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Special topic :
Fiscal consolidation in the long-run:
Sensitivity to general economic conditions

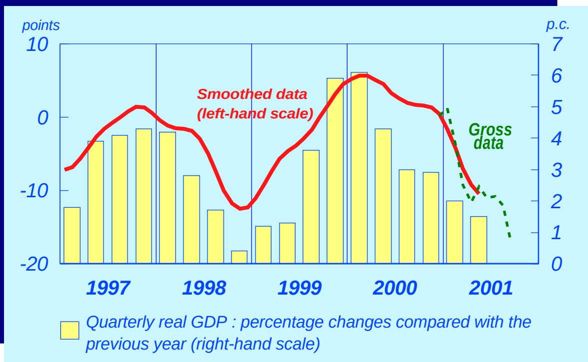
CONSENSUS FORECAST

	2000 Belgium	2000 Euro area [3]	2001 p Belgium Consensus	2001 p Belgium Previous consensus	2002 p Belgium Consensus	2002 p Belgium Previous consensus
Real GDP [1]	4.0	3.4	**1.2**	2.2	**1.3**	2.6
Employment [1]	1.6	1.9	**1.0**	1.1	**0.4**	0.7
Consumer prices [1]	2.7	2.3	**2.4**	2.3	**1.6**	1.8
Current account [2]	4.7	0.1	**4.2**	4.3	**4.4**	4.1
General government balance [2] *	0.1	-0.7	**-0.1**	0.1	**-0.3**	0.2
Primary balance [2] *	6.8	3.3	**6.5**	6.7	**5.8**	6.4
Public debt [2]	109.3	69.7	**106.7**	106.0	**102.8**	101.7

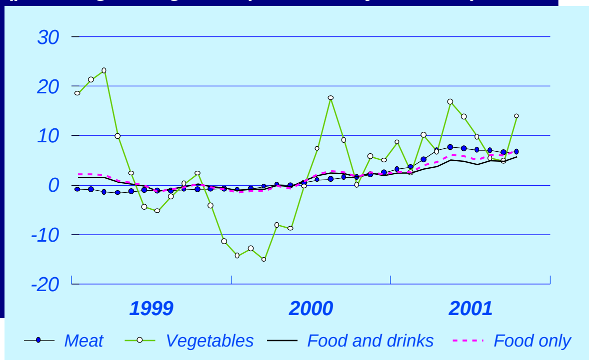
[1] P.c. change. [2] In p.c. of GDP. [3] European Commission (forecast available since April 2001; next publication in Autumn 2001).
* Excluding the proceeds of the auction of UMTS licences.

MACROECONOMIC DEVELOPMENTS

BUSINESS CYCLE INDICATOR AND GDP



CONSUMER PRICES
(percentage changes compared to the year before)



In the aftermath of the terrorist attacks in New York and Washington, economic projections are surrounded by lots of uncertainty, in particular concerning the consumers and enterprises' reactions. One thing seems certain at this juncture: the recovery will be postponed.

This shock comes at a bad moment in time, as exports have been hit by the sharp slowdown of the world economy. After an increase by 9.7% in volume last year, exports dropped in the second quarter of 2001.

Following heavy rains during the spring vegetable prices went up by 24.3% between January and June while the foot-and-mouth disease pushed meat prices higher (+5.2% for the same period). The consumers' purchasing power was hit in real terms, resulting in a decline in real spending during the second quarter. Some food prices began to decrease in July and August, as was the case for fresh vegetables, but meat and especially fruit prices continue to rise.

According the estimate by the NAI, GDP contracted by 0.5% q-o-q in the second quarter of 2001. It should be pointed out that such a negative q-o-q growth is not uncommon in Belgium, owing to the very volatile character of the growth in a small and open economy. However, high inventory levels will negatively affect industrial activity during the third quarter. The downward trend of unemployment reversed and consumer confidence began to weaken. The recent sharp decline of the business confidence indicator suggests a stabilisation of the economy or even a slight decrease. According to our consensus, GDP will grow by 1.2% in 2001 and by 1.3% in 2002.

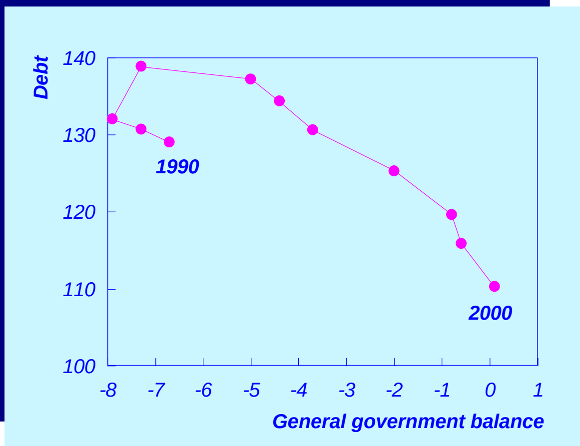
Despite the marked slowdown of the economy, the deterioration of public finances remained only marginal until now, as the 2001 budget was based on cautious assumptions aimed at providing a cushion against unpleasant surprises. Besides, the government took additional measures in July in order to offset the impact of recent economic developments. According to our consensus, the government's balance (excluding the proceeds from the UMTS auction) will show a 0.1% deficit in 2001 (against a budget target of a 0.2% surplus). The drop in interest rates (which affects the public debt burden favourably) will limit the impact of the slowdown of the economy on public finances. Public debt will fall from 109.3% in 2000 to 106.7% in 2001 and 102.8% in 2002.

SPECIAL TOPIC

FISCAL CONSOLIDATION IN THE LONG-RUN: SENSITIVITY TO GENERAL ECONOMIC CONDITIONS

Belgian public finances have improved greatly in recent years: the budget deficit has gradually disappeared and the debt to GDP ratio has fallen constantly. The general government balance, which stood at 8 % of GDP in 1992, was turned into a small surplus of 0.1 % of GDP in 2000. The debt to GDP ratio fell to 109.3 % in 2000 after having peaked in 1993 at 138.1 %. Despite the sharp adjustment this ratio is still high, however, compared with the euro area average. In addition, a further reduction of public debt seems necessary in view of population ageing which will start to weigh more heavily on the budget from 2010 onwards.

Chart 1:
Public finance consolidation over the last 10 years

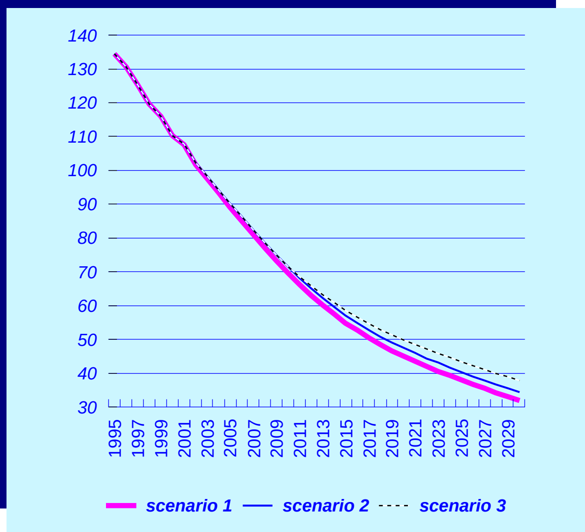


The government's medium term fiscal plan, as outlined in the December 2000 update of the stability programme presented in December 2000 aims at building up a small surplus which should reach 0.7 % of GDP in 2005. By then the debt ratio should have been reduced to less than 90 % of GDP. Obviously, the exact figure depends upon the nominal GDP growth (assumed to work out at 4 % a year in the stability programme), the evolution of market interest rates and the actual fiscal policy outcomes – both on the expenditure and on the revenue side – in the 2001-2005 period.
The most recent stability programme provides no indications as to the course of fiscal policy beyond the 2005 horizon. The government has however recently created the so-called Silver Fund, an ageing fund which would be financed with exceptional receipts (e.g. the proceeds from the UMTS auction), but also with budgetary surpluses from the federal government and the social security system. This suggests that the government plans to continue its policy of running surpluses at least until population ageing starts to kick in in 2010.

In the remainder of this article a mechanical projection exercise will be considered based upon a further increase in the general government surplus to 1% of GDP by 2010, followed by a gradual return to a balanced budget by 2020, after which the balance would be kept constant at zero. Against this background, public debt would continue to fall under normal circumstances. The pace of debt reduction does however not only depend on the budget balance but also on economic growth. Three different scenarios are considered here. In the first one, real GDP growth would work out at 2.5% a year during the whole 2001-2030 period. The second one is based on a somewhat lower trend growth estimate of 2.25%. The third scenario, finally, sees activity growth amounting to 2.25% a year until 2010 but then falling to 1.75% due to the expected ageing-related drop in the population of working age from 2010 onwards. All scenarios are based upon a 1.5% inflation rate.

Chart 2 shows that, in all three scenarios, the debt ratio stays on its downward trend. Public debt reduction is quite similar under the three different assumptions for economic growth considered here: the debt ratio would fall from around 110 % last year to a level between 30 % and 40 % in 2030. The 60 % mark would be reached somewhere in the middle of the next decade. Obviously, yearly percentage points drops in the debt ratio are higher in the beginning of the period and would work out at slightly more or slightly less than 4 percentage points per year between 2000 and 2010 depending on the scenarios

Chart 2:
Path for the debt ratio



The decrease of the debt ratio induces a parallel decline in the level of interest charges that, in combination with the fixed aforementioned assumption for overall budget balance, implies that the primary surplus can be decreased continuously. This mechanism amounts to a budgetary margin in the sense that budgetary means which become available by the drop in this surplus can then be used to cut revenue or hike up expenditure. Evidently, this budgetary margin might be primarily devoted to cover the cost of increasing pension or health care expenditure due to ageing. The extent to which the ageing crisis could be financed in this way also depends on the evolution of market interest rates. A drop in market rates can amplify the impact of falling public debt on interest charges whereas an increase in market rates will somewhat reduce this impact.

SPECIAL TOPIC (continuation)

Table 1:
DROP IN PRIMARY BALANCE BETWEEN 2000 AND 2030

Interest rates	Growth SCENARIO 1	SCENARIO 2	SCENARIO 3
+100bp	4,9	4,8	4,5
constant	5,2	5,0	4,9
-100bp	5,4	5,3	5,1

Therefore, the mechanical exercise considered above is extended with three different hypotheses concerning market interest rates: over the whole period their level is either equal to the present one, 100 basis points higher than the present one or 100 basis points lower than the present one. Depending on these assumptions and the growth rate scenario, the drop in the primary balance would range from 4.5 % of GDP (a rise in market rates combined with the worst-case scenario 3 for economic growth) to close to 5.5 % of GDP (a drop in market rates combined with the more favourable growth scenario 1). In all cases, the drop in the primary balance would allow to cushion to some extent the blow of population ageing. These mechanical simulations show the importance of continuing fiscal consolidation and sticking to the commitment of building up a small cyclically-adjusted surplus in the coming years in order to prepare public finances for the ageing costs. This does not suggest however that there is no need for structural changes.

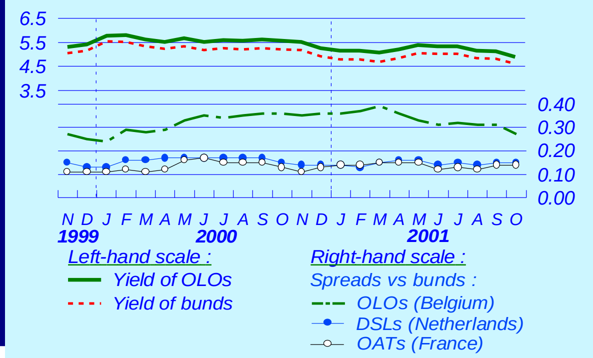
A high level of public debt is certainly a very important economic handicap, as it leads to a higher tax burden, for instance, or a lower level of primary expenditure. However, one can conclude that the current high level of primary surplus and the continuation of a strict budgetary policy trigger an important debt dynamics mechanism that in turn creates a spontaneous budgetary margin. Both the decrease of the debt ratio and the budgetary room for manoeuvre appear to be to a large extent independent of the general economic conditions.

GOVERNMENT SECURITIES MARKET

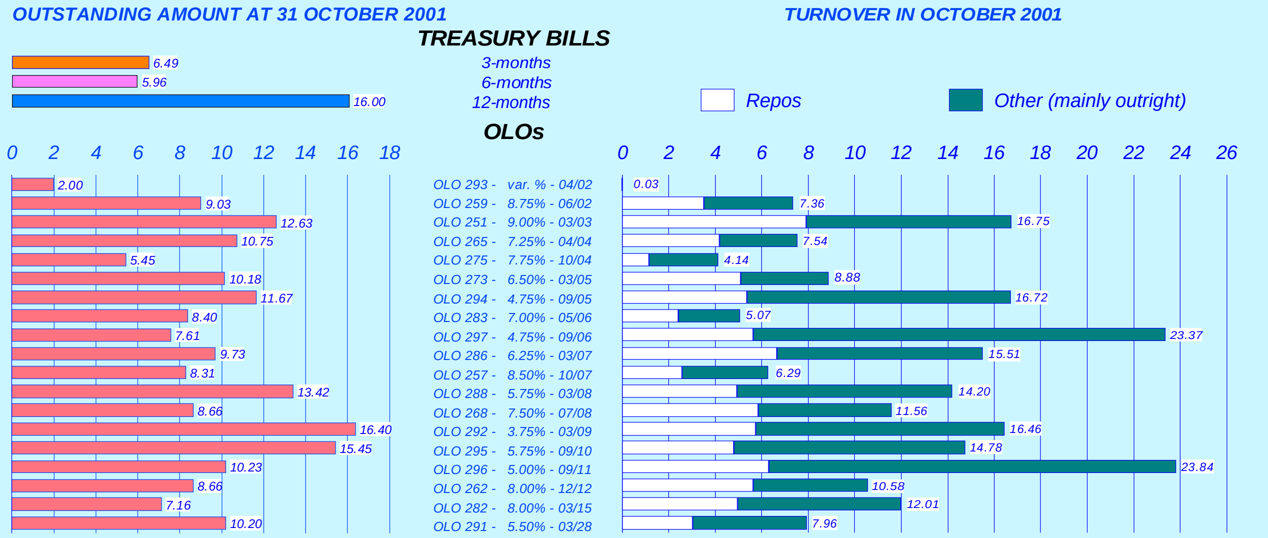
PRIMARY MARKET (billions of euros)

	OLOs Gross issues 2000	2001		Net issues 2000	2001		TREASURY BILLS Net issues 2000	2001
J	4.986	5.345	J	4.506	5.345	J	1.790	-0.187
F	0.199	0.652	F	-0.009	0.023	F	0.831	1.444
M	4.752	3.577	M	3.884	-0.213	M	2.690	2.172
A	1.571	0.890	A	0.583	0.087	A	-1.368	0.182
M	0.031	2.418	M	0.003	0.110	M	-1.171	1.021
J	3.774	5.151	J	2.927	1.579	J	1.030	-0.851
J	1.185	0.862	J	0.137	0.742	J	-0.811	-0.611
A	4.925	3.119	A	0.349	2.224	A	0.262	0.635
S	3.704	3.621	S	3.007	2.914	S	-0.558	-0.197
O	0.389	0.182	O	0.013	-0.043	O	-1.502	-0.719
N	5.535		N	3.230		N	-0.699	
D	0.876		D	- 3.558		D	-3.977	

BENCHMARK 10-YEAR BOND YIELDS (p.c.)

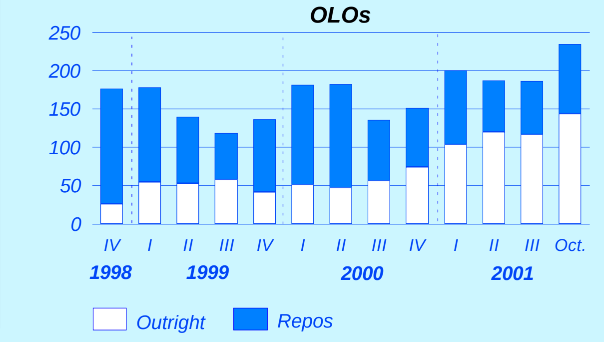


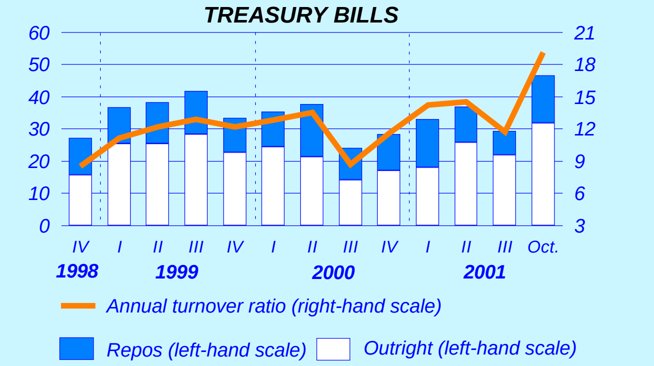
OUTSTANDING AMOUNT AND TURNOVER (billions of euros)



GOVERNMENT SECURITIES MARKET (continuation)

SECONDARY MARKET ACTIVITY (billions of euros, standardised monthly averages)





TREASURY HIGHLIGHTS

It should be noted that the Treasury currently uses the exchange offer technique for exchanging its old general public paper bonds and not OLOs. The latter are now subject to buy-backs, which can be carried out by the Treasury on a daily basis via MTS Belgium or over the telephone. These buy-backs have the same objective as the exchange offers, i.e. smoothing out the schedule of maturities. However, buy-backs also aim at increasing the amount of the benchmark OLOs that are not offered at exchange offers, and at providing primary dealers with a more or less permanent bid, thus ensuring them a counterparty. For these buy-backs, prices are determined by the Treasury, which posts them on MTS Belgium screens every working day for at least 4 hours. The first buy-backs via MTSB took place on July 31.

In addition, the Treasury can also organise reverse auctions at the start of buy-backs on a OLO line. The Treasury initiates the buy-back programme via reverse auctions with a view to increasing market awareness of the fact that the line concerned can be bought back. The invitation to the reverse auction is announced to the participants, at the latest, one calendar week before the reverse auction via the Treasury's pages on Bloomberg (BELG), Reuters (BELG/OLO) and Telerate (36365+36366). In this case offers are accepted at the prices submitted by the participants in the reverse auction through the Bloomberg electronic auction system between 11:30 AM and 12 noon on the day of the auction. The prices accepted must be lower than or equal to the stop price determined by the Treasury. Offers submitted at the stop price may be proportionally scaled down. The results of the reverse auctions are published shortly after the cut-off time of the reverse auction process, first via the Bloomberg electronic auction system and thereafter via the Treasury's pages on Bloomberg, Reuters and Telerate. A first reverse auction took place on July 9.

OLO AUCTION AND EXCHANGE OFFER DATES

Month	Date	Settlement	Auction	Exchange Offers			
November 2001	26	29	Cancelled				
Janvier 2002	28	31	Auction				
March 2002	25	28	Auction				
April 2002	29	02 May		Code 271	Philippe XII	VR	15 March 2003
May 2002	27	30	Auction				
June 2002	24	27		Code 271	Philippe XII	VR	15 March 2003

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General information on the Belgian government's action can be found on the site www.fgov.be.