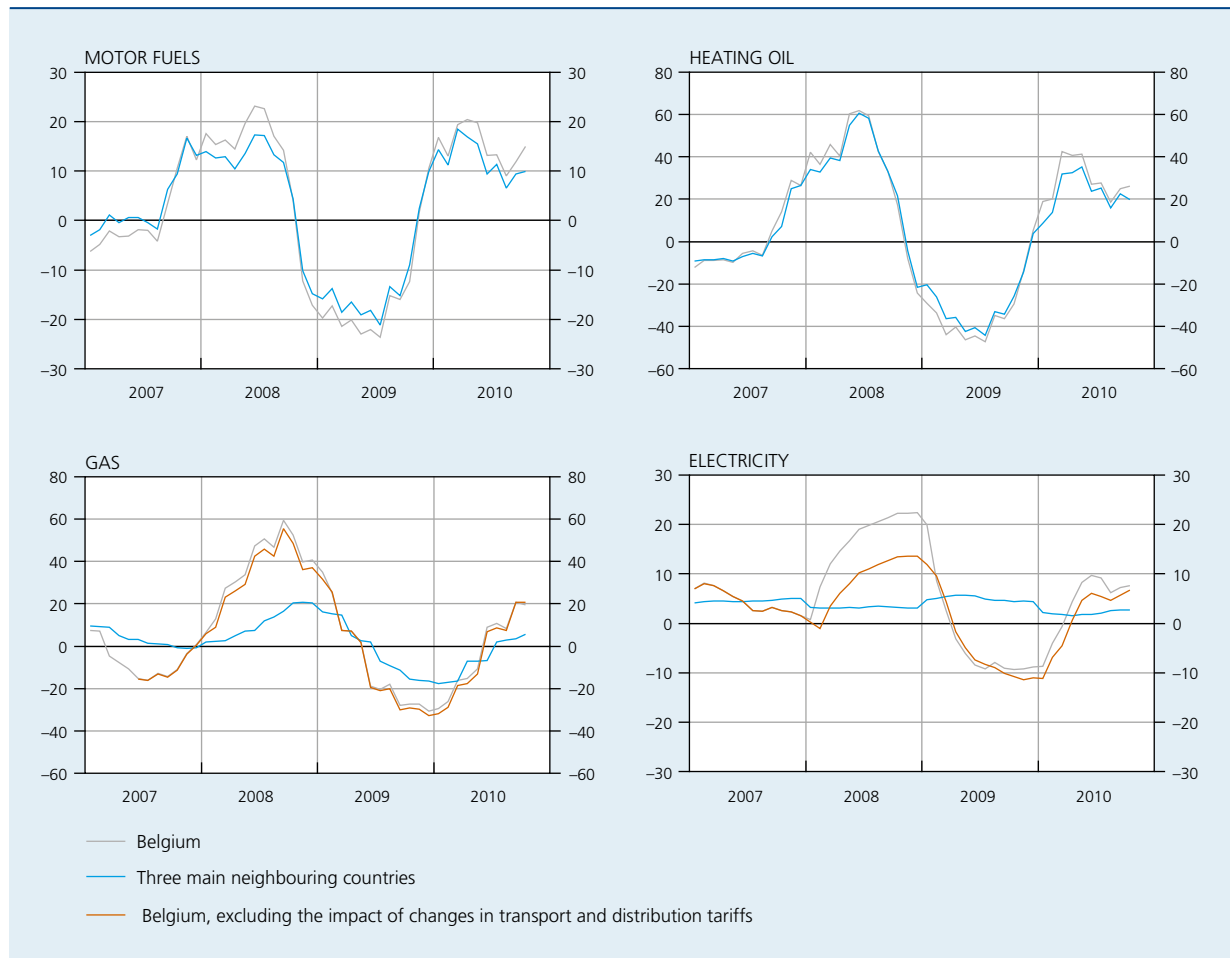
In the case of oil products, various analyses – and notably that conducted by Baugnet and Dury (2010) – provide evidence that the transmission is comparable in the different countries, at least when it is expressed in eurocents per litre. In both Belgium and the neighbouring countries, it is complete (in other words, a rise in the price of the refined product normally triggers an equivalent absolute increase in the consumer price) and the feed-through is very quick (transmission completed only after a few weeks). Also, the programme contract does not seem to have any notable influence on the dynamics of the transmission of crude oil price fluctuations to Belgian consumer prices for oil products. On the other hand, the gross margins on petrol and diesel appear to be slightly higher in Belgium than those recorded in Germany and France, but somewhat lower than margins in the Netherlands. This finding can probably be explained both by the fact that petrol stations generate a higher turnover (and thus reap greater economies of scale) in Germany and France and that the market is not as concentrated there. In France, it should also be noted that supermarkets sell motor fuel at relatively low

prices. Therefore, it seems that there is still some margin, albeit very small, for bringing down petrol and diesel price levels in Belgium by sharpening competition and reaping economies of scale. This option seems a lot less conceivable for the pre-tax price of heating oil, which is lower in Belgium than in the three main neighbouring countries. The contrast between the situation for heating oil and motor fuels could also suggest a certain degree of cross-subsidisation between the products targeted by the programme contract.

As regards natural gas, the transmission is slower than for oil products: here we are talking about months rather than weeks. However, Baugnet and Dury (2010) show that it is a lot less rapid in Belgium than in its neighbouring countries⁽¹⁾. In addition, gas prices in Belgium were pushed upwards in 2007 by the change made by the country's main gas supplier to one of the parameters of the reference index for energy costs in October 2007. Following the collapse of gas prices in early 2007 and changes in supply contracts, the supplier had decided to raise the constant term in the corresponding indexation formula. This pricing formula review was followed by similar – but less far-reaching – adjustments by other

(1) The feed-through of gas and electricity prices to the consumer price index has also become faster than during the period prior to 2007, given that prices are recorded under the "acquisition" approach (each month, the rate applied during the month in question is registered), whereas the "payment" approach had been used before (each month, the price from a fictitious annual invoice covering the last twelve months was recorded). While this change in methodology has evidently speeded up the (observed) transmission compared with the pre-2007 period, it is no longer a source of divergence from the neighbouring countries, since the so-called acquisition method has been used there for much longer. Besides, this is in line with the methodological recommendations in this field. See, for example, Cornille (2009).

CHART 9 CONSUMER PRICES FOR ENERGY
(percentage changes compared to the corresponding period of the previous year)



Sources: EC, NBB.

suppliers. The result was a price increase that can be regarded as permanent (see also Swartenbroekx, 2010, for more details).

Consumer prices of electricity in Belgium also appear to be particularly sensitive and react quickly to price fluctuations on the international energy markets, while in the neighbouring countries the latter do not seem to have any impact on electricity prices (see Coppens, 2010). This is one of the reasons why electricity prices shot up in Belgium in 2008 at a much faster pace than in the neighbouring countries. And it is for exactly the same reason that electricity prices for households in Belgium fell in 2009, before rising significantly again from the middle of 2010. A sharp rise in distribution and transmission rates in 2008 – and to a lesser extent in 2009 – also played a significant part in the rise in electricity consumer prices in Belgium, something that was much less pronounced

in the case of gas. These increases in transport costs and distribution charges replaced the cuts that had previously been imposed by the Commission for Electricity and Gas Regulation (CREG), which had ruled that the prices being charged were inappropriate. The arguments put forward to justify this assessment have nevertheless been contested in the law courts and CREG's case was thrown out at the end of 2007. Consequently, substantial price increases were made at the beginning of 2008 which effectively cancelled out the reductions that had previously been required.

The Belgian particularities of price-setting by electricity and gas suppliers – i.e. the part of the final price that does not include taxes and transport and distribution tariffs – can be explained by the unique model of monthly indexation of consumer gas and electricity prices based on pricing formulas which depend mainly on energy

commodity price movements. Consumer prices are in fact adjusted less frequently in the other countries and, in some countries like France and the Netherlands, there are still price controls of some form, while in Belgium, suppliers have been free to fix their own prices since the market was opened up to competition.

The principle of gas and electricity raw material prices being passed on to the consumer should not be called into question. It needs to be defended especially when it comes to more permanent movements since this is a major signal intended to encourage more rational energy consumption. It nevertheless remains to be seen whether pricing formulas closely reflect real supplier cost developments and whether an immediate repercussion onto the consumer of each change in raw material prices really is optimal. But, on the basis of information available in the public domain, it is not possible to make any decisions on whether there are any grounds for these indexation formulas (see, for example, Coppens, 2010, Baugnet and Dury, 2010, or, in this Economic Review, Swartenbroekx, 2010).

Both the keen and atypical sensitivity of consumer electricity prices in Belgium to fluctuations in energy commodity prices in a European context and the changes made to natural gas pricing formulas in 2007 raise questions. It therefore seems quite clear that the regulatory authority should play a more active role here. Under the wider competences the CREG has enjoyed since 2008 (the Law of 8 June 2008 notably gives it the power to assess whether prices offered by gas or electricity companies are objectively justified by their costs), it can now act on an *a posteriori* basis and point out any possible anomalies to the Competition Council. Using its price monitoring powers, the CREG would have liked the Council to re-examine the changes made in 2007 by the main supplier in the gas-pricing formula but the Competition Council no longer wanted to take the case given that it had already ruled previously that this change was not problematical at all. A model for *a posteriori* monitoring of price-setting seems to work better in Germany (see Swartenbroekx, 2010). In the Netherlands, the procedure is different: regulatory authority examines the grounds for energy suppliers' prices and their adjustments before they are actually put into practice.

UNDERLYING INFLATION TREND

The above-mentioned developments have strongly influenced the health index. Food price changes are actually fully reflected in the index, while energy price developments are only partly disregarded. While it excludes petrol and diesel, the health index covers heating oil, gas and

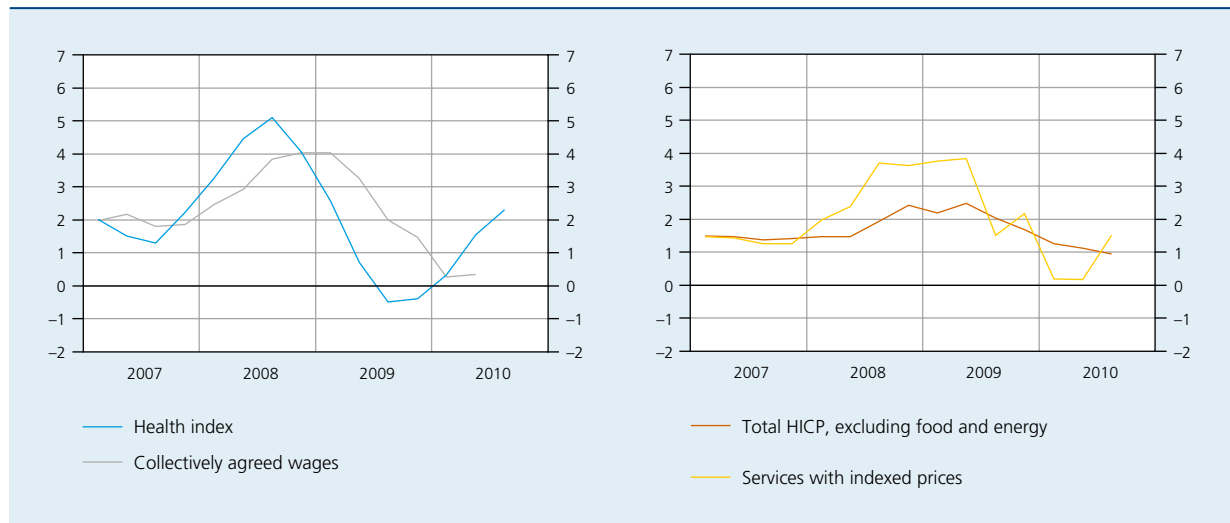
electricity, which together account for around 60% of the energy weighting. Moreover, gas and electricity price developments seem to have been more volatile over the last four years than previously. As a consequence, the health index has not been shielded from fluctuations in energy raw material prices as during the period from 1996 to 2006. So, the pace of increase in the health index climbed to 5.1% in the third quarter of 2008 and fell back to -0.5% in the third quarter of 2009 before accelerating again to reach 2.3% during the third quarter of 2010. In October 2010, it even got as high as 2.6%. As a result, the new trigger index in force in the general government sector had already been reached in August 2010, although it should not have been until the beginning of 2011 according to the inflation forecasts made in early 2010, assuming lower oil prices and food commodity prices.

These developments have obviously had some impact on the trend in underlying inflation. To start with, a whole range of services are automatically index-linked via the health index or a related index. This is notably the case with housing rent, which can be set freely when a lease is renewed, but any adjustment of the rent during the lease term is limited by law to an annual indexation based on movements in the health index. Other practical examples of indexation include prices of postal and rail services, for which any increases are linked to inflation, or premiums on fire insurance contracts, which are linked to the ABEX index⁽¹⁾. Overall, changes in prices for roughly a quarter of all services, making up around 10% of the HICP, are due to a more or less formalised system of indexation. The trend in prices for these services, which follow movements in the health index with a certain time lag, picked up again in the third quarter of 2010 after a net decline in the first two quarters.

It should also be pointed out that an acceleration of the upward trend in the health index feeds through to collectively agreed wages after some delay, owing to the wage indexation system. This faster increase in wages, in turn, is not without repercussions on the trend in underlying inflation, which rises almost in line with wages. Moreover, it was during the period of an upward trend in underlying inflation in 2008 and 2009 that a positive gap appeared with the three main neighbouring countries for this component, which accounts for almost 70% of the HICP. This gap narrowed in the second half of 2009 and at the beginning of 2010, notably under the influence of the marked weakening of indexation effects at the time.

(1) The ABEX is compiled twice a year by the Association of Belgian Experts. This index follows movements in construction costs in Belgium on the basis of construction material prices and wage costs in the building industry.

CHART 10 UNDERLYING INFLATION TREND
(percentage changes compared to the corresponding quarter of the previous year)



Sources: DGSEI; FPS Employment, Labour and Social Dialogue.

It nevertheless remained positive throughout this period and, in the meantime, the dampening of indexation pressures came to a halt. Likewise, indexation is expected to fuel inflation anew.

Once again, it appears that indexation is a major challenge for safeguarding the Belgian economy's competitive edge. This is precisely why the 1996 law incites the social partners to cancel out the undesirable effects of indexation, by taking full account of their impact on wage formation as well as on competitiveness vis-à-vis the three main neighbouring countries. Under the current circumstances, it must be a priority during the negotiations with a view to concluding a central agreement for the 2011-2012 period.

3.2 Trend in the inflation gap relative to the three main neighbouring countries since 1996

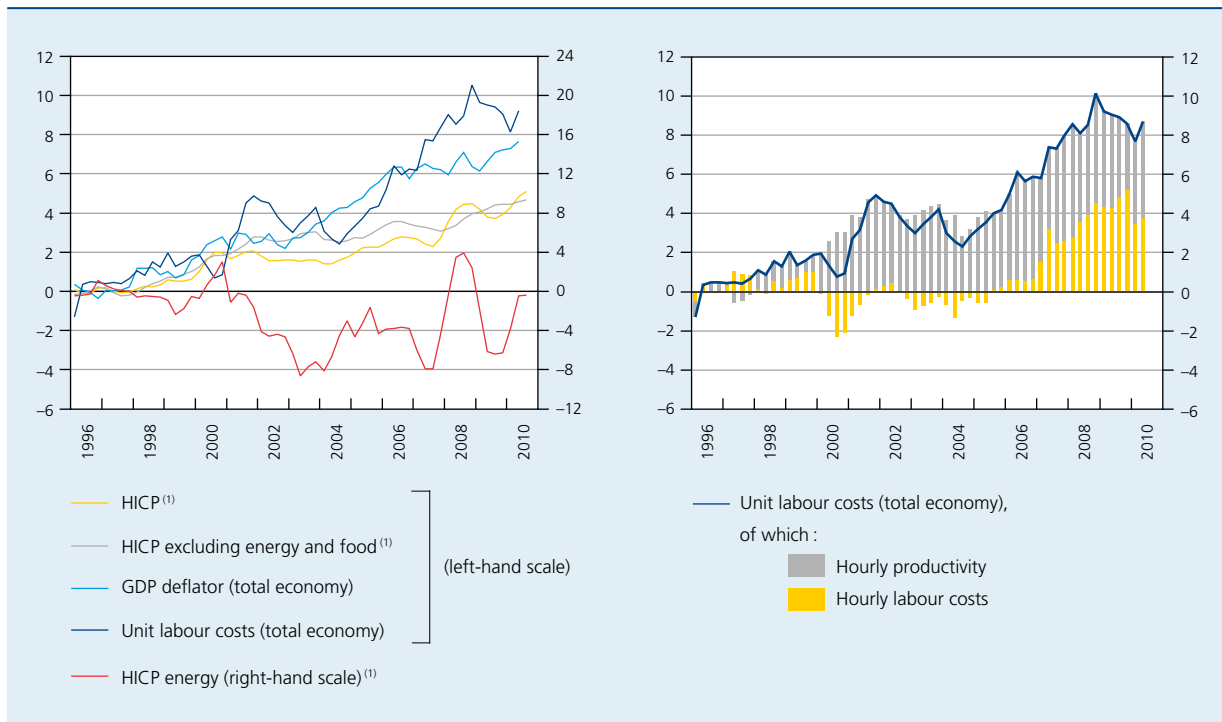
A comparison, over a long period, of the main indicators of changes in prices and costs in Belgium and the three main neighbouring countries produces roughly the same indication from all of them, namely that Belgium's competitive position in terms of prices and costs has deteriorated since 1996 in relation to these three countries. The rise in the overall HICP, the underlying inflation trend, the GDP deflator and unit labour costs in the total economy was between 5 and 9% faster than in these countries. The fact that the main indicators all point in the same direction emphasises how robust these

findings are and confirms previous reports compiled by the Central Economic Council for the social partners on the basis of the relative trend in hourly labour costs in the private sector.

It is also striking that, for the whole period running from 1996 to September 2010, the cumulative trend in energy prices in Belgium has remained in line with that in the three main neighbouring countries, even though there is clearly greater volatility in Belgium. In the event of an increase in the price of crude oil expressed in euro (2000, 2008, 2010), the Belgian HICP actually goes up more than the three neighbouring countries' indices, while the opposite happens when there is a fall in crude oil prices (2002-2003, 2007, 2009). The alignment of cumulative energy price trends between Belgium and its three main neighbours can be explained as follows: the impact of the greater sensitivity of the Belgian HICP to oil prices – the whole of the period under consideration has in fact been marked by a trend increase in crude oil prices expressed in euro – was offset by an initially more favourable movement in natural gas and electricity prices. This does not necessarily mean that there is no need for a more in-depth analysis of gas and electricity price-setting. In view of the growing volatility of these energy products and the fact that their prices have risen more rapidly than in the three main neighbouring countries since 2007, such an analysis would most certainly be relevant, especially from a forward-looking perspective. In the past, however, energy price developments, unlike labour cost trends, have not been among the main causes of the Belgian economy's

CHART 11 CUMULATIVE RELATIVE TRENDS IN PRICES AND COSTS: COMPARISON OF THE DIFFERENT INDICATORS

(period Q1 1996 – Q2 2010, cumulative divergence from the three neighbouring countries, seasonally adjusted data)



Sources: EC, ECB.
(1) Period Q1 1996 – Q3 2010.

deteriorating price and cost competitiveness vis-à-vis the three neighbouring countries.

Despite some brief periods of divergence, the GDP deflator actually shows a similar relative movement to unit labour costs in the total economy. This is hardly surprising since wages are an important cost factor. The more stable evolution of the GDP deflator shows that the stronger cyclical pattern of unit labour costs is to some extent offset by profit margins. However, very few differences emerge in the trend movement of the two indicators; indeed, the impact of the buffer role played by profits is limited to the short term. Over the whole period, the relative trend in consumer prices measured on the basis of the overall HICP, or the underlying inflation trend, has remained slightly below that exhibited by the GDP deflator. This can be explained by the fact that consumer prices do not just reflect changes in domestic costs, but they are also influenced by import prices. This divergence is no doubt also partly attributable to a series of indirect tax measures, which usually have a stronger impact on consumer price movements than on the GDP deflator. These measures have actually pushed the consumer price index up faster in the three neighbouring countries

than in Belgium. It is mainly Germany that has seen a significant increase in indirect taxes during the period under consideration (essentially in 2007). These tax rises were intended to finance the reduction of social security contributions. Moreover, the relative trend in the HICP deviates from that of the underlying inflation trend from time to time, because Belgian consumer prices are much more sensitive to fluctuations in energy commodity prices. Over the whole period from 1996 to September 2010, the relative movements in the two measures of inflation have nevertheless remained quite similar.

Breaking down relative movements in unit labour costs, it appears that the increase in hourly labour costs in Belgium has remained more or less in line with that seen in the three main neighbouring countries over the period between 1996 and 2005. However, over these years, the rise in productivity was not as high in Belgium, so unit labour costs still rose faster than in these three countries. Yet the main reason for the widening of the gap observed since 2006 is the increase in labour costs per hour worked. This pattern is to a large extent in line with the Central Economic Council's findings concerning the relative trend in hourly labour costs in the private sector.

Conclusions

As a result of the economic crisis, it has become clear that more effective monitoring of imbalances and shifts in competitiveness is required in the monetary union that the euro area countries form. To this end, the Van Rompuy Task Force has drawn up a new framework, which was endorsed by the European Council at the end of October 2010. Several indicators show that, since the European monetary union was set up, Belgium has managed to maintain its price and cost competitiveness vis-à-vis the euro area. Some deterioration in its competitive position with the three main neighbouring countries has nevertheless been observed, and more particularly in comparison to Germany. Meanwhile, against a backdrop of a severe recession, a correction of the competitive handicaps that have built up in the past is now underway, and most notably in Ireland, Spain and Portugal. This means that Belgium has less scope for allowing its competitive position to deviate from that of its three neighbours if it is to consolidate its overall position in relation to the euro area. On the other hand, it is highly unlikely that Germany will continue to boost its competitive edge at the same pace.

This article has also confirmed the Central Economic Council's findings concerning the competitive disadvantage in terms of hourly labour costs in the private sector that has built up in Belgium since 1996 by comparison to the three neighbouring countries. The repercussions of this handicap have been weighed down even further by less favourable productivity trends. The end result is a cumulative positive inflation gap with the same countries of around 5 percentage points since 1996, largely attributable to faster growth of unit labour costs, while the contribution of energy price developments has on the whole been neutral over this period.

Over the first ten months of 2010, inflation rose more quickly than in the three main neighbouring countries. It reached 3.1 % in October in Belgium, while it only averaged 1.5 % in Germany, France and the Netherlands.

Several parallels can be drawn with the year 2008. A rise in energy and food commodity prices once again seems to give rise to stronger first-round effects in Belgium. Oil product price trends and also movements in natural gas and electricity prices play an important role here, as they did in 2008. In the last few months, the price of food has also risen a bit more sharply in Belgium than in the three main neighbouring countries, and the experience of 2008 suggests that this gap could widen further in the near future. In this context, the rise in the health index has accelerated sharply, reaching 2.6 % in October, something which tends to enhance the risk of second-round effects. This is a major challenge for safeguarding the country's competitive edge which is absolutely essential.

In the immediate future, vigilance is therefore required on two fronts. On the one hand, attention needs to be paid to the extent of the first-round effects that commodity price changes have on inflation. The Price Observatory, the CREG and the Competition Council have an important role to play here. Besides food price developments, several recent studies by the Bank suggest that, regarding energy products, attention really needs to be focused on natural gas and electricity. For these energy products, raw material price changes feed through to the consumer very quickly through the monthly index-linked pricing formulas used in Belgium – a unique practice in comparison with the neighbouring countries – and, furthermore, it is impossible to tell from publicly available data whether these pricing formulas do actually offer a true reflection of trends in costs. On the other hand, it is important that the social partners seize the opportunity of the next round of wage bargaining negotiations to internalise all possible effects of indexation and strive to reach agreement on nominal wage rises that will help protect the country's competitive position in accordance with the 1996 Law on the promotion of employment and the preventive safeguarding of competitiveness. In the longer term, a reduction in the energy intensity of Belgium's consumption profile would also help to keep price and cost developments under control.

Bibliography

Baugnet V. and D. Dury (2010), "Energy markets and the macroeconomy", NBB, *Economic Review*, September.

Cornille D. (2009), "Methodology or pricing: how can the higher volatility of consumer gas and electricity prices in Belgium be explained?", NBB, *Economic Review*, December.

Coppens F. (2010), "The increased volatility of electricity prices for Belgian households", NBB, *Economic Review*, September.

Swartenbroekx C. (2010), "Implications of liberalisation for methods of setting retail gas prices in Belgium", NBB, *Economic Review*, December.