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MISSION CONCLUDING STATEMENT

Belgium - 2008 Article IV Consultations: Concluding Statement of the Mission

December 19, 2008

> Describes the preliminary findings of IMF staff at the conclusion of certain missions (official staff visits, in most cases to member countries). Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, and as part of other staff reviews of economic developments.

December 15, 2008

Belgium currently faces an extraordinary set of economic challenges. The global financial crisis has hit the country particularly hard in recent months, forcing government intervention in major financial institutions. The crisis has also sparked a deep recession in Europe and the US, the effects of which will be acutely felt in Belgium during 2009 and beyond. The boom in energy and commodity prices in early 2008 caused inflation to spike to well above the euro area average, creating risks of second-round inflationary effects and damaging the competitiveness position of the country. Beyond the current crisis, important medium- and long-term challenges remain. In particular, the long-run fiscal health of the country depends upon actions now to address the future costs of an aging population; the existing fiscal federalism arrangements are creating unsustainable imbalances; and structural rigidities persist, dampening growth, impeding job creation, and eroding Belgium's competitive position in the world. Extraordinary challenges call for extraordinary actions, and we encourage the authorities to fully address the crisis while not losing sight of the more fundamental reforms needed to assure that-once these difficulties are past-the country can move onto a higher and more sustainable economic path.

1. The Economic Outlook: A sharp economic downturn, with a slow recovery

Belgium is expected to suffer a significant recession in 2008-09, and economic activity will likely remain weak into 2010. After slowing in recent quarters, growth will turn negative in the fourth quarter of 2008, and the contraction is forecast to continue in the first half of 2009, with a weak recovery beginning only late in the year. Economic stimulus packages in many countries and looser monetary policy will help cushion the global downturn, but Belgian growth is still expected to fall to around
-¾ percent in 2009, and it will likely remain below potential in 2010, as the recovery in the world economy will be slowed by the aftermath of the financial crisis. Risks to the forecast are large and tilted to the downside, mainly reflecting the high uncertainties surrounding the international environment. Unemployment will rise, eventually peaking well above 8 percent during the downturn.

The spike in inflation experienced in early 2008 has now begun to reverse, but the aftereffects will continue to be felt in 2009. Indexation mechanisms will generate higher wage growth than in partner countries over the coming year, which will help sustain demand but also contribute to a continued decline in external competitiveness. Services prices are also showing some second-round inflationary effects. Recent inflation dynamics have moreover highlighted structural concerns about price-setting in food and energy markets. Inflation should fall to around 2 percent in 2009, but may still remain above the euro area average.

2. Responding to the Crisis—the Financial Sector

Once the financial crisis exploded in Belgium, the authorities responded well. Action was quick, comprehensive, and decisive in Fortis and Dexia in late September, coordinated with partner countries. However, the authorities have now to deal with legal complications in case of the Fortis operation. Steps to intervene in the Ethias insurance group and to strengthen capital in KBC were also appropriate. Risks in the financial system remain elevated: additional problems in financial institutions in advanced economies could once again spill over into Belgium; contagion from the global downturn to Eastern Europe and other emerging markets could constitute another risk; and the recession may place further stress on banks' balance sheets from worsening performance in the corporate sector.

While the *ad hoc* interventions in September and October were well-handled, a broader intervention framework should now be established to guide future actions. Consideration should be given to the formation of a legal framework that provides pre-established rules for future interventions and allows significant further financial resources to be mobilized if needed, as has been done in other countries. Such a mechanism would help reassure markets that the financial system will remain secure while standardizing the criteria for intervention. Specific contingency plans should be prepared jointly by the Government, the Bank Finance and Insurance Commission (BFIC), and the National Bank of Belgium (NBB) for further action (if needed) in each of the major banks, in smaller banks, and in the insurance industry, detailing the steps to be taken in the event of another round of crisis. Immediate steps should be taken to further strengthen information sharing and coordination between the BFIC and the NBB. These could include creating joint databases for offsite inspections of banks, and setting up joint onsite inspection teams where financial supervisors from the BFIC and macrofinancial risk experts from the NBB would work together to identify risks. Eventually, consideration should be given to unifying macrofinancial risk analysis with banking and insurance supervision under a single structure, while leaving supervision of financial markets in a separate institution. Finally, the recent banking interventions have highlighted deficiencies in international cooperation in financial regulation and supervision. The Belgian authorities should continue to press for an expansion of pan-European banking supervision mechanisms. In the meantime, priority should be given to strengthening existing venues of cooperation, such as supervisory colleges and bilateral memoranda of understanding with supervisors in other countries where Belgian banks are active.

3. Responding to the Crisis—the Fiscal sector

The fundamental challenge for the public finances is to use fiscal policy to address short-term need for stimulus without derailing medium- and long-term fiscal consolidation objectives. For 2008, the fiscal deficit will likely be near 1 percent of GDP, reflecting the late approval and implementation of the budget and the initial effects of the economic downturn. In 2009, the effect of the recession on public revenues and expenditures-together with the recently announced *Plan de Relance*-will likely result in a deficit between 2-2½ percent of GDP, corresponding to a deterioration of the structural balance of around ¾ percent of GDP. In our view, this stimulus is of the right magnitude under the circumstances. A larger package at this juncture would be hazardous to stability, given the still-elevated public debt level in Belgium and the serious challenges to long-term fiscal consolidation. Nonetheless, if the economic situation were to deteriorate significantly further, a larger stimulus might have to be considered, but only in coordination with the EU.

While the fiscal stance in 2009 will be broadly appropriate given the economic crisis, the composition of the fiscal stimulus could be improved. Best international practices dictate that a discretionary stimulus should be timely, temporary, and targeted on sectors most likely to generate growth. In addition, in the Belgian case, we recommend that the stimulus be tied to structural fiscal measures aimed at ensuring longer-term sustainability. On each of these criteria, the *Plan de Relance* is less than ideal. In terms of timeliness, the plans of both the federal and regional governments rely significantly on boosting investment. While the plan includes the acceleration of existing investment plans, there are limits to how much investment can be brought forward in order to bring the stimulus to bear at the moment when it is most needed to cushion the downturn, the first half of 2009. With respect to the objective of "temporary" stimulus, calculations suggest that roughly 2/3 of the cost of the *Plan de Relance*'s measures could be permanent, boosting the deficit in future years. The plan includes expensive reductions in social contributions and permanent increases in unemployment and other social benefits. While a lower tax wedge on employment is a desirable objective, lower social contributions should be accompanied by countervailing long-term savings. The targeting of the plan is also only partial. The measures to lower the VAT in specific areas (construction) and boost unemployment benefits have targeted effects, but in other areas, the benefits are diffuse and may well result in an increase in savings by the recipients rather than higher spending. We would recommend that sunset clauses or long-term compensatory savings be included in all elements of the *Plan de Relance*, and that measures be more focused on increasing incomes of those most likely to spend it (e.g. the low-income and unemployed) and on accelerating investments already underway.

4. Beyond the crisis—Achieving fiscal sustainability

The fiscal stance in recent years has fallen short of what is needed to assure long-term sustainability, and will have to be significantly tightened over the medium-term. The financial crisis has boosted the gross debt-to-GDP ratio by some 6 percentage points, and the deficits in 2008 and 2009 will further increase public indebtedness, making long-term fiscal sustainability a more difficult goal. As an anchor to fiscal policy, the government-in collaboration with regions and communities-should firmly commit now to a structural adjustment of at least 0.7 percent of GDP per year once the crisis has past, to return as soon as possible to fiscal balance, and eventually to a surplus to ensure fiscal sustainability.

Despite the unavoidability of fiscal deficits in the short-run, policy actions should be taken now to lay the groundwork for a future return to balance. These steps could even be coupled with the temporary stimulus measures to reassure markets that the government remains committed to debt reduction. Among the institutional measures to be considered are:

• **Multiyear budgeting.** In line with recent IMF recommendations,[1 (#P26_10103)] the authorities should consider a medium-term budgetary framework to guide the annual budget process. Such a framework will allow the government to articulate spending priorities and set out in detail plans for the main spending categories over a multi-year horizon. To increase the effectiveness of the framework, spending plans should be translated in binding ceilings that form the basis for the annual budget cycle.

• **Strengthen the role of the High Finance Council (HFC).** To the existing function of recommending an appropriate medium-term fiscal stance, the HFC could take on the role of independent evaluator of the government's fiscal plans and corresponding outcomes, and could produce regular reports to improve the budget process and outturn. The HFC's mandate could be expanded to include expenditure policy issues and to helping set parameters for the multiyear budget process.

• **Undertake comprehensive expenditure and revenue reviews.** Other countries facing fiscal difficulties have found that comprehensive reviews of spending and taxation can identify significant areas where tax expenditures can be reduced, and spending streamlined and improved in efficiency. These reviews could help the country find ways to reduce the size of government, which-at nearly 50 percent of GDP-is above the average for advanced countries.

• **Tackle the imbalances inherent in the current fiscal federalism arrangements.** Resolving vertical imbalances will require shifting more of the burden of fiscal consolidation and preparation for population aging from federal/social security to community/regional entities. Horizontal imbalances between communities/regions should be reconsidered with a view to providing a better match between spending authority and revenue-raising responsibility and improving the transparency and incentive effects of intergovernmental solidarity mechanisms.

5. Beyond the crisis—Competitiveness and Structural reforms

A competitiveness gap has been emerging in recent years vis-à-vis partner countries. This gap is evidenced by declining Belgian shares in European markets, an appreciating real effective exchange rate, and a deteriorating external current account balance, which has slipped into deficit for the first time in many years. Action should be taken to improve productivity and market efficiency both to boost competitiveness and to improve the living standards and purchasing power of workers and their families.

The labor market. The centralized wage-setting mechanism has played an important role in incorporating macroeconomic considerations in the social bargaining process, and has helped minimize costly labor unrest. Unfortunately, the associated indexation arrangements have also generated real wage rigidity, which has contributed to weakening competitiveness and plays a role in perpetuating inflationary pressures. In the current context, as noted by the Central Economic Council in its recent report,[2 (#P33_13216)] there is no room for real wage increases over the 2009-10 period. In fact, the existing real wage gap ought to be reduced, but the present indexation mechanisms do not permit it. While not recommending that the existing mechanisms be abandoned, there is a clear need for adaptations that can reverse the competitiveness erosion and increase flexibility. The government and the social partners should give consideration to reforming the wage indexation parameters to permit full coverage for the poorest, most vulnerable workers, while allowing for less-than-complete indexation for the economy as a whole. Steps to increase the use of all-in agreements might also help introduce greater real wage flexibility. Beyond indexation, reforms to improve activation policies and remove inactivity traps keeping potential workers out of the labor force remain crucial. These measures should be coupled with increased training opportunities, at least to previously agreed targets, and focused on improving labor productivity.

Product and services markets. In retail, easing of restrictions on new retail establishments and deregulating opening hours and sales periods would promote a competitive environment leading to lower prices to consumers. Doing away with price regulations on over-the counter drugs while in tandem liberalizing their market would also help. In energy supply and distribution, the specificity of the sector requires a careful examination of pricing policies-we welcome the recently enhanced investigation power of the sectoral regulator (CREG), but would also recommend additional actions by the newly created price observatory to obtain more transparency for the end-user. Finally, the EU Services Directive provides a liberalizing opportunity that should be fully seized. Reforms of this type could lower the consumer price level by as much as 1-2 percentage points over time, boosting purchasing power by hundreds of euros per household while narrowing the external competitiveness gap.

Competition. International experience indicates that gains from product market reforms and price liberalization are optimized by the presence of a competition authority with robust powers. We recommend further reinforcing the Competition Council to make it both a vocal public advocate for competition-a voice still largely absent from the policy debate-and a watchdog against rent-seeking behavior. It should accordingly be empowered and sufficiently staffed to analyze areas where policy changes could boost competition, and should issue periodic reports with in-depth sectoral studies and specific recommendations. In addition, cooperation with sectoral regulators such as the CREG should be reinforced.

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1 (#P26_10104) From the 2008 *Report on Observance of Standards and Codes-Fiscal Transparency Module* for Belgium, available at http://www.imf.org/external/country/BEL/index.html (/external/country/BEL/index.html).

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2 (#P33_13217) Available at http://www.ccecrb.fgov.be/txt/fr/doc08-1401.pdf (http://www.ccecrb.fgov.be/txt/fr/doc08-1401.pdf) .

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