Economic projections for Belgium – Autumn 2014

Introduction

The economic recovery that got underway in the spring of last year is still very fragile, both in Belgium and in the euro area. Against a backdrop of declining producer and consumer confidence, the Bank's spring projections for Belgium already factored in some decline in growth from the second quarter of 2014. However, the actual slowdown was significantly steeper than projected, with economic developments in Belgium much the same as in the broader euro area. Here too, the economy virtually stalled in the second quarter, much as it did in Belgium. Most notably, the core countries were the worst affected, and Germany and France even reported slight contractions. By contrast, growth gathered momentum in quite a few of the countries in the euro area periphery, with the one exception of Italy, where economic activity also declined. The growth figures for Spain, Portugal and particularly Ireland were even remarkably high. The first flash estimate suggests no further declines in euro area growth in the third quarter, with the overall figure ending up at a still subdued 0.2 %. Growth in Germany and France, the two main euro area economies, is back in positive territory, albeit only marginally in the case of Germany.

These diverging growth figures for the euro area suggest that the domestic recovery process is gradually leading to the expected rebalancing, with the revival much stronger in countries that have had to address the biggest macroeconomic imbalances. These countries have gone through the toughest adjustment programmes to repair their competitiveness and are now showing the first rewards. In Ireland's case, growth is significantly underpinned by the country's strong trade links with global growth drivers such as the United States and the United Kingdom.

Worldwide, the economic recovery continues. Although global growth was held back by a number of specific factors in the first six months of the year – e.g. the very bad weather in the United States at the beginning of the year, and the VAT increase that depressed household consumption in Japan in the second quarter – economic activity would seem to have picked up again in the second half of the year. Global growth should end 2014 at more or less the same level as in 2013, but developments diverge in the various parts of the world. Emerging countries as a whole still account for the steepest growth rates, though some are facing gradual or even steep slowdowns. In China, for one, third-quarter growth fell back to its lowest rate since the great recession. Russia's economy would even appear to be grinding to a complete halt in the wake of its deteriorating relationship with the advanced countries and the resultant mutual economic sanctions. By contrast, some advanced countries are enjoying robust and rising growth, in some cases even exceeding expectations.

One source of concern, which is perhaps related to the changing composition of global growth, is that international trade flows would seem to benefit significantly less from growth. Less trade-intensive global growth may weigh on the pace at which the recovery spreads, and, more particularly, slow down the revival of the euro area, which has been trailing despite the sharp depreciation of the euro.

Meanwhile, the financial markets seem to be mainly reflecting the very accommodative monetary policies and significant liquidity creation in the advanced countries. Asset prices have bounced back and yields have fallen to historic lows, including those on government bonds that until recently commanded very high risk premiums. Several bouts of financial instability, like in August and

October, have jolted memories of how jittery markets can be in response to rising geopolitical tensions and to any changes, however small, in the growth outlook.

These autumn projections for Belgium, which were completed on 20 November 2014, incorporate a range of measures that were already taken or announced in sufficient detail by the various new governments, even if not all the details about their implementation were known by the cut-off date. The key measure announced by the federal government is the temporary suspension of the indexation mechanisms for wages and replacement incomes by means of the so-called "index jump" on top of the continued real wage growth freeze. As this is a key element in this projection exercise, Box 1 below goes into some detail about our assessment of its macroeconomic impact. Although it is likely to cause a sharp drop in inflation, the measure's real effects should be limited over the term of the projection horizon. After all, in an environment of low inflation it would take a while for this temporary suspension of index-linking, scheduled for the first quarter of 2015, to fully percolate through to lower wage growth. It will also take some time for lower wage costs to be transmitted to prices and for the positive effects of improved cost competitiveness to materialise in exports. Lastly, the favourable effects of the indexation suspension on economic activity will initially be offset by lower income growth depressing household consumption.

Although forecasts are still pointing to a further pick-up in economic activity, growth estimates have clearly been revised downwards. The bigger-than-expected decline in growth since the spring is keeping economic activity at only 1 % for this year. The Belgian economy is expected to grow at a similar pace next year before accelerating somewhat in 2016. The significant downward revision of the 2015 growth estimates, i.e. 0.7 percentage point relative to the spring projections, can for one third be ascribed to the carry-over effect of this year's lower growth. Other factors also come into play. For one thing, the adoption of the consolidation measures in the federal and regional government budgets has shaved about 0.1 percentage point off government expenditure's contribution to growth. Household consumption growth has also been revised downwards due to the aforementioned effects of lower income growth. The same applies to business investment, due to lower levels of production as of 2014. Lastly, net exports excluding the carry-over effect should also contribute 0.1 percentage point less in 2015, as the common technical and external assumptions underpinning Eurosystem forecasts are positing much more subdued market growth. The most important of these assumptions are described in Box 2 in this article's first section.

The recovery does continue to show on the labour market: whereas 12 000 jobs were lost in 2013, over 60 000 are expected to be created between 2014 and 2016 – barely below the figure put forward in the spring projections, despite the lower growth estimates. This is of course due to the fact that labour would be relatively cheaper thanks to much lower labour cost growth, but in part it also reflects the stronger-than-expected increase in employment in the first half of this year. With participation rates up due to certain activation measures, job creation would not be enough to push down the unemployment rate.

Like the euro area as a whole, Belgium is looking at unusually low inflation in 2014, albeit partly because of the reduction in VAT rates on household electricity bills since April 2014. After adjustment for volatile components, however, prices should rise a little faster than in 2013. Current projections do see the underlying rate of inflation gradually dipping down to below 1 %, primarily as a result of labour cost control. By contrast, the rate of inflation of the volatile components looks set to rise considerably on the back of the recovery in oil prices from 2015 as foreseen in the common assumptions. Despite the downward underlying trend, the NCPI and HICP indices for consumer inflation would therefore still increase from their current unusually low levels to over 1 % in 2016.

Turning to public finances, the budget deficit would exceed the threshold of 3 % of GDP this year, then drop significantly from 2015 but still be above the budgetary target in 2016. In this respect, it should be pointed out that, in accordance with the rules applicable to the Eurosystem projection exercises, account is taken only of measures which have been formally adopted by the government – or which are very likely to be approved – and for which the implementation arrangements have been specified in sufficient detail on the cut-off date for the forecasting exercise. In addition, estimates of the budgetary impact of certain measures, such as those designed to combat fraud, may differ from the amounts included in the budget.

1. International environment and assumptions

1.1 Global economy

The global economy's uneven recovery continued at the same pace in 2014. Overall, economic activity in the advanced countries picked up on the back of highly accommodative monetary policies and a slower pace of budgetary consolidation, while growth in the emerging economies was disappointing. This overall picture nevertheless hides strongly diverging developments in the various countries and regions.

In the United States, economic activity appeared to be gathering momentum following a temporary contraction in the first quarter due to adverse weather conditions. Better labour and housing market conditions and the diminishing impact from household deleveraging drove the revival, coupled with even more expansive monetary policies during most of 2014 and a slower pace of budgetary consolidation.

Box 1 – The macroeconomic effects of temporarily suspending indexation

The new federal government has announced it is planning a series of general policy measures, one of the most important elements for Belgium's macroeconomic development in the next couple of quarters being the aforementioned "index jump". Although not all details of its implementation are known, this article interprets the "index jump" as a non-increase of 2 % in all wages and replacement incomes, i.e. social benefits, pensions and the like. Skipping the automatic increase should benefit companies when it comes to private sector employment and the government with regard to both employment and benefit spending.

In addition to its proposed indexation suspension, the federal government has expressed its intention to continue its wage restraint policies, which implies zero growth for real negotiated wages in both 2015 and 2016. This implies that it is assumed that employees will not be able to offset the negative shock dealt to wages by the indexation suspension when the next set of wage negotiations rolls around. In the current low inflation environment, the suspension of the indexation mechanism – which is scheduled to be implemented in the first quarter of 2015 – will result in only a very minor indexation of average wages over the projection horizon, with wage drift becoming the key driver of nominal wage increases.

This significant restraint of wage growth is likely to result in :

- A negative household income shock, causing a temporary fall in private consumption. However, the decline should be gradual as consumption patterns are typically smoothed, which implies that the savings ratio will decline.
- A positive shock boosting business competitiveness, which will be bigger to the extent that the initial wage shock pushes down end prices. Companies tend not to adapt their sales prices to their production costs immediately and it also takes time for relative prices to feed through to export results, so any gains in terms of market share will only become visible in the medium term.
- A relative reduction in labour factor costs that should gradually increase labour intensity in the production process.
- A slightly negative effect on public finances in the first few years, as the positive impact on benefit spending and wages will be wiped out by lower direct tax receipts from households and social contributions, as well as by lower indirect taxes in keeping with the steady fall in consumption. Over time, though, the shortfall should be recouped through higher employment and economic activity, making up for the initial budgetary costs of skipping the indexation.

It will take time for the 2 % contraction of nominal hourly wages to percolate through relative to a scenario in which indexation is not skipped. After all, the speed at which the indexation suspension affects the average nominal wage will depend on the indexation mechanisms specific to each sector, and the shock will also be delayed by low inflation in Belgium. Moreover, companies typically make their output prices mirror production costs – and wages – only gradually. Lastly – and as this article has already noted – real macroeconomic variables (consumption, exports, job creation, etc.) typically reflect price changes after a time lag, and the macroeconomic effects will not become fully visible until after 2016, i.e. beyond the projection horizon. From 2017 onwards, the impact is likely to be stronger in the sense that lower prices should make for less dynamic wage growth once indexation mechanisms are switched back on. All in all, the total impact on wages of temporarily suspending the index-linking should be bigger, over time, than the initial 2 % shock.

The indexation suspension's quantitative effects have been estimated by the National Bank of Belgium's quarterly econometric model [1]. The table below captures the outcomes of the simulation, which sees the impact of wages on companies' marginal costs revised downwards relative to the published version of the model, slightly reducing the wage-price spiral in the quarters after the indexation suspension. The revised specification takes on board the findings of Cornille and Robert (2005) [2] among others, who argue that labour costs account for only around one-third of the total production costs of a standard consumer item.

IMPACT OF THE INDEXATION SUSPENSION IN THE AUTUMN PROJECTIONS

(percentage change compared to the baseline scenario without the indexation suspension; cumulative growth differences from 2015)

	2015	2016	2017	2018	2019
Nominal hourly labour costs	–0.3	–1.6	–2.7	–3.0	–3.1
Export deflator	0.0	–0.4	–1.0	–1.2	–1.2
Inflation (HICP)	–0.1	–0.5	–0.9	–1.1	–1.1
GDP deflator	–0.1	–0.8	–1.7	–2.1	–2.2
Disposable household income (1)	–0.1	–0.6	–0.9	–1.0	–1.0
Household consumption (1)	–0.1	–0.3	–0.4	–0.5	–0.4
Household savings ratio (2)	0.0	–0.3	–0.5	–0.5	–0.5
Net export contribution to growth (1) (2)	0.0	+0.1	+0.3	+0.5	+0.7
GDP (1)	0.0	0.0	+0.1	+0.3	+0.5
Private sector employment (3)	0.0	+0.1	+0.2	+0.5	+0.8
	(0.4)	(4.4)	(11.9)	(22.3)	(33.3)
Overall government balance (in % of GDP) (2)	0.0	–0.1	–0.1	0.0	+0.2
Government debt (in % of GDP) (2)	+0.2	+1.1	+2.0	+2.2	+1.9

Source: NBB.
(1) In real terms.
(2) Change in percentage points.
(3) Figures in brackets in thousands of people, measured at the end of the calendar year.

The simulation based on the above assumptions suggests that skipping the indexation will have only a subdued effect on economic growth over the projection horizon, with a slightly negative impact on consumption in 2015 and a bigger effect in 2016. The impact of improved cost competitiveness on exports will not become fully noticeable until after 2016.

That said, the assumption of zero growth in real wages might prove untenable in the medium term. In contrast to the proposed scenario, wage negotiations might be reopened and real wages might rise, partly reducing the expected improvements in cost competitiveness. Another drawback to the proposed analysis is that this simulation fails to factor in the expectations that the affected economic agents have for the future and the possibility that these agents might act on the announced measures even before they are implemented. Besides, the simulation assumes that every gradual nominal wage cut will come as a surprise to both households and companies, while a model based on rational expectations would posit awareness on the part of these agents of the measure's future benefits for competitiveness and real growth; they would immediately adapt their behaviour, and the wage restraint policy would feed through to the real economy more quickly.

(1) Jeanfils P. and K. Burggraeve, *Noname – a new quarterly model for Belgium, National Bank of Belgium,* Working Paper 68, May 2005.
(2) Cornille D. and B. Robert (2005), "Sectoral interdependencies and cost structure in the Belgian economy: an application for input-output tables", NBB, *Economic Review*, June, 33-48.

Economic activity in Japan slumped in the second quarter of 2014 in the wake of the April consumption tax hike. To some extent, consumption shifted to the first quarter, which did see a robust growth figure. Although much-needed fiscal consolidation is likely to put a brake on growth in the years ahead, more accommodative monetary policies and better financing conditions should support the economy. However, economic activity unexpectedly contracted further in the third quarter.

The euro area recovery that had begun in the spring of 2013 fell back significantly during the course of 2014. Recording quarter-on-quarter growth of barely 0.1 %, the economy almost stalled in the second quarter. Increasing geopolitical tensions and a slowdown in growth in key emerging countries depressed exports and – through uncertainty effects – investment as well. The lack of any resolute structural reforms in a number of core euro area countries – and the resultant languishing growth – may also have played a role. No steep upturn in economic activity is expected for the second half of 2014 and so, not surprisingly, the European Commission revised its growth outlook for the euro area sharply downwards in its autumn forecast. The first available quarterly statistics suggest that third-quarter growth did not contract any further but was still limited to a modest 0.2 %. The euro area economy is therefore expected to grow only modestly in 2014, and would then accelerate in 2015 and 2016. Domestic demand should be the largest contributor to growth in the years ahead, underpinned by accommodative monetary policies, low financing costs, improved credit conditions, a slower pace of deleveraging and a return to more neutral fiscal conditions. In contrast, net exports are expected to make only a modest contribution to growth. Turning to individual euro area countries, the German economy virtually stagnated in the second and third quarter, but its strong labour market and the pick-up in foreign demand should support economic activity in the next few years. Despite surprisingly positive third-quarter growth, the French economy has in fact stalled since 2011 ; and with investment falling, household consumption flat and exports weak, no pick-up in growth is likely to materialise before 2016. The euro area periphery, by contrast, is catching up. Ireland, Greece, Spain and Portugal have already been recording high to very high quarterly growth figures, Cyprus should also see economic activity trend upwards.

In tandem with weak economic growth, labour markets have been recovering modestly as well. The unemployment rate in the euro area is expected to come down only a little in the next couple of years and to still be at pre-crisis levels by 2016. Differences between Member States continue to be significant, but the gap is narrowing as the situation is improving in the countries most affected by the crisis.

Conditions in the emerging economies diverge sharply, due to both global and country-specific factors. The emerging Asian countries such as China, India and Indonesia have enjoyed relatively robust growth, whereas geopolitical tensions have been weighing on economic activity in Russia and falling commodity prices have had a negative impact on growth in some countries in Latin America. Despite still strong growth figures, the Chinese economy is steadily losing momentum, due in part to a correction in the housing market. This correction, coupled with measures to curb credit growth in the financial sector, is likely to put a further brake on growth going forward. In Russia, investment – which had seen subdued growth even before the Ukrainian crisis – has been hit hard. The Russian economy is therefore expected to more or less stagnate in 2014, and to edge up when investment and exports revive.

Having come out of a prolonged spell in the doldrums, global trade had gained momentum in the second half of 2013 only to fall back again in the first months of 2014. Like economic activity, growth in global trade also levelled off at the beginning of the year, with falls being most marked in the Asian emerging countries, and with most notably sharply lower imports in China. Underpinning these trends are both cyclical factors – particularly the sharp slowdown in trade-intensive demand components such as business investment – and more fundamental issues, including the fact that global production chains are getting shorter after years of expansion. All these factors have led to a reduction of the elasticity of international trade relative to economic growth. While world trade is expected to start moving back up, it would do so at a slower pace than before the crisis.

In the financial markets, long-term government bond yields have fallen or stabilised at low levels against a backdrop of strongly accommodative monetary policies in the advanced countries. Prospects of a prolonged period of very low interest rates have led investors to search for yield elsewhere, a trend reinforced by the generally low volatility in international markets. As a result, equity prices have continued their upward trajectory in 2014, while risk premiums on high-yield government bonds – in the euro area periphery, for instance – fell to their lowest post-crisis levels. Although there were bouts of heightened turbulence in financial markets in 2014, such as those in August and October, these periods have so far proved temporary.

The general fall in commodity prices that had started in 2011, came to an end late in 2013. Although Brent-grade crude oil prices and industrial commodities did not show any clear trends during the first few months of 2014, food commodity prices were sharply up due to poor weather conditions in some countries and unease about the situation in Ukraine, a key grain exporter. In early May and at the end of June respectively, oil and food prices fell back steeply again, followed more recently by industrial commodity prices. The demand side is still dominated by subdued global demand and, in the case of industrial commodities, by concerns about declining growth in China. On the supply side, shale oil production in North America and the massive reserves in Saudi Arabia more than made up for supply interruptions due to geopolitical tensions in Russia, Libya and Iraq. Good harvests this year should also make for a high supply of food, primarily grain.

Movements in bilateral exchange rates in 2014 have been largely due to diverging expectations of monetary policies in the relevant countries. The euro started falling against sterling in March and against the US dollar in early May, in keeping with expectations of a faster normalisation of monetary policies in both countries compared with the euro area.

TABLE 1 PROJECTIONS FOR THE MAIN ECONOMIC REGIONS

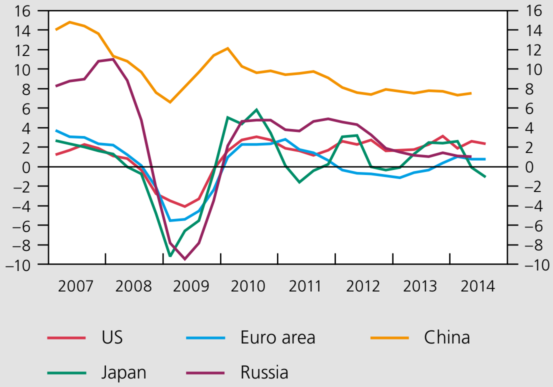
(percentage changes compared to the previous year, unless otherwise stated)

	2013	2014 e	2015 e	2016 e
Real GDP				
World	3.1	3.3	3.8	4.1
of which:				
Advanced countries	1.3	1.8	2.2	2.5
United States	2.2	2.2	3.1	3.2
Japan	1.5	1.1	1.0	1.0
European Union	0.0	1.3	1.5	2.0
Emerging countries	4.5	4.4	5.0	5.3
China	7.6	7.3	7.1	6.9
India	4.7	5.8	6.4	6.9
Russia	1.3	0.3	0.3	1.2
Brazil	2.5	0.2	1.4	2.6
p.m. World imports	*2.7*	*3.0*	*4.6*	*5.5*
Inflation (1)				
United States	1.5	1.8	2.0	2.3
Japan	0.4	2.8	1.6	1.4
European Union	1.5	0.6	1.0	1.6
China	2.6	2.4	2.4	n.a.
Unemployment (2)				
United States	7.4	6.3	5.8	5.4
Japan	4.0	3.8	3.8	3.8
European Union	10.8	10.3	10.0	9.5

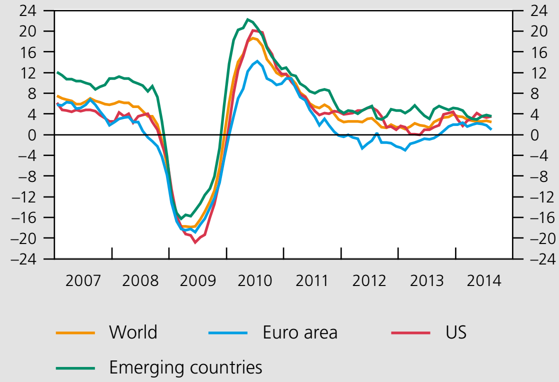
Source: EC.
(1) Consumer price index.
(2) In % of the labour force.

CHART 1 GLOBAL ECONOMIC ACTIVITY AND DEVELOPMENTS ON COMMODITY AND FINANCIAL MARKETS

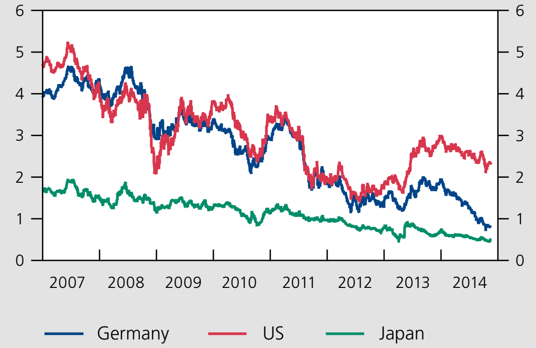
REAL GDP GROWTH
(quarterly data, percentage change compared to the previous year)



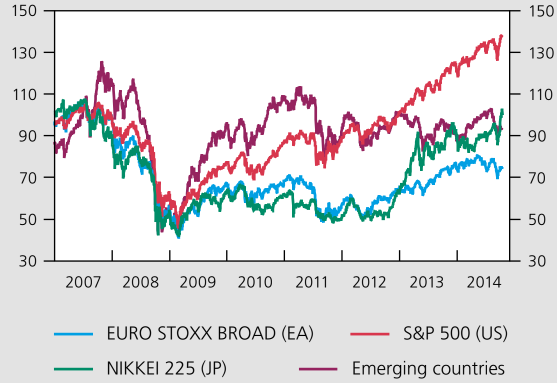
INTERNATIONAL TRADE
(seasonally adjusted three-month moving average of export and import volumes, percentage change compared to the previous year)



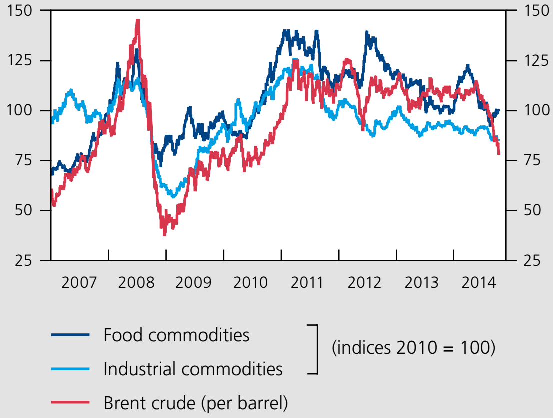
YIELD ON TEN-YEAR GOVERNMENT BONDS
(as a %)



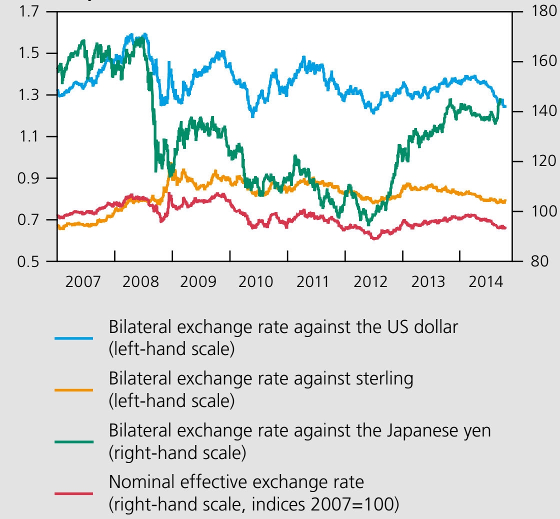
STOCK MARKET PRICES
(MSCI, daily data, indices 2007 = 100)



COMMODITY PRICES
(daily data, in $)



EURO EXCHANGE RATES
(daily data)



Sources : CPB, OECD, Thomson Reuters Datastream.

Box 2 – Assumptions underpinning projections

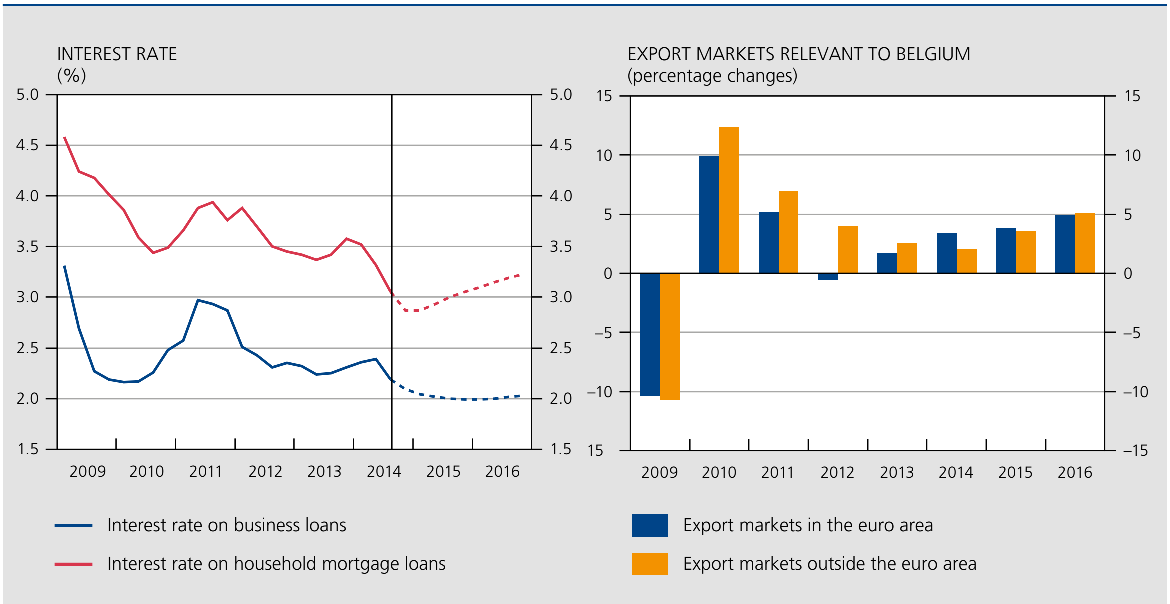
The macroeconomic projections for Belgium described in this article are the result of a joint Eurosystem exercise for the euro area. The projection exercise is based on a set of technical assumptions and forecasts for the international environment drawn up jointly by the participating institutions, namely the ECB and the national central banks of the euro area.

The projections assume that, throughout the projection period, future exchange rates will remain at the average levels recorded in the last ten working days before the cut-off date for the assumptions on 14 November 2014. In the case of the US dollar, the exchange rate then stood at $ 1.25 to the euro, a marked appreciation against the average of $ 1.33 in 2013.

As usual when it comes to mineral oil prices, account is taken of market expectations as reflected in forward contracts on the international markets. In mid-November 2014, this indicator suggested that, following the steep falls of the previous few months, the price per barrel of Brent could start picking up over the projection horizon, from an average of $ 84.6 in the last quarter of 2014 to $ 88.9 in the last quarter of 2016. Despite the expected gradual upturn, oil prices should end 2016 a lot lower than in 2013 and levels reached in the first half of 2014 – a significant downward revision with regard to the spring projections.

Interest rate assumptions are also based on market expectations in mid-November 2014. The three-month interbank deposit rate was projected to remain at an unusually low level of below 10 basis points in the final quarter of 2014. Short-term interest rates are expected to stay at such a low level for some time, only edging up to over 15 basis points by the end of the projection horizon. Long-term interest rates in Belgium are also expected to rise gradually, from 1.3 % in the final quarter of 2014 to an average of 1.6 % in 2016. Long-term interest rates for 2014 and 2015 have been revised downwards quite considerably compared to the assumptions in the projections of last spring.

INTEREST RATES AND VOLUME GROWTH OF EXPORT MARKETS



Source : Eurosystem.

The interest rates that banks are forecast to charge on business investment loans and household mortgage loans take account of the transmission generally apparent in relation to market rates. Retail rates as offered by banks have generally been revised downwards to a lesser extent, compared to the June projections. Average mortgage rates should work out at around 2.9 % in the fourth quarter and are expected to drop by nearly 20 basis points in 2015 before moving back up in 2016. Average interest rates on business investment loans, which typically reflect shorter-term rates, are projected to remain virtually unchanged at nearly 2 %.

Global economic growth projections for 2015 and 2016 have been revised upwards slightly relative to the June 2014 spring projections. In the wake of the lower trade intensity of this growth as observed earlier, there was a marked downward adjustment of the elasticity of import demand relative to global growth; hence, the new global growth assumptions generate a distinctly lower demand for imports. In this context, the year-on-year growth of the foreign markets relevant to Belgium was revised down sharply over the projection horizon. The adjustment was steepest for markets outside the euro area, although euro area markets would also revive less quickly than had been predicted, in view of the clear slowdown in the euro area in the course of 2014. That said, these markets should still grow from less than 3 % in 2014 to nearly 5 % in 2016, with export markets outside the euro area expected to return to faster growth than those within the euro area from 2016.

Growth in Belgian exports is determined not only by the growth of these markets but also by changes in market share, and therefore Belgium's competitiveness. With regard to cost-related competitiveness aspects, one important factor is the movement in the prices which competitors charge on the export markets. In 2014, competitors' prices on the export markets would decline by 0.9 %, after already having fallen by 1.7 % on average in 2013. For both 2015 and 2016, prices are projected to stage a clear upturn, implying an upward revision on the spring projections. The revision is due partly to the fall in the value of the euro as measured on the basis of the real effective exchange rate.

The revisions relative to the spring projections of the technical, financial and international assumptions should result in an overall downward impact of nearly 0.3 percentage point on the 2015 growth estimates and of around 0.2 percentage point on those for 2016. The relatively substantial effects of more subdued growth in Belgium's markets are only partly offset by positives such as lower interest rates, lower oil prices and higher prices of foreign competitors as expressed in euros.

EUROSYSTEM PROJECTION ASSUMPTIONS

(in %, unless otherwise stated)

	2014	2015	2016
		(annual averages)	
EUR/USD exchange rate	1.33	1.25	1.25
Crude oil prices (US dollars per barrel)	101.2	85.6	88.5
Three-month interbank rate in euro	0.2	0.1	0.1
Yield on ten-year Belgian government bonds	1.7	1.3	1.6
Corporate loan rates	2.3	2.0	2.0
Household mortgage rates	3.2	3.0	3.2
		(percentage changes)	
Export markets relevant to Belgium (volume)	2.9	3.7	4.9
Export competitors' prices	–0.9	1.0	1.4

Source: Eurosystem.

1.2 Estimates for the euro area

The Eurosystem's autumn projections suggest that the recovery in the euro area, which began in the spring of 2013, would gather greater momentum, albeit at a much slower pace than indicated in the ECB's spring and September projections. The economic growth rate in the following quarters is likely to still be restrained by the factors that brought on a marked growth slowdown in this year's second and third quarter: the ongoing major geopolitical tensions, the fragile recovery of international trade and the lack of progress on economic reforms in some euro area countries. Growth should nevertheless still perk up in the next two years, to 1.5 % in 2016.

Unlike in the 2011-2013 period, domestic demand should turn into the biggest engine for growth by far, gradually also pushing up imports and thus largely offsetting higher exports on the back of growing foreign demand and a cheaper euro. Higher domestic demand will be supported by accommodative monetary policies and steady household income growth in a low inflation environment. However, the need for both governments and the private sector to continue to deleverage in a good many countries will continue to depress the growth outlook in the longer term.

Having fallen to an unusually low level since the spring 2014 projections, inflation is expected to gradually rise to around 1.4 % by the final quarter of 2016. This upward trend should come on the back of rising demand as well as the expected turnaround in price pressure from volatile components such as energy, whose massive price falls over the past months have sharply reduced inflation. This latter factor explains why underlying inflation – i.e. inflation excluding volatile movements in prices of energy and food – is expected to accelerate less swiftly and would, coming from a higher level to start with, end up at more or less the same level as HICP inflation by 2016.

The recovery in the labour market appears to be unaffected for now by the recent slowdown in economic activity. Wage restraint and recently implemented labour market reforms would seem to be driving recovery and have increased the labour intensity of economic growth. Employment momentum should become even more robust in 2015 and 2016, although the unemployment rate is still expected to be above its structural level by the end of the projection period, despite its decline by one percentage point in three years.

The average budget deficit in the euro area is projected to decline to 2.2 % of GDP by 2016. However, the improvement is attributable mainly to the revival in economic activity and the decline in interest charges on the back of unusually low interest rates. Fiscal policies are expected to remain virtually neutral in the period under review.

TABLE 2 EUROSYSTEM PROJECTIONS FOR THE EURO AREA

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

	2014 e	2015 e	2016 e
Inflation (HICP)	0.5	0.7	1.3
Underlying inflation (1)	0.8	1.0	1.3
Real GDP	0.8	1.0	1.5
Household and NPI final consumption expenditure	0.8	1.3	1.2
General government final consumption expenditure	0.9	0.5	0.4
Gross fixed capital formation	0.7	1.4	3.2
Exports of goods and services	3.2	3.2	4.8
Imports of goods and services	3.3	3.7	4.9
Domestic employment	0.4	0.6	0.5
Unemployment rate (2)	11.6	11.2	10.9
General government financing requirement (–) or capacity (3)	–2.6	–2.5	–2.2

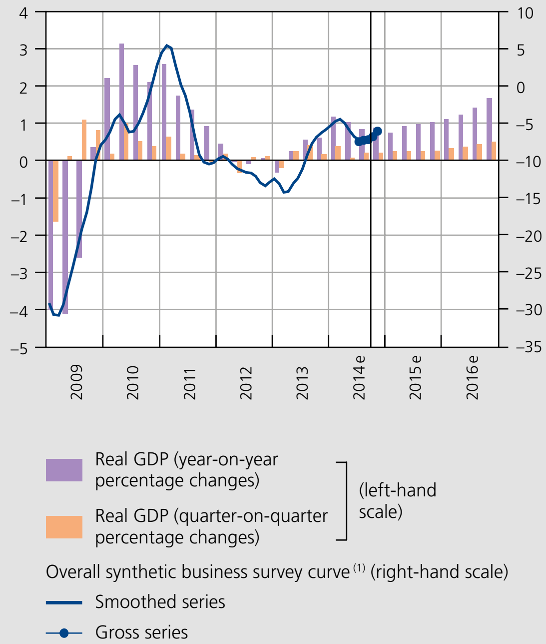
Source: ECB.
(1) Measured by the HICP excluding food and energy.
(2) In % of the labour force.
(3) In % of GDP.

2. Activity and demand

From the second quarter of 2014, Belgium's economic recovery waned faster than had been predicted. The Bank's spring projections had factored in some edging down, but the first quarterly statistics revealed a significantly steeper fall to no more than 0.1 %. Domestic demand slowed only slightly but net exports were reported to have contributed very negatively to growth. To a degree, this was down to specific factors, such as key purchases of ships abroad by a shipping company, driving up both business investment and imports. According to the NAI's latest quarterly estimates, economic activity grew by 0.3 % in the third quarter.

The picture in Belgium is in line with that seen in the rest of the euro area. Other euro area countries, and particularly Belgium's main trading partner Germany, saw growth dip in the second quarter after a slightly more robust first quarter. For the broader euro area, lower domestic demand – and, more specifically, lower investment volumes – are mainly to blame for the slowdown. Eurostat's initial flash estimates put euro area growth in the third quarter at 0.2 %. Despite the recent volatility of quarterly growth rates and the diverging growth performance of the various euro area countries, initial analyses suggest that the underlying trend still points to ongoing recovery in the euro area.

CHART 2 GDP AND BUSINESS CYCLE INDICATOR
(data adjusted for seasonal and calendar effects, unless otherwise stated)



Sources: NAI, NBB.
(1) Non-calendar-adjusted data.

TABLE 3 GDP AND MAIN EXPENDITURE CATEGORIES
(volume data adjusted for calendar effects, percentage changes compared to the previous year, unless otherwise stated)

	2013	2014 e	2015 e	2016 e
Household and NPI final consumption expenditure	0.3	0.7	1.0	0.9
General government final consumption expenditure	1.1	0.9	0.8	0.4
Gross fixed capital formation	–2.2	2.7	2.3	2.6
general government	–5.4	–1.8	5.7	–1.7
housing	–3.5	1.2	1.7	1.1
enterprises	–1.2	3.9	2.0	3.8
p.m. Domestic expenditure excluding change in inventories	*–0.1*	*1.2*	*1.2*	*1.2*
Change in inventories (1)	–0.7	–1.0	0.0	0.0
Net exports of goods and services (1)	1.0	0.7	–0.3	0.2
Exports of goods and services	2.9	2.9	3.1	4.7
Imports of goods and services	1.7	2.0	3.6	4.6
Gross domestic product	0.3	1.0	0.9	1.4

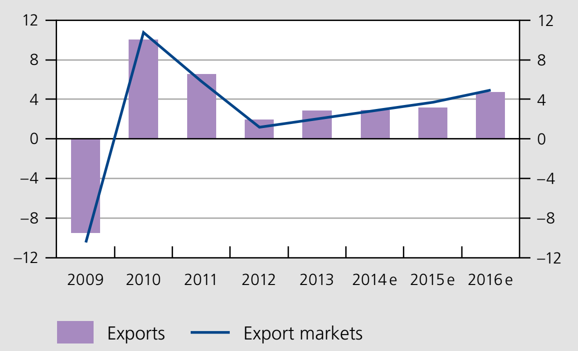
Sources: NAI, NBB.
(1) Contribution to the change in GDP compared to the previous year, in percentage points.

Belgium's subdued second and third quarter should be seen against a backdrop of weaker producer and consumer confidence. According to the Bank's surveys, these two confidence indicators have been declining in Belgium since the beginning of the year. In fact, consumer confidence has again dipped below its long-term average; producer confidence is hovering around that level but would seem to have been perking up in the past few months. The sub-indicators most closely correlated to short-term economic trends present a rather more balanced picture: employment prospects for respondents in the consumer confidence survey are no worse than they were at the beginning of the year and remain closer to the long-term average. As regards producer sentiment, demand trends in the manufacturing industry are key, and although these were down, they appear to have bounced back in the past couple of months to a level clearly above the long-term average.

The short-term forecasting models (nowcasting models) used by the Bank, such as the BREL model described in the June 2014 Economic Review, therefore suggest unchanged growth in the final quarter of 2014. Overall, growth in 2014 would amount to 1 %. A lower-than-expected carry-over effect, among other things, should keep 2015 growth at nearly the same rate, and it will not be until 2016 that annual growth rises above potential growth – to 1.4 % – thanks to the positive effects of improved cost competitiveness on exports.

In the annual figures for 2014, both domestic demand, excluding the change in inventories, and net exports still make important contributions to growth in economic activity. For net exports, this is down solely to a significant positive carry-over effect from 2013: in 2014 itself, growth in exports would fall below that in imports. Much of the positive contribution by both these demand components is wiped out by a remarkably large negative contribution from the change in inventories, which is also only attributable to a carry-over effect from developments up to and including the second quarter of 2014, the most recent quarter for which detailed quarterly statistics are available. This negative growth contribution of stock-building suggests that companies have wound down their production rates faster than domestic and foreign demand have fallen, possibly because of the renewed uncertainty. Although we cannot rule out the possibility that companies will reduce their inventories more slowly or speed up their stock-building in the near future, the technical assumption made for all quarters of 2015 is that the change in inventories will be neutral for growth, as this whole concept is hedged with great statistical uncertainty.

CHART 3 EXPORTS AND EXPORT MARKETS
(volume data adjusted for seasonal and calendar effects, percentage changes compared to the previous year)



Sources: NAI, NBB.

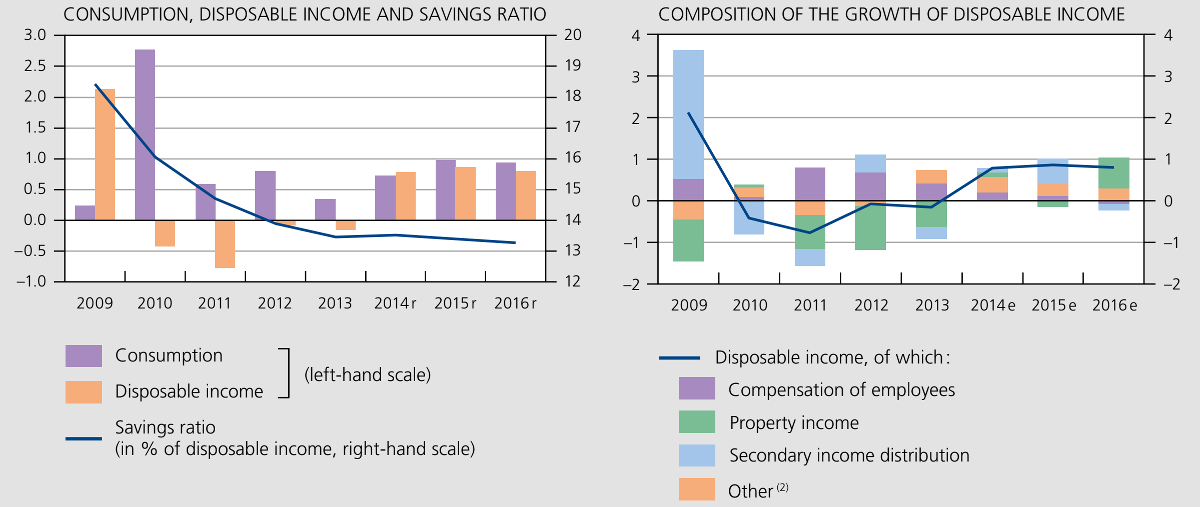
In 2015, net exports would still put a brake on annual growth in economic activity. As mentioned in Box 1 and elaborated in section 4, unit labour costs should grow more slowly because of robust wage restraint and in 2016 also because of lower social security contributions. This should result in significantly improved competitiveness and give a boost to exports, as the projections of market shares of Belgian exporters clearly show. According to the national accounts and the available statistics on the growth in demand for imports from partner countries, Belgian exporters have seen their market shares increase in real terms over the most recent period, namely from 2011 to 2013. Longer-term, however, the trend has been for the Belgian economy to lose market share, the main reason being a difference in competitiveness attributable to both costs and non-cost factors. The autumn projections suggest that this gap will gradually narrow and even reverse into a small quarterly gain as 2016 progresses. This, coupled with higher demand for imports from partner countries, should boost Belgian export growth to 4.7 % in volume terms by 2016.

With import growth set to grow more slowly as competitiveness improves over the projection horizon, net exports should gradually pick up and contribute 0.2 percentage point to annual growth by 2016. The marked increase in this contribution compared to 2015 is the reason behind the significant rise in growth in the final year of our projection period.

The contribution to growth from domestic demand excluding inventories, by contrast, is projected to remain virtually unchanged over the projection period. Over the next two years, year-on-year growth of household consumption, the key component of domestic demand, is even expected

CHART 4 HOUSEHOLD CONSUMPTION, DISPOSABLE INCOME [1] AND SAVINGS RATIO

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



Source: NBB.
(1) Data deflated by the household consumption expenditure deflator.
(2) Gross operating surplus and gross mixed income (of the self-employed).

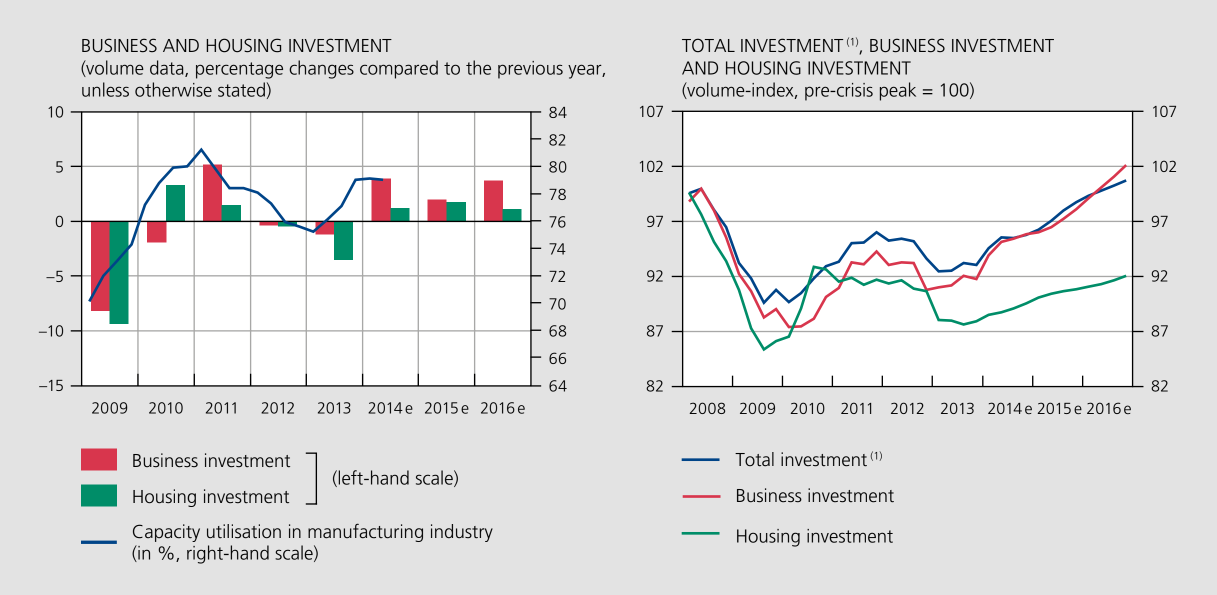
to be significantly higher than in 2014, despite a slight expected decline in 2016.

The recovery in household consumption is primarily related to an increase in disposable income. In the past four years, disposable income has recorded negative growth in real terms, mainly because property income fell markedly. However, over the projection horizon, disposable income is set to edge up by an average 0.8 % per annum. Growth in income from employment, by contrast, will be significantly limited by negligible nominal wage growth and is likely to mainly reflect the projected increases in employment and in the average number of hours worked. In fact, growth in income from employment might even turn negative in 2016 in the wake of the index suspension, but this would be amply compensated by the other sources of income. Property income for one, could rise in 2016 on the back of the interest rate rise predicted in the technical assumptions, whereas it is likely to still edge down in 2015. Despite the government's consolidation measures, the secondary distribution of income should also support disposable income growth. In 2015, this is the result of the higher tax allowance for professional expenses, but by 2016 this measure should be amply offset by other factors, such as social security cuts.

According to the current forecasts, household consumption would rise a little more rapidly than disposable income in both 2015 and 2016, causing the savings ratio to fall even further. This is the outcome of two opposite movements: property income is typically saved to a larger degree and its rising share in total household income – particularly in 2016 – should in principle lead to a higher savings ratio. A factor pulling in the opposite direction is that there is typically a delay in households changing their consumption patterns in response to lower growth in income from employment, as described in Box 1. Current projections suggest that this second effect, which pushes down savings ratios, will weigh in more heavily. This implies that the household savings ratio will touch a historic low of 13.3 % by 2016. That is barely higher than the average savings ratio in the euro area, whereas the saving propensity of Belgian households used to be much higher than this average.

On the investment front, the projections point to a slow increase in housing investment across the projection horizon. After many years of steep falls, housing investment has displayed renewed real growth since the final quarter of 2013 and there do not appear to be any immediate factors that might crush this tentative recovery. Granted, consumer confidence has slid since the beginning of 2014, but, as we have noted, the relevant sub-indicators – including consumer unemployment prospects – have hardly deteriorated. The important reform of tax rebates on mortgage loans in one of the Regions may cause the

CHART 5 PRIVATE INVESTMENT



Sources: NAI, NBB.
(1) Also includes public investment.

timeline of investment in housing to fluctuate a little (although it would seem more likely for this to affect the secondary market), but relatively little impact is expected on trend growth. In volume terms, though, investment in housing is projected to end the year 2016 at a level still nearly 8 % below that seen before the great recession.

Business investment is expected to notch up clearly higher volume growth over the projection horizon. That said, in 2015, growth is likely to come down to about half its 2014 level, as business investment in 2014 benefited greatly from a single specific factor (ship purchases by a shipping company). The current projections imply that business investment volumes should exceed pre-great recession levels by the end of 2016. This robust expansion takes place on the back of more favourable demand prospects in a reviving economy. In addition, since the beginning of 2014, capacity utilisation in the manufacturing industry has again slightly exceeded its long-term average. Stronger demand will therefore gradually lead to higher investment in expansion, on top of increased replacement investment. The financing scope for companies is also favourable : internal funding is backed by growing gross operating surpluses, while the bank lending survey also reports further relaxation of lending conditions for external financing since the beginning of the year and financial accounts reveal that businesses have significant cash positions.

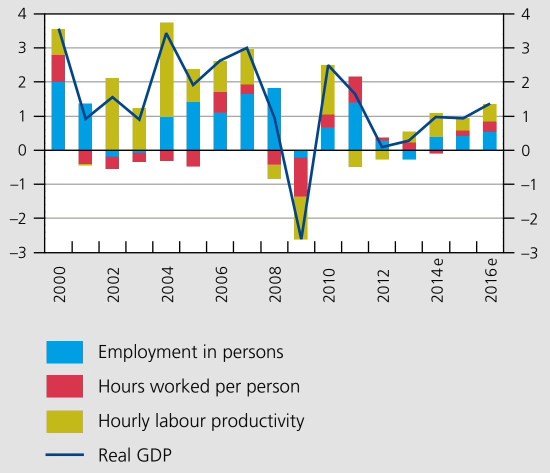
Despite consolidation efforts, public consumption should keep on rising over the projection horizon, although the rate of volume growth would reach a mere 0.4 %, primarily because of the indexation suspension. Government investment, which last year declined in real terms due to the usual election cycle, should edge down a little further in 2014 only to kick ahead from 2015.

3. Labour market

As it usually does in a recovery, productivity per hour worked is expected to increase at a relatively constant but subdued rate. At the same time, economic activity growth should go hand in hand with rising labour volumes over the projection horizon. Average working hours are expected to keep edging down in 2014, as has indeed been borne out by available quarterly statistics for the first three quarters of the year. For one thing, this fall is due to the fact that employers are increasingly relying on flexible instruments, such as short-term temporary contracts, as they are reluctant to commit to fixed contracts at this early stage of the recovery. The decline is also due to the significant drop in average working hours in the second quarter of 2014, notably in the industry and construction sectors, only partly recouped in the rest of the year. In the two years ahead, these average working hours are expected to edge up slightly, reaching pre-recession levels by 2016. Note that this is not the case if employees only are factored in : their average working hours in 2016 are still projected to be below 2008 levels.

CHART 6 DOMESTIC EMPLOYMENT, AVERAGE WORKING TIME AND PRODUCTIVITY

(contribution to annual growth of GDP, data adjusted for seasonal and calendar effects)



Sources : NAI, NBB.

All this should add up to net creation of about 62 000 jobs between 2014 and 2016. By contrast, 2013 as a whole saw employment shrink by 0.3 % despite the increases of the last two quarters of the year. Employment growth is expected to accelerate over the projection horizon, not only because economic activity should be growing faster by 2016 but also because labour as a factor of production should be relatively cheaper thanks to the government measures to curb labour costs. It is important to keep in mind that the effect of these measures will take some time to be felt in the real economy. The benefits, for employment in particular, should in principle become even more significant after the projection period.

All in all, employment in branches sensitive to the business cycle should find its way back to growth, starting off modestly but gaining momentum into 2016 and so becoming the key factor underpinning job creation. The highly subsidised "other services" branch – mainly health care and social work – is also expected to make a sizeable contribution to growing employment over the projection

TABLE 4 LABOUR SUPPLY AND DEMAND

(calendar adjusted data ; annual averages, unless otherwise stated)

	2013	2014 e	2015 e	2016 e
		(percentage changes)		
Volume of labour	–0.1	0.3	0.6	0.8
Domestic employment in persons	–0.3	0.4	0.4	0.5
		(changes in thousands of persons)		
Domestic employment	–12.4	17.9	19.3	25.2
p.m. Change in the course of the year, in thousands of people (1)	*12.2*	*24.0*	*17.8*	*32.1*
Employees	–19.1	10.8	11.5	16.3
Branches sensitive to the business cycle	–23.4	1.5	7.0	12.0
Public administration and education	2.2	–0.4	–5.4	–4.2
Other services	2.1	9.8	9.9	8.5
p.m. Service vouchers	*8.5*	*5.2*	*4.0*	*3.4*
Self-employed people	6.7	7.1	7.8	8.9
Frontier workers	–0.7	–0.1	0.0	0.0
National employment	–13.0	17.8	19.3	25.2
Unemployed job-seekers	24.6	13.7	55.5	–6.4
p.m. Change in the course of the year, in thousands of people (1)	*–20.2*	*–1.4*	*58.3*	*–14.3*
Labour force	11.5	31.5	74.8	18.7
p.m. Harmonised unemployment rate (2)	*8.4*	*8.5*	*8.8*	*8.7*

Sources : NAI, NEO, NBB.
(1) Difference between the fourth quarter of the relevant year and the fourth quarter of the previous year.
(2) In % of the labour force.

horizon. The system of service vouchers should likewise remain supportive, although it is expected to grow at a rather slower pace because of a gradual saturation of demand and the higher hourly cost for its users, as well as the recruitment problems facing providers of these services. On the other hand, employment in the public administration and education branch is forecast to fall as budgetary measures result in a proportion of public servants not being replaced upon retirement. This trend might gather further momentum on the back of the staff cuts announced in the various government agreements for the coming years. Lastly, as in the past, self-employed workers will contribute to the rise in employment, with a growth rate of around 1 % between 2014 and 2016, accounting for 7 000 to 9 000 extra workers a year. The growth rate of the self-employed category is therefore expected to remain higher than that of workers with employee status, despite the increase in the growth rate of this category.

Although there has been a steep fall in growth of the working age population since 2013 and recent demographic forecasts see it stalling on average over the projection horizon, the labour force should benefit from rising employment participation. The expected increase for the year 2014 is around 32 000 persons. Employment is not likely to increase enough to absorb the growing labour force and unemployment should continue to rise for the year 2014 as a whole, albeit at a lower pace than in 2013, with 14 000 new job-seekers, compared to 25 000 in 2013. This would still take the total number of unemployed close to an annual average of 600 000. The harmonised unemployment rate is projected to inch up a little further to 8.5 %, its highest level since 2005.

The steeper increase in the labour force predicted for 2015 reflects the federal government's decision to abolish special arrangements for older unemployed workers who are exempt from job-seeking. Indeed, from 1 January 2015, this group – which the National Employment Office put at 56 000 persons in the third quarter of 2014 – will be classified as regular job-seekers, who will be entitled to actively look for work and will benefit from the same mediation and assistance from government services in their applications. With this group reclassified as part of the labour force, the unemployment rate is likely to jump to 8.8 %.

Not until 2016 will employment grow enough to bring down the unemployment rate – to 8.7 %, still above the high level reached in 2013. Although the euro area unemployment rate is likely to still be over two percentage points higher in 2016, it nevertheless shows a clear downward trend over the projection horizon (see table 2).

4. Prices and costs

Labour cost projections are dominated by the measures taken by the federal government to improve the competitiveness of the Belgian economy, notably through reduction of labour costs. The assumption is that real negotiated wages will remain frozen for the year 2014 as a whole, in accordance with the draft interprofessional agreement for 2013 and 2014 as imposed by the government. Labour cost moderation policies will stay in place and be enhanced in the 2015-2016 period. This essentially means that real negotiated wages will

TABLE 5 COST AND PRICE INDICATORS
(percentage changes compared to the previous year)

	2013	2014 e	2015 e	2016 e
Labour costs in the private sector				
Labour costs per hour worked	2.4	0.8	0.6	0.2
of which indexation	1.9	0.7	0.2	0.2
Labour productivity (1)	0.2	0.5	0.3	0.5
Unit labour costs	2.2	0.3	0.3	–0.2
GDP deflator	1.5	0.6	0.9	1.0
HICP	1.2	0.6	0.8	1.2
Health index	1.2	0.4	0.7	1.1
Underlying inflation trend (2)	1.4	1.5	1.3	0.9

Sources: EC, NAI, FPS Employment Labour and Social Dialogue, NBB.
(1) Value added in volume per hour worked by employees and self-employed people.
(2) Measured by HICP excluding food and energy.

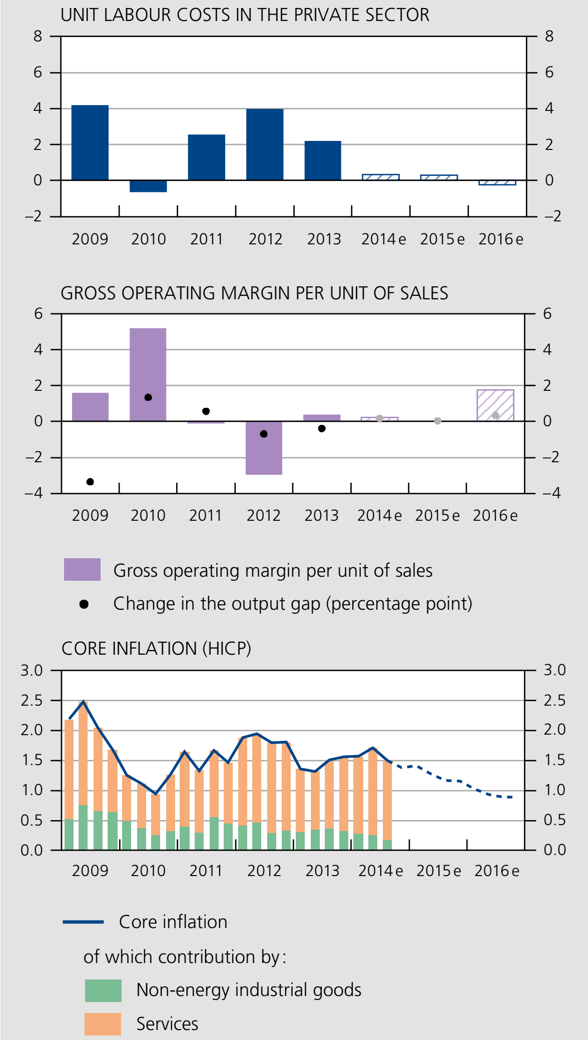
remain frozen, although, as the economy recovers, the wage drift may cause moderate real increases in the wake of emerging tensions in various sectors of the labour market. The key contributing factor driving wage restraint will be the temporary suspension of indexation mechanisms and the indirect effects this should have on inflation. From 2016, measures announced in regard to the reduction in employers' social security contributions should also kick in and push down labour costs. This reduction, which will entail cuts of nearly € 960 million, are an adjustment to the November 2013 Pact for Competitiveness and Employment, with measures scheduled for 2015 now coming into force in 2016 but significantly strengthened by measures that were initially scheduled for 2017. However, some of these relate to reductions in payroll tax which are not taken into account in calculating labour costs according to the national accounts definition.

The new federal government's decision to enforce a 2 % freeze of the indexation mechanisms in 2015 should directly affect labour costs. Although some of the mechanisms currently in place allow only a gradual suspension of indexation and will therefore imply the continuation of a certain degree of index-linking, their effect on wage growth should be very limited. In addition, suspending the indexation mechanisms should add to the effect of a slower increase in the health index (0.4 % in 2014, compared with 2.7 % in 2012 and 1.2 % in 2013), which tied in with the VAT reduction on household electricity bills from 1 April 2014, as agreed in the Pact for Competitiveness and Employment.

All in all, nominal labour costs are forecast to see significantly lower growth, from 2.4 % in 2013 to 0.8 % in 2014, dipping to 0.6 % in 2015 and to 0.2 % in 2016. This, coupled with the steady recovery of labour productivity growth, should prove a favourable force in terms of unit labour cost prospects in the private sector. Since touching a high of 4 % in 2012, these costs have grown much less rapidly and they are predicted to contract by 0.2 % in 2016. As a result, Belgian companies should see their cost competitiveness improve relative to the country's three main trading partners – Germany, France and the Netherlands – in the 2014-2016 period, particularly in 2016.

As explained in Box 1, labour cost developments should gradually be reflected in prices and more specifically in underlying inflation, which does not include food and energy prices. That said, in Belgium, underlying inflation is marked by some downward rigidity and is expected to still come in at an average 1.5 % in 2014. The past couple of months have seen tentative signs of a slowdown,

CHART 7 LABOUR COSTS AND CORE INFLATION
(percentage changes compared to the previous year, unless otherwise stated)



Sources: EC, NBB.

though, and this should continue into 2015, taking the underlying inflation trend to an average 1.3 % for the year before it gradually inches down to below 1 % in 2016.

The current climate – of a subdued economic revival adversely affecting the recovery of company margins, which have narrowed significantly since 2011 – should encourage the transmission of wage restraint to pricing. Margins are not expected to pick up until 2016, although this has more to do with a delayed passing on to prices of moderate wage growth and the big cut in social security contributions.

Overall, inflation measured by HICP is estimated at 0.6 % in 2014, compared with 0.5 % in the euro area, pushing the rate of price increases significantly below those in the previous year, with inflation at 3.4 % in 2011 and at 2.6 % in 2012. The deceleration of total inflation is due to fluctuations in food prices, and above all, energy prices. The latter have been falling year-on-year since the beginning of 2013. Current projections indicate a reduction of 5.9 % in 2014 compared with 2013, a year in which these prices had already fallen by an average of 4.6 %. Although the scale of the contraction is expected to diminish gradually, negative year-on-year growth rates are still forecast up to the third quarter of 2015, with prices down on average by 2.8 %. Energy products are expected to be back in positive territory by 2016.

Together, the fall in energy prices gradually bottoming out over the projection horizon and the higher rate of food inflation explain why, in the face of an eroding underlying inflation trend, consumer inflation is still expected to go up from its uncharacteristically low rate today to a little over 1 % in 2016.

5. Public finances

5.1 Overall balance

Based on the latest forecasts and assuming no policy changes, public finances would have ended the year 2014 with a deficit of 3.2 % of GDP. In the macroeconomic context described in this article, the deficit should decline to 2.5 % of GDP in 2015 and to 2.1 % in 2016 – higher than the 2.1 % and 1.3 % of GDP that the Belgian government pegged on these two years at the beginning of October.

The 2014 overall balance deteriorated solely because of lower revenues as a percentage of GDP. The projected improvement in the 2015 and 2016 balance will be due to a large degree to consolidation measures taken by the federal government and the authorities in the Communities and Regions, primarily aimed at cutting government spending. Interest charges should come down further in 2014 and 2015 but remain at the same level in 2016.

The deficits would occur mainly at federal government level, while social security is expected to reach equilibrium thanks to an allocation granted by the federal government for this express purpose. Belgium's Communities and Regions and local authorities are likely to show small deficits.

TABLE 6 GENERAL GOVERNMENT ACCOUNTS
(in % of GDP)

	2013	2014 e	2015 e	2016 e
General government				
Revenue	51.5	51.0	50.9	50.8
Fiscal and parafiscal revenue	44.8	44.7	44.9 (1)	44.8
Other	6.7	6.3	6.0	6.0
Primary expenditure	51.2	51.2	50.6	50.1
Primary balance	0.3	–0.2	0.4	0.7
Interest charges	3.2	3.1	2.8	2.8
Net borrowing (–) or net lending	**–2.9**	**–3.2**	**–2.5**	**–2.1**
p.m. Effect of non-recurring factors	*0.5*	*0.4*	*0.0*	*0.0*
Overall balance per sub-sector				
Federal government	–2.4	–2.8	–2.1	–1.7
Social security	–0.1	0.0	0.0	0.0
Communities and Regions	–0.2	–0.3	–0.2	–0.3
Local authorities	–0.2	–0.1	–0.2	–0.1

Sources: NAI, NBB.
(1) The projected increase in fiscal and parafiscal revenues in 2015 is largely due to statistical changes related to the sixth State reform. These factors, which have no effect on the overall balance, add over € 1.3 billion or 0.3 % of GDP to parafiscal revenues.

5.2 Revenue

Public revenue expressed as a percentage of GDP is set to fall by 0.5 percentage points in 2014 and a further 0.1 percentage point in both 2015 and 2016, reversing the 2009-2013 trend of permanent revenue increases.

The loss in income received by the State from various financial institutions was primarily to blame for shrinking revenues in 2014. Temporary factors also came into play: in 2013, tax revenues were boosted by exceptional receipts from tax regularisation and by front-loading related to the liquidation bonus measure, while in 2014 only tax regularisation accounted for exceptional receipts. In addition, corporate tax receipts were dragged down by sizeable refunds to a number of companies. By contrast, structural fiscal and parafiscal measures are expected to be generally favourable for government revenues, adding 0.1 % of GDP. Key elements include higher excise duties and the reduction of the notional interest deduction for companies in the wake of the lower reference interest rate. Meanwhile, revenues should also benefit from a range of measures concerning capital and the income which it generates, notably the fairness tax – applicable to certain companies whose distributed profits exceed the corporation tax base – and an increase in the tax on savings deposits will also boost revenues. However, other measures, such as the reduction in VAT on electricity and new cuts in social security contributions, will reduce the amounts raised and compensate in part for the additional revenues generated.

In 2015, both the indexation suspension and wage restraint will depress fiscal and parafiscal revenues, as the part that would have been subject to indexation can now not be taxed. Personal income tax in particular should drop off significantly, compounded by the higher deductible professional expenses allowance. In addition, tax regularisation-derived revenues will cease altogether. Only revenues from corporation tax are set to rise on the back of companies' improved profitability, taxes levied on inter-municipal utility companies and the fresh reduction of the notional interest deduction in the wake of a further decline of the reference interest rate and restrictions on the use of this system by banks. While extra revenue will be generated by the early collection of tax on pension savings, non-fiscal and non-parafiscal revenues are likely to continue falling, owing to the reduction in fees paid by banks for guarantees granted by the State.

In 2016, fiscal and parafiscal revenues will continue to be squeezed by continued wage restraint policies, while also being depressed by structural labour cost reductions via employers' social security contributions and the further increase in deductible professional expenses. Excise duty measures, by contrast, are likely to boost revenues, as well as the expected decline in the reference interest rate for calculating the notional interest deduction. Non-fiscal and non-parafiscal revenues are expected to diminish a little more, as financial institutions will be paying less dividends.

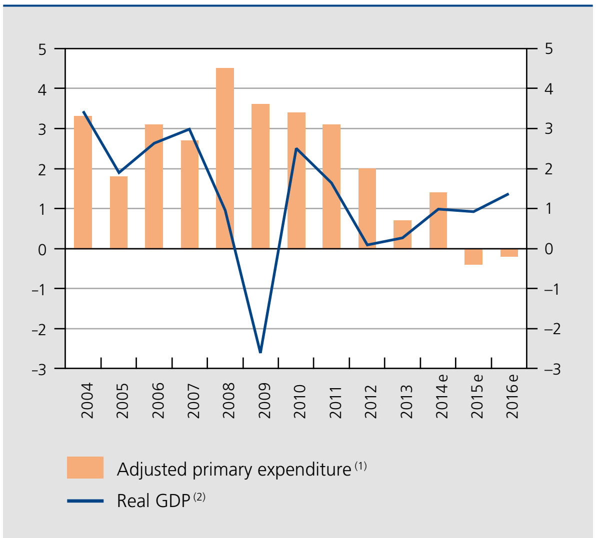
5.3 Primary expenditure

As a ratio of GDP, primary expenditure should hold steady in 2014 but decline very strongly in the two subsequent years. In nominal terms, then, expenditure is expected to grow less strongly than economic activity.

Adjusted for the impact of one-off and cyclical factors, as well as the indexation effect, real primary expenditure should rise to 1.4 % in 2014, just above the real GDP increase. Adjusted expenditure by the federal government and local authorities should record a modest upturn after last year's decline. Expenditure by Belgium's Communities and Regions as well as social security spending is forecast to go up nearly a percentage point more than economic activity. The key driver in the case of social security spending is pensions.

CHART 8 PRIMARY EXPENDITURE OF GENERAL GOVERNMENT AND GDP

(percentage changes compared to the previous year)



Sources: NAI, NBB.

(1) Primary expenditure deflated by the GDP deflator and adjusted for cyclical, non-recurring and fiscally neutral factors, as well as the impact of wage indexation. This effect derives from the difference between actual indexation (or the theoretical indexation when it comes to 2015 and 2016, in keeping with the approved skipping of the automatic indexation of public sector wages and social security benefits) on the one hand and the rise in the GDP deflator on the other hand.

(2) Calendar-adjusted data.

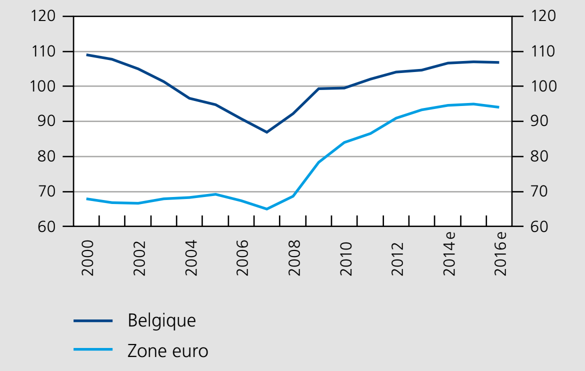
The primary expenditure projections for 2015 and 2016 closely tie in with savings plans launched by the new federal and local governments formed after the elections of 25 May 2014. The expected decline in adjusted expenditure – by 0.4 % in 2015 and 0.1 % in 2016 – is attributable to non-indexation of social security benefits and civil servants' pay in the wake of the indexation suspension and low inflation. Primary expenditure staying well below expected economic growth should further enhance the consolidation of public finances seen over the past few years.

5.4 Debt

The debt ratio has been on a steady upward trajectory since the onset of the financial crisis, and reached 104.5 % at the end of 2013.

In 2014, the general government debt is expected to rise to 106.6 % of GDP. Endogenous factors should have an upward impact on the debt ratio amounting to 1.7 percentage points of GDP, caused by the relatively low growth of nominal GDP, coupled with a primary balance of -0.2 % of GDP. Exogenous factors – so called because they influence the government's debt but not its overall balance – should further drive up general government debt by around 0.4 percentage point of GDP. Contributing factors include assessed but as yet not received corporate taxes, loans granted by the European Financial Stability Facility to euro area countries with funding issues and the capital contribution to the ESM. General government debt management should have a downward effect, primarily because of the large issue premiums. With coupons on general government debt securities exceeding market interest rates, the issue values of these securities were higher than their nominal values.

CHART 9 **CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT**
(in % of GDP)



Sources: EC, NAI, NBB.

In 2015, general government debt should edge up further, to 107 % of GDP. The endogenous factors will still push debt upwards, but the primary balance is expected to be in the black from that year.

2016 should bring a reversal in the debt ratio trend, as a very slight fall to 106.8 % of GDP is projected, solely as a result of endogenous factors.

While Belgium looks set to see its debt ratio rise between 2014 and 2016, the euro area is expected to record a slight decline, widening the gap between Belgium and the euro area that had been steadily narrowing in the past two decades.

6. Risk factor assessment

This year's autumn projections still describe a gradual recovery, if at a slightly slower pace than the spring projections had foreseen. Expected economic activity growth, particularly in 2015, has been revised significantly downwards, but the risks in the international environment continue to be on the downside.

In terms of external risks, Belgium's small and open economy depends on the further recovery in the other countries of the euro area, especially its key trading partners. Any intensification of geopolitical tensions would have a greater impact on Belgian growth, also and mainly via indirect mechanisms such as growth in the country's trade partners and confidence effects. From a more general perspective, there is always a risk that the current slowdown in China and other emerging countries could turn out to be more significant or more prolonged than international forecasts currently assume. In addition, there is still a degree of uncertainty over the sustainability of the recovery in a few advanced countries, as recently underlined by the unexpectedly sharp contraction of the Japanese economy in the third quarter of 2014. Lastly, the trade intensity of global growth may have been revised down, but current assumptions still imply an increase in this intensity over the projection horizon. If global growth again turns out not to boost trade as strongly as envisaged, Belgian exporters and their domestic suppliers will also see their production affected.

Turning to domestic risk factors, attention should be drawn to the way these projections incorporate new

TABLE 7 COMPARISON WITH ESTIMATES OF OTHER INSTITUTIONS

(in %)

Institution	Publication date	Real GDP growth			Inflation (HICP, unless otherwise stated)		
		2014 e	2015 e	2016 e	2014 e	2015 e	2016 e
Federal Planning Bureau	September 2014 (1)	1.1	1.5		0.6	1.3	
IMF	October 2014	1.0	1.4	1.5	0.7	1.0	1.3
Consensus Economics	October 2014	1.1	1.3		0.6	1.2	
EC	November 2014	0.9	0.9	1.1	0.6	0.9	1.3
OECD	November 2014	1.0	1.4	1.7	0.6	0.7	1.2
NBB	**December 2014**	**1.0**	**0.9**	**1.4**	**0.6**	**0.8**	**1.2**

(1) Economic budget (September 2014). Inflation figures reflect the NCPI, which may differ slightly from the HICP.

government measures to improve competitiveness, particularly the indexation suspension, in addition to a further freeze of real wage growth and reduced social security contributions. As noted in Box 1, this analysis assumes that the much slower growth of nominal wages will be largely passed on to prices, albeit after some delay. The same applies to the significant reduction – in the last year of the projection period – in employers' social security contributions. If this happens more slowly or more quickly, to a greater or to a lesser extent, or if economic agents – including employers, investors and foreign buyers of Belgian exports – respond differently to lower wages and prices than has been posited here, economic activity, employment, the budget balance and inflation may deviate from these autumn projections.

The relatively wide range of forecasts by the various institutions – for both growth and inflation – illustrates the significant margins of uncertainty. Any comparison of these forecasts will need to allow for the different times at which they were drawn up and the datasets available at the time. For instance, the major changes introduced by the new federal government were not factored into forecasts released in September or October, such as the Federal Planning Bureau's most recent projections in the framework of the economic budget. In addition, among all the forecasts in table 7, only the Bank's autumn projections and the OECD forecasts were able to take on board the most recent quarterly statistics, drawn up in line with ESA 2010, and the National Accounts Institute's flash estimate for economic activity growth in the third quarter.

Regardless of the latter point, the autumn projections by the European Commission (EC) are possibly most comparable with this article's forecasts. The EC expects slightly higher inflation but, most importantly, clearly lower economic growth in 2016. A comparison of spending components in both sets of projections shows that, although the EC also believes domestic demand will rise less quickly, the major growth difference in 2016 can be traced back to less dynamic export growth. This would seem to reflect a markedly less sanguine take on the macroeconomic impact of Belgium's most recent efforts to improve competitiveness. Higher inflation as assumed by the EC might well reflect a situation in which lower labour costs are passed on to prices more slowly or to a smaller degree.

Annex

PROJECTIONS FOR THE BELGIAN ECONOMY: SUMMARY OF THE MAIN RESULTS

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

	2013	2014 e	2015 e	2016 e
Growth (calendar adjusted data)				
Real GDP	0.3	1.0	0.9	1.4
Contributions to growth:				
Domestic expenditure, excluding change in inventories	–0.1	1.2	1.2	1.2
Net exports of goods and services	1.0	0.7	–0.3	0.2
Change in inventories	–0.7	–1.0	0.0	0.0
Prices and costs				
Harmonised index of consumer prices	1.2	0.6	0.8	1.2
Health index	1.2	0.4	0.7	1.1
GDP deflator	1.5	0.6	0.9	1.0
Terms of trade	0.1	0.5	0.3	0.1
Unit labour costs in the private sector	2.2	0.3	0.3	–0.2
Hourly labour costs in the private sector	2.4	0.8	0.6	0.2
Hourly productivity in the private sector	0.2	0.5	0.3	0.5
Labour market				
Domestic employment (average year-on-year change, in thousands of people)	–12.4	17.9	19.3	25.2
p.m. Change in the course of the year, in thousands of people (1)	*12.2*	*24.0*	*17.8*	*32.1*
Total volume of labour (2)	–0.1	0.3	0.6	0.8
Harmonised unemployment rate (in % of the labour force)	8.4	8.5	8.8	8.7
Incomes				
Real disposable household incomes	–0.2	0.8	0.9	0.8
Household savings ratio (in % of disposable income)	13.5	13.5	13.4	13.3
Public finances				
Overall balance (in % of GDP)	–2.9	–3.2	–2.5	–2.1
Primary balance (in % of GDP)	0.3	–0.2	0.4	0.7
Public debt (in % of GDP)	104.5	106.6	107.0	106.8
Current account (according to the balance of payments, in % of GDP)	**0.1**	**1.4**	**1.3**	**1.5**

Sources: EC, DGSEI, NAI, NBB.
(1) Difference between the fourth quarter of the relevant year and the fourth quarter of the previous year.
(2) Total number of hours worked in the economy.

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Limited liability company
RLP Brussels – Company number: 0203.201.340
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Publisher

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Cover and layout: NBB AG – Prepress & Image

Published in January 2015