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Belgium: 2009 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2009 Article IV consultation with Belgium, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 14, 2009, with the officials of Belgium on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 22, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 8, 2010 discussion of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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BELGIUM

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation with Belgium

Approved by Ajai Chopra and Thomas Dorsey

February 22, 2010

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I. Executive Summary and Staff Appraisal[1]

1. **The authorities' actions have helped to stabilize the financial sector and halt the economic downturn.** The Belgian economy was hit hard by the global financial crisis and economic downturn. In response, the authorities took measures to support the financial sector and let the automatic fiscal stabilizers operate freely while implementing a moderate stimulus plan. But the recovery is expected to be slow and fragile. At the same time, ground has been lost in addressing the high public debt and public spending pressures related to population aging, and in strengthening competitiveness and labor market participation. The political situation remains complex and the June 2009 regional elections have strengthened political parties that are not part of the federal coalition. With a crowded election calendar over the next years, this complicates the authorities' efforts to tackle the medium-term challenges facing the country in the areas of public finances and structural reforms.[2]

2. **The near-term outlook is challenging.** Real GDP is expected to have dropped by about 3 percent in 2009, and only a gradual recovery is projected for 2010. The unemployment rate would continue to rise in 2010 and inflation pressures are expected to remain subdued. Uncertainty to the outlook is high but risks appear broadly balanced. The dislocation from the crisis lowered potential growth in 2009-11, in addition to the downward impact due to demographic factors.

3. **The main post-crisis challenges faced by the Belgian authorities are to prepare for an orderly exit from the crisis measures as the recovery gains strength while at the same time laying the ground for high and sustained growth over the medium term.** It is particularly important to take early action to strengthen financial stability, restore fiscal sustainability, and improve the functioning of labor and product markets to boost competitiveness and economic growth.

4. **Helped by massive public intervention, the banking sector has stabilized but its financial situation remains fragile and its supervision needs to be strengthened.** Bank recapitalization and balance sheet repair remain important while targeted liquidity support needs to continue in the near future. Moreover, Belgian banks remain vulnerable to potential spillovers from mature markets and emerging Europe. The risk of a creditless recovery is a cause for concern although this is mitigated by the public support and ongoing bank restructuring. Hence, credit to the economy should be closely monitored. Exit from the emergency support to the financial sector should take place gradually to avoid adverse

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[1] A staff team comprising Mr. De Vrijer (head), Ms. Tytell, Ms. Xiao, Ms. Yontcheva (all EUR), and Ms. Yakadina (FAD) visited Brussels during December 2-14, 2009. Belgium is an Article VIII country and data provision is adequate for surveillance (see Informational Annex).

[2] General elections are scheduled for 2011 and 2015; regional elections for 2014; and local elections for 2012.

market reactions and a credit squeeze. The initiated reorganization of the Belgian supervisory authority is welcome and the authorities should continue to strongly support enhanced international cooperation in regulatory reform and coordination of exit policies.

5. **The financial crisis and the economic downturn threaten the medium-term sustainability of public finances already under pressure from a rapid rise of aging-related spending.** The government's new Stability Program aims appropriately to achieve a balanced budget by 2015 to avert unsustainable public debt dynamics. The intergovernmental burden-sharing agreement for 2009-10 and the planned agreement for 2011-12, along with the first multi-year fiscal framework are welcome first steps but leave important decisions, including a comprehensive fiscal federalism reform, open until after the 2011 federal elections. While the 2010 budget strikes the right balance between initiating the fiscal consolidation and supporting the recovery, additional measures are needed to achieve the deficit targets for 2011 and beyond, including by reversing most of the fiscal stimulus measures after 2010. Post-crisis fiscal consolidation will require efforts at all government levels and social security. The adoption of a rule-based fiscal framework would help to increase the credibility of the consolidation efforts.

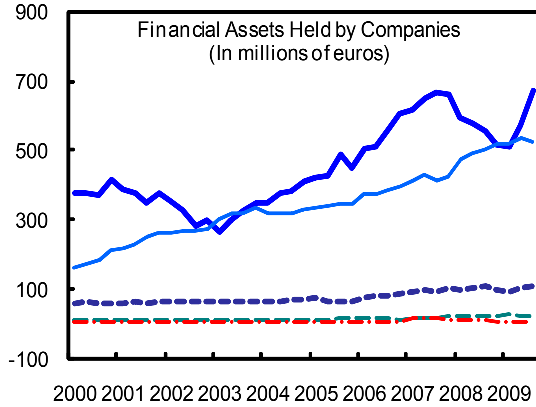
6. **Structural reforms remain crucial to improve competitiveness and boost growth.** In view of declining export shares, there remains a need to moderate wage increases, strengthen competition and enhance the mobility of resources across sectors. There is also a pressing need to raise the low Belgian employment rate, by both reabsorbing the unemployed and raising labor market participation, especially among senior workers.

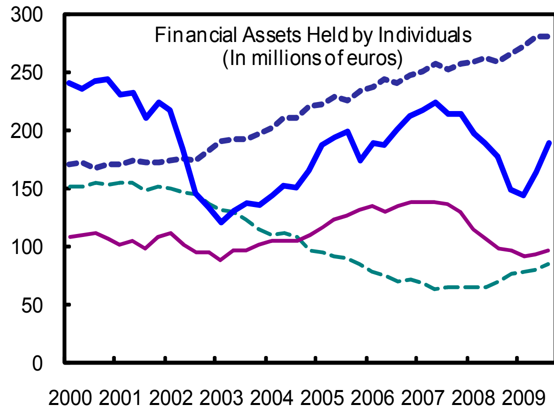
7. **It is proposed that the next Article IV consultation be held on the regular 12-month cycle.**

II. Deep Recession and Challenging Outlook

A. Severe Recession in 2009

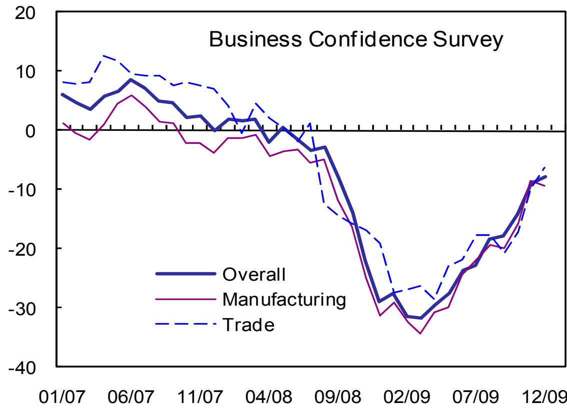
8. **Hit by the financial crisis and the collapse in world trade, the Belgian economy experienced an abrupt and severe contraction in the last quarter of 2008 and the first half of 2009.** Sizeable financial wealth losses of households and non-financial corporations contributed to plummeting consumer confidence and business sentiment. The serious problems in the financial sector also led to a tightening of credit conditions. Private consumption fell despite gains in real disposable income, the latter in part due to lower inflation. Exports contracted rapidly, reflecting the sharp drop in world trade and, given the importance of intra-EU trade, spillover effects from the slump in the Euro area. As a result, private investment was significantly scaled down and firms sharply reduced their inventories.

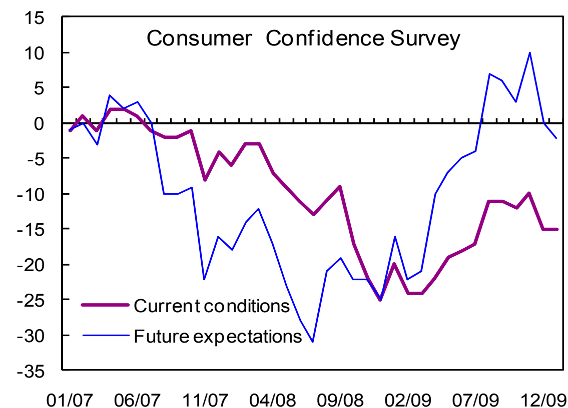


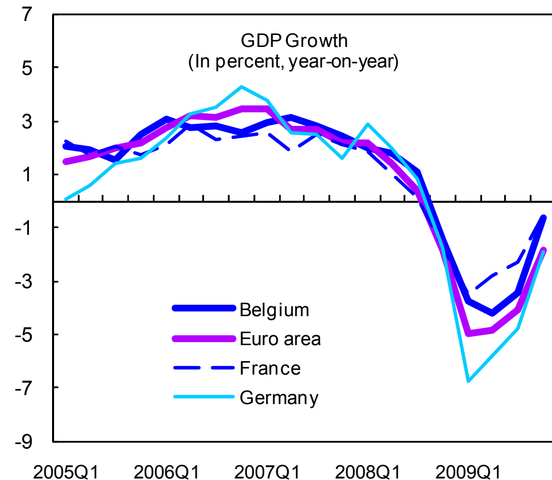


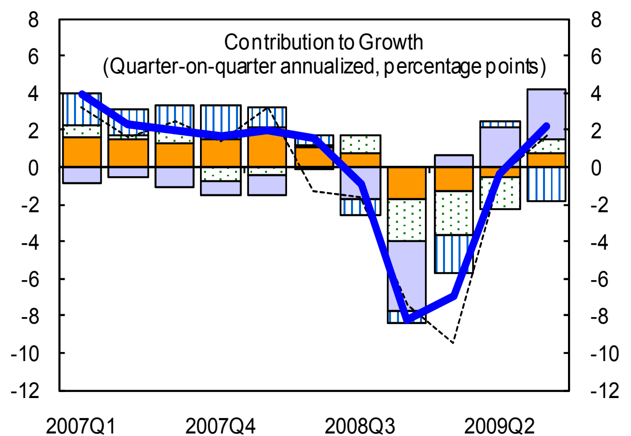
Source: NBB.

Industrial production fell by a cumulative 10 percent over the first three quarters of 2009, reflecting both falling domestic demand and the deteriorating global environment. While confidence indicators have started to recover from the second quarter onward, they remain





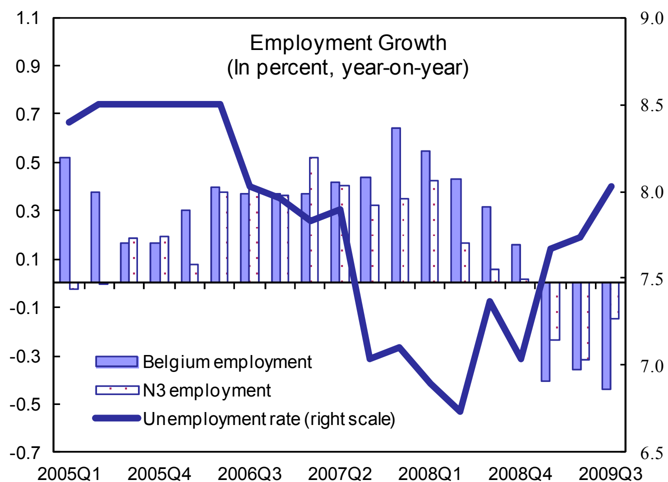




Sources: Haver Analytics; WEO; and IMF staff estimates.

largely below their pre-crisis levels. Real GDP started to increase again in the third quarter as the recession in partner countries is bottoming out, financial market conditions were improving, and firms began rebuilding some of their depleted inventories. For 2009 as a whole real GDP is expected to have contracted by about 3 percent.

9. **Unemployment is heading upwards.** The recession has brought an end to the continuous decline in unemployment since 2005. The unemployment rate has thus far risen by over 1 percent since its cyclical trough in May 2008 and exceeded 8 percent in October 2009. This relatively modest increase also reflects the impact of measures to encourage firms to use reduced working-time arrangements to respond to the drop in activity. However, employment has steadily contracted during the year and the unemployment rate would continue to rise in the near future as recovery prospects are feeble and there is a considerable time lag between higher activity levels and job creation.



Sources: WEO; and IMF staff estimates.

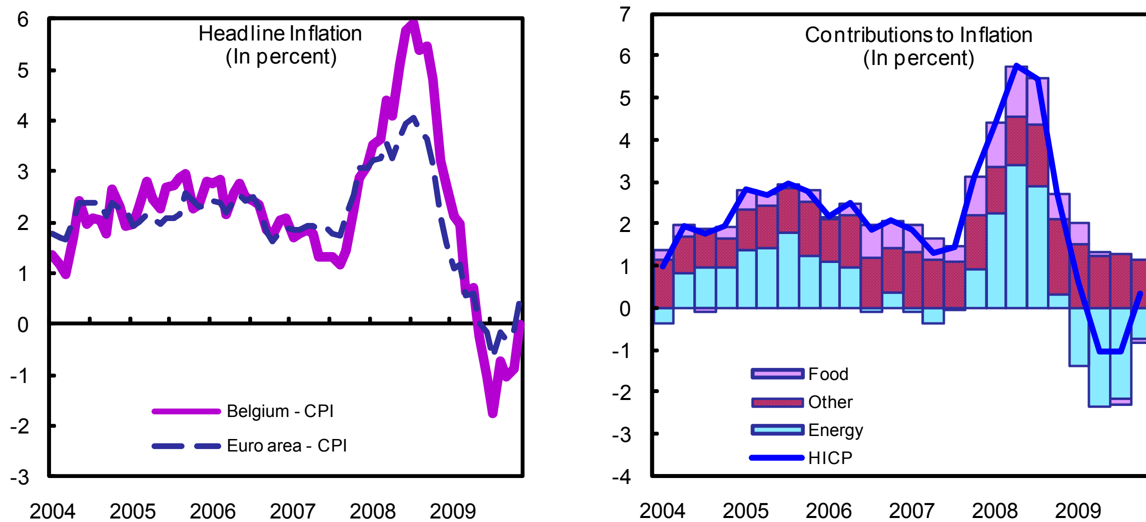
B. Outlook and Risks

10. **The recovery is expected to be gradual and tepid**, with real GDP growth forecasted at slightly above 1 percent in 2010 and to increase to almost 2 percent over the medium term. Exports are likely to pick up in 2010 as global activity would gain strength, although the expansion in Belgium's main trading partners is likely to remain sluggish while relatively high wage costs and supply rigidities remain a constraint on export performance. In addition, as the level of inventories has fallen sharply, some further restocking could take place. However, a rebound in private consumption and investment will take some time. The considerable wealth losses due to the financial crisis, the ongoing rise in unemployment, and the deterioration in the fiscal position are likely to induce a further increase in the households' savings rate and slow consumption.[3] Also, the very low rate of capacity utilization and tightened financing conditions would induce firms to postpone new investments. The authorities project a stronger recovery with growth exceeding 2 percent by 2012, mostly driven by a stronger rebound in domestic demand. In light of the fiscal

[3] During 1993-2008, public savings and household savings in Belgium were negatively correlated (correlation coefficient: -0.8), supporting the hypothesis that Belgian households display Ricardian behavior.

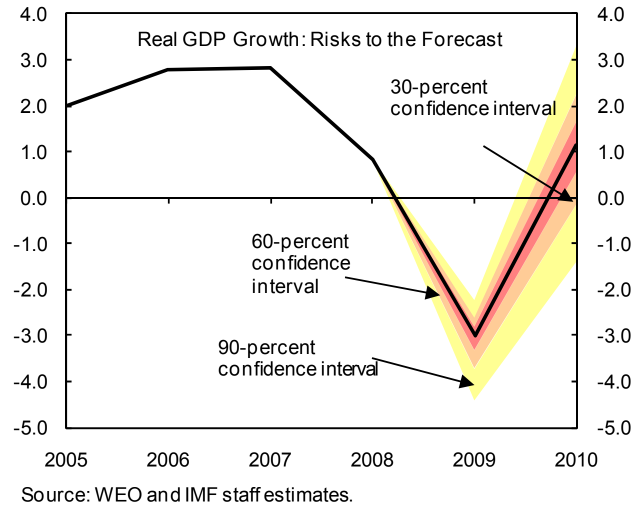
consolidation program (see Section IV), staff considers this rather optimistic. Unemployment would increase to above 9 percent in 2010. The gradual strengthening of domestic demand would raise GDP growth above its potential rate while staff expects the output gap to narrow gradually over the medium term.

11. **Lower energy and food prices since mid-2008 have brought inflation sharply down with a modest inflation risk going forward.** Headline inflation dipped into negative territory in early 2009 due to the base effects from substantial declines in energy prices. Annual core inflation remained above 1 percent and is higher than in the Euro area, partly reflecting the impact of automatic wage indexation. Inflation pressures are expected to remain subdued in the period ahead, even once the energy and food price base effects dissipate, due to the weak outlook for growth and employment.



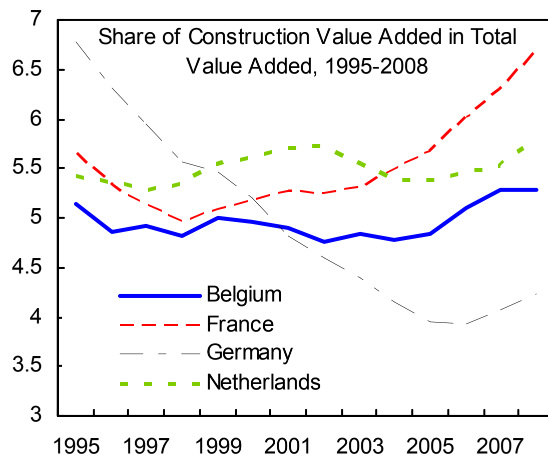
Sources: WEO, and IMF staff estimates.

12. **The outlook is unusually uncertain and risks are broadly balanced.** On the upside, the global monetary easing, fiscal stimulus, and the waning of financial market turbulence would strengthen foreign demand. Stronger recoveries in partner countries, in particular in the Euro area, would speed up Belgian economic growth. On the downside, the public support of the financial sector and the fiscal impact of the downturn have significantly increased the public debt ratio, which could trigger adverse market reactions and dampen growth. Moreover, a backlash from the financial crisis cannot be ruled out because of the still strained capital positions and risky exposures in the banking sector. Although thus far the slowdown in lending appears in line with lower demand, credit may not be able to fully expand with the demand from firms and households as the recovery gains strength.

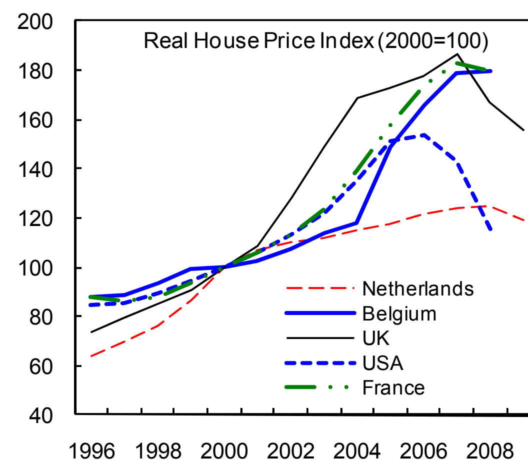


Source: WEO and IMF staff estimates.

13. **The risk of a further house price correction remains considerable but the impact on the real economy will likely be limited**. Real house prices doubled over the past decade and were estimated to have been overvalued by some 15-20 percent compared to fundamentals in 2007.[4] House prices stabilized in 2008 and have fallen by about 8 percent in 2009. The proportion of household wealth invested in housing has increased since 2000, but remains considerably less than that in France, the U.K., and the Netherlands. The impact of a further price correction on the real economy is likely to be mitigated by the relatively low indebtedness of households and conservative lending practices.[5] Mortgages tend to be fixed



Sources: Haver Analytics, and IMF staff estimates.



Source: Haver.

[4] IMF, World Economic Outlook, the Changing Housing Cycle and the Implications for Monetary Policy, April 2008.

[5] Mortgage debt stands at about 30 percent of GDP, below the European average of above 40 percent.

rate and have conservative loan-to-value ratios, diminishing the risk of foreclosures. Refinancing products are uncommon making a significant adverse impact on consumption less likely. In addition, while construction activity has fallen in 2009, the sector's share in GDP has been stable at around 5 percent, below the European average.

C. External Developments and Competitiveness Issues

14. **The small current account deficits in 2009-10 are expected to be temporary.** Belgium's highly open economy has been significantly affected by the global downturn and the sharp drop in net exports during 2008-09 came on top of an already weakening export performance. Accordingly, the national saving-investment balance turned negative, reflecting a large increase in the overall government deficit that is partly offset by a rise in net savings of the private sector. Exports are expected to pick up again from 2010 onwards, in line with the recovery in global trade. With a more sluggish expansion of domestic demand and imports, the foreign contribution to growth would become positive again. In view of the persistent fiscal deficits, however, the current account surpluses projected over the medium term would be smaller than during the pre-crisis period.

Belgium: Saving-Investment Balances, 2002-2015
(In percent of GDP)

				Projections			
	2002-06	2007	2008	2009	2010	2011	2012-15
Private savings	24.7	25.3	22.4	27.2	26.4	26.2	26.8
Private investment	18.8	21.2	22.1	19.9	19.9	20.0	20.0
Private saving surplus	6.0	4.0	0.4	7.4	6.5	6.2	6.6
Government saving surplus	-2.3	-1.8	-2.9	-7.6	-7.0	-6.3	-5.2
National saving surplus	3.6	2.2	-2.5	-0.3	-0.5	-0.1	1.3

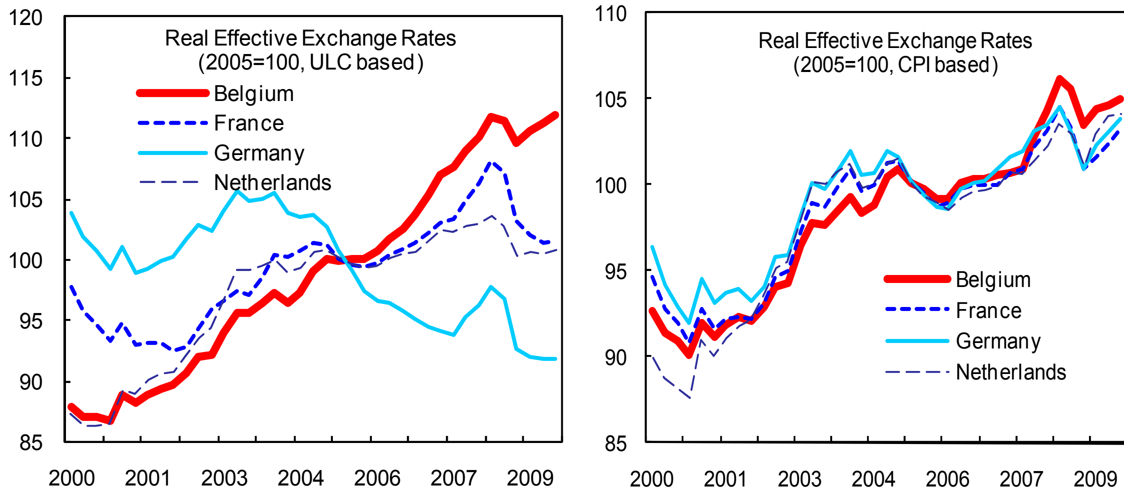
Sources: National Bank of Belgium; and IMF staff projections.

15. **Competitiveness issues remain a constraint on the export performance of the Belgian economy.** Estimates based on the CGER methodologies suggest that the real exchange rate is broadly in equilibrium. However, developments in real effective exchange rates based on unit labor costs (ULC) continue to point to a competitiveness gap with respect to the key trading partners, especially Germany. This gap is due, in part, to the relatively high wage growth in Belgium—owing to the automatic wage indexation mechanism—that is not offset by higher productivity growth. Belgian exporters have been losing market shares over the past decade, although some sectors (mainly chemicals) have gained in market share. Accordingly, there is need for some wage

Belgium: CGER Competitiveness Assessment
(In percent)

Macro balances approach	4
External sustainability approach	-1
Equilibrium RER approach	6
Simple average	3

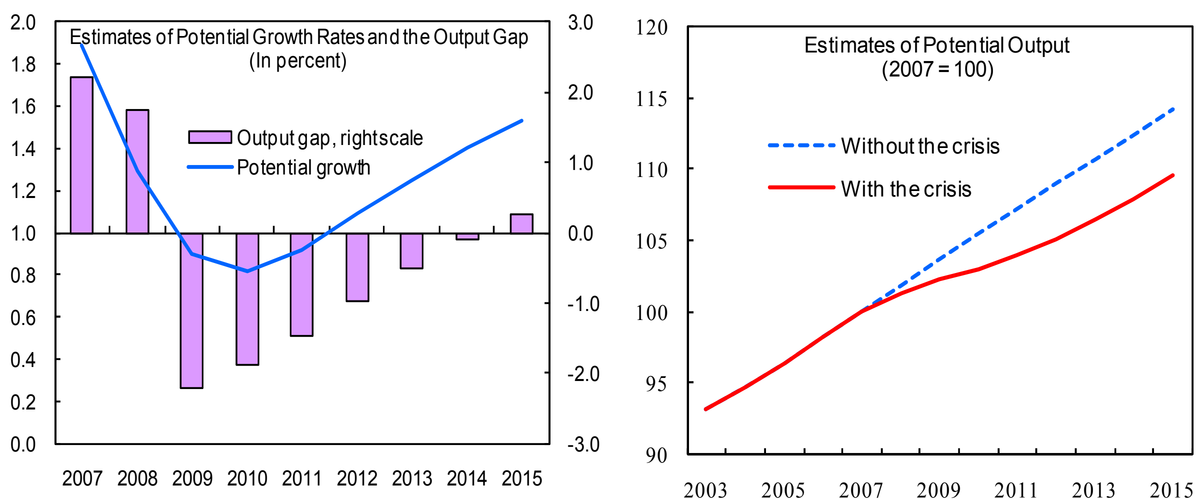
moderation that needs to be supported by measures to increase competition and facilitate movement of resources (especially labor) within and across sectors.



Source: IFS.

D. Consequences of the Crisis for Potential Growth

16. **The financial crisis and the economic recession will have a significant adverse impact on the Belgian economy's growth capacity.** The banking crisis and the collapse of global trade will compound the long-term slowdown of potential growth reflecting the impact of demographic factors, notably population aging. Trade and financial sector developments will affect potential growth in Belgium both directly and through indirect effects on the production capacity of other sectors that depend on external finance and/or



Sources: WEO; and IMF staff estimates.

foreign demand. To evaluate the path of potential output going forward, staff has used historical data on the evolution of potential output following recessions of the early 1990s in Belgium and in Scandinavian countries that experienced banking crises (see Analytical Note 1). The results indicate that in 2009-11 potential growth would be about 1 percent lower than its trend rate, which is itself declining due to demographic factors. Potential growth is projected to recover gradually to its trend rate of about 1½ percent by 2015.

III. The Financial System: Post-Crisis Assessment and Exit Strategies

A. Financial Sector Conditions have Stabilized but Challenges Remain

17. **Since the worst of the financial crisis in the latter part of 2008, the financial situation of the Belgian banking sector has stabilized but risks remain elevated.** Decisive government support and a gradual improvement in investor confidence have resulted in a decline in CDS spreads and stabilization in equity prices.[6] As a result, liquidity conditions and access to financing have improved, while interbank rates have steadily come down from their peak in October 2008. The government interventions and improved market conditions have enabled the banks to raise their capital ratios and to de-leverage. In addition, Belgian banks benefit from relatively low risks in the domestic residential real estate market and lower household debt and non-financial companies' leverage than the Euro area average. However, risks to the loan portfolio are expected to rise and possible additional losses and write-downs over the next few quarters remain a concern. While Belgian banks have very few activities in Greece, all three major banks are still highly exposed to mature markets and impaired structured asset classes, and one bank is quite vulnerable to developments in Central and Eastern European (CEE) markets.

18. **Public support has boosted capital ratios but banks may face additional capital charges.** The government interventions have kept the regulatory capital ratios of the main Belgian banks in line with the European average (Tier 1 ratios rose to above 10 percent in 2009) but banks remain highly leveraged. However, as market participants increasingly focus on a more stringent capital definition, Belgian banks will need to boost their capital to maintain market confidence and support the financing of the economy.

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[6] For a summary of the government interventions in the financial sector see IMF Country Report No. 09/87 of March 2009.

Solvency Ratios of Belgian Banks
(In percent)

	With Government Capital Injections			Without Government Capital Injections
Q3-09 except when indicated otherwise	Tier 1 ratios	Core Tier 1 ratios	Leverage ratios*	Core Tier 1 ratios
Dexia (Group)	11.8	10.8	3.3	8.7
Fortis Bank	10.7 (YE 2008)	8.9 (YE 2008)	3.7	6.6 (YE2008)
KBC	10.2	8.8	3.9	4.0

Sources: Companies reports; Moody's; and IMF staff calculations.
Leverage ratio defined as Tier1 capital divided by total capital – goodwill and intangibles

19. **The uncertain profitability outlook constrains the banks' capacity to rebuild a high-quality capital base through internal capital generation.** The profitability of Belgian banks improved gradually over 2009 because of rising net interest income. The improvement in interest margins mainly reflected significantly lower funding costs in the current monetary policy environment which, however, may not last. At the same time, the banks continued to face impairments on their investment portfolio, notably through their remaining exposure to structured assets, and lower revenues from asset management activities reflecting the sizable wealth losses in the economy. This suggests that the banks may have to continue to rely on external sources of capital, either public or private, for an extended period and that the repair of balance sheets remains important and needs to be accompanied by asset disposal.

B. Macro-Financial Linkages and Cross-Border Spillovers

20. **A negative feedback loop between the financial sector and the real economy has led to an increase in counterparty risk and deteriorating asset quality**.[7] Although the risks of impairments on the banks' domestic consumer and mortgage loan portfolio appear relatively modest due to low household indebtedness and conservative lending practices, the share of non-performing loans in the total loan portfolio has risen significantly and impairment costs have more than doubled compared to their pre-crisis levels (see Analytical Note 2). In particular, credit risks on corporate loans and international loans are on the rise. Further losses could be expected given the usual lag between an economic downturn and credit defaults.

[7] The financial sector's contribution to the Belgian economy is substantial with total assets representing about 400 percent of GDP and providing 14 percent of employment in 2008.

21. **Bank lending to the private sector has shrunk since the beginning of the crisis.** The recession and declining producer confidence have dampened credit demand. At the same time, lending conditions to the private sector for all types of loans, including mortgages, have been tightened over the course of 2009, reportedly reflecting lingering difficulties in tapping funding markets and ongoing deleveraging pressures. Growth of credits granted to resident non-financial corporations of all sizes slowed down to 3.5 percent year-on-year in August 2009 from a maximum of about 15 percent in the course of 2008. However, while the balance between credit demand and supply factors remains unclear, lending conditions in Belgium appear marginally less restrictive than in other European countries according to recent European Central Bank's surveys (see Analytical Note 2).

22. **Credit to the economy should be closely monitored as risks of a creditless recovery are a cause for concern even though mitigating factors are at play.** Staff estimates, based on the results of a cross-country analysis, that Belgium has a relatively high probability of experiencing a creditless recovery.[8, 9] An additional shock to the financial sector could reduce credit and particularly affect sectors that are dependent on external financing, potentially leading to a suboptimal allocation of resources. This points to the need to ensure that exit strategies from support programs are carefully designed, in order to avoid a credit squeeze. At the same time, the public support to the banks and their restructuring with the banks' increased focus on lending activities in the core home markets would limit the risk of a creditless recovery.

23. **Belgian banks remain vulnerable to potential spillovers from both mature markets and CEE.** All main Belgian banks have major cross-border operations and Belgium has a relatively high exposure to debtor countries. In particular, Belgian banks are highly exposed to France, the US, the UK and the Netherlands. The breakdown of the Belgian loan portfolio by countries shows that exposure is relatively high in some countries where nonperforming loans have increased particularly rapidly such as Ireland and Spain. In addition, one bank is quite vulnerable to developments in CEE.

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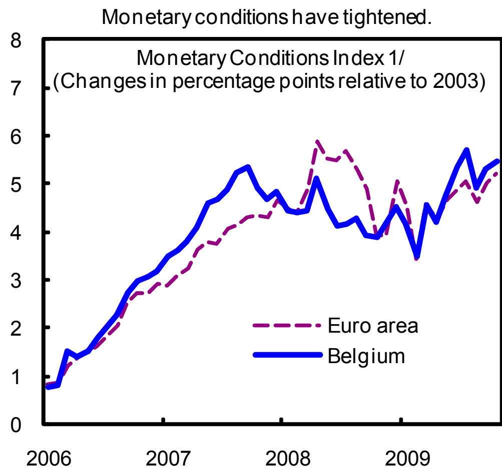
[8] In general a country is at risk of a creditless recovery (i.e., with negative real credit growth) if its economic downturn was severe, if it experienced a credit boom before the crisis or if the recession came with a banking crisis.

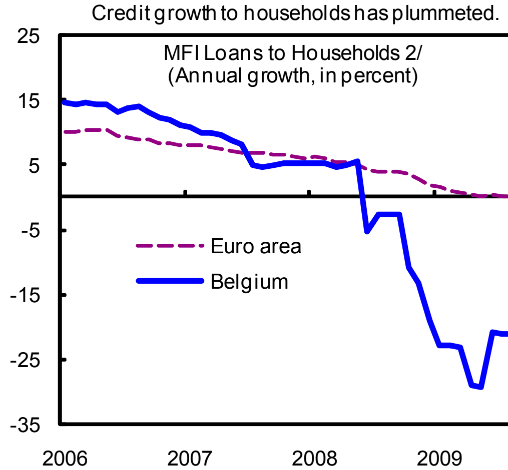
[9] See Abiad, A., G. Dell'Ariccia, and B. Li,, forthcoming, "Creditless Recoveries," IMF Working Paper.

Belgium: Monetary and Financial Sector Developements

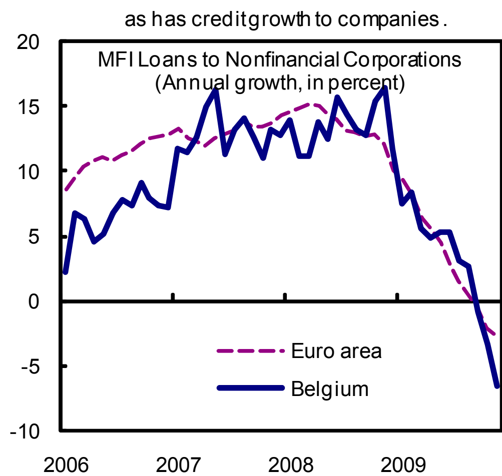
Monetary conditions have tightened.



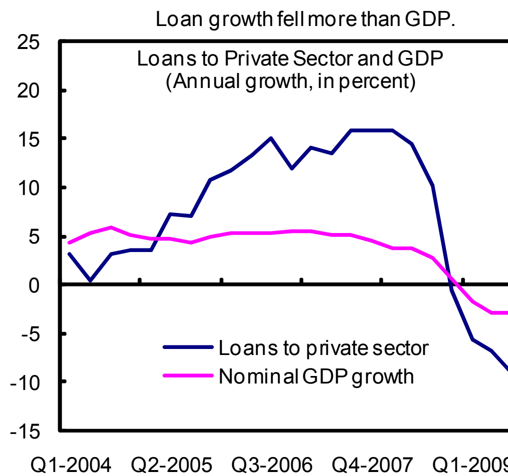
Credit growth to households has plummeted.



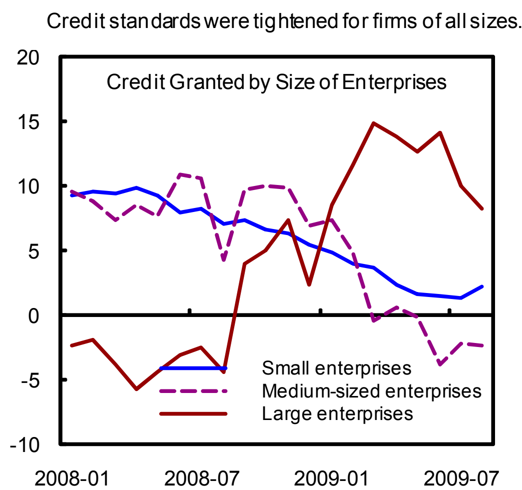
as has credit growth to companies.



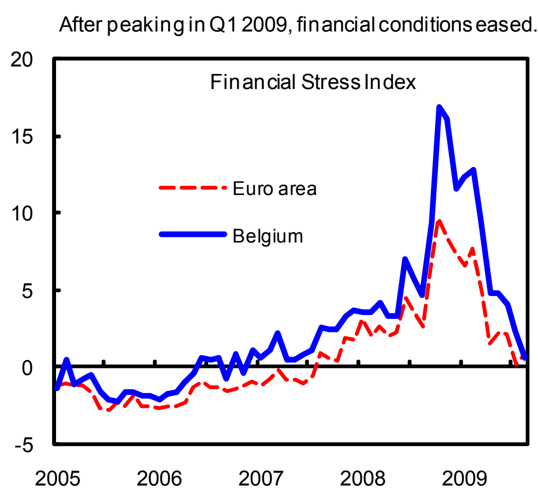
Loan growth fell more than GDP.



Credit standards were tightened for firms of all sizes.



After peaking in Q1 2009, financial conditions eased.



Sources: Haver; IMF, IFS; ECB; and Eurostat.
1/ Weighted average of changes in interest and exchange rates relative to their average values in a base period. An increase (decrease) indicates a monetary tightening (loosening).
2/ Credit growth to households in 2008 and 2009 was largely affected by securitization operations. Excluding these operations, the underlying credit growth decelerates but remains positive in 2008 and 2009.

Belgium: Vulnerability of the Belgian Banking System to Cross-Border Contagion

Debtor Country	Belgian Banks' Exposure to Debtor Country (In percent of total foreign exposure)	Impaired Loans/Equity of Banking Sector in Debtor Country (2008)	Asset Quality Deterioration (Percent change of impaired loans/equity compared to previous year) 1/
Advanced Economies			
France	13.93	30.1	13
United States	12.03	12.2	70
United Kingdom	11.95	38.9	94
Netherlands	9.11	30.8	117
Germany	6.17	46.2	32
Italy	5.72	48.6	22
Spain	5.08	34.9	203
Ireland	4.83	43.7	249
Luxembourg	2.82	11.9	86
CEE			
Czech Republic	5.46	25.4	14
Poland	2.80	29.4	8
Hungary	1.84	47.0	32
Turkey	1.15	15.9	11

Sources: Bankscope; and IMF staff estimates.

1/ A positive number indicates a deterioration in asset quality.

C. Preparing for Exit from Government Support

24. **Most of the government support schemes do not have built-in sunset clauses but the restructuring plans of banks that benefitted from state aid are subject to the European Commission's approval and include the gradual withdrawal from the emergency public support** (see Analytical Note 2). The Belgian authorities agreed that reducing the large public support in a timely manner is needed to reduce the distortions created by public interventions and to lessen the moral hazard problems associated with bailout operations, while exit needs to be well-organized to avoid market disruptions and support credit.

Preparing for a timely and orderly exit

25. **Flexibility and clear communication are crucial for a successful exit strategy.** The authorities indicated that the pace of exit from the financial sector would be gradual in order to test whether the financial system and financial markets can function on their own again. Communicating exit plans in conjunction with the decision of the European Commission on state aid will help anchor expectations and assuage lingering market fears.

26. **Public capital injections into financial institutions should be withdrawn only when the capital adequacy of Belgian banks is satisfactory and the financial stability of**

the banks is ensured. While the banks are implementing restructuring programs, it will most likely take some time for their financial health to improve enough for the authorities to be able to sell their shares or for the banks to reimburse the state directly. The authorities considered that appropriate policies could provide incentives for the private recapitalization of banks, including through restrictive compensation and dividend policies. In the meantime, the government should actively safeguard the public's investment in financial institutions and maintain a level playing field across institutions.

27. **The unwinding of state refinancing guarantees is being done gradually and in a targeted manner** to avoid a backlash in market expectations. Staff supports the amended one-year extension of refinancing guarantees offered to Dexia with a gradual reduction in the level of coverage of the guarantees.[10] The authorities indicated that that associated costs and restriction on dividend and coupon payments should minimize moral hazard and induce the bank to cease using the guarantees when they are no longer needed. Dexia already waived, from October 16, 2009, the benefit of the guarantee for all new contracts with a maturity below one month, and all new contracts with no fixed maturity, and is committed to end all new guaranteed funding by mid-2010.

Strengthening the regulatory framework

28. **Staff welcomes the initiated reorganization of the Belgian supervisory authority.** While there is no first-best model of financial supervision, the current crisis has highlighted the important role of adequate macro-prudential supervision in order to prevent banks from undertaking excessively risky activities with large externalities. The creation by early 2011 of a new unified structure for the supervision of financial institutions, as in Germany and the Netherlands, entails the merger as soon as feasible of the authorities vested in the central bank and in the Banking, Finance and Insurance Commission (CBFA). The CBFA will henceforth focus on surveillance of financial markets and the protection of consumer interests. This reform should effectively combine the supervision of individual institutions and of the system as a whole. The authorities agreed with staff that the transition period should be carefully handled and have set up a transition committee to ensure that control activities are not interrupted. They have also prepared a draft crisis law that would establish a rule-based resolution framework for failed financial institutions while preserving their systemic functions. It allows the authorities to transfer property and business lines from a troubled financial institution to another private bank or public entity when the institution enters resolution proceedings.

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[10] Given the improvement in the liquidity situation of Dexia, the cap on guaranteed outstanding was lowered from €150 billion to €100 billion and the maturity of new long-term debts issued under the revised guarantee framework was extended to a maximum of four years.

29. **Given the cross-border orientation of Belgian banks, the authorities should continue to strongly support enhanced international cooperation in regulatory reform and coordination of exit policies.** Belgium should play an important role in implementing the new European financial stability arrangements based on the recommendation of the de Larosière group.[11] In addition, there is a need to enhance information flows among national supervisors and create a body that could settle potential conflicts arising from home-host supervision issues and the complex nature of cross-border banking. International coordination of financial sector exit strategies is needed to avoid destabilizing financial flows, particularly as regards liquidity support, the maximum coverage of deposit insurance and bank/asset guarantees across the European Union.

IV. Restoring Fiscal Sustainability is a Priority

30. **The economic and financial crisis and the necessary public interventions have led to a significant deterioration in the public finances.** The cost of letting the automatic stabilizers operate freely, the fiscal stimulus plan, and shoring up the financial sector have significantly worsened the overall fiscal situation. The overall deficit jumped to about 6 percent of GDP in 2009 from 1.2 percent in 2008, and the public debt rose to close to 100 percent of GDP in 2009. The crisis has undone the gradual debt reduction achieved during the last decade and has further hampered the planned pre-funding of the impending rise in aging-related public expenditures. High debt raises the risk of sizeable increases in interest expenditures, especially once interest rates increase from their currently subdued levels or as markets begin to reassess sovereign risks in the Euro area.

31. **Recognizing the risk of unsustainable public debt dynamics, the government has announced an appropriate fiscal consolidation strategy that aims to achieve a balanced budget by 2015,** in order to start reducing debt after 2011. The associated deficit objectives and burden sharing path that was adopted by the government in the fall of 2009 had to be further strengthened to reflect the recent ECOFIN Council recommendation to bring Belgium's overall deficit below the 3 percent Stability and Growth Pact (SGP) threshold already in 2012. On this basis, the authorities have prepared a new Stability Program for the period 2009-12.

A. Fiscal Outlook and Economic Stimulus

32. **The 2010 budget strikes the right balance between initiating the much-needed fiscal consolidation and supporting the recovery.** The budget is based on the

[11] See http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf. The new European supervisory institutions comprise : (i) the European Stability Risk Board, linked to the ECB, to bridge micro- and macro-prudential oversight; and (ii) the European System of Financial Supervisors to oversee the work of national supervisors.

intergovernmental burden-sharing agreement for 2009-10 and the first multi-year fiscal framework covering 2010-11, both welcome first steps in the consolidation strategy. The 2010 budgets at every level of government aim at streamlining spending and boosting revenue in order to reduce the overall deficit to 5.1 percent of GDP (the new Stability Program for 2009-12 aims at a deficit of 4.8 percent of GDP in 2010). The total fiscal effort of about ¾ percent of GDP reflects the burden-sharing agreement allocating 65 percent of the adjustment effort to the federal government and social security, and 35 percent to the regions, linguistic communities, and local governments.

33. **In view of the signs of an incipient economic recovery and the strong need for medium-term fiscal consolidation, most of the fiscal stimulus measures should be reversed after 2010.** In line with other European Union countries, the Belgian authorities reacted to the crisis by adopting a stimulus package for 2009-10.[12] The size of the stimulus package is broadly appropriate given the large negative output gap and the limited fiscal space in Belgium, but its composition raises concerns as some measures are neither temporary nor targeted.[13] While the reduction in the (very high) tax wedge on labor is a welcome measure, it is important to reverse all other measures that entail a permanent increase in expenditure or revenue losses.

B. Challenges of a Credible Medium-Term Fiscal Adjustment

34. **The government's medium-term consolidation strategy should be enhanced by a more formal institutional framework.** Recent experience indicates that structural deficit reductions are challenging to implement in Belgium. Key factors in this regard are the lack of adequate incentives to keep real spending increases in line with trend economic growth and the off-loading on the federal government of revenue shortfalls, higher social security outlays, and some spending decided at regional and local government levels. The current approach identifies the necessary structural fiscal efforts of at least 0.75 percent of GDP that are required every year to achieve the balanced budget target by 2015. However, especially for the period beyond 2012, it does not articulate the measures or mechanism to help ensure the credibility of this commitment.

35. **Moreover, pressing aging-related costs cannot be ignored any longer.** For the period until 2014 it is estimated that the fiscal costs of aging will increase by more than

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[12] The fiscal stimulus package of about ½ percent of GDP in 2009-10 came in addition to income support measures of ½ percent of GDP already in the 2009 budget. These discretionary measures have to be added to the impact of the automatic stabilizers which is estimated at around 2½ percent of GDP in 2009 and ¾ percent of GDP in 2010.

[13] The Belgian stimulus included measures providing liquidity support to corporations, higher unemployment benefits, a lower VAT rate for restaurants, "green economy" measures, accelerating public investment, and support to the construction sector.

3 percent of GDP. The need for front-loaded fiscal tightening for intergenerational equity purposes is largely accepted by the public and the authorities alike but the necessary adjustment has been continuously postponed. The 2009 Sustainability Report of the European Commission concludes that aging-induced structural adjustment in Belgium should be at least 0.6 percent of GDP per year as opposed to the loosening fiscal stance over the recent years.

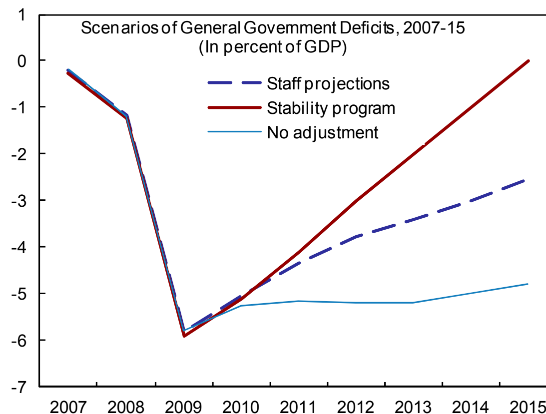
Belgium: Projections of the Fiscal Costs of Aging, 2008–60

(In percent of GDP)

	2008	2014	2030	2060
Pension	9.1	10.3	13.3	14.4
Health care	7.3	8.6	9.5	11.5
Other social spending	6.8	7.5	6.2	5.4
Total social spending	23.2	26.4	29.0	31.3

Source: High Finance Council's Study Committee on Aging 2009 Report.

36. **The new Belgian Stability Program for 2009-12 represents a significant effort in the right direction.** The Program is based on the intergovernmental burden-sharing agreement for 2009-10 and the planned agreement for 2011-12. It builds on the deficit reduction targeted for 2010, and aims to reduce the overall deficit to 3 percent of GDP by 2012. The consolidation strategy contains a balanced package of revenue measures, steps to discourage the use of early retirement schemes in the private sector, and measures to strengthen fiscal responsibility at the regional and local levels. Any better-than-expected fiscal performance at every level of government is to be directed towards debt reduction over the coming years. However, part of the sharp consolidation results from rather optimistic macroeconomic and revenue assumptions for 2011-12. Under more realistic assumptions, additional fiscal efforts starting in 2011 will be needed to achieve the deficit targets.



Sources: Belgian authorities; and IMF staff projections.

37. **In view of the need to credibly commit to medium-term fiscal consolidation amid considerable political uncertainty, the adoption of a rule-based framework would help cement and reinforce the planned consolidation efforts.** Under current fiscal federalism arrangements the federal government is responsible for servicing most of the general government debt while controlling only a fraction of general government revenue and spending. In order to address the large existing imbalances it will be important to build on the existing burden sharing agreements by framing them into a more credible multi-year fiscal framework rather than having to resort to periodic renegotiations. Since a very sizeable adjustment is needed to bring the public debt back to sustainable levels, the need to reach a new consensus on deficit objectives anytime the fiscal situation deteriorates is very costly and severely limits the potential scope of consolidation. Often, the consolidation objectives are delayed, as was the case with the intergovernmental agreement for 2009-10 that was signed on December 15, 2009, and based on already voted budgetary objectives of each level of government. The agreement, while an important and welcome step, is still insufficient to ensure deficit reduction efforts beyond 2010.

38. **Staff recommends introducing a cap on total expenditure growth for each level of government and the social security administration while also considering additional revenue measures.** Overall spending limits could be set on a multi-annual basis and translated into expenditure growth caps for each level of government. The implementation could come either under a reinforced multi-year budgetary framework or evolve into a fiscal rule, and should in both cases be based on realistic macroeconomic assumptions. Analytical Note 3 compares the Swiss debt-brake rule to the recently adopted German fiscal rule and discusses the applicability of this type of rule to Belgium. In view of the considerable growth in healthcare spending and pensions expected in the coming years, it is important to take measures to increase the effective retirement age and to reduce healthcare costs.[14] At the same time, regional governments should tighten their fiscal control over local governments by strictly enforcing the existing golden rule and by ensuring the feasibility of the local investment programs. Revenue measures should focus on broadening the tax base and improving revenue collection. Significant gains can also be achieved by streamlining the existing large number of tax expenditures.

39. **The government has expressed its support for continuing to implement part of the fiscal consolidation by taking advantage of the age structure of the civil service**, but no specific decisions have been taken thus far. Over the next 10 years, about a third of the public servants are scheduled to retire. The table below analyzes potential savings from indicative scenarios of non-replacing every second or every fourth retiring public sector employee. Depending on the scope of adjustment considered appropriate, each scenario will

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[14] The effective retirement age at less than 60 years is much below the standard statutory retirement age of 65 years while the growth norm for real health care spending of 4½ percent far exceeds trend economic growth.

have to be matched to the desired level of efficiency of the public services. At the same time, the efficiency of public services in Belgium can be significantly improved, especially at sub-national levels of government.[15]

Belgium: Projections of Civil Servants Retirement, 2010-20

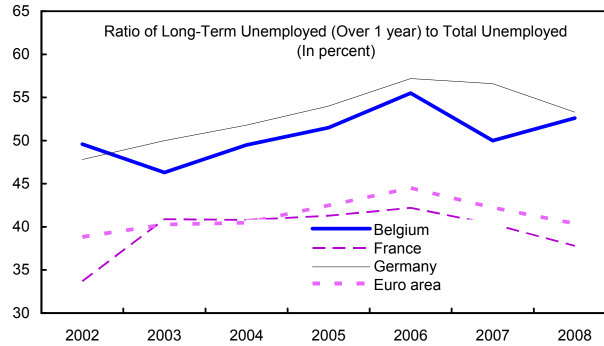
	Expected Number of Retirees, 2010-20	Estimated Saving from Non-Replacement of 50 Percent	Estimated Saving from Non-Replacement of 25 Percent
	(In persons)	(In percent of 2009 GDP)	
Type of government			
Federal	31,850	0.10	0.05
Flemish	12.731	0.04	0.02
Waloon	7,322	0.02	0.01
Brussels	1,756	0.00	0.00
Local	143,144	0.48	0.24
Total	196,803	0.64	0.32

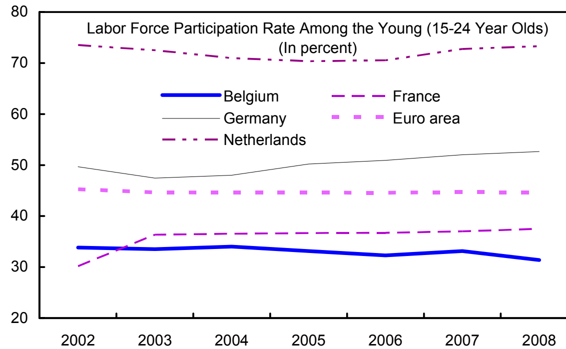
Sources: ITINERA Institute (2009); and IMF staff calculations.

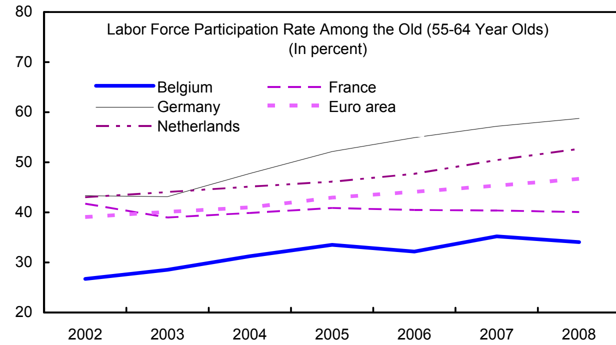
V. Structural Reforms: Restoring Potential Growth

40. **Pushing ahead with structural reforms in the labor and product markets is important to restore growth in the aftermath of the recession.** The adverse effect of the crisis on potential output compounds the negative impact of demographic factors. In this context, further labor and product market reforms are especially urgent, as they can help prevent a rise in structural unemployment and limit productivity losses. Now that the worst of the recession seems to have passed, the time is ripe for ambitious action on the structural front that would support the budding recovery, strengthen competitiveness, and durably improve living standards.

[15] See 2009 OECD Economic Survey of Belgium.







Source: OECD, and IMF staff estimates.

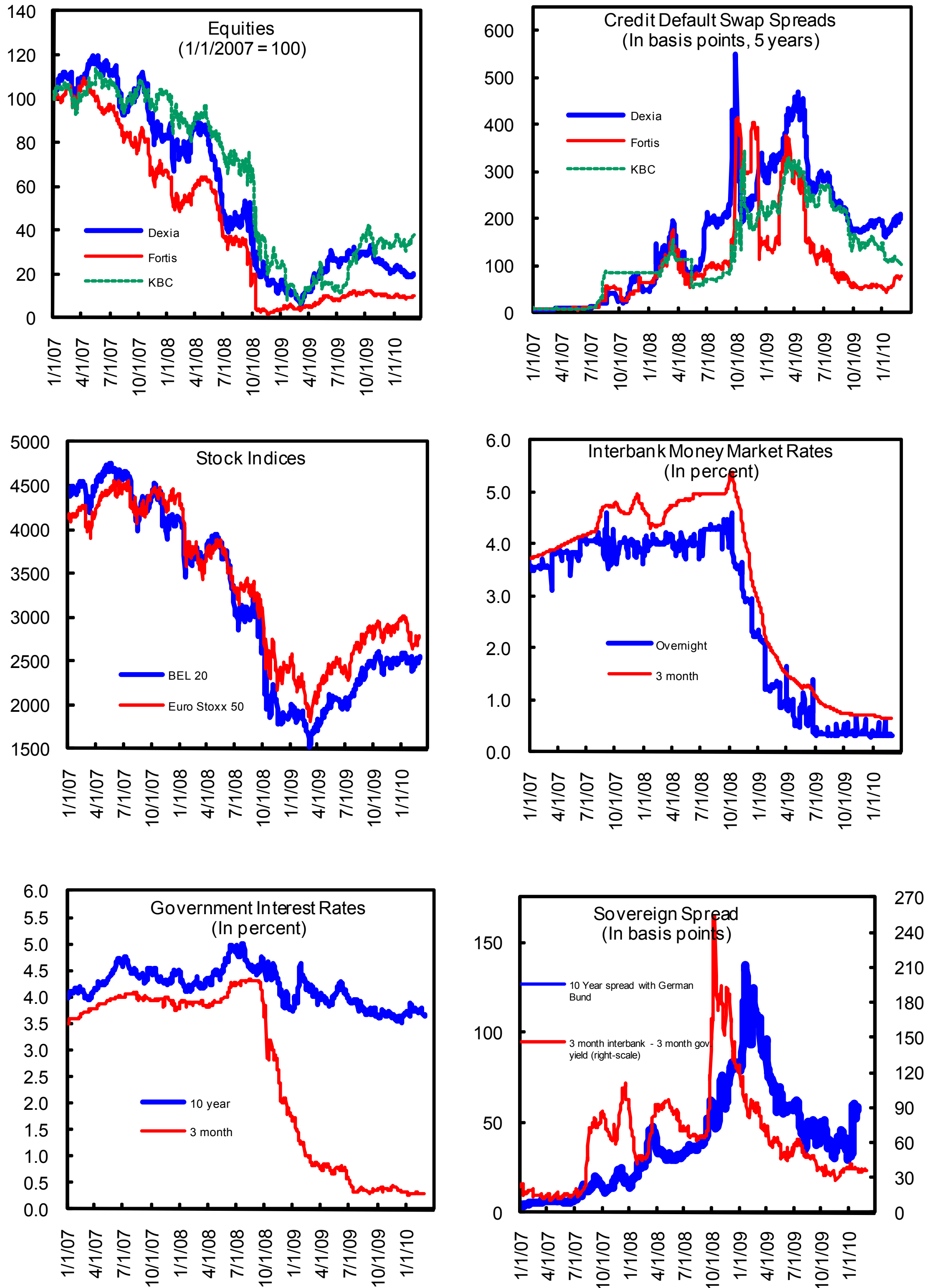
41. **Further labor market reforms are essential for increasing the labor supply and potential output, as well as for supporting job creation during the recovery.** The low employment rate in Belgium reflects in large part a high share of the long-term unemployed and a low rate of labor force participation, notably for both younger and older workers. Lifting the Belgian employment rate (currently at 61.5 percent of the working-age population) to the Euro area average (65 percent) by reducing long-term unemployment and raising labor force participation could increase potential output growth by about ½ percent per year, on average, over the next five years. In this regard, and in broad agreement with the authorities, staff recommends to focus on the following reform priorities:

- ***Support re-absorption of the unemployed.*** With a further rise in cyclical unemployment expected in 2010, the extension of the temporary unemployment programs until the middle of the year is welcome. However, to avoid lasting damage to employment incentives, such programs need to be phased out once the recovery takes hold. At the same time, active labor market policies need to be stepped up, while efforts to reduce the long-standing rigidities stemming from distortionary labor taxes need to be continued. Further action is needed to enhance monitoring of job search activities, apply penalties for refusal of suitable jobs, and increase job counseling and training opportunities. In addition, limiting the level of unemployment benefits over time or their duration would be effective in strengthening incentives for job search.

- ***Improve labor market participation.*** To counter demographic pressures on potential output and promote the creation of new jobs in the economy, labor market participation needs to be increased for both older and younger workers. This would involve raising the effective retirement age by further limiting pathways into early retirement, as well as extending activation programs to older workers. In this regard, the system spelled out in the Stability Program 2009-12 that links the pre-pension age with the benefits payable by employers is a step in the right direction. For younger workers, this calls for reconsidering employment protection legislation, including for workers on temporary contracts. For both groups, expanding job counseling and training opportunities would help ease their way into the labor force.

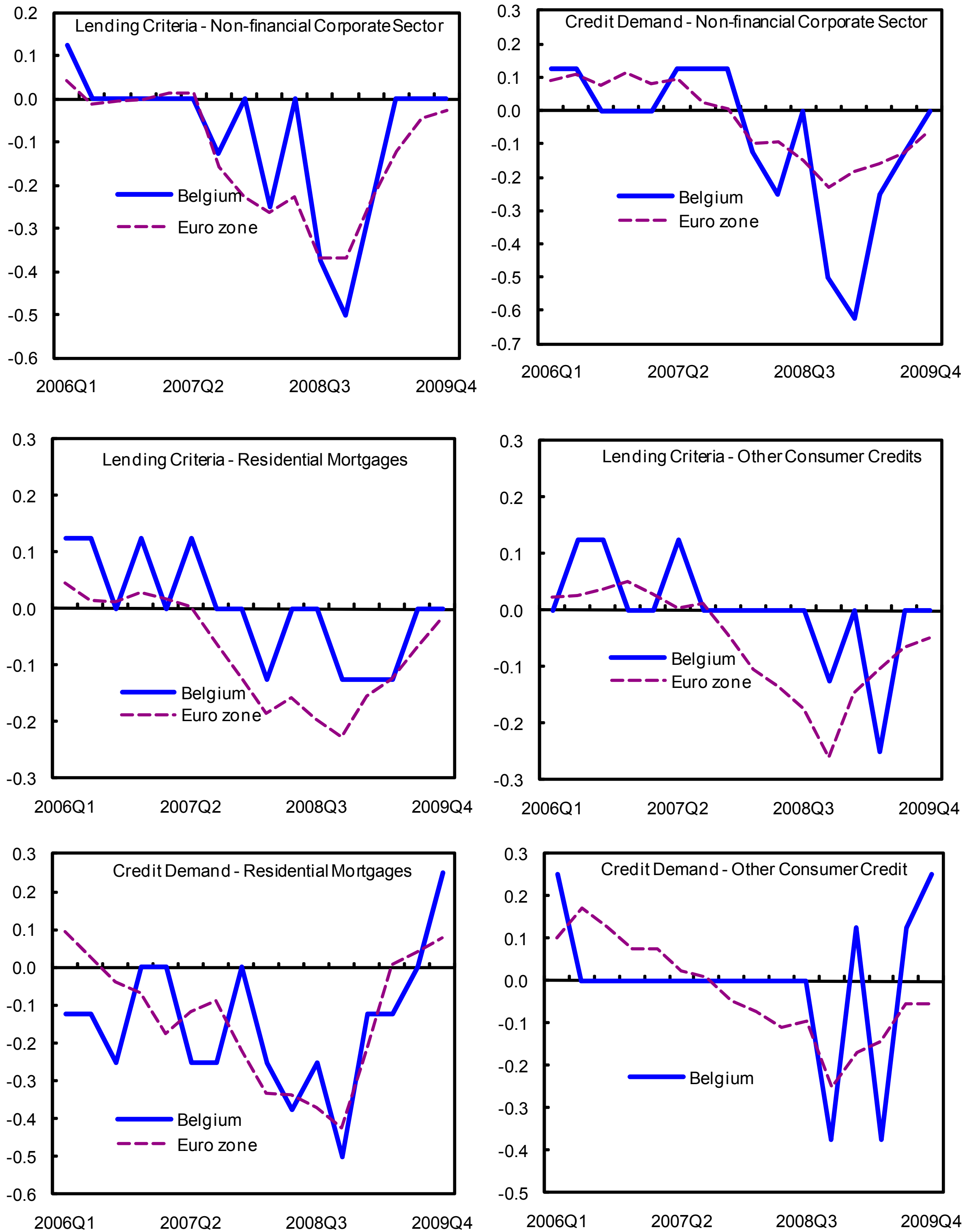
42. **Further product market reforms are key to facilitate the necessary post-crisis restructuring and to raise productivity and potential output over the medium term.** Staff recommends further strengthening the independence of the Competition Authority and ensuring that it is provided with adequate resources. The Competition Authority should be able to conduct independent sectoral analyses and issue specific recommendations regarding policy changes that could improve competition. At the same time, the role of sectoral regulators needs to be clearly defined and effective cooperation among the regulators needs to be established. In the service sector, the EU Services Directive provides an opportunity for further liberalization that should be fully seized.

Figure 1. Belgium: Financial Indicators



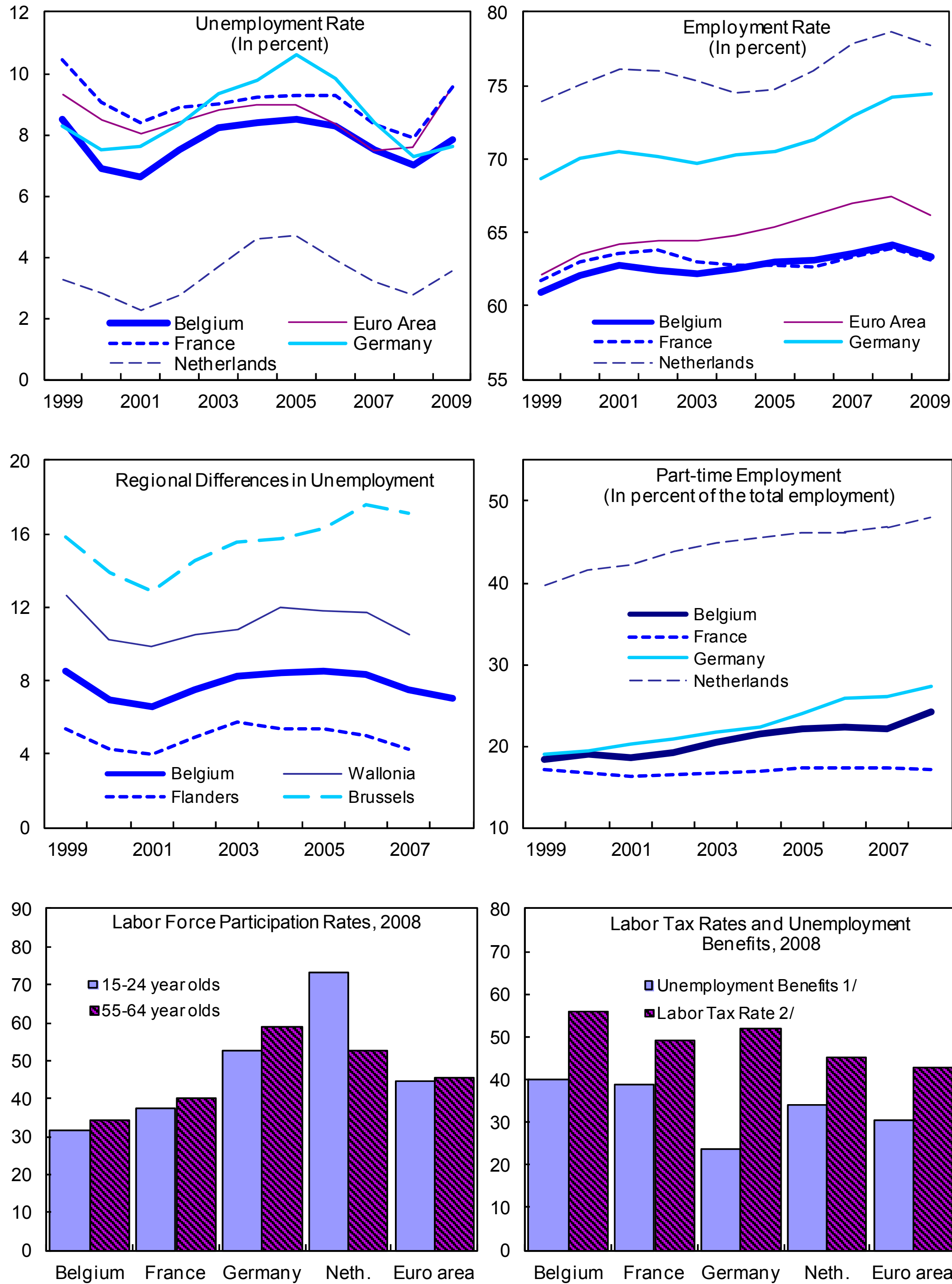
Source: Thomson Financial/DataStream and Bloomberg.

Figure 2. Belgium: Bank Lending Survey 1/



Source: National Bank of Belgium.
1/ Data above the zero line are looser conditions and below the zero line are tighter

Figure 3. Belgium: Labor Market Indicators



Sources: Belgian authorities; Global Insight; OECD; and IMF, WEO.

1/ Unemployment benefits are measured in percent of previous earnings. Data are for 2007.
2/ Labor taxes are for a single person without children, at 100 percent of the average wage, measured in percent of labor costs.

Table 1. Belgium: Selected Economic Indicators 2005-14

					Prel.	Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	(Percentage change from the previous period; unless otherwise indicated)										
Real economy											
Real GDP	2.0	2.8	2.8	0.8	-3.0	1.2	1.3	1.6	1.7	1.8	1.9
Private consumption	1.2	1.8	1.6	1.0	-1.7	0.6	0.9	1.0	1.0	1.3	1.7
Public consumption	1.2	1.0	2.6	3.3	1.7	0.8	0.7	1.0	1.0	1.0	1.0
Gross fixed investment	7.7	2.7	5.7	3.8	-4.2	-2.5	-0.2	0.5	0.7	0.9	1.0
Business investment	5.5	4.5	8.7	6.1	-6.1	-3.1	-0.3	0.5	0.8	1.0	1.2
Dwellings	10.9	3.4	-0.8	-1.6	-2.9	-2.5	-0.4	0.2	0.2	0.4	0.4
Public investment	15.8	-12.4	3.6	3.4	7.7	2.8	1.3	1.5	1.5	1.5	1.5
Stockbuilding 1/	0.3	0.6	0.2	-0.2	-1.1	0.1	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-1.0	0.4	0.2	-1.0	0.0	0.7	0.8	0.8	0.8	0.8	0.6
Exports, goods and services	4.8	5.0	4.4	1.4	-9.2	4.9	4.5	5.2	5.3	5.3	5.7
Imports, goods and services	6.5	4.7	4.4	2.7	-9.5	4.2	3.8	4.6	4.6	4.8	5.4
Household saving ratio (in percent)	15.0	15.8	16.2	16.6	19.7	18.4	18.3	18.2	18.2	18.0	18.0
Potential output growth	1.7	1.8	1.9	1.3	0.9	0.8	0.9	1.1	1.2	1.4	1.5
Output gap (in percent)	0.3	1.3	2.2	1.7	-2.2	-1.9	-1.5	-1.0	-0.5	-0.1	0.3
Employment											
Unemployment rate	8.5	8.3	7.5	7.0	8.0	9.3	9.4	9.3	9.2	9.1	8.9
Employment	1.4	1.2	1.6	1.8	-0.5	-1.1	0.8	0.8	0.5	0.6	0.7
Prices											
Consumer prices	2.5	2.3	1.8	4.5	-0.2	1.6	1.5	1.5	1.6	1.7	1.7
GDP deflator	2.4	2.2	2.2	1.9	1.2	1.3	1.7	1.8	1.9	1.9	1.9
ULC (in whole economy)	1.3	1.9	2.3	4.1	4.2	-1.1	1.2	1.5	1.6	1.7	1.7
	(In percent of GDP; unless otherwise indicated)										
Public finance											
Revenue	49.4	48.7	48.2	48.8	48.0	48.7	49.3	49.6	49.6	49.6	49.6
Expenditure	52.1	48.5	48.4	50.0	53.8	53.8	53.6	53.4	53.0	52.6	52.2
General government balance	-2.7	0.3	-0.2	-1.2	-5.8	-5.1	-4.4	-3.8	-3.4	-3.0	-2.6
Structural balance	-1.0	-1.4	-1.4	-2.2	-4.9	-4.3	-3.5	-3.2	-3.0	-2.8	-2.6
Primary balance	1.5	4.2	3.6	2.6	-2.1	-1.2	-0.4	0.2	0.7	1.1	1.6
General government debt	92.1	88.1	84.2	89.8	97.3	100.1	101.5	101.9	101.7	101.0	99.8
Balance of payments											
Trade balance	1.6	0.8	0.7	-3.0	-2.8	-2.9	-2.6	-2.2	-1.8	-1.4	-0.7
Current account	2.6	2.0	2.2	-2.5	-0.3	-0.5	-0.1	0.4	1.1	1.6	2.2
Terms of Trade (percent change)	-0.2	-1.4	-0.1	-1.4	2.0	-0.9	-0.3	-0.1	0.1	0.0	1.4
Exports, goods and services (volume, percent change)	4.8	5.0	4.4	1.4	-9.2	4.9	4.5	5.2	5.3	5.3	5.7
Imports, goods and services (volume, percent change)	6.5	4.7	4.4	2.7	-9.5	4.2	3.8	4.6	4.6	4.8	5.4

Sources: Data provided by the Belgian authorities, and IMF staff projections.
1/ Contribution to GDP growth.

Table 2. Belgium: High-Frequency Financial Indicators

	1/18/10 Level	Change since:			
		1/15/10	1/11/10	12/18/09	1/19/09
Financial institution equity prices 1/					
Dexia	4.73	-0.2	-5.0	10.7	85.6
Fortis	2.68	-0.9	-5.5	4.9	102.6
KBC	33.75	-0.3	-5.0	13.2	164.1
Credit default swap spreads 2/					
Dexia	168.7	-0.7	9.2	-28.4	-152.5
Fortis	48.7	1.1	5.0	-10.0	-84.4
KBC	107.2	-2.7	-7.7	-27.6	-107.8
Stock indices 3/					
BEL 20	2,553	0.6	-1.3	4.1	38.7
Euro stoxx 50	2,958	0.6	-1.7	3.0	31.3
Interbank interest rates 4/					
Overnight	0.3	3.8	-2.4	-4.4	-84.5
3-month	0.7	-0.4	-1.7	-4.6	-71.9
Government interest rates 4/					
3-month	0.3	0.0	11.1	-11.8	-79.2
10-year	3.8	-0.4	4.8	8.1	-8.1
Money market risk spread 5/	37.7	38.0	41.9	37.0	97.0

Sources: Bloomberg; Datastream.
1/ Euros; change in percentage points.
2/ Basis points, 5 Yr CDS.
3/ Index; change in percentage points.
4/ Percent; change in percentage points.
5/ Basis points; 3-month interbank rate minus 3-month Treasury Bill.

Table 3. Belgium: Fiscal Scenarios, 2005-15

(In percent of GDP, unadjusted for working days; unless otherwise indicated)

					Prel.	Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Staff Projections (A)											
Revenue	49.4	48.7	48.2	48.8	48.0	48.7	49.3	49.6	49.6	49.6	49.6
Expenditure	52.1	48.5	48.4	50.0	53.8	53.8	53.6	53.4	53.0	52.6	52.2
Primary expenditure	47.9	44.6	44.5	46.2	50.1	49.9	49.7	49.4	49.0	48.5	48.1
Interest payments	4.2	3.9	3.8	3.8	3.7	3.8	3.9	4.0	4.1	4.1	4.1
Balance	-2.7	0.3	-0.2	-1.2	-5.8	-5.1	-4.4	-3.8	-3.4	-3.0	-2.6
Structural balance 1/	-1.0	-1.4	-1.4	-2.2	-4.8	-4.3	-3.4	-3.1	-3.0	-2.8	-2.6
Primary balance	1.5	4.2	3.6	2.6	-2.1	-1.2	-0.4	0.2	0.7	1.1	1.6
Structural primary balance 1/	3.2	2.6	2.4	1.6	-1.1	-0.4	0.5	0.9	1.1	1.3	1.6
Debt 1/	92.1	88.1	84.2	89.8	97.3	100.1	101.5	101.9	101.7	101.0	99.8
Memorandum items (in percent):											
Real primary expenditure growth 2/	9.1	-4.4	2.9	4.8	5.0	0.8	0.9	0.9	0.9	0.9	0.9
Real discretionary spending growth 2/	5.0	0.7	3.7	4.1	4.2	-0.9	0.1	-0.5	-0.6	-0.6	-0.7
Output gap	0.3	1.3	2.2	1.7	-2.2	-1.9	-1.5	-1.0	-0.5	-0.1	0.3
GDP growth	2.0	2.8	2.8	0.8	-3.0	1.2	1.3	1.6	1.7	1.8	1.9
Authorities Scenario (B)											
Revenue	49.4	48.7	48.2	48.8	47.7	49.1	49.5	49.8	…	…	…
Expenditure	52.1	48.5	48.4	50.0	53.7	53.9	53.6	52.8	…	…	…
Primary expenditure	47.9	44.6	44.5	46.2	50.1	50.2	49.9	49.0	…	…	…
Interest payments	4.2	3.9	3.8	3.8	3.6	3.7	3.7	3.8	…	…	…
Balance	-2.7	0.3	-0.2	-1.2	-5.9	-4.8	-4.1	-3.0	-2.0	-1.0	0.0
Structural balance 2/	-1.0	-1.4	-1.4	-2.2	-3.7	-3.3	-2.7	-2.0	…	…	…
Primary balance	1.5	4.2	3.6	2.6	-2.4	-1.1	-0.4	0.8	…	…	…
Structural primary balance	3.2	2.6	2.4	1.6	-0.1	0.4	1.0	1.8	…	…	…
Debt 2/	92.1	88.1	84.2	89.8	97.9	100.6	101.4	100.6	…	…	…
Memorandum items (in percent):											
Real primary expenditure growth	9.3	-4.6	3.0	5.6	4.1	1.3	1.1	0.3	…	…	…
Output gap 2/	0.4	1.4	2.4	1.7	-2.5	…	…	…	…	…	…
GDP growth	1.8	2.8	2.9	1.0	-3.1	1.1	1.7	2.2	2.1	2.2	2.1

Sources: IMF staff projections; Belgian Stability Programme 2009-12; data provided by authorities.

1/ Excludes one-off measures including the restructuring of the national railway company in 2005 and part of the fiscal stimulus 2009.

2/ Source: High Finance Council, 2010.

Table 4. Belgium: Financial Soundness Indicators of the Banking Sector, 2003-09 1/
(In percent)

	2003	2004	2005	2006	2007	2008	2009 2/
	Belgian GAAP			**IFRS**			
Earnings and profitability							
Return on assets	0.4	0.5	0.5	0.7	0.4	-1.3	-0.3
Return on equity	13.6	15.8	18.5	22.4	13.2	-36.5	-8.9
Net interest income to total income	56.4	56.3	53.5	47.9	50.3	75.0	90.9
Interest margin	1.1	1.0	0.9	1.0	1.1	1.0	1.1
Average yield on assets	3.71	3.46	3.62	4.6	5.3	5.0	3.1
Average cost of funding	2.58	2.42	2.68	3.6	4.2	4.0	1.9
Noninterest income to gross income	43.6	43.7	46.5	52.1	49.5	24.9	9.1
Of which: Net fee and commission income	24.4	25.5	25.9	25.1	27.9	35.1	35.2
(Un)realised capital gains booked in P&L	10.1	8.9	8.2	14.6	14.3	-19.9	-27.6
Cost/income ratio	73.9	72.0	72.6	55.7	61.1	86.1	90.6
Structure assets							
Total assets (in percent of GDP)	376.2	395.4	453.5	421.1	456.2	398.9	347.3
Of which (in percent of total assets)							
Loans to credit institutions 3/	20.0	18.6	20.3	20.1	20.3	15.0	13.8
Debt securities 3/	27.4	25.5	23.4	22.5	18.8	21.0	21.2
Equity instruments 3/	1.7	2.7	3.5	3.6	3.3	1.1	1.1
Derivatives 3/	0.0	0.0	0.0	4.5	7.6	15.7	12.4
Loans to customers 3/	41.5	42.2	43.2	41.6	42.2	39.1	44.1
Of which: Belgian residents (in percent of loans)	52	49	42	43	43	53	57
Other EMU residents (in percent of loans)	23	23	26	29	30	20	19
Rest of the World (in percent of loans)	25	29	33	28	27	28	25
Mortgage loans (in billion euro)	117	132	155	190	208	132	152
Consumer loans (in billion euro)	14	13	14	15	17	17	18
Term loans (in percent of loans)	53.7	53.5	54.8	46.1	40.1	47.8	47.1
Reverse repo operations	...	...	...	41.0	37.8	21.9	17.9
Funding and liquidity (in percent of total assets)							
Debts to credit institutions	24.9	24.6	30.1	29.2	27.4	19.4	18.7
Bank bonds and other debt securities	11.2	10.0	8.7	11.2	11.3	8.7	10.2
Customer deposits	40.3	39.9	36.7	39.1	37.9	40.2	43.2
Of which: Sight deposits 3/	13.7	13.4	13.5	11.1	11.8	10.9	13.3
Saving deposits 3/	12.9	13.2	11.6	10.2	8.5	9.2	12.0
Term deposits 3/	12.5	12.1	10.6	10.6	11.5	11.7	10.0
Retail deposits	...	...	...	20.4	17.8	18.2	21.8
Repo's	...	...	...	13.5	11.7	14.8	13.8
Liquid assets 4/	33	33	31	19	16	14	...
Asset quality							
Sectoral distribution of loans							
Credit institutions	...	...	...	20.1	20.3	15.0	13.8
Corporate	...	...	...	18.3	19.9	20.5	20.9
Retail	...	...	...	18.3	17.5	14.6	19.0
Central governments	...	...	...	0.8	1.0	0.9	1.1
Non-credit institutions	...	...	...	4.1	3.8	3.1	3.0
Non-performing loans (NPL) as percent of gross loans 5/	2.6	2.3	2.0	1.7	1.1	1.7	2.1
Provisions + writeoffs as percent of NPL 5/	53	54	52	51	48	67	57
Capital adequacy							
Regulatory capital to risk-weighted assets	12.8	13.0	11.5	11.9	11.2	16.2	16.3
Regulatory Tier I capital to risk-weighted assets	8.8	9.4	8.5	8.7	12.1	11.3	12.7
Capital to assets	3.1	3.1	2.7	3.3	4.1	3.3	4.0
NPL net of provisions as percent of Tier I capital 5/	15.7	12.8	13.8	10.9	9.2	6.5	10.3
Large exposures as percent of Tier I capital 5/	46.0	40.0	42.5	36.2	...	...	...
Net open position in foreign exchange to capital	7.0	5.3	5.8	6.4	...	...	...

Sources: CBFA and NBB.

1/ Consolidated data. Since 2006, the data are based on the IAS/IFRS reporting Scheme.

2/ Data for the first 6 months of 2009. The flow data are annualised.

3/ Deposits booked at amortised cost only.

4/ As of 2006, liquid assets include cash and debt instruments issued by central government and financial institutions.

5/ Unconsolidated data.

Table 5. Belgium: Financial Soundness Indicators of the Non-Banking Sectors, 2003-09
(In percent)

		2003	2004	2005	2006	2007	2008	2009 2/
Insurance sector 1/								
Solvency ratio		248.4	250.7	258.8	252.6	222.6	223.3	229.9
Profitability 3/								
	Return on equity (percent, annualised)	7.8	18.9	24.3	21.3	28.6	-24.9	5.6
Life	Premiums (billions of euros)	17.6	20.0	25.2	20.4	21.9	19.5	6.8
	Technical result/premiums (percent)	2.7	4.0	4.7	4.9	4.4	-18.8	4.4
Non-life	Premiums (billions of euros)	9.1	9.6	8.9	9.3	9.3	9.7	6.8
	Combined ratio (percent)	102.1	99.6	104.3	101.7	102.1	100.2	101.2
	Technical result/premiums (percent)	8.8	12.8	12.0	12.7	13.8	1.8	9.4
Corporate sector								
Total debt as a percentage of equity		78.2	62.7	65.6	60.5	59.9	59.9	...
Profitability (return on equity)		12.9	10.3	10.8	9.6	9.8	11.4	...
Debt service coverage ratio		195.6	185.9	194.5	152.5	162.8	278.2	...
Household sector 4/								
Debt (percent of GDP)		40.1	40.7	43.1	45.9	47.8	50.3	53.0
Interest burden (percent disp. income)		1.5	1.1	1.6	2.1	2.9	3.0	2.8
Financial savings ratio (percent of GDP)		4.9	3.5	4.3	3.5	2.0	2.2	9.1
Savings rate		16.7	15.4	15.0	15.8	16.2	16.6	19.7
Real estate sector 4/								
House price inflation								
Houses		7.9	3.9	16.1	12.3	9.9	4.5	-2.2
Apartments		8.9	14.6	14.6	11.3	7.4	3.5	0.2
Mortgage loans as percent of total loans		27.6	27.4	26.2	34.0	32.7	24.3	27.5
Of which: domestic households		15.6	15.5	14.5	17.6	16.5	14.7	12.7
Variable rate mortgages (percent of total new loans)		25.9	53.3	36.3	7.4	1.2	2.9	20.9

Source: NBB, Stadim, UPC.
1/ Unconsolidated data.
2/ Provisional data for first 9 months of 2009, unless mentioned otherwise.
3/ Provisional 2009 figure for first 9 months (annualised).
4/ 2009 data are for the first half of the year.

ANALYTICAL NOTE 1: THE EFFECT OF THE CRISIS ON POTENTIAL OUTPUT IN BELGIUM[1]

1. **Measuring potential output is difficult even when the economic environment is fairly stable, and it is especially challenging in times of crises.** Potential output is usually understood as the productive capacity of an economy, or the highest level of output that can be attained without inflationary pressures. As such, it is of importance for both monetary and fiscal policy makers, with implications for the sustainability of public finances, especially in a country like Belgium. Alas, potential output is not directly observable and its estimates are never precise, with uncertainty rising tremendously in times of crises.

2. **The current crisis is likely to have a large negative effect on potential output through several channels, although some positive effects are also possible.** Potential output can be viewed as a product of potential, or "normal," labor input (often defined in terms of hours) and "normal" labor productivity. The effects on labor arise as a result of: (i) growth in structural unemployment caused by crisis-related dislocations and the damage to human capital from prolonged unemployment; (ii) declines in labor force participation, because unemployment tends to discourage some workers from seeking jobs; and (iii) increases in labor force participation, in particular of second-income earners, in response to income and wealth losses. Turning to the effects on labor productivity, these may arise due to: (i) reductions in capital-labor ratios reflecting slower capital accumulation as a result of investment declines and obsolescence of parts of the pre-crisis capital stock; (ii) a deterioration in total factor productivity associated with crisis-related dislocations and impaired funding systems—including for efficiency-enhancing innovation—that can slow resource reallocation; and (iii) an improvement in total factor productivity driven by expulsion of inefficient activities and increased incentives for restructuring prompted by the crisis.

3. **The effects of the crisis on potential output can be exacerbated or mitigated by domestic policy measures and by external developments.** In particular, failures to reverse short-term crisis-related measures, such as unemployment support programs, as well as a crisis-related rise in the recourse to early retirement could further depress potential output. Conversely, certain fiscal stimulus measures—such as infrastructure investment—and additional structural reform efforts spurred by the crisis are likely to have lasting positive effects on potential output. At the same time, an accelerated build-up of public debt could be a serious drag on potential output, because of the possible upward pressure on interest rates and the higher tax burdens going forward. Finally, external developments—changes in potential output in trading and financial partners—could have important effects on domestic potential output, especially in very open economies, such as Belgium.

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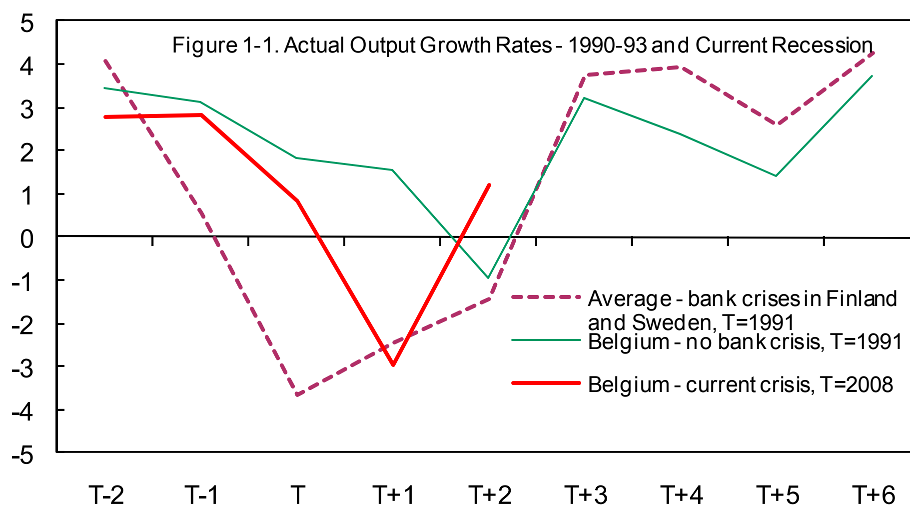
[1] This note was prepared by Irina Tytell. Comments from the Research Department of the National Bank of Belgium and the Federal Planning Bureau of Belgium are gratefully acknowledged.

4. **The common methods of estimating and forecasting potential output are not well suited to the inherently unstable crisis environment.** Potential output is typically estimated by isolating trend components in total GDP or its supply-side determinants—usually within a Cobb-Douglas production function framework—and projecting these into the future.[2] Beside the well-known issues associated with filtering, such as end-point problems and substantial revisions of recent estimates, these trend-based projections cannot adequately reflect sudden shifts in potential output that may occur in a crisis. These estimates can, however, provide helpful information about potential output dynamics in past crises, for which the end-point and revision problems are much smaller. Specifically, historical potential output estimates (based on the production function approach) can be used as a benchmark for evaluating a current crisis-driven deviation of potential output from its pre-crisis path—the approach adopted below.

5. **The dynamics of potential output during the recessions and banking crises of the early 1990s can provide a useful benchmark for potential output in Belgium.** During the early 1990s, many advanced European economies, including Belgium, simultaneously experienced recessions, making that episode somewhat similar to the ongoing global downturn. Although Belgium did not have a banking crisis at that time, the early 1990s saw major banking crises in two other European economies—Finland and Sweden—that offer a convenient proxy for Belgium. Of course, the crises are different: the current crisis in Belgium was triggered by external financial spillovers, while the crises in Finland and Sweden followed financial liberalization carried out without adequate policy adjustments.[3] Yet, the current recession in Belgium is similar in severity to the early 1990s' recessions in Finland and Sweden, on average, and markedly more severe than the concurrent Belgian recession that was not associated with a banking crisis (Figure 1-1).

[2] For a detailed survey of methods of estimating potential output, see Cotis, Elmeskov, and Mourougane (2005).

[3] For more information on the financial crises in Finland and Sweden, see Haugh, Ollivaud, and Turner (2009).



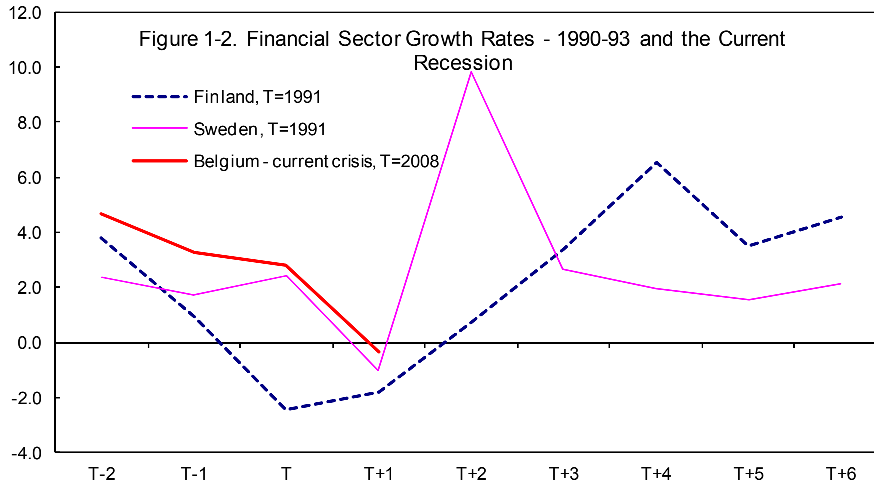
Sources: Haver Analytics; Eurostat; and IMF staff calculations.

6. **The effects of financial crises on potential output may be similar across Belgium, Finland, and Sweden, while the effect of trade developments is larger in Belgium.** The current crisis is likely to affect potential output through its long-lasting effects on the financial and the export sectors, as well as other sectors that are dependent on bank financing and/or external demand. Table 1-1 compares the importance of these sectors in Belgium with that in Finland and Sweden. It shows that although the weight of the financial sector in GDP is somewhat higher in Belgium, it is not out of line, especially when compared to Sweden. This observation supports the idea that financial sector disruptions may have broadly similar effects in these economies. That said, the share of exports in GDP in Belgium is about twice that of Finland and Sweden, hence external developments are likely to have larger effects on Belgium. Although the growth dynamics of the financial sector in Belgium are now similar to that in Finland and, especially, Sweden in the early 1990s, the recent slowdown in exports is much bigger (Figures 1-2 and 1-3).

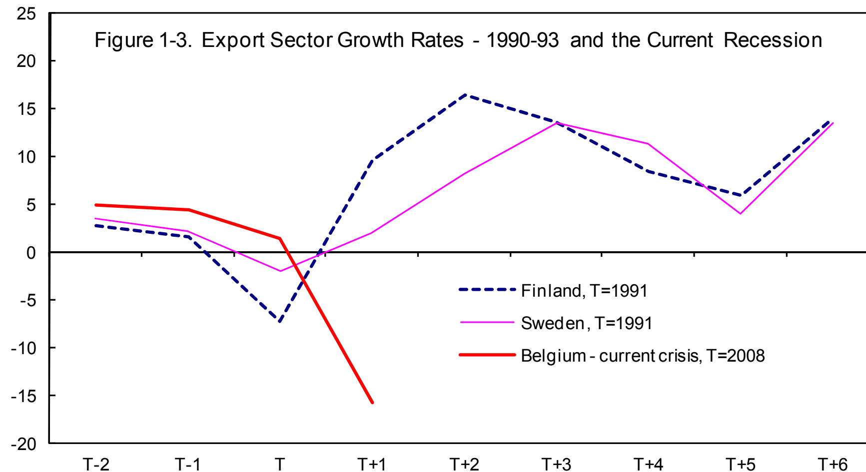
Table 1-1. A Comparison of Output Composition in Belgium to Finland and Sweden
(In percent of GDP)

	Share of Financial Intermediation and Real Estate			Share of Total Exports of Goods and Services		
	1980-1990	1997-2007	1980-2007	1980-1990	1997-2007	1980-2007
Belgium	19.9	24.9	22.6	67.5	76.4	70.8
Finland	12.3	17.5	15.1	27.3	41.1	33.6
Sweden	16.7	21.5	19.2	33.1	46.3	38.5

Sources: Haver Analytics; Eurostat; and IMF staff calculations.



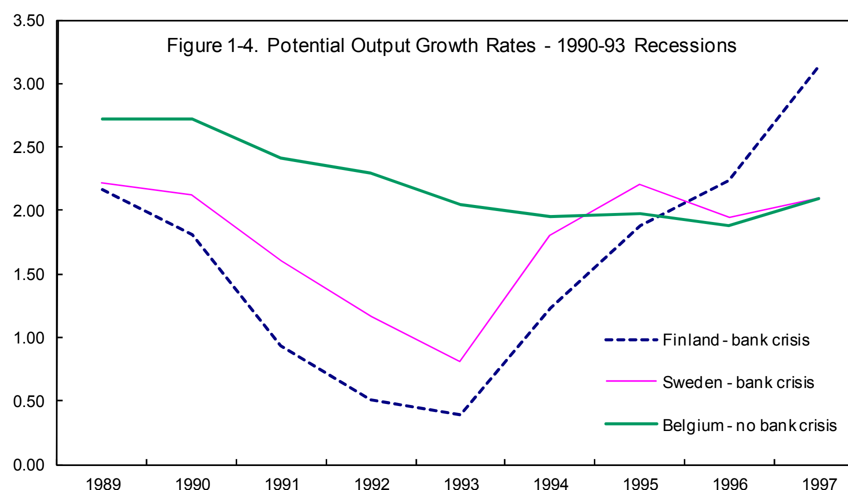
Sources: Haver Analytics; Eurostat; and IMF staff calculations.



Sources: Haver Analytics; Eurostat; and IMF staff calculations.

7. **Banking crises in Finland and Sweden were associated with large slowdowns in potential output, unlike the concurrent Belgian recession.** According to the production function estimates of the European Commission, potential growth began to decline in 1990 in all three economies, a year before the banking crises hit Finland and Sweden in 1991 (Figure 1-4). In these two latter countries potential growth fell about 1.5 percentage points below its pre-crisis rate in 1992-93, before recovering over the next three years. The fairly rapid recovery was likely associated with the relatively timely resolution of the banking crisis and successful restructuring of the manufacturing sectors. In Belgium, potential growth slowed less dramatically in the early 1990s, but remained below its pre-recession rate over the medium term. Table 1-2 shows average deviations of potential growth from the pre-crisis (1989) rates in Belgium, Finland, and Sweden over the period following the crises of 1991. The "baseline scenario" assigns the weights of ½ to Belgium and ¼ each to Finland and

Sweden, while the "alternative scenario" assigns equal weights to all three countries in the calculation of average potential growth. The "baseline scenario" generates the pattern of a more gradual slowdown and recovery in potential growth, while the "alternative scenario" produces the pattern of a deeper decline followed by a stronger rebound.[4]



Sources: European Commission; and IMF staff calculations.

Table 1-2. Benchmark Declines in Potential Growth
(In percentage points)

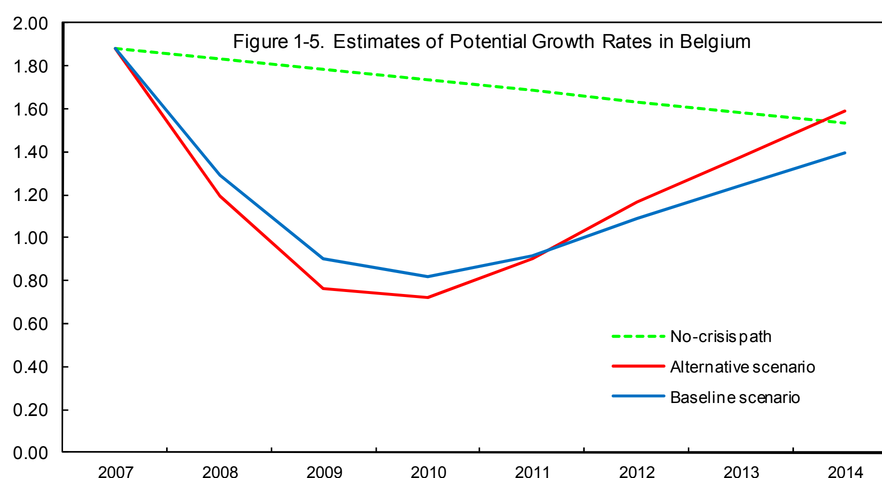
	1991	1992	1993	1994	1995	1996	1997
Baseline scenario	-0.5	-0.9	-0.9	-0.8	-0.5	-0.3	-0.1
Alternative scenario	-0.6	-1.0	-1.0	-0.8	-0.5	-0.2	0.1

Sources: European Commission; and IMF staff calculations.
Note: 1991 is crisis year; three-year moving averages.

8. **The historical benchmarks combined with the effects of demographic changes indicate that a significant slowdown in potential growth in now likely in Belgium.** Potential growth has begun to weaken prior to the current recession because of moderating migrant inflows, with ageing-related declines of the labor force expected to deepen the slowdown in the coming years. This slowdown can be approximated by a no-crisis path based on a linear interpolation of potential growth rates between the pre-crisis (2007) and post-crisis (2014) points, using the production function estimates of the European

[4] Given some uncertainty about the timing of the impact, the deviations of potential growth from its pre-crisis rates are computed using three-year moving averages.

Commission (Figure 1-5, the dashed line). Accordingly, demographic pressures—notably ageing—are expected to be responsible for a decline in potential growth in Belgium of about 0.4 percentage points between 2007 and 2014. Applying benchmark discounts based on the experiences of Belgium, Finland, and Sweden in the early 1990s to this no-crisis path yields potential growth rates shown in Figure 1-5 and Table 1-3. Overall, potential growth is expected to slow considerably from about 1.9 percent in 2007 to between 0.7 and 0.8 percent in 2010, depending on the scenario, before gradually returning to its no-crisis trend rate of 1.5 percent. These losses in potential output are broadly in line with the losses observed in OECD countries following financial crises in the post-World War II period.[5] That said, given Belgium's sensitivity to external developments, the recovery of potential growth will depend a lot on the strength of the global economy going forward.



Sources: European Commission; and IMF staff calculations.

Table 1-3. Potential Growth With and Without the Crisis Effect
(In percent)

	2008	2009	2010	2011	2012	2013	2014
No-crisis path	1.8	1.8	1.7	1.7	1.6	1.6	1.5
Baseline scenario	1.3	0.9	0.8	0.9	1.1	1.2	1.4
Alternative scenario	1.2	0.8	0.7	0.9	1.2	1.4	1.6

Sources: European Commission; and IMF staff calculations.
Note: no-crisis path based on a linear interpolation.

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[5] See Furceri and Mourougane (2009) for more information about this historical evidence.

References

Cotis J.P., J. Elmeskov, and A. Mourougane (2005), "Estimates of potential output: Benefits and pitfalls from a policy perspective," in *L. Rechling (ed) Euro area business cycle: Stylized facts and measurement issues*, CEPR London.

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ANALYTICAL NOTE 2: IMPACT OF THE FINANCIAL CRISIS ON BELGIAN BANKS, CREDIT AND RISKS[1]

This note aims at taking stock of the financial soundness of the Belgian banking sector a year after the crisis. After sizeable losses in the second half of 2008 and the first half of 2009, Belgian banks are slowly recuperating.[2] Massive public intervention has strengthened capitalization and improved access to liquidity. However, profitability remains weak due to higher cost of risks linked to deteriorating asset quality. Hence, higher capital ratios and better quality of capital are likely to be required. While a severe banking crisis may impair the sector's capacity to perform its role of financial intermediation, public support and the trend in the industry towards re-focusing on the home market could help ensure credit to the economy will not be excessively tight when the demand picks up. Section A reviews key financial soundness indicators of the Belgian banking sector and Section B discusses risks of a creditless recovery.

A. Taking Stock: Belgian Banks One Year After

Market capitalization and balance sheet developments

1. **Among European countries, Belgium was particularly severely hit by the financial crisis in 2008:Q4 and 2009:Q1 leading to substantial losses in market capitalization and to sizeable balance sheet contraction.** The financial crisis of 2008 affected simultaneously all three largest Belgian banking groups (Fortis, Dexia, and KBC). As liquidity conditions tightened in 2008:Q4, the main Belgian banks saw their share prices plummet when market participants expressed serious concerns over the banks' exposure to risky assets, business models and general solvency. In spite of massive public support, Belgian banks lost more market capitalization than peer European banks (Figure 2-1). A year after the crisis, the sector's overall balance sheet has shrunk, reflecting in part the divestment of Fortis NL during 2008:Q4 but also a general shortening of the banks' balance sheets as institutions have cut back on trading and investment banking activities and put some portfolios in run-off (Figure 2-2).

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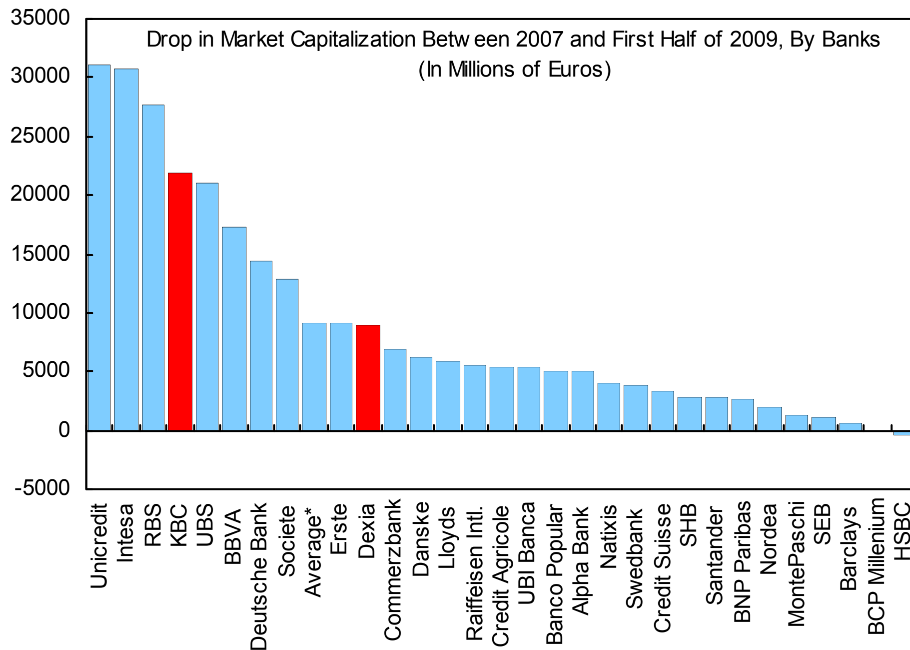
[1] This note was prepared by Boriana Yontcheva.

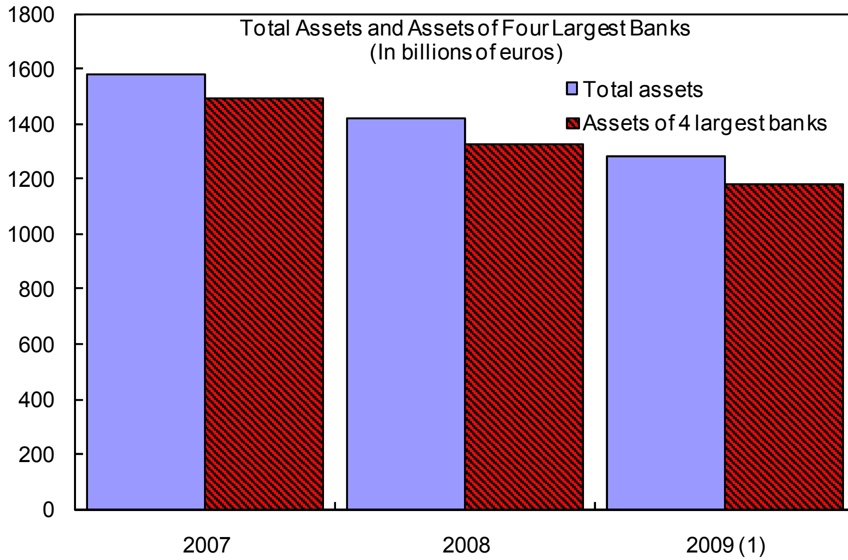
[2] The Belgian banking sector is highly concentrated with four bancassurance groups—Fortis BNP Paribas (now subsidiary of BNP Paribas), Dexia, KBC, and ING-Belgium (subsidiary of Dutch bank ING)—holding more than 80 percent of banking sector assets, deposits, and loans. Further to public interventions, Fortis group was dismantled, its Dutch subsidiary sold to the Netherlands government and Fortis bank Belgium to BNP Paribas. This note will focus on Dexia and KBC as these are the largest remaining Belgian banks.

Figure 2-1. Market Capitalization of Major European Banks



Sources: Bankscope; and IMF staff estimates.

Figure 2-2. Aggregate Balance Sheet of Belgian Banking Sector

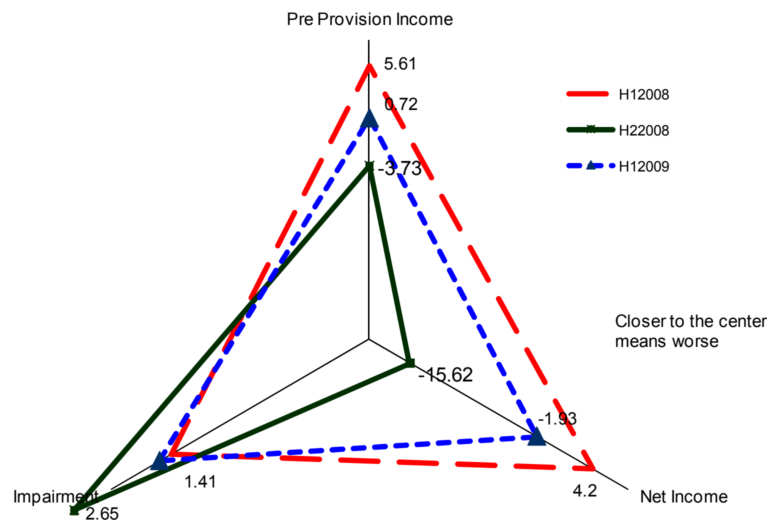


Sources: Belgian authorities; and IMF staff estimates.

Profitability and asset quality

2. **Profitability is recovering but impairment costs remain higher than their pre-crisis levels.** Over the last year, significant losses resulting from the banks' investment portfolio, notably through their exposure to structured assets, but also from lower revenues from asset management and losses on the trading books severely affected profitability but results are gradually improving. The majority of the losses occurred during the second half of 2008 (Figure 2-3). The fall in net income was mostly caused by exceptional losses and one-off risk charges as can be seen for the almost tenfold increase in impairment-related costs from €1.41 billion to €11.9 billion and the reduction in pre-provision income. Pre-provision income gradually returned to positive territory in 2009 but impairment costs are still dragging profit down.

Figure 2-3. Profitability Indicators of the Belgian Banking Sector in 2008 and 2009
(In billions of euros)



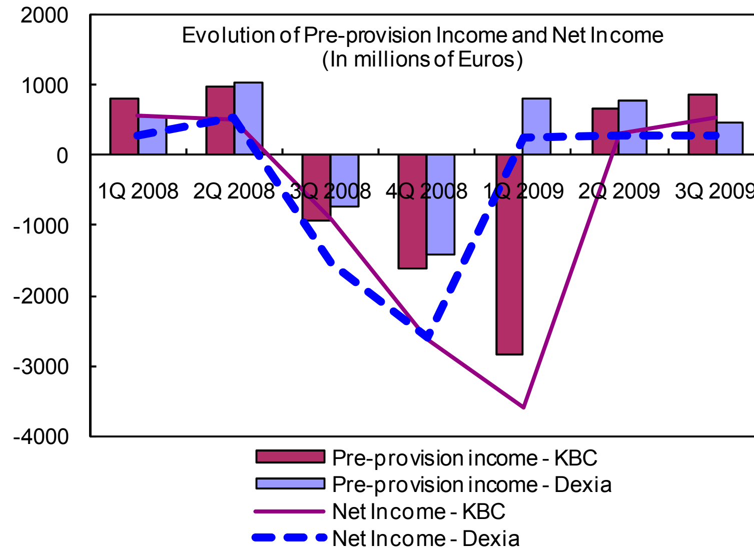
Sources: Belgian authorities; and IMF staff estimates.

Notes: H1 2008 represents the pre-crisis level. The main losses occur in H2 2008 and the drop in pre-provision income reflects losses on financial instruments. Impairment costs remain twice as high in 2009 as in the pre-crisis level, dragging net income down even though pre-provision income has improved.

Box 2-1. 2009:Q3 Earning Results of KBC and Dexia

Third quarter results released by major Belgian banks confirm the recovery trend. The quarterly income results profile of KBC and Dexia show a progressive return to pre-crisis levels for gross income for both banks. Banks have been able to improve pre-provision profits but credit charges are a severe drag on profitability. Liquidity conditions have improved with banks issuing significant amounts of both covered and unsecured bonds in the wholesale market.

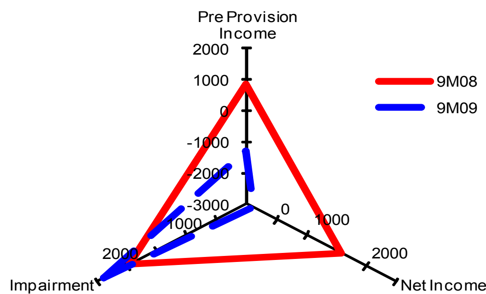
Figure 2-4. Income Statements of Dexia and KBC



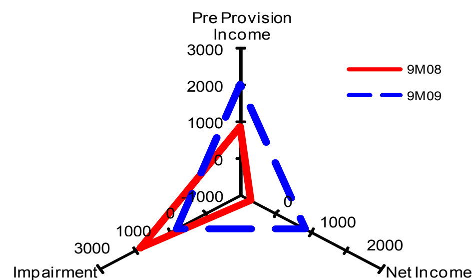
Sources: Bankscope, Company Reports and IMF Staff calculations.

Looking at net income, the results differ markedly between the two banks. After the divestment from its US monoline FSA, Dexia's impairment costs returned to a lower level allowing consolidated net income for the first nine months of 2009 to exceed its level over the same period in 2008. In the case of KBC, high loan loss provisions associated with deteriorating asset quality exceeded other sources of revenue even in 2009 as value adjustments on the banks' synthetic CDO portfolio occurred in 2009:Q2. Hence, while gross income improved, net income remains much lower than in 2008.

Profitability of KBC, First 9 Months of 2009 Compared to First 9 Months of 2008 (In millions of Euros)



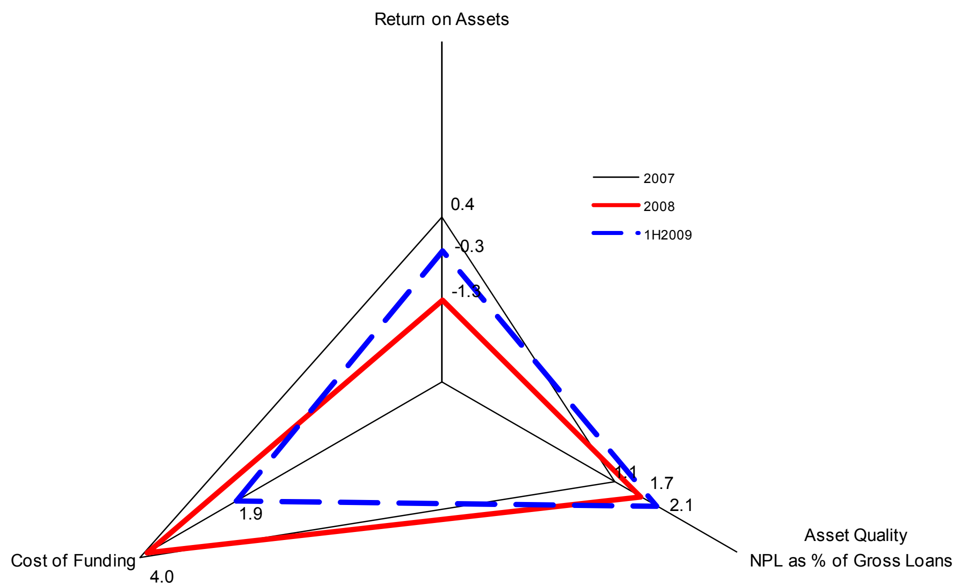
Profitability of Dexia, First 9 Months of 2009 Compared to First 9 Months of 2008 (In millions of Euros)



Sources: Bankscope, Company reports, IMF Staff calculations.

3. **Revenues and profit are driven by net interest income and benefit from current monetary conditions but asset quality remains a challenge.** Funding costs have significantly fallen, helping the rate of return on assets recover somewhat in spite of significant increases in nonperforming loans (NPLs; Figure 2-5). However, banks' profitability is dependent on a yield curve that is unlikely to remain as steep as currently. In addition, impairment costs have more than doubled from their pre-crisis level (Figure 2-6). The cost of risk has shifted from provisioning for financial assets to provisioning for the loan book, reflecting both a welcome disengagement from riskier asset classes but also a deterioration of the economic environment. Some further losses could be expected given the usual lag between economic downturns and credit defaults.

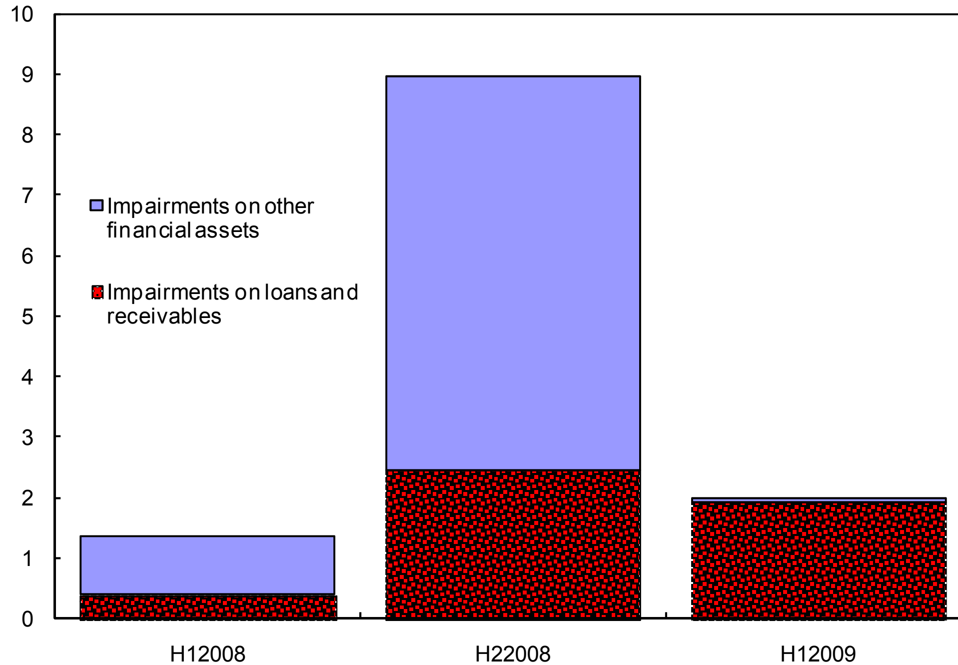
Figure 2-5. Financial Soundness of Belgian Banks
(In billions of euros)



Sources: Belgian authorities; and IMF staff calculations.

Notes: Monetary policy has halved cost of funding. Asset quality has deteriorated, dragging down ROA.- Looking ahead, profitability will be vulnerable to interest rate developments

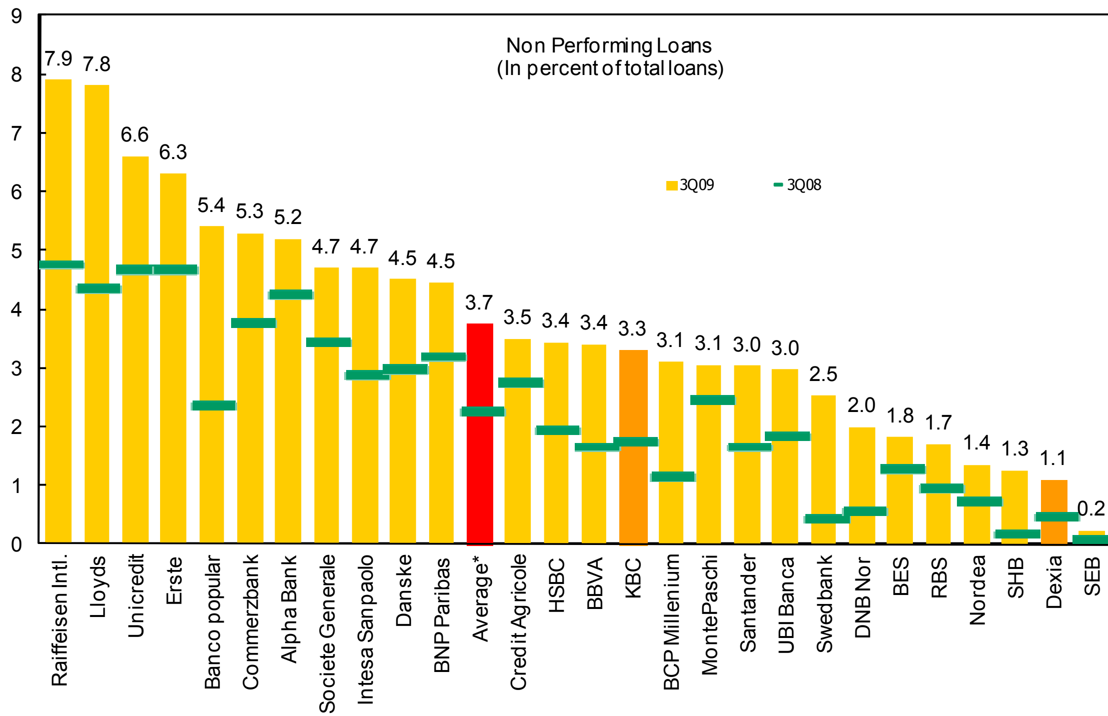
Figure 2-6. Evolution of Impairment Costs in the Belgian Banking Sector
(In billions of euros)

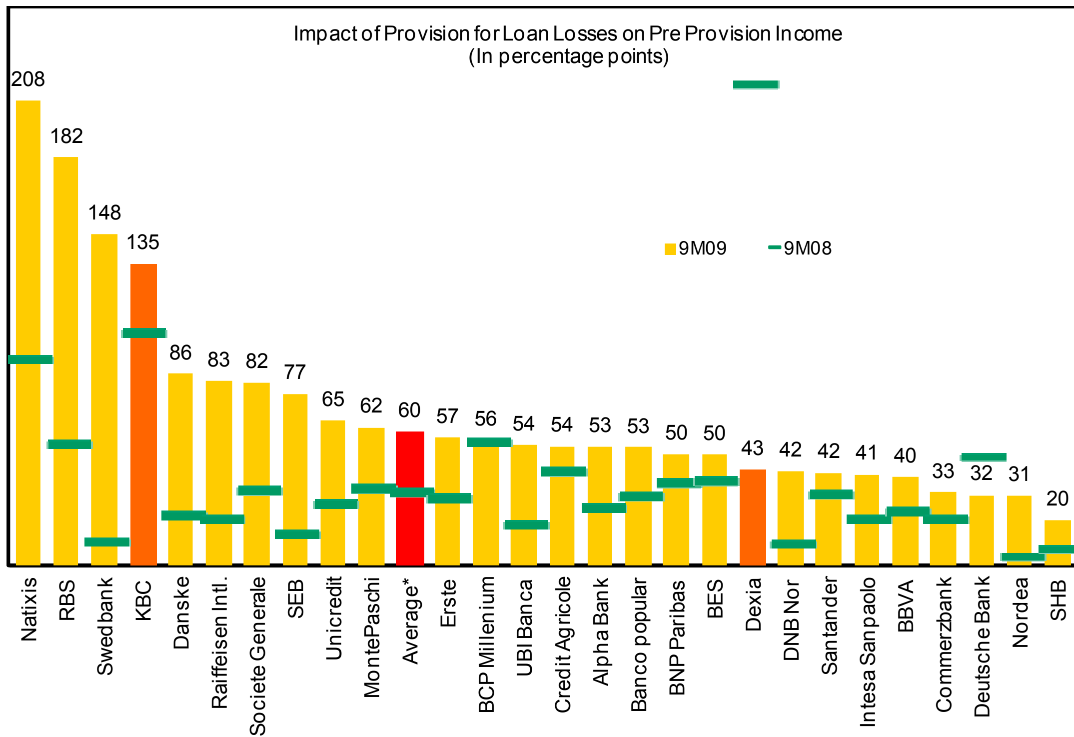


Sources: Belgian authorities; and IMF staff estimates.

4. **Thanks to traditionally sound loan portfolios, Belgian banks' NPL ratios are lower than the average for other banks in Europe but loan losses are nonetheless rising.** The share of non-performing loans in the total loan portfolio for Belgian banks has increased but remains lower than in other European banks, especially compared to those with strong presence in CEE markets. In particular, Dexia's relatively low NPL level reflects the specificity of its portfolio of municipal bonds. However, costs of risks have nonetheless doubled as provisions for loan losses have significantly increased from pre-crisis levels, adversely affecting net income and the capacity to internally generate capital (Figure 2-7).

Figure 2-7. Comparison of Impairment Costs of European Banks



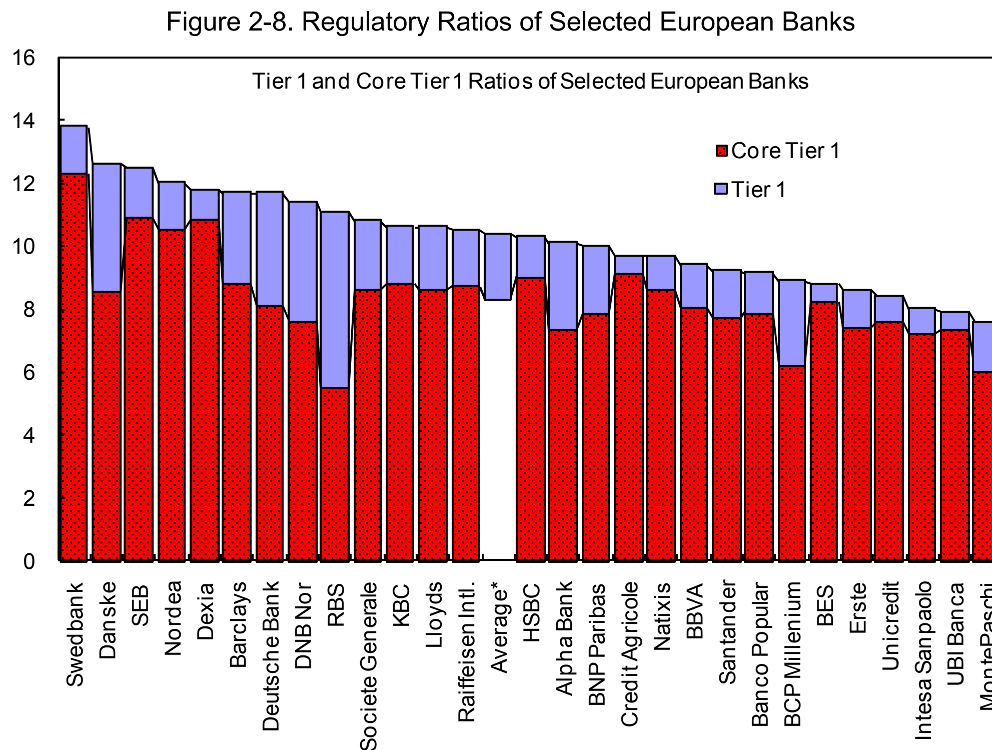


Sources: Company reports; and IMF staff calculations.

Capitalization

5. **Government intervention has increased capital and allowed regulatory ratios to remain in line with European averages, but the availability and quality of capital will be the main challenge ahead.** Unprecedented public capital injections helped Belgian banks to maintain tier 1 and core tier 1 ratios in line with peer European banks (Figure 2-8). However, market participants increasingly focus on the more stringent capital definitions, with "equity-like" features. Looking ahead, regulatory reforms will likely require banks to raise the share of capital with stronger loss absorption features and reduce the share of hybrid capital. In addition, risks remain in the trading and loan books of Belgian banks. Optimal capitalization levels should not only provide sufficient buffers to absorb future losses from a further deterioration in asset quality but also support confidence in the banks. In this respect, Belgian banks may still need to boost their equity tier 1 level capital (Table 2-1). Given the expected slow economic recovery, the banks capacities to generate and retain earnings will need to be accompanied by adequate deleveraging strategies.

Figure 2-8. Regulatory Ratios of Selected European Banks



Sources: Bankscope; and IMF staff estimates.

Table 2-1. Solvency Ratios of Belgian Banks
(In percent)

With Government Capital Injections				Without Government Capital Injections
Q3-09 except when indicated otherwise	Tier 1 ratios	Core Tier 1 ratios	Leverage ratios*	Core Tier 1 ratios
Dexia (Group)	11.8	10.8	3.3	8.7
Fortis Bank	10.7 (YE 2008)	8.9 (YE 2008)	3.7	6.6 (YE2008)
KBC	10.2	8.8	3.9	4.0

Sources: Companies reports; Moody's; and IMF staff calculations.
Leverage ratio defined as Tier1 capital divided by total capital – goodwill and intangibles

Restructuring plans

6. The financial crisis has triggered structural changes in the Belgian banking system and has led to a shift in the business model for all three main banks. Fortis has been sold to a foreign bank and is being transformed from a previously integrated group to distinct national banking and insurance entities. KBC and Dexia as beneficiaries from state aid also had to develop restructuring plans that need approval by the European Commission. The announced strategies generally emphasize back-to-basics business, de-risking, and strengthening core and domestic retail franchises (see Box 2-2).

B. Looking Ahead: How Acute are Risks of a Creditless Recovery?

7. **The ability of the financial sector to supply credit for investment and consumption will be a crucial factor in the economic recovery process.** Disruptions in the credit supply may force firms and households to delay investment and consumption expenditures. Reduced credit supply can lead to lower growth rates for financially dependent sectors and industries that rely on external financing, potentially resulting in a suboptimal allocation of resources. In creditless recoveries, investment makes a disproportionately smaller contribution to growth and output growth is on average one-third lower than in "normal" recoveries.

Box 2-2. Restructuring Plans of Main Belgian Banks

KBC

Objective: Enhance long-term viability through refocusing on core business, divestment of non-core activities and reduction in risk-weighted assets (RWA).
KBC plans to raise about €13 bn capital (needed for: (i) repayment of government capital (€10.5 bn); and (ii) organic growth) through retained earnings and divestments of non-core assets. KBC also intends to reduce its RWA (by -€39 bn or 25 percent of group's total 2008 level).
Timeline: 2009-2013
Status: approved by European Commission
Measures include:

- ⇨ Merchant banking: reduce international loan portfolio (currently 42bn) and put KBC Financial structured products in run-off status (RWA impact: -€23bn).
- ⇨ Divest KBL European Private Bankers (RWA impact: -€6bn).
- ⇨ Sell non-core activities in Belgium: (Fidea (insurance) and Centea (retail banking) (RWA impact: -€5bn).
- ⇨ Reduction in activity in CEE (RWA impact: -€5bn)
  - o List 30-40 percent of Czech subsidiary (CSOB); and
  - o Sell activities in Russia and Serbia

Dexia

Objective: reduction of the group's risk profile through deleveraging (reduction of balance by 35 percent by 2014); improvement of funding and liquidity situation; and reduction of market risk.
Status and timeline: approved by European Commission
Measures include:

- ⇨ Divest FSA Holdings, excluding its Financial Products activity (FSAAM) (finalized July 2009).
- ⇨ Dispose of municipal-lending units in Italy and Spain, the Slovak consumer-banking network and the Turkish insurance unit within the next 3 years
- ⇨ Stop proprietary trading activities.
- ⇨ Stop bond investment activities and put existing portfolios into run-off, of which:
  - non-transferred portfolio of FSA (€11.1 bn); and
  - a bond portfolio worth €158 bn consisting of Public Bonds, Credit Spread Portfolios, and the Treasury and Financial Market trading.
- ⇨ Sell bonds within the portfolio in runoff, including bonds not eligible to repurchases or central bank refinancing, thereby improving the liquidity profile.
- ⇨ Restrictions on dividends, hybrids and acquisitions for the next two years

Fortis Bank

Objective: Refocus on core business, reduce exposure to structured finance assets, and improve access to liquidity.
Timeline: 2008-2009
Measures include:

- ⇨ Sale of 75 percent of Fortis Bank to BNP Paribas on May 12, 2009.
- ⇨ Transfer -€11.4bn toxic assets to a special purpose vehicle (SPV), jointly owned by the Belgian state, BNP Paribas, and Fortis bank whose part of the funding benefits from the Belgian state guarantee.
- ⇨ Reorganization of trading activities within BNP Paribas structure.

8. **Creditless recoveries are associated with impaired financial intermediation.** A recent IMF study[3] identifies creditless recoveries in a broad set of countries and assesses which types of downturn are more prone to be followed by a creditless recovery.[4] When a country experiences a recession preceded by a banking crisis, the likelihood for its recovery to be creditless more than doubles. Accordingly, Belgium has a relatively high probability to have a creditless recovery after the crisis.

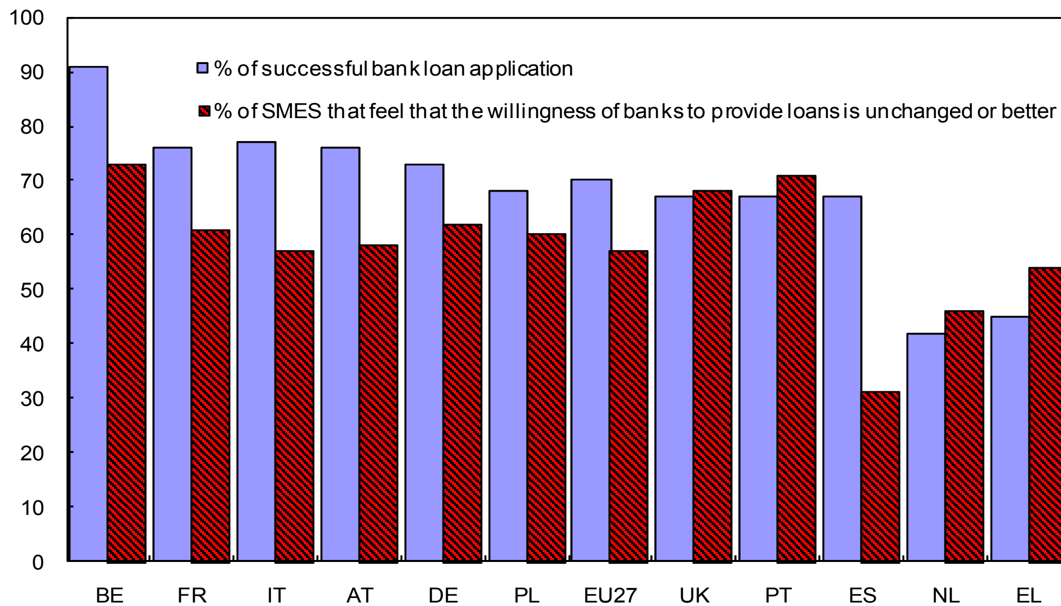
9. **Credit to the economy has slowed in Belgium compared to the pre-crisis levels but conditions appear marginally more favorable than in other European countries.** Lending to businesses in Belgium continued to slow in 2009:Q3 but still increased by 1.4 percent year-on-year while credit in the euro-zone contracted by 0.1 percent year-on-year in September 2009. As in other countries, the balance between credit demand and supply factors remains unclear but information collected from bank lending officers and surveys of SMEs indicate that Belgian small businesses obtain credit more easily and have better confidence about future access to bank financing (Figure 2-9).[5] Easier access to credit might be reflecting the success of public loan-guarantee schemes that Belgian small businesses benefit from. In addition, in the third quarter of 2009, the net percentage of banks reporting a tightening of credit standards applied to loans and credit lines to enterprises declined, bringing the net tightening close to a halt. Among other factors, improved banks' access to market financing and their strengthened liquidity position contributed to an easing of credit standards for loans to enterprises.

[3] Abiad, A., G Dell'Ariccia and B. Li, forthcoming, "Creditless Recoveries," IMF working paper.

[4] A creditless recovery is defined to happen when the growth rate of real bank credit is zero or negative during the 3-year period following a recession. A recession episode is identified whenever the cyclical component of GDP exceeds one-standard deviation below zero. It is measured starting the year before the previous peak and until the year of the trough.

[5] The European Central Bank commissioned a poll over 9,063 companies across Europe.

Figures 2-9. SME's Perception of the Economic Environment



Sources: European Central Bank; and IMF staff estimates.

10. **The public intervention and ongoing changes in the Belgian banking business model could be mitigating factors that lessen the risks of a creditless recovery.** Unprecedented public intervention helped the banking sector and is likely to prop up financial intermediation. Due to the prompt intervention that boosted capital levels and guaranteed or disposed of toxic assets, banks should be able to resume lending faster compared to some of their European peers that remain saddled with losses on toxic assets. The post-crisis restructuring of Belgian banks will also lead them to focus on traditional lending activities in their core home market. Part of the restructuring strategies designed for both KBC and Dexia imply that their business model will rely much less on trading activities than before the crisis and the acquisition of Fortis by BNP Paribas will also lead to transferring most proprietary trading to some other BNP structure. Hence, Belgian banks are likely to allocate resources to lending to Belgian non-financial corporations when the demand for credit picks up.

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Analytical Note 3. Fiscal Rules to Ensure Sustainability: Would a Debt-Brake Rule Work for Belgium?[1]

1. **In the context of Belgium's current complicated political environment and frequent elections,[2] fiscal rules could help to limit distorted incentives in policymaking.** Political expediency considerations may lead the numerous layers of government to act with an insufficient degree of commitment to longer-term challenges such as much-needed fiscal consolidation and public debt reduction. Specifically, this could involve a relative neglect for future tax hikes and expenditure cuts that current deficits inevitably entail. Moreover, special interest groups and regional constituencies may constrain longer-term fiscal policy decisions that invariably entail distributive consequences. Against this background, early commitment to a credible medium-term fiscal framework and a set of appropriate fiscal rules could help to restore fiscal sustainability and avert the related adverse effects on the economy.

2. **Previous successful fiscal consolidation efforts in Belgium were rooted in a strong political commitment but increased political uncertainty has diminished the prospects of fixing the looming public debt and ageing problems based on a durable political consensus.** Fiscal policy in Belgium is constrained by the supranational fiscal rules under the EU Stability and Growth Pact (SGP). Historically, the numerical deficit targets set in the annual Stability Programs represented upper limits on the overall deficit path and periodic negotiations determined the fiscal effort to be undertaken by the Federal Government, the communities, and the regions while local governments were subject to a balanced budget rule. However, in most recent years there were frequent target renegotiations (sometimes twice a year, during the annual budget preparation in September/October and its revision in February/March). However, given the current political uncertainty, the cost of such flexibility is high in terms of diluting the credibility of commitment to medium-term targets and the need to grant political concessions to achieve the necessary fiscal tightening.

3. **Effective options other than fiscal rules could also be considered but these involve far-reaching institutional reforms.** Several countries have strengthened their fiscal frameworks without emphasizing numerical fiscal targets. Some of these countries have managed to achieve significant fiscal consolidations and enjoy public and market confidence in the sustainability of their public finances. Structural reforms that reinforced their

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[1] This note was prepared by Irina Yakadina based on FAD work for the Board Paper "Fiscal Rules: Anchoring Expectations for Sustainable Public Finances" and simulations using the Fund's Global Integrated Monetary and Fiscal (GIMF) model calibrated for Belgium.

[2] The near future elections schedule includes elections at the federal level in 2011, at the local level in 2012, at the regional level in 2014, and then the cycle restarts. In addition, the same candidates often run for different levels of government.

institutional fiscal policy frameworks were a key ingredient for this success. For instance, Australia and New Zealand have maintained a good fiscal performance during recent decades in connection with the adoption of institutional arrangements—generally referred to as fiscal responsibility frameworks—during the 1990s to ensure prudent fiscal policies. Other countries, such as Brazil, have placed fiscal responsibility laws at the center of their fiscal framework, complemented by explicit numerical targets on some fiscal aggregates.

4. **The discussion is ongoing on the best time to introduce a fiscal rule, depending on country-specific circumstances and the degree of economic uncertainty.** A fiscal rule can be adopted at the inception of an adjustment strategy or accompany consolidation efforts. The first would aim at lending much-needed credibility at the outset of a policy change; the latter would seek to lock in changes in policy preferences that have been signaled over time. Which of the two strategies promises greater success would depend on country-specific circumstances, such as credibility of existing policies (e.g., enhanced by accompanying fiscal and structural reforms) or a departure from the earlier policy direction, and the degree of economic uncertainty. In the case of Belgium, announcing a fiscal rule before the next election at the federal level in mid-2011 which would be introduced in 2-3 years from now would be an option that could help strengthen the credibility of fiscal consolidation. The current high degree of uncertainty about the measurement of the main macroeconomic aggregates will have to be taken into account in the design of such rule.

5. **Fiscal discipline is particularly challenging in federal states where sub-national governments account for a large share of resources, as is the case for Belgian regional, community, and local governments that receive over 10 percent of GDP in transferred revenues from the federal government.[3]** This arises from adverse incentives to excessive spending and insufficient revenue collection that trigger large fiscal imbalances at the federal level with repercussions for the general government finances. The chief factors leading to fiscal profligacy by sub-national governments include limited revenue authority and dependence on central government transfers that create moral hazard, spillovers from higher-spending jurisdictions, and asymmetries in economic cycles across regions that may spur procyclical fiscal behaviors. As the need for fiscal adjustment in Belgium is rather large, it would be important to have a fiscal rules framework in place which ensures that the burden of fiscal consolidation is shared fairly across different government levels and according to which the effort distribution between different layers of government is perceived as fair.

6. **A good example of a fiscal rules framework is the structural debt-brake rule that has been successfully applied in Switzerland for some time.** This rule aims at a balanced budget over the cycle: for each year, an expenditure ceiling is set based on

[3] Source: High Finance Council, "Evaluation for 2008-09 and Budgetary Trajectories in Preparation of the Next Stability Programme," January 2010.

expected, cyclically adjusted revenues. It is possible to run deficits in a recession but surpluses are required in a boom period so that over the course of a full cycle deficits and surpluses are expected to cancel out. Differences between budget targets and outcomes are recorded in a notional account, and the authorities must eliminate any negative balance on this account once it cumulatively exceeds a predetermined level. While there are some concerns about the operation of such a rule with regards to the adequate room for discretionary fiscal policy and about technical complexities that may make the rules less transparent, these can be addressed through the use of appropriate escape clauses and the operation of an independent fiscal agency.

7. **Another useful example is the structural fiscal rule that has been recently adopted in Germany and that builds on the Swiss experience.** The structural (and net of one-off items) federal budget deficit is bound by the Constitution not to exceed 0.35 percent of GDP from 2016 the states will be bound by a balanced budget rule starting in 2020. If the structural balance deviates from the limit, the (positive or negative) gap is stored in a notional control account corrected for those errors deriving from a different than expected real GDP growth. If the control account debit exceeds 1.5 percent of GDP, the Constitution requires an adjustment. However, the adjustment only needs to start during an economic recovery to avoid a procyclical tightening. The fiscal rules allow for exceptions, if sanctioned by a super-majority in parliament, in case of a natural disaster or exceptional emergencies outside government control.

Fiscal Rules in the Face of Shocks: Insights from Model Simulations

8. **Model-based simulations were used to gain further insights into what could be the best design of a fiscal rule in Belgium and to illustrate how different fiscal rules interact with a variety of economic shocks.** The simulations were performed with the IMF Global Integrated Monetary and Fiscal (GIMF) model[4] calibrated to represent the main features of the Belgian economy. These simulations confirm the significant macroeconomic stabilizing effects of cyclically-adjusted balance rules under both demand and supply shocks. This is in contrast to fiscal rules that target the nominal (cyclically unadjusted) budget balance. The simulations also show that a structural balance rule complemented with an adjustment to dampen public debt volatility performs significantly better than a nominal budget balance rule and can materially reduce public debt accumulation while maintaining substantial countercyclical effectiveness.

[4] For a discussion of the main features and design of the IMF GIMF model, see Kumhof and Laxton (2007, 2009).

Table 3-1. Comparison between Swiss and German Fiscal Rules

	Switzerland	Germany
Ex ante specification of the rule	One-year ahead ceiling on central government expenditures not to exceed structural projected revenues.	Every year, a ceiling of 0.35 percent of GDP on the structural Federal budget and balanced structural budget requirement for the states.
One-off items	Excluded for both revenue and expenditure.	Excluded for both revenue and expenditure.
Cyclical factor	Determined as the ratio of trend real GDP (estimated by running a modified HP filter on historical data) to expected real GDP.	Calculated based on the European Commission's method, using commonly agreed-upon revenue and expenditure elasticities and an output gap estimate (derived from a production function approach).
Ex post verification of the rule	Ex post expenditure ceiling is calculated at the end of the budget year by multiplying the actual revenue ratio by trend GDP.	Ex post structural balance is calculated at the end of the budget year taking into account the realization of the actual output for the output gap calculation.
Use of notional accounts	Any deviations of actual spending from the ex post spending ceiling, independent of their cause, are accumulated in a notional compensation account.	The (positive or negative) deviations are accumulated in a notional control account.
Corrective measures	If the negative balance in the notional compensation account exceeds 6 percent of expenditures (about 0.6 percent of GDP) the authorities are required by law to take measures sufficient to reduce the balance below this level.	If the negative control account balance exceeds 1.5 percent of GDP the Constitution requires an adjustment. In practice, the adjustment is meant to start already when a limit of 1.0 percent of GDP is reached, as set out in ordinary law.
Avoiding procyclicality	The adjustment needs to take place within three years if the notional account reaches its ceiling.	The adjustment only needs to be launched during an economic recovery.
Escape clauses	Parliament can approve with a supermajority a budget deviating from the rule in "exceptional circumstances." A rule specifies how such deviations should be corrected.	The budget rules allows for exceptions, if adopted by supermajority in parliament, in case of a natural disaster or exceptional emergencies. Adoption of exceptionally higher budget deficits, however, needs to be accompanied by an amortization plan. While there are no binding sanctions for violating the new budget rule, a Stability Council will be established with the task to monitor the development of public finances and issue early warnings.

9. **The performance of the model economy and the path of fiscal aggregates was explored for the following fiscal rules:**[5]

A. ***Nominal balance rule.*** The actual balance must meet the balanced-budget target every year. Deviations from trend in revenue and expenditure, prompted endogenously by the different shocks, must be offset by discretionary budget measures. In the simulations, these offsetting measures are modeled as direct transfers (or levies, as the case may be) in amounts necessary to meet the predetermined balanced-budget target.

B. ***Structural balance rule.*** The actual balance deviates from the target when actual output deviates from its potential level, by an amount that corresponds to the free play of the automatic stabilizers. Debt is allowed to rise (or decline) endogenously without prompting specific action. Thus, after severe downward shocks, debt accumulation could be substantial and, although temporary from a long-term standpoint, strongly persistent over the medium-term.

C. ***Structural balance rule with medium-term debt adjustment.*** This is similar to the above structural balance rule, but with an additional adjustment to bring debt to its target over time—gradually, but at a faster pace than under a pure structural balance rule.

10. **The different fiscal rules were evaluated for a small open economy calibrated to mimic main features of Belgium under a variety of negative shocks.** In particular, the shocks considered were downward domestic demand shocks to consumption and investment, and an exogenous fall in output capacity (a fall in productivity).

11. **The simulations highlight the trade-off between macroeconomic volatility and debt sustainability.** For each shock, the volatility of macroeconomic variables that are likely to be of concern to policymakers (output, employment, and consumption) is higher under a balanced budget rule than under a structural balance rule—often by a large measure. This is achieved through a countercyclical fiscal policy under the structural balance rule: in the model, government transfers to liquidity constrained households do not need to be reduced in the face of declining tax revenue. Thus, the income of economic agents, particularly those that are liquidity constrained, is also more stable—supporting consumption and activity through the downturn caused by the shocks. However, the more active countercyclical fiscal policy comes at the price of significant debt accumulation over the trough of the downturn. It

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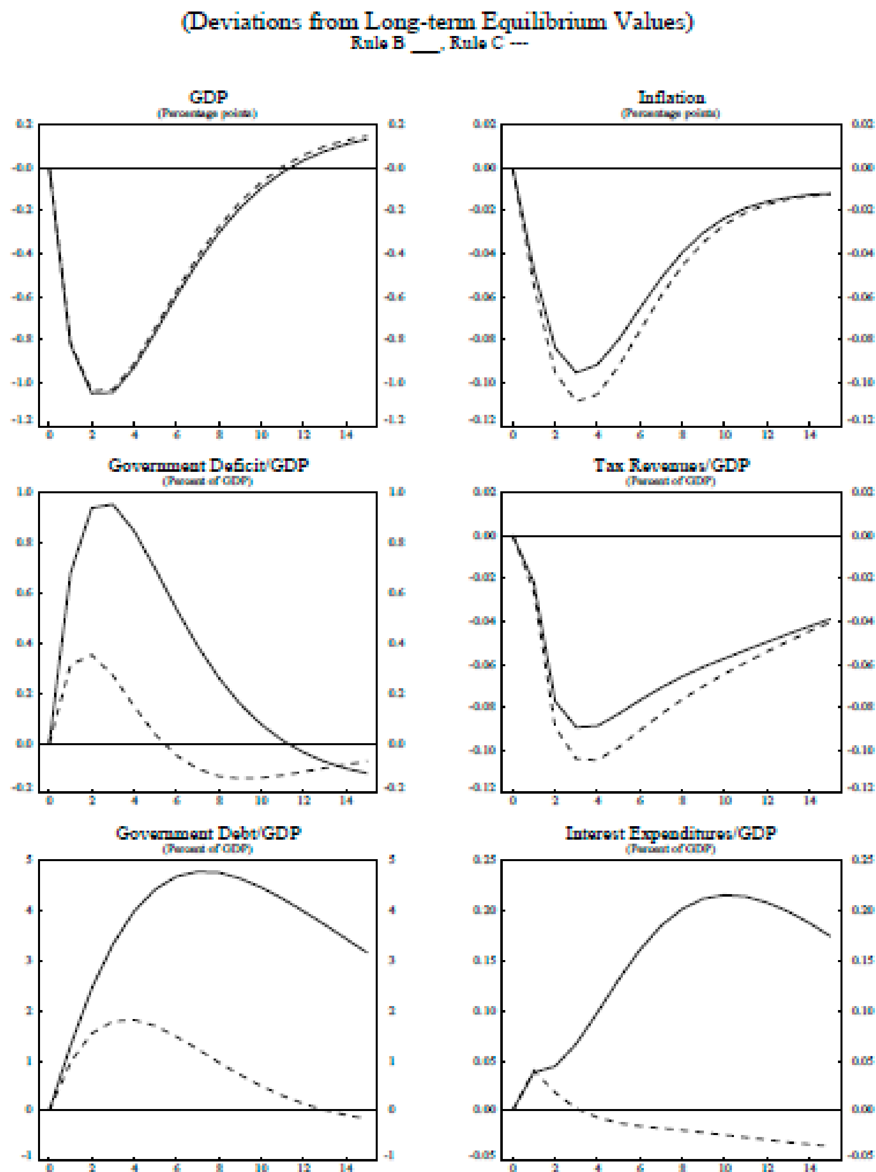
[5] The following formula (written in *surplus* form) maps the rules by selecting different values for the feedback coefficients on the output gap and debt deviation from a long-term objective. A balanced budget rule sets all cyclical adjustment coefficients to zero while the structural balance rule sets the output gap coefficient equal to 0.4, obtained by correcting the European Commission estimate of 0.5 by the numerous one-off measures; to which a debt-adjustment coefficient of 0.4 is added to help bring debt ratio back to target faster.

$$\frac{surplus_t}{gdp_t} - \overline{surplus^{rat}} = d^{out}\frac{output_t - \overline{output_t}}{gdp_t} + d^{debt}\left(\frac{debt_t}{gdp_t} - \overline{debt}^{rat}\right)$$

is worth mentioning the model's limitation in replicating output volatility under different fiscal rules. The main transmission channel in the model operates through the wealth effect of the liquidity-constrained agents who respond to any negative shock to their income by supplying more labor (hours worked). This, in turn implies that the model will always underestimate the fall in aggregate output in response to negative shocks.

12. **In the current circumstances of rapid escalation in public debt and associated potential market concerns, adjustments to a structural balance rule that accelerate debt reduction could be considered.** Adding to a pure structural balance rule (rule B) a moderate adjustment to temper the operation of the automatic stabilizers when the public debt is particularly high (rule C), maintains to a large extent the desired stabilization properties while significantly mitigating the accumulation of debt (Figure 3-1). When the economy starts at or near the debt target and suffers an adverse shock the government can initially conduct countercyclical fiscal policy in virtually the same manner under a structural balance target (rule B) and under a modified structural balance target (rule C). As the public debt rises above its target, however, the modified structural balance rule will call for an increasing annual adjustment to moderate the debt build-up. This could be particularly useful in situations of long downturns when concerns about fiscal solvency could emerge in the face of persistent large deficits and mounting public debt. For example, under a demand shock that prompts a decline of output to 1 percentage point below its potential level, the associated debt increase at its peak under a structural balance rule (rule B) is about 4 percent of GDP but much smaller (1½ percent of GDP) under a modified structural balance rule (rule C).

Figure 3-1. Effects of a Negative Demand Shock under Adjusted and Unadjusted Structural Balance Rules



B = Structural Balance Rule Responding to Output Gap;
C = Structural Balance Rule with Medium-term Debt Adjustment.

Sources: WEO; and IMF staff estimates.

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INTERNATIONAL MONETARY FUND

BELGIUM

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the European Department

February 22, 2010

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ANNEX I. BELGIUM: FUND RELATIONS
(As of December 31, 2009)

Mission: Brussels, December 2-14, 2009

Staff team: Mr. De Vrijer (Head), Ms. Yontcheva, Ms. Xiao, Ms. Tytell (all EUR), and Ms. Yakadina (FAD).

Country interlocutors: The vice-prime minister for the budget, the governor of the National Bank of Belgium, the director of the Treasury, the chairman of the Finance, Banking and Insurance Commission, the head of the Federal Planning Bureau, the chairman of the public borrowing section of the High Finance Council, the head of the Central Council for the economy, the head of the Competition Authority, the head of the Federal Holding and Investment Company, and their staffs; staff of the Prime Minister's office, the federal ministry of finance, the federal ministry for the economy, the federal ministry for employment, the health care administration, the regional ministries of the budget and of employment for Flanders, Brussels and Wallonia, respectively; representatives of labor unions, employer organizations, and the financial sector. Mr. Kiekens (Executive Director) or Mr. De Lannoy (Advisor to the Executive Director) attended the meetings.

Fund relations: The previous Article IV consultation took place on March 4, 2009. The associated Executive Board's assessment is available at http://www.imf.org/external/np/sec/pn/2009/pn0932.htm and the staff report at http://www.imf.org/external/pubs/cat/longres.cfm?sk=22766.0. Belgium accepted the obligations under Article VIII and, apart from certain security restrictions, maintains an exchange system free of restrictions.

Data: Belgium subscribes to the Fund's Special Data Dissemination Standard, and comprehensive economic data are available on a timely basis (Appendix II).

I. **Membership Status:** Joined December 27, 1945; Article VIII

II.	**General Resources Account:**	**SDR Million**	**Percent of Quota**
	Quota	4,605.20	100.00
	Fund holdings of currency	3,840.50	83.39
	Reserve position in Fund	764.73	16.61

III.	**SDR Department:**	**SDR Million**	**Percent of Allocation**
	Net cumulative allocation	4,323.34	100.00
	Holdings	4,405.78	101.91

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	**2011**	**2012**	**2013**	**2014**
Principal					
Charges/interest	0.32	0.32	0.32	0.32	0.32
Total	0.32	0.32	0.32	0.32	0.32

VII. **Article IV Consultations:**

Belgium is on the 12-month cycle; the last consultation was completed on March 4, 2009 (IMF Country Report No. 09/87).

VIII. **Exchange Rate Arrangements**

- Belgium's currency is the euro, which floats freely and independently against other currencies.
- Belgium maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for restrictions maintained solely for security reasons. These measures are established by European Union regulations and have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

IX. **FSAP Participation:**

FSAP Assessment IMF Country Report No. 06/75

Summary: The report concluded that Belgium's financial system is resilient and benefits from a number of Belgium-specific features that help stability. These include a traditionally cautious attitude toward risk by banks, large holdings of government securities, extremely low holdings of equity by banks, a stable source of funding benefiting from generous tax incentives, a high standard of banking supervision, and a stable macroeconomic policy framework. Overall, supervision showed a high degree of compliance with international standards. Near-term vulnerability appears low, reflecting the soundness of the dominant banking system, the generally benign financial environment, the strong financial condition of the corporate sector, and the relatively healthy financial position of the household sector. Financial institutions were found to withstand an adverse macroeconomic stress well, helped in part by the beneficial diversification in the *bancassurance* model.

Notwithstanding the strengths of the Belgian financial sector, a number of issues emerged from the FSAP. The heavy exposure abroad, the open nature of the economy, and the importance of the Euroclear Group globally, made the domestic financial system potentially vulnerable to global economic developments and financial contagion. Risks remained and may increase with a downturn in the business cycle, increased cross-border operations, and deeper links with the global money centers. In line with the 2005 FSAP recommendations, the supervisory framework has been strengthened. The Banking, Finance, and Insurance Commission's (CBFA) management committee has been streamlined and synergies between the CBFA and the National Bank of Belgium (NBB) have been further developed. Regular stress tests have helped promote a systematic dialogue between supervisory authorities and market participants, while detailed procedures for financial crisis management have been tested. Prudential supervision of the insurance sector has been upgraded and regulation of the pension funds sector reinforced.

ANNEX II. BELGIUM: STATISTICAL ISSUES

Belgium's economic and financial statistics are adequate for surveillance purposes. The National Bank of Belgium (NBB) regularly publishes a full range of economic and financial data and provides calendar dates of main statistical releases. On-line access to these comprehensive databases is facilitated by the NBB's data search engine, Belgostat. Belgium is a SDDS subscriber. Statistics for *International Financial Statistics* on banking institutions and monetary aggregates are prepared on a monthly basis and are timely.

Belgium adopted the European System of Integrated Economic Accounts 1995 (ESA95) in 1999. Revisions of national accounts started in November 2005 to comply with EUROSTAT requirements and prepare for the adoption of chain-linked national accounts statistics. Unlike in other countries, the NBB is responsible for compiling national accounts statistics. Quarterly accounts are published within a lag of three months. Both annual and quarterly accounts data are of good quality, with shortcomings mainly related to export and import deflators, which are based on unit values, rather than prices collected directly from exporters and importers.

General government revenue, expenditure, and balance on an accrual basis (ESA95) are published annually. The NBB publishes monthly data on central government operations and quarterly data on general government operations since April 2007.

The overall quality and availability of financial indicators are good. The authorities are providing quarterly updates of financial sector indicators (FSIs) in a timely manner.

Key publicly accessible websites for macroeconomic data and analysis are:

National Statistical Portal .... www.belgostat.be
National Statistics Institute .... www.statbel.fgov.be
Institute for National Accounts .... www.inr-icn.fgov.be
National Bank of Belgium .... www.nbb.be
Federal Planning Bureau .... www.plan.be
Banking, Finance, and Insurance Commission .... www.cbfa.be
High Finance Council .... www.docufin.be
Central Economic Council .... www.ccecrb.fgov.be

BELGIUM: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of February 16, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	2/12/10	2/12/10	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/09	1/14/10	M	M	M
Reserve/Base Money	12/09	1/10	M	M	M
Broad Money	12/09	1/10	M	M	M
Central Bank Balance Sheet	12/09	1/10	M	M	M
Consolidated Balance Sheet of the Banking System	12/09	1/10	M	M	M
Interest Rates[2]	2/12/10	2/12/10	D	D	D
Consumer Price Index	12/09	1/10	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2008	6/30/09	A	A	A
Revenue, Expenditure, Balance, and Composition of Financing[3]—Central Government	2008	6/30/09	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/09	1/10	M	M	M
External Current Account Balance	Q3 2009	12/09	Q	Q	Q
Exports and Imports of Goods and Services	Q3 2009	12/09	Q	Q	Q
GDP/GNP	Q3 2009	12/09	Q	Q	Q
Gross External Debt	Q3 2009	12/09	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/37
FOR IMMEDIATE RELEASE
March 15, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2009 Article IV Consultation with Belgium

On March 8, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Belgium.[1]

Background

The Belgian economy was hit hard by the global financial crisis and economic downturn. In response, the authorities took measures to support the financial sector and let the automatic fiscal stabilizers operate freely while implementing a moderate stimulus plan. These actions helped to stabilize the financial sector and halt the economic downturn. At the same time, ground has been lost in addressing the high public debt and the spending pressures related to population aging, and in strengthening competitiveness and pursuing labor and product market reforms. The political situation remains complex, complicating the authorities' efforts to tackle the medium-term challenges facing the country in the areas of public finances and structural reforms.

The near-term outlook is challenging, with real GDP expected to drop by about 3 percent in 2009 and a gradual recovery projected for 2010. The unemployment rate will continue to rise in 2010 and inflation pressures are expected to remain subdued. Uncertainty to the outlook is high

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

but risks appear broadly balanced. The crisis will have a considerable downward impact on potential growth, in addition to that of demographic factors, in 2009-11.

The banking sector has stabilized after massive public intervention, but its financial situation remains fragile and vulnerable to potential spillovers from mature markets and emerging Europe. The uncertain profitability outlook constrains the banks' capacity to rebuild a high-quality capital base through internal capital generation. The withdrawal from the emergency support to the financial sector will be done gradually to avoid market disruptions and a credit squeeze. The authorities have initiated the creation by early 2011 of a unified structure to supervise financial institutions at the National Bank of Belgium, in order to more effectively combine the supervision of individual institutions and of the system as a whole. A draft crisis law that would establish a rule-based resolution framework for failed financial institutions has also been prepared.

Recognizing the risk of unsustainable public debt dynamics, the government has announced a fiscal consolidation strategy that appropriately aims to achieve a balanced budget by 2015. The economic and financial crisis and the necessary public interventions have led to a significant deterioration in the public finances with the overall deficit jumping to 5.8 percent of GDP and the public debt rising to close to 100 percent of GDP in 2009. The 2010 budget aims at streamlining spending and boosting revenue to reduce the overall deficit to 5.1 percent of GDP. The total fiscal effort of about ¾ percent of GDP reflects the intergovernmental burden-sharing agreement for 2009-10 and the first multi-year fiscal framework covering 2010-11. The new Belgian Stability Program for 2009-12 builds on the deficit reduction targeted for 2010 and aims to reduce the overall deficit to 3 percent of GDP by 2012. The planned fiscal consolidation requires significant efforts at all government levels and in the social security system.

Executive Board Assessment

Executive Directors, noting that Belgium had been severely hit by the global crisis, commended the authorities for taking prompt measures to support the economy and stabilize the financial system. Directors observed that, although the economic recession in Belgium was less severe than the euro area average, the recovery is expected to be gradual and fragile, with unusually high uncertainty. The near term outlook is clouded by a sluggish rebound in both domestic and external demand, rising unemployment, and growing public debt. Early action is crucial to restore fiscal sustainability, further reinforce financial stability, and intensify labor and product market reforms to boost competitiveness and growth prospects.

Directors underscored the importance of strong and credible medium-term adjustment to put Belgium's public finances back on a sustainable path and address the challenges arising from an aging population. They supported the authorities' fiscal consolidation strategy to achieve a balanced budget by 2015, stressing that such a strategy should be backed by concrete

measures and based on prudent macroeconomic assumptions. Directors agreed that the 2010 budget strikes the right balance between initiating the much-needed fiscal consolidation and supporting the recovery. They welcomed the authorities' commitment to take additional actions if necessary to achieve the deficit targets for 2011 and beyond. In addition to reversing most of the fiscal stimulus measures after 2010, it would be important to restrain expenditure, increase the effective retirement age, and reduce the growth of health care costs. These require significant efforts at all government levels and in the social security system. Adopting a rule-based fiscal framework would help enhance the credibility of the consolidation efforts.

Directors considered that, although the banking sector has stabilized after massive public intervention, its financial situation remains fragile and is vulnerable to potential spillovers from both mature markets and emerging market countries in Europe. This points to continued need for bank recapitalization, balance sheet repair, and targeted liquidity support in the near future. Directors recommended that the authorities withdraw exceptional support to the financial sector gradually, in a manner that is fully aligned with the concerted EU exit policies, and monitor credit to the economy closely to avoid adverse market reactions and a credit squeeze. They welcomed the reorganization of the Belgian supervisory authority consolidating the supervision of individual institutions and that of the system as a whole. The preparation of a draft crisis law is a welcome step toward establishing a rule-based resolution framework for failed financial institutions.

Directors highlighted the urgency of structural reforms aimed at raising productivity and restoring growth to its potential. They encouraged the authorities to push ahead with the restructuring of the labor and product markets. Reabsorbing the unemployed and increasing labor market participation are a priority. In this context, Directors welcomed the proposed system that would link the pre-pension age to the benefits payable by employers. To strengthen competition, Directors recommended enhancing the independence of the Competition Authority, defining clearly the role of sectoral regulators, and establishing effective cooperation among the different regulators. The importance of wage moderation was also emphasized, with a number of Directors suggesting that the authorities reconsider the merits of wage indexation.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2009 Article IV Consultation with Belgium is also available.

Belgium: Selected Economic Indicators 2005-10

	2005	2006	2007	2008	Projection 2009	Projection 2010
	(Percentage change from the previous period; unless otherwise indicated)					
Real economy						
Real GDP	2.0	2.8	2.8	0.8	-3.0	1.2
Private consumption	1.2	1.8	1.6	1.0	-1.7	0.6
Public consumption	1.2	1.0	2.6	3.3	1.7	0.8
Gross fixed investment	7.7	2.7	5.7	3.8	-4.2	-2.5
Business investment	5.5	4.5	8.7	6.1	-6.1	-3.1
Dwellings	10.9	3.4	-0.8	-1.6	-2.9	-2.5
Public investment	15.8	-12.4	3.6	3.4	7.7	2.8
Stockbuilding 1/	0.3	0.6	0.2	-0.2	-1.1	0.1
Foreign balance 1/	-1.0	0.4	0.2	-1.0	0.0	0.7
Exports, goods and services	4.8	5.0	4.4	1.4	-9.2	4.9
Imports, goods and services	6.5	4.7	4.4	2.7	-9.5	4.2
Household saving ratio (in percent)			16.2	16.6	19.7	18.4
Potential output growth	1.7	1.8	1.9	1.3	0.9	0.8
Output gap (in percent)	0.3	1.3	2.2	1.7	-2.2	-1.9
Employment						
Unemployment rate	8.5	8.3	7.5	7.0	8.0	9.3
Employment	1.4	1.2	1.6	1.8	-0.5	-1.1
Prices						
Consumer prices	2.5	2.3	1.8	4.5	-0.2	1.6
GDP deflator	2.4	2.2	2.2	1.9	1.2	1.3
ULC (in whole economy)	1.3	1.9	2.3	4.1	4.2	-1.1
	(In percent of GDP; unless otherwise indicated)					
Public finance						
Revenue	49.4	48.7	48.2	48.8	48.0	48.7
Expenditure	52.1	48.5	48.4	50.0	53.8	53.8
General government balance	-2.7	0.3	-0.2	-1.2	-5.8	-5.1
Structural balance	-1.0	-1.4	-1.4	-2.2	-4.9	-4.3
Primary balance	1.5	4.2	3.6	2.6	-2.1	-1.2
General government debt	92.1	88.1	84.2	89.8	97.3	100.1
Balance of payments						
Trade balance	1.6	0.8	0.7	-3.0	-2.8	-2.9
Current account	2.6	2.0	2.2	-2.5	-0.3	-0.5
Terms of Trade (percent change)	-0.2	-1.4	-0.1	-1.4	2.0	-0.9
Exports, goods and services (volume, percent change)	4.8	5.0	4.4	1.4	-9.2	4.9
Imports, goods and services (volume, percent change)	6.5	4.7	4.4	2.7	-9.5	4.2

Sources: Data provided by the Belgian authorities, and IMF staff projections.
1/ Contribution to GDP growth.