Outlook for Belgium

Opportunity for reform could boost uninspiring outlook
Highlights

• The Belgian economy is on the road to recovery, but the pace will be limited by both domestic and external factors. Risks to stability remain, not least from the Government’s debt burden – the largest relative to GDP among the Eurozone’s core countries. In other respects though, Belgium has some underlying strengths. The challenge this year is for parties contesting the elections to demonstrate how they would exploit these more effectively and offer a faster path back to prosperity.

• After growing by an estimated 0.2% in 2013, we expect GDP growth of just over 1% in 2014. Aided by a second consecutive year of inflation at about 1%, households will become more positive, raising spending by 1.2%. Meanwhile, a tentative recovery in external trade will allow exports to grow by 1.8%, after stagnating in 2013.

• But the pace of recovery will be limited to 1.4% in 2015, and about 1.7% a year in 2016-18. With unemployment currently around 8.5% (23% among the under-25s) and set to rise in 2014, households will remain concerned about job security well into 2015, so the rebound in consumer spending will take time to gather speed.

• Furthermore, the consequence of a lack of austerity over the past few years is that a long period of fiscal restraint is in order. And the impact of wage indexation and high non-wage labor costs on competitiveness means that Belgium’s export recovery will be slower than in more ambitious reformers.

• The weakness of the recovery is a problem. The debt ratio (over 100% of GDP) is much higher than in other core Eurozone economies, making Belgium more vulnerable to faster increases in borrowing costs or to debt-deflation. With tax already accounting for over 50% of GDP, the burden of additional fiscal adjustment would fall mainly on spending cuts, further undermining the recovery.

• The elections due in May provide an important opportunity for Belgium to debate these structural challenges and reassert its position as a center of high-value-added activity in the Eurozone. Tackling barriers to job creation and improving the labor participation rate are priorities in this respect.
Activity slowly picking up and confidence returning

The gradual improvement in Belgium’s economic performance and prospects has continued over the past few months, with industrial production rebounding in Q4 2013 and consumer and business confidence close to long-run averages for the first time since late 2010. Looking ahead, domestic demand and external trade will contribute roughly equal portions to the resumption of growth in 2014, with GDP expected to grow by just over 1% after two years of stagnation. However, the recovery will be modest and prone to setbacks. On a more positive note, the elections in May provide the country with an opportunity to debate Belgium’s economic future.

External improvements underpin the recovery ...

As the Eurozone’s most open economy (measured in terms of trade relative to GDP) Belgium’s recovery is closely linked with recovery in the rest of the Eurozone and the revival of intra-Eurozone trade. With the uncertainty caused by the financial crisis continuing to wane, and demand picking up, particularly in core economies, we expect Belgian exports to grow by 1.8% in 2014 and 2.5% in 2015.

However, labor market rigidities mean that Belgium has continued to lose competitiveness compared with other Eurozone economies. We estimate wage growth in Belgium has outstripped productivity by 2-3 percentage points a year over the last 3 years, compared with 1 percentage point or so in France and Germany. This will hurt exporting firms over the course of the recovery. At 3.5% a year in 2016-18, export growth will be 1-1.5 percentage points below growth in import demand in Belgium’s markets.

... spurring a modest rebound in investment

In turn, the improvement in external demand should support a modest rebound in business investment. Capacity utilization picked up in Q4 2013, with firms now reporting only a few percentage points of spare capacity relative to “normal” levels.

Table 1

<table>
<thead>
<tr>
<th>Belgium (annual percentage changes unless specified)</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>0.2</td>
<td>1.1</td>
<td>1.4</td>
<td>1.6</td>
<td>1.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Private consumption</td>
<td>0.6</td>
<td>1.2</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>Fixed investment</td>
<td>-2.9</td>
<td>0.4</td>
<td>2.3</td>
<td>2.7</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Stockbuilding (% of GDP)</td>
<td>0.6</td>
<td>0.4</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Government consumption</td>
<td>0.7</td>
<td>0.6</td>
<td>0.8</td>
<td>0.9</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>1.6</td>
<td>1.8</td>
<td>2.5</td>
<td>3.5</td>
<td>3.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>0.9</td>
<td>1.3</td>
<td>2.1</td>
<td>3.4</td>
<td>3.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Consumer prices</td>
<td>1.2</td>
<td>1.0</td>
<td>1.7</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Unemployment rate (level)</td>
<td>8.4</td>
<td>8.6</td>
<td>8.5</td>
<td>8.1</td>
<td>7.7</td>
<td>7.6</td>
</tr>
<tr>
<td>Current account balance (% of GDP)</td>
<td>-2.1</td>
<td>-1.3</td>
<td>-1.3</td>
<td>-1.2</td>
<td>-1.1</td>
<td>-0.9</td>
</tr>
<tr>
<td>Government budget (% of GDP)</td>
<td>-3.1</td>
<td>-2.7</td>
<td>-2.3</td>
<td>-1.9</td>
<td>-1.7</td>
<td>-1.5</td>
</tr>
<tr>
<td>Government debt (% of GDP)</td>
<td>103.2</td>
<td>106.3</td>
<td>108.5</td>
<td>109.7</td>
<td>110.3</td>
<td>110.4</td>
</tr>
<tr>
<td>ECB main refinancing rate (%)</td>
<td>0.5</td>
<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
<td>1.4</td>
</tr>
<tr>
<td>Euro effective exchange rate (1995 = 100)</td>
<td>120.8</td>
<td>120.7</td>
<td>118.0</td>
<td>115.8</td>
<td>114.8</td>
<td>114.7</td>
</tr>
<tr>
<td>Euro-US dollar exchange rate ($ per €)</td>
<td>1.33</td>
<td>1.30</td>
<td>1.25</td>
<td>1.22</td>
<td>1.20</td>
<td>1.20</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.
This means that the pickup in external demand should feed through to firms’ investment plans. We expect businesses to boost capital spending in real terms by around 2% in 2014, following two years of falling investment. However, in line with the subpar recovery of exports, fixed investment will grow more slowly than in previous recoveries – by 2.3% in 2015 and just under 3% in 2016-18, compared with 5% or more during the pre-crisis period.

Balance sheets remain relatively strong in the non-financial industrial sector, and Belgian banks seem to have come out of restructuring with much-improved solvency positions. As a result, in the right economic and policy environment firms might be persuaded to accelerate capital spending beyond our expectations. This is an upside risk to our forecast.

**Consumers will respond, gradually …**

In spite of the improvement in activity seen in recent months, there is little sign of improvement in the labor market, with unemployment about 8.5%. In light of an only modest recovery in external demand and business investment, we expect relatively weak job creation over the coming years and, as a result, unemployment is likely to edge up further in 2014, before falling only gradually through 2015 and beyond.

Nevertheless, consumer confidence has continued to improve over recent months, inflation remains below 1% on an annual basis and Belgian households are among the least indebted in the Eurozone. As such, we expect consumer spending to grow by 1.2% in 2014. However, the unemployment rate is set to remain above 8% through 2015 and 2016, limiting the pace of household income and consumer spending growth to just above 1%, with a modest pickup in the medium term to just 1.3% a year.

**… but the Government is constrained by debt burden**

At the same time, the Government will need to embark upon a period of fiscal restraint. Belgium has avoided sharp fiscal cuts over the past few years, but at the cost of a steadily increasing debt burden, now around 105% of GDP. In turn, this creates a higher burden of interest payments than experienced by its peers: the country’s interest payments now account for 3.2% of GDP, 1 percentage point more than in France or the Netherlands.

With limited room to raise tax revenues, which are already over 50% of GDP, it seems inevitable that the burden will fall mainly on spending. We expect government consumption to grow by around 0.6% in 2014, picking up to 0.8% in 2015, and to be only a little higher thereafter.

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**Table 2**

<table>
<thead>
<tr>
<th>Forecast for Belgium by sector (annual percentage changes in gross added value)</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>0.2</td>
<td>1.1</td>
<td>1.4</td>
<td>1.6</td>
<td>1.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.6</td>
<td>3.0</td>
<td>2.1</td>
<td>2.5</td>
<td>2.6</td>
<td>2.3</td>
</tr>
<tr>
<td>Agriculture</td>
<td>-0.7</td>
<td>-0.1</td>
<td>0.4</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Construction</td>
<td>-1.5</td>
<td>-0.4</td>
<td>1.1</td>
<td>1.6</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.0</td>
<td>1.6</td>
<td>1.8</td>
<td>1.9</td>
<td>1.8</td>
<td>1.7</td>
</tr>
<tr>
<td>Trade</td>
<td>-0.3</td>
<td>0.6</td>
<td>1.2</td>
<td>1.4</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>Financial and business services</td>
<td>0.9</td>
<td>1.5</td>
<td>1.9</td>
<td>2.1</td>
<td>2.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Communications</td>
<td>0.5</td>
<td>1.2</td>
<td>1.9</td>
<td>2.2</td>
<td>2.4</td>
<td>2.6</td>
</tr>
<tr>
<td>Non-market services</td>
<td>0.3</td>
<td>0.1</td>
<td>0.8</td>
<td>0.9</td>
<td>1.1</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Source: Oxford Economics.
Opportunity for reform could boost uninspiring outlook

Only a weak recovery expected ...

So although confidence has started to rebound among Belgian firms and households, a number of structural impediments will inhibit the pace of recovery. Exporting firms whose competitiveness has suffered will struggle to match pre-crisis rates of trade growth, in turn curbing their appetite to invest. In light of modest job creation, households seem set to remain conservative with respect to longer-term economic prospects, constraining the pace of consumer spend. Overall, we expect GDP growth to pick up from 1.1% in 2014, to 1.4% in 2015, but remain limited to just over 1.5% a year over the medium term.

... and risks remain

Despite the easing of the Eurozone financial crisis, we remain concerned by the vulnerability posed by Belgium’s debt stock. We estimate that every percentage point increase in the cost of borrowing increases interest payments by €300m a year. This is especially pertinent in light of the possible impact of the US Federal Reserve’s tapering of global liquidity through 2014, as well as the risk of a repeat of the inconclusive Belgian election of 2010, when borrowing costs spiked above 7%.

Belgium’s debt stock also makes the economy more vulnerable to deflation than other core Eurozone economies. Corporates and households enjoy relatively strong balance sheets, so would be insulated from the direct impact of debt deflation, but the same cannot be said of the public sector. Falling nominal revenues would leave the Government with a difficult choice between more hikes in taxes or cuts to spending that would further undermine the recovery.

Need to debate Belgium’s economic future

Belgium’s prospects could be substantially strengthened by an ambitious program of economic reform, in particular in the area of labor market policy. Tackling regulation that deters job creation and labor force participation, especially among low-skilled workers, would go a long way toward reversing the loss of competitiveness that is set to hamper Belgian exporters during the recovery. This in turn would boost investment, both from domestic and external firms, accelerate the labor market recovery, and encourage a faster consumer rebound. As a number of other commentators (including most recently the International Monetary Fund) have noted, progress in this respect over the past few years has been slower in Belgium than in most other Eurozone economies. This is partly because financial market volatility has not provided such an urgent trigger for reform as in the periphery, but also in part due to the long period without an effective government and the compromises necessary in reaching agreement on a coalition.

Set against the backdrop of a tentative recovery, the elections in May provide a fresh opportunity for Belgium to debate these challenges – perhaps with more confidence this time. In light of the social risk posed by youth unemployment (which recently reached 23%, the highest rate since the mid-1990s) and the ongoing vulnerability of the public finances, it is important this opportunity is not missed.

Figure 3
Government deficit and debt

Figure 4
Contributions to GDP growth

Source: Oxford Economics.
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