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BELGIUM AS A SMALL OPEN ECONOMY IN THE CORE OF EUROPE

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ABSTRACT: Small open economies in Europe share many of the same characteristics, policy choices and economic problems. This paper argues that Belgium is profoundly affected by its position as a small open economy in the core of the European Union. Yet, this European dimension does not prevent that even a small open economy as Belgium takes policy decisions with far-reaching consequences. The Belgian experience also provides several interesting insights for other small European countries and for the European integration process as a whole. In this context, particular attention is paid to (1) the consequences of a fixed exchange rate policy, (2) the interdependence between exchange rate stabilization, income policy and international competitiveness, (3) budgetary discipline in the run-up to European Monetary Union, (4) long-run international trade specialization, (5) labor market performance and (6) Belgian federalism

KEY WORDS: small open economies, European integration, federalism

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TIIVISTELMÄ: Monilla Euroopan pienillä avoimella talouksilla on samanlaisia ominaisuuksia, politiikkavalintoja ja taloudellisia ongelmia. Tässä raportissa osoitetaan, kuinka syvästi Belgiaan on vaikuttanut sen asema pienenä avoimena taloutena Euroopan unionin sydämessä. Tämä eurooppalainen ulottuvuus ei kuitenkaan ole esteenä kauaskantoisille poliittisille päätöksille Belgian kaltaisissa pienissä avoimissa maissa. Belgian kokemukset tarjoavatkin mielenkiintoisia oivalluksia muille Euroopan pienille maille sekä koko Euroopan integraatioprosessille. Tässä julkaisussa kiinnitetään erityistä huomiota (1) kiinteiden valuuttakurssien järjestelmän seurauksiin, (2) valuuttakurssien vakauttamisen, tulopolitiikan ja kansainvälisen kilpailukyvyn vuorovaikutukseen, (3) budjettitalouden kurinalaisuuteen ponnistettaessa kohti Euroopan valuuttaunionia, (4) pitkän aikavälin erikoistumiseen kansainvälisessä kaupassa, (5) työmarkkinoiden toimivuuteen sekä (6) belgialaiseen federalismiin.

ASIASANAT: pienet avoimet taloudet, Euroopan integraatio, federalismi

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INTRODUCTION

On the first of January Finland, Sweden and Austria became members of the European Union (EU). They joined the expanding group of small open economies in the Union. While deeply influenced by European-wide developments, those countries also face specific challenges. They possess less political clout and are forced to rely more on coalitions to achieve their objectives (see Widgren, 1994 for a theoretical analysis). In an integrating Europe they are furthermore confronted with other economic constraints than large countries due to their openess and size. In turn, the experience of smaller countries often offers deeper insights in key aspects of the European integration process.

In this paper we study the Belgian experience. Belgium is a small economy that accounts for 3 % of EU population and 3.2 % of EU GDP. It is an open economy with an export/GDP ratio of 67.9%. Moreover, Belgium is very much a core country of the EU not only due to its location but also because of the participation in the European integration process. In effect, Belgium is a founding member of the European Community and has been actively involved in each step of the integration process.

The central hypothesis of this paper is that the size, the location and the openess of the Belgian economy as well as the participation in the European integration process are the keys for understanding Belgian economic policy and performance. In spite of the strong dependence on European developments, Belgian policy makers take decisions which greatly influence Belgium's economic performance. Finally, we argue that the Belgian experience carries some wider implications for other smaller European economies and for the European integration process.

To make these points we first draw a stylised picture of the Belgian economy in Section 1. Section 2 is devoted to the strong currency (Franc fort) policy which is the cornerstone of Belgian macro-economic policy. In Section 3 we turn to the public debt problem that constitutes the fundamental macro-economic weakness of the Belgian economy. Next, in a fourth section, we take a longer term perspective and address the structural challenges in the areas of international trade and the labor market. The fifth section draws a parallel between the problems of Belgium as a federal state and federalism in the EU. The paper ends with some concluding remarks.

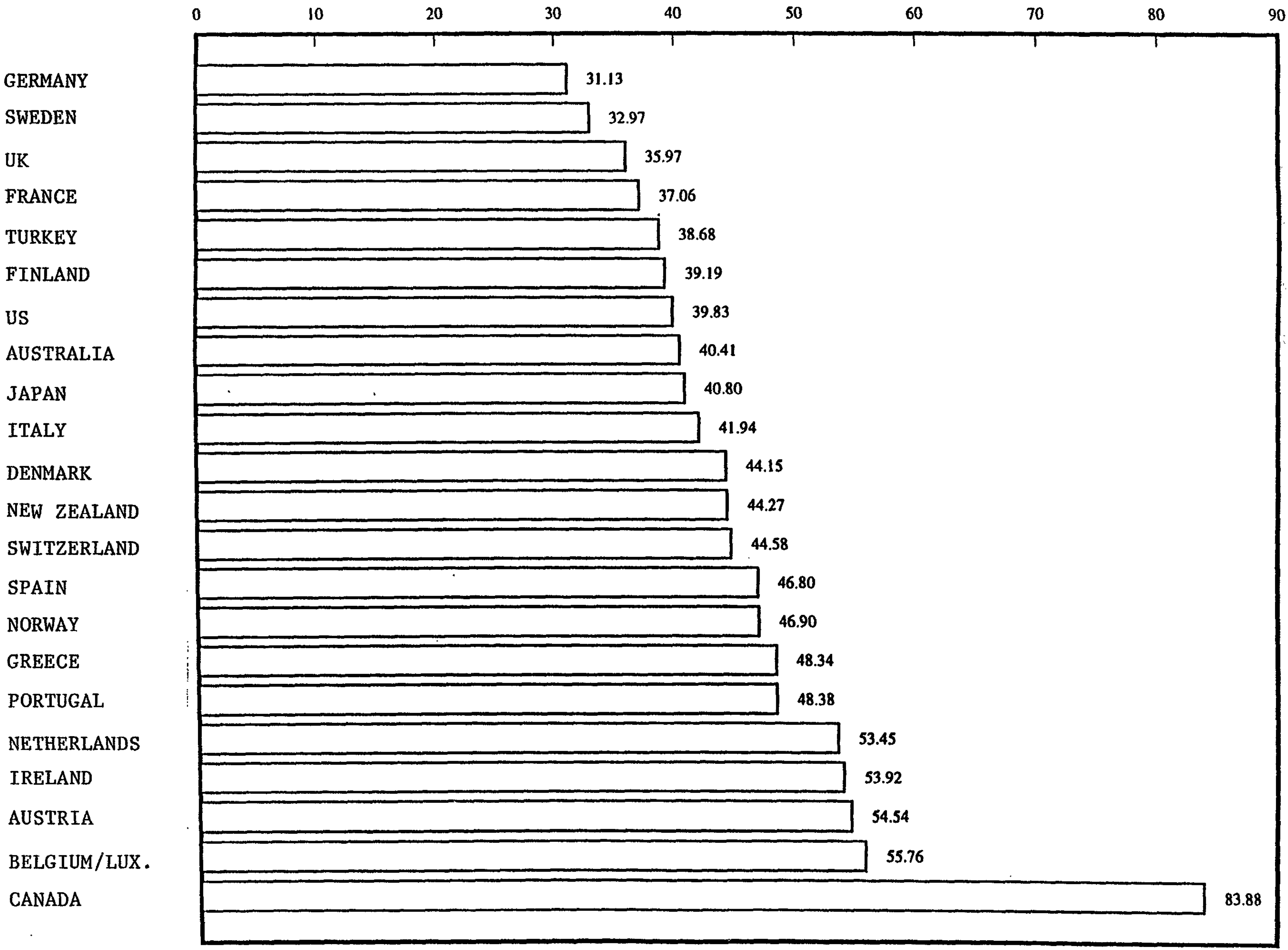
1. MAIN FEATURES OF THE BELGIAN ECONOMY

As mentioned in the introduction, Belgium is an open economy with intense exposure to international trade. The orientation of trade flows is distinctly European. Table 1 lists the main Belgian export markets in 1992 as measured by their respective export shares. The current 15 European Union countries account for 78.1 % of total Belgian exports. The geographical concentration on three trading partners, Germany, France and the Netherlands is striking. Figure 1 shows that 55.8% of Belgian exports are sold in those three markets. In the OECD only Canada is characterised by an even more concentrated export pattern.

Table 1: Main export markets of Belgium in 1992

	Export share (% of total
EC TOTAL	78.07
France	19.26
Netherlands	13.66
Germany	22.85
Italy	5.89
United Kingdom	7.85
Ireland	0.34
Denmark	0.91
Greece	0.60
Portugal	0.79
Spain	2.75
Sweden	1.39
Finland	0.47
Austria	1.32
EFTA TOTAL	2.70
Iceland	0.02
Norway	0.47
Switzerland	2.21
US	3.86
JAPAN	1.04
REST OF WORLD	14.33

Figure 1. Export shares of the three main export markets in 1992 (in % of total exports)



Belgium is a low inflation country. Table 2 compares for 1994 the Belgian inflation rate with other countries in the EU. Belgium belongs to the group of low inflation countries. Throughout the 1980's and 1990's Belgium has consistently maintained a good track record for inflation. In the light of the inflation convergence criterion of Maastricht, Belgian policy makers are determined to continue this satisfactory inflation performance.

Table 2: Position of EU member states w.r.t. the Maastricht convergence criteria

	Inflation rate (%) 1994 average	Budget balance (% of GDP) 1994	Debt (% of GDP) 1994	Long-term interest rate (%) 1994 average
Germany	2.8	-2.5	50.1	6.9
France	1.7	-6.0	48.5	7.5
Italy	4.0	-9.0	125.4	10.6
UK	2.5	-6.9	50.1	8.1
Spain	4.9	-6.6	62.3	9.7
Netherlands	2.3	-3.1	78.1	7.2
Belgium	2.6	-5.3	136.1	7.7
Denmark	1.8	-4.0	75.6	7.9
Portugal	5.5	-5.8	69.2	10.4
Greece	10.8	-12.5	114.1	-
Ireland	2.8	-2.3	89.8	8.2
Luxembourg	2.3	2.3	7.2	6.4
Sweden	2.2	-10.4	79.1	9.5
Austria	3.0	-4.0	64.5	6.7
Finland	1.1	-5.6	60.1	8.4

Belgium is not a fast grower. As seen in Figure 2, real GDP growth was below the EU average in both the periods 1981-1990 and 1991-1993. Growth was slower than in the three major trading partners Germany, France and the Netherlands except for the lower French growth rates in recent years. Keeping in mind that the European Union's growth figures are not that high when compared to other trading blocks, the Belgian growth performance can hardly be described as impressive.

Figure 2. GDP growth in some European countries

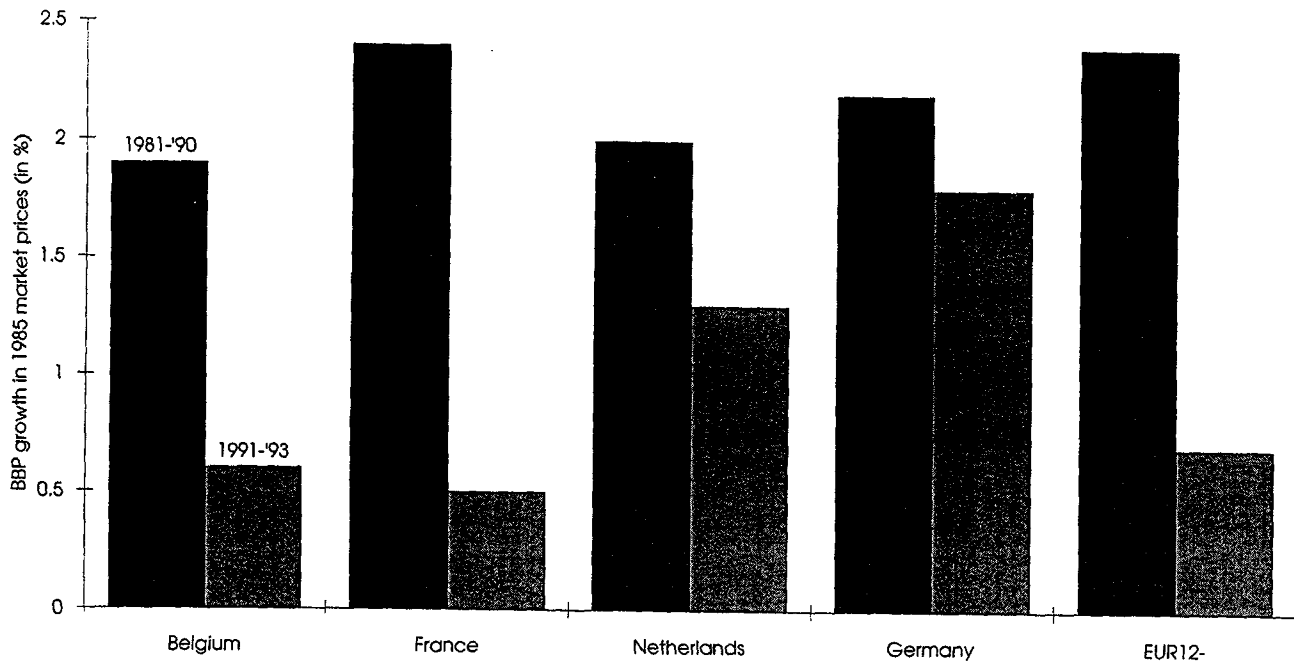
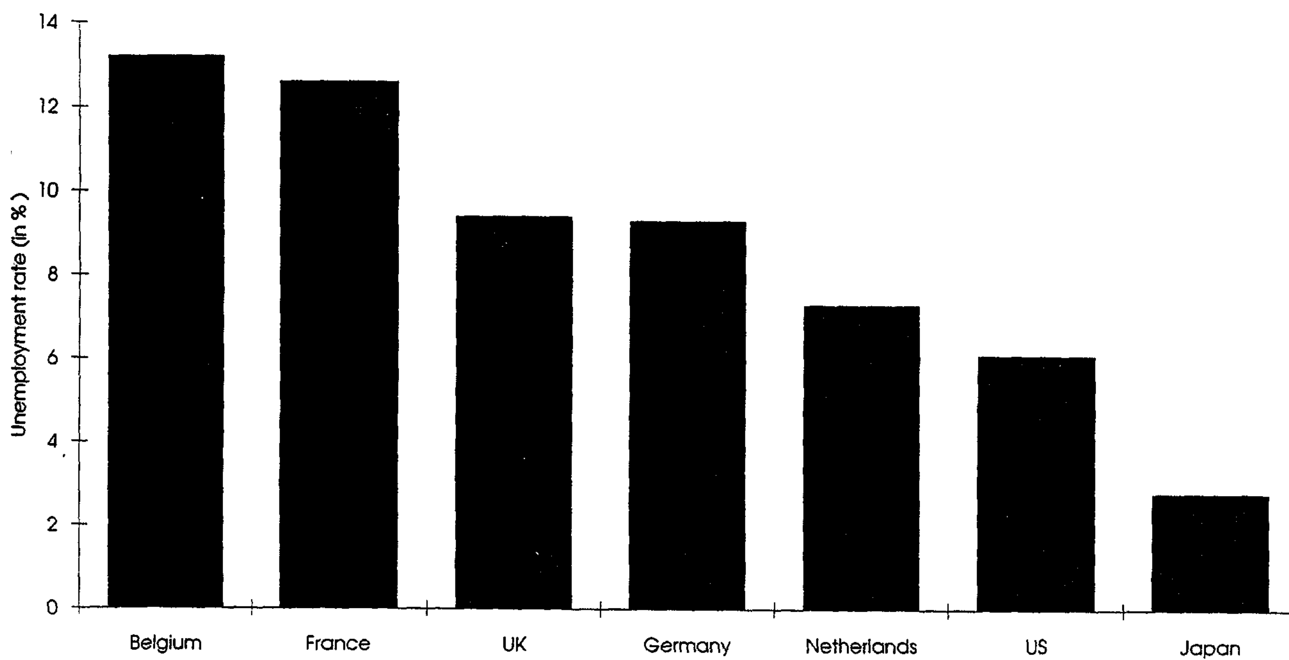


Figure 3. Unemployment rates in Belgium and its main trading partners in 1994



The weak growth spills over in high unemployment. In 1994, Belgian unemployment was above the unemployment rates of the main trading partners inside and outside of Europe (see Figure 3). The internationally exposed industrial sector in particular experiences a rapid destruction of employment. Work by Abraham (1993) illustrates that since 1985 Belgian industrial employment has consistently been declining more than the trade-weighted average of the five and seven main trading partners. In short, Belgium suffers a serious employment problem.

A final distinguishing feature of the Belgian macroeconomic scene is the precarious fiscal situation. As seen in Table 2, the public debt ratio reached 136.1 % in 1994, which puts Belgium at the top of the EU league. The budget deficit amounted to 5.3 % of GDP in that same year and is largely due to the interest payments on the existing debt which in 1994 accounted for 10.3 % of GDP. In fact, the Belgian government runs a substantial primary surplus. In addition, more than 75 % of the debt is in domestic hands. In spite of this, the debt represents without any doubt a heavy burden on the Belgian economy.

2. THE STRONG CURRENCY (FRANC FORT) POLICY

2.1. The making of a strong Belgian Franc

For many years now, a strong currency has been the anchor of Belgian macroeconomic policy. Belgium participated in the European Monetary System (EMS) right from the start in 1979. Except for a major devaluation of the Belgian Franc (BEF) in 1982, Belgium belonged to the stronger currencies in the EMS. From 1990 onwards, the official policy objective became a strict pegging of the BEF to the German mark and an implicit reduction in the fluctuation margins with respect to the DM to 0.3 %. While the turmoil of the August 1993 currency crisis marked an abrupt end to this ambitious policy, the BEF recovered quickly and since then has remained consistently in the "old" 2.25 % EMS margins with respect to the DM. Not surprisingly, Belgium strongly advocates the irrevocably fixed exchange rates and the single currency foreseen in the Maastricht Treaty on European Monetary Union (EMU).

Figure 4 pictures the evolution of the Belgian exchange rate with respect to the two strongest currencies in the EMS, the DM and the Dutch Guilder (FL). The early 1980's show a marked loss in value of the BEF, reflecting the devaluation of the currency and the Belgian efforts to restore international competitiveness. From 1984 onwards the BEF closely mirrors the evolution of the Dutch and German currencies. As a consequence, the Belgian currency experienced a considerable appreciation when compared to currencies of most other EU trading partners. While the relation between the Belgian and the French Franc did not change all that much, Figure 5 illustrates the sharp depreciation of the Lira and the Pound in recent years. A similar story holds for the relationship between the BEF and the currencies of Spain and Portugal.

Figure 4. Evolution of exchange rates: DM/BEF and FL/BEF (1980=100)

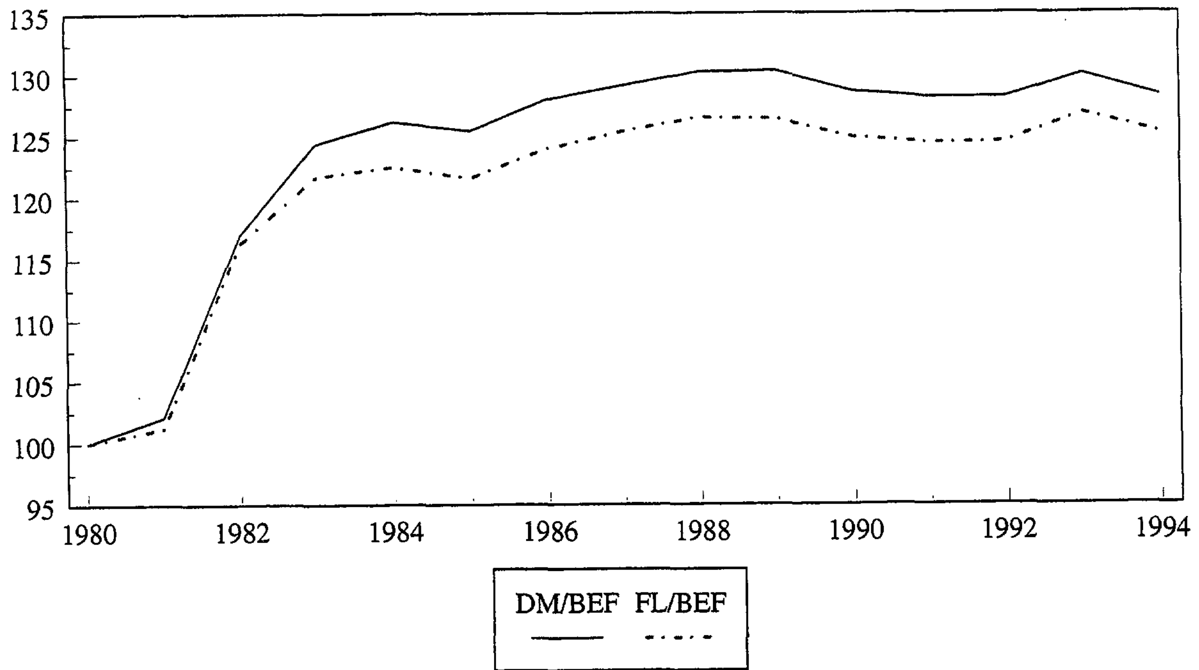
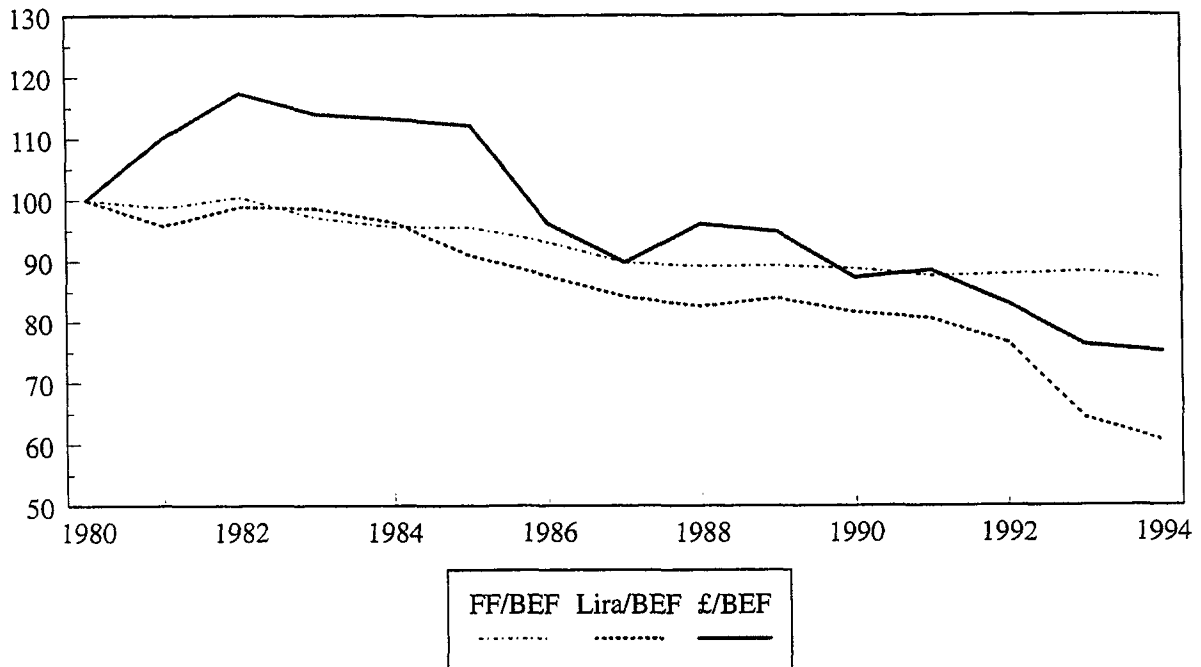


Figure 5. Evolution of exchange rates: FF/BEF, Lira/BEF and £/BEF (1980=100)



2.2. Why a strong currency ?

The motivation for the franc fort policy is fivefold. First and foremost, Belgian policy makers recognize the importance of *exchange rate stability*. As a small open core country in Europe, Belgium is particularly sensitive to unexpected variations in exchange rates. In view of the dominating weight of Germany, the Netherlands and France in the Belgian trade composition, participation in the EMS and pegging to the DM is a reasonable choice. The creation of an internal market reinforces the need for stable exchange rates. Sudden realignments of key currencies are disruptive in a marketplace where protective barriers are gradually being eliminated. To make this point in a different way, one can imagine the resistance of Ohio, Pennsylvania, Indiana and other U.S. states if Michigan were to significantly devalue the Michigan dollar.

A second reason relates more to the specific institutional and economic characteristics of the Belgian economy. As a small open economy Belgium imports a lot of intermediate inputs and consumer goods. Belgium is also the only country in Europe where wages are automatically and fully indexed to changes in the consumer price index. Those features limit the *effectiveness of a devaluation* for restoring international competitiveness. A devaluation quickly spills over in imported inflation through higher import prices. To counteract this inflationary pressure, the indexation system must be temporarily abolished and a tight income policy imposed, measures which were successfully implemented after the 1982 devaluation. Such actions constitute a major reorientation of macroeconomic policy that will only be accepted by the various interest groups in Belgian society if no alternative is available. Hence, exchange rate realignments are not a flexible policy instrument. Generally speaking, it easier to achieve a consensus on a policy of exchange rate stability.

Thirdly, Belgium's desire to be at the *forefront of the European integration process* matters. This factor underlies the continued Belgian participation in the EMS even in periods of turmoil in the financial markets. Today, the prospect of EMU provides a new incentive for maintaining a strong currency. The exchange rate criterion of Maastricht requires a participation in the EMS without any devaluation for at least two years before the start of EMU. Belgium takes EMU seriously.

The precarious state of public finances are a fourth motivation for the exchange rate policy. Pegging the BEF to the DM is expected to *lower nominal interest rates* in Belgium, reducing the interest payments on newly issued government debt. Nominal interest rates are sensitive to exchange rate and inflationary risk. By coupling the BEF to the solid currency of the low inflation anchor in the EMS, the interest rate spread between Belgium and Germany is minimized. Figure 6 shows a gradual convergence of German and Belgian long term interest rates in the period 1982-1994 and a corresponding decline of the interest rate spread.

Finally, a strong currency inspires *confidence in the financial system* of a country. This argument is often heard in Belgian financial circles. Like many medium-sized financial centres in Europe, the Brussels financial marketplace faces intense competition from global financial centres and in particular London. In this context, so the argument goes, Belgium can ill afford a weak currency.

2.3. Income policies as a building block for a strong currency

The choice of an exchange rate objective has far-reaching consequences for the conduct of macroeconomic policy. The pegging of the BEF implies that Belgian inflation should not exceed the inflation rates of the major trading partners and, in particular, should be in line with the inflation performance of the German anchor. If not, the Belgian real exchange rate will appreciate and Belgian trade competitiveness will be undermined.

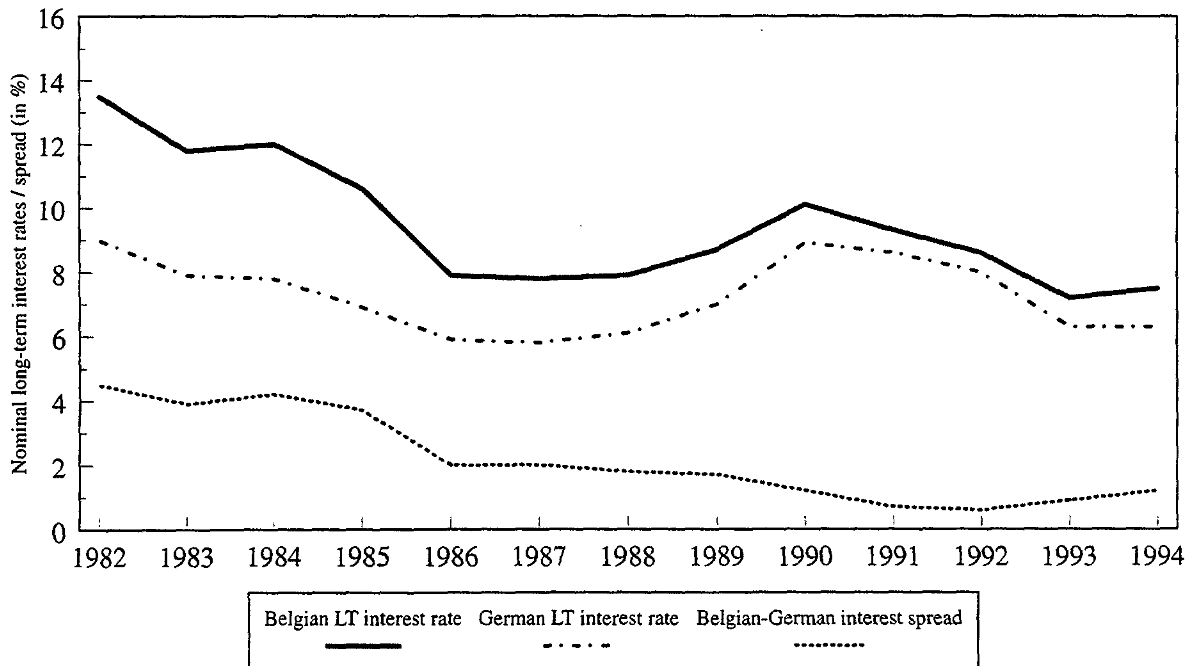
The exchange rate goal constrains monetary authority. The monetary policy of the Belgian central bank therefore closely follows the decisions made by the German Bundesbank. In its turn, a strong currency needs to be backed up by a consistent income policy in order to keep inflation under control. This fact is well recognised in Belgium but, as will be argued now, has proven harder to achieve.

The deep concern for the Belgian international trade position is expressed in the *law on the protection of Belgian international competitiveness* of 1989. Belgium must be one of the few countries in the world with an explicit legal framework of this kind. The law foresees a bi-annual evaluation of the competitive situation based on various measures of export performance, price and cost indices. The benchmark in this evaluation is the weighted average performance of the five (Germany, Netherlands, France, U.K. and Italy) and the seven major trading partners (the five + US and Japan). The assessment of

Table 3. Evolution of the wage cost in Belgium and its five main trading partners (annual % changes)

	Wage cost per employee			Wage cost per product unit		
	Belgium (in BEF)	Five trading partners (in national currency)	(in BEF)	Belgium (in BEF)	Five trading partners (in national currency)	(in BEF)
1982-1984	6.9	7.1	10.9	4.6	5.0	8.7
1985-1990	4.0	4.7	3.7	2.4	2.8	1.8
1991-1994	5.5	4.7	3.4	4.0	3.0	1.6

Figure 6. Evolution of nominal long-term interest rates for Belgium and Germany



competitiveness is done by the social and economic council which is composed of trade union and employer representatives as well as of independent experts. The council reports to the government which is supposed to take action if Belgian competitiveness is deteriorating.

In this process a lot of emphasis is being placed on the evolution of Belgian wage costs and unit wage costs in comparison to the five or seven trading partners. The principle is that the yearly growth in Belgian (unit) wage costs should not exceed the weighted wage growth of the five and seven trading partners. The economic rationale for this rule is that wage developments are an important determinant of domestic inflation and hence of the real exchange rate and relative trade performance. It is not difficult to establish a close theoretical link between the real exchange rate and unit labor costs expressed in a common currency. The wage principle formulated here is a rule of thumb approach to this theoretical relationship.

We conclude that wage control is at the core of the macroeconomic strategy to protect international competitiveness. This is not all that surprising since labor costs are one of the few policy variables available in a small open economy with quasi-fixed exchange rates.

How successful has the implementation of the wage rule been in the last decade or so[1]? Table 3 presents information for manufacturing on the evolution of nominal wage costs per employee and of nominal unit wage costs[2]. The average annual percentage wage growth in Belgium is compared with the wage growth of the five trading partners expressed both in their own national currency and a common currency (the BEF). The manufacturing sector was selected because it accounts for a major part of international trade in Belgium and the European Union.

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[1] The law only took effect in 1989. The figures for the period 1982-1989 should not be interpreted as an evaluation of the law.

[2] A similar picture emerges for wage costs per employee and wage costs per product unit (unit wage costs) suggesting that gains in labor productivity are quite similar in Belgium and the five trading partners.

We find a different pattern for the three time periods considered. During the period 1982-1984 Belgian wage growth was well below the wage increases granted in the major trading partners. This was true for the figures in national currency reflecting the strict income policy following the devaluation of 1982. The devaluation itself is clearly visible by noting the significantly higher Belgian wage advantage when the figures for the trading partners are converted in BEF. This points to the competitive advantage of a depreciating exchange rate accompanied by effective income policies.

Exchange rate movements dominate the wage comparison for the second half of the 1980's. Belgian wage increases remain below the wage gains of the five trading partners when exchange rate changes are not taken into account. Yet, the picture is reversed when wage changes are compared in a common currency : Belgium suffers from a wage handicap. This reflects the gradual appreciation of the Belgian effective exchange rate in this period. Again, we conclude that exchange rates matter for international developments in cost competitiveness.

In the early nineties Belgian wage discipline is slipping even more. Wage costs per employee expressed in national currencies rise at more (5.5 %) in Belgium as in the five trading partners (4.7 %). A similar picture emerges when unit wage costs are considered. The appreciation of the BEF accentuates the Belgian cost disadvantage as is seen from comparing the wage evolution in a common currency. The recent depreciation of the British, Portuguese, Italian and Spanish currencies only aggravates this tendency.

We conclude that, from the second half of the eighties onwards, Belgian wage negotiators did not adhere to the wage principles found in the law on international competitiveness. This is partially but not fully due to the evolution of the exchange rate which is hard to predict on the moment of the wage negotiations. No wage moderation was imposed ex post to correct for the resulting wage handicap.

Table 4: Labour costs in manufacturing in 1993 (Belgium = 100)

	Labour cost	Wage Cost	Non-wage costs
Germany	117.4	124.5	109.8
Switzerland	108.8	138.3	77.1
Japan	102.6	113.3	91.1
Belgium	100.0	100.0	100.0
Norway	99.9	127.7	70.0
Netherlands	95.5	100.2	89.9
Austria	91.6	90.7	92.6
Denmark	90.9	144.7	33.0
Luxembourg	87.2	116.1	56.2
Sweden	82.2	92.5	71.0
France	78.4	78.1	78.7
Canada	76.9	107.6	44.0
U.S.	76.6	103.3	47.9
Italy	74.7	71.9	77.6
Finland	71.9	81.8	61.2
U.K.	61.0	83.1	37.1
Ireland	58.5	80.2	35.2
Australia	58.0	82.3	31.9
Spain	57.0	60.1	53.7
Greece	31.9	37.1	26.3
Portugal	21.5	22.9	19.9

This is a worrysome finding because Belgium is a country with high labor costs. Table 4 contains information about manufacturing labor costs for twenty-one OECD countries in 1993. In the second and third column labor costs are divided in wage costs and non-wage labor costs (primarily social security contributions by employers). All data are converted in a common currency and expressed as an index with respect to the Belgium figure. Belgium is among the top five countries with the highest labor costs behind Germany, Switzerland and Japan. Wage costs are undoubtedly contributing to this position but are not the primary cause. The social security system imposes a heavy burden on employers resulting in the second highest non-wage labor costs (behind Germany) of the countries considered here. Consequently, insufficient wage discipline is not compensated by low non-wage labor costs.

High labor costs and an unfavorable relative wage evolution are not without consequences for Belgian export performance. Figure 7 shows the yearly percentage change in the export market shares of the Belgian-Luxembourg Economic Union (BLEU) and (the weighted average of) the five main trading partners. The market shares refer to manufacturing and are defined in real (volume) terms as the difference between the export growth of Belgium or the five trading partners and the total growth observed in the main export markets. For most of the time span considered, both the BLEU and the five trading partners face losses in market shares. Recalling that the BLEU and the five countries are all members of the European Union[1], this points to a more widespread decline of European competitiveness. After 1987 the export performance of the BLEU is moreover consistenly worse than that of the five trading partners with the exception of 1991 when Belgium benefited greatly from the effects of German reunification. In short, Belgium has been loosing ground relative to a group of EU member states which is itself under pressure on international markets.

2.4. Towards a sustainable exchange rate policy ?

The conflict between the exchange rate target and the international trade position gives rise to a double response. The first strategy attempts to make the income policy compatible with the chosen exchange rate policy. In this reasoning, the pegging to the DM is the only reasonable policy choice. This view is fiercely defended by the central bank (see Nationale Bank, 1995) and implies that labor cost developments should be brought in line with this policy. To do so, the government introduced a hidden temporary wage desindexation in 1994 by revising downward the price index that is at the base of the automatic wage indexation. It furthermore imposed a two year real wage freeze for 1994-1996 and selectively reduced non-wage labor costs by lowering social security contributions for specific groups in the labor market. In the months to come, the new government is likely to evaluate the effectiveness of the law on competitiveness in close cooperation with the trade union and employer representatives. The idea is to speed up intervention in the wage formation process once a deterioriation of the competitive position has been established.

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1 As mentioned earlier, the five main trading partners are Germany, the Netherlands, France, U.K. and Italy.

The other school of thought questions the unconditional pegging of the BEF to the German mark. The early proponents of this view were a group of academic economists from the University of Leuven in august 1993. Recently, similar doubts are increasingly being heard in the industrial export sector which argues that the benefits of the real wage freeze have been offset by nominal wage moderation in several major trading partners. The competitive effects of the decline in the value of the pound, the lira, the peseta and the escudo are emphasized. Serious concerns are being voiced about a potential devaluation of the French Franc in the early stages of the Chirac presidency.

At stake is a fundamental controversy about the optimal anchor for a small open economy. The choice of the financial sector, the central bank and the government is that only the DM has proven to be a trustworthy anchor in the past. In industrial circles more attention is paid to the impact of labor costs on competitiveness and a close link to the DM is not deemed appropriate if the currencies of key trading partners decline in value against the DM.

2.5 Lessons from the Belgian experience

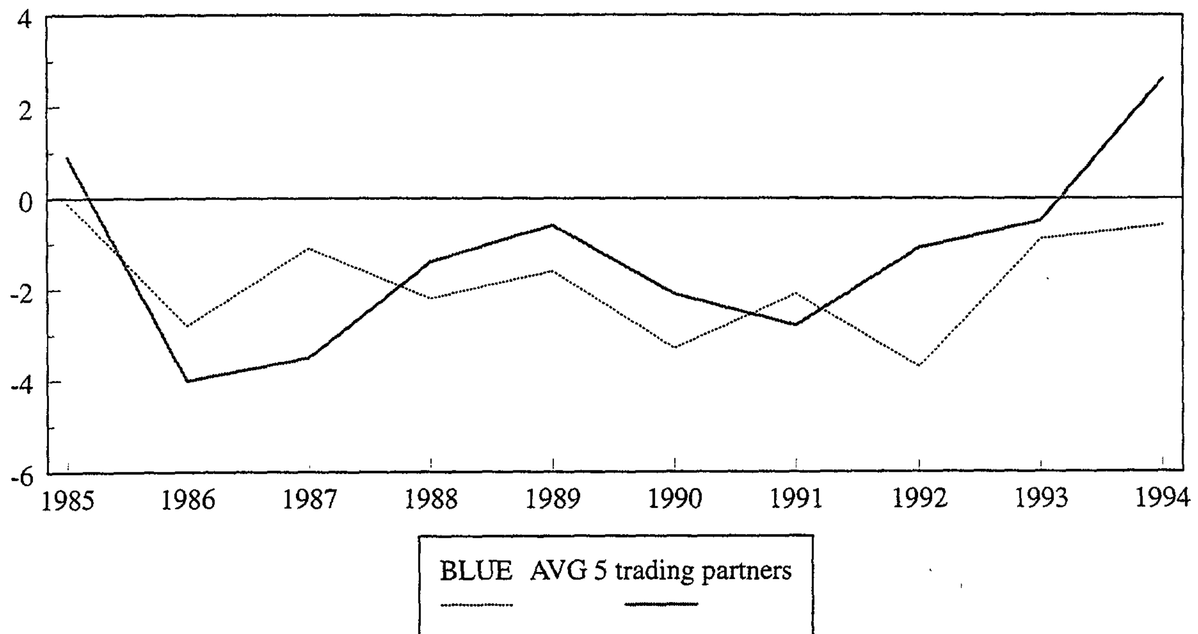
The Belgian experience with the strong currency policy carries broader implications for other small open economies . We discern four main lessons:

1. Countries should carefully select the exchange rate anchor when they decide to peg their currency. The anchor should be stable and preferably belong to (one of) the country's trading partner(s). On the other hand, the proposed anchor should be realistic in the sense that countries must be able to meet the macroeconomic constraints imposed by the fixing of the exchange rate.

2. Income policy is a fundamental building block of a successful exchange rate pegging. With a fixed exchange rate, the stabilization of the real exchange rate requires an identical inflation rate as in the anchor country. In practice, this means that the growth in wages and labor costs, expressed in a common currency, is at most equal to that of the anchor country unless labor productivity is growing more rapidly. The Belgian experience shows this to be a difficult task that becomes even more challenging when exchange rate realignments take place.

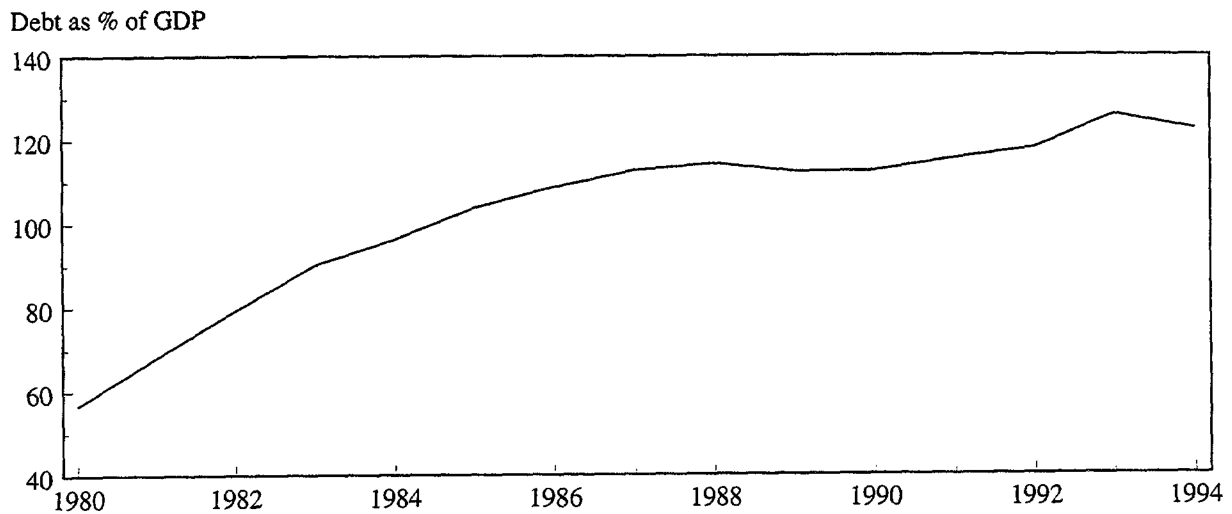
3. Looking at the future, the emphasis on income policy is likely to become even stronger. In EMU irrevocably fixed exchange rates and/or a single currency rule out devaluations that are aimed at restoring trade balance equilibrium. Labor cost moderation is one of the few macroeconomic options open for economies facing country-specific adjustment problems (see European Commission, 1990, chapter 6).

Figure 7. Export performance in manufacturing - Gain /loss in market share (in volume)



Export performance = observed growth of export volume - growth of export market

Figure 8. Evolution of Belgian debt



4. The Belgian experience points to conflicting interests within one country on the exchange rate policy to be followed. The objectives of the central bank, financial and public sector do not necessarily coincide with the considerations of the industrial sector. Trade unions may hold yet another view on which exchange rate policy best suits the interests of their members.

3. THE BUDGETARY MESS

As pointed out in the overview of the Belgian economy, Belgium is burdened with a heavy government debt. This debt leaves very few degrees of freedom for activist budgetary policy. On the contrary, governments can offer the electorate little else than a sheer endless series of austerity packages as they are usually called in Belgium. This has been going on since the early eighties and will undoubtedly continue for the years to come. The light at the end of the tunnel is not yet in sight.

One wonders how it came this far. The answer is a sobering one for any policy-maker. The seeds for the budgetary mess were sown in a relative short time period and were insufficiently corrected afterwards. Through the mechanism of interest payments on the existing debt, a cumulative debt accumulation was set in motion that is difficult to halt. Clearly, economic policy decisions matter greatly even in small open economies with limited macroeconomic independence.

The years of budgetary mismanagement were situated from 1975 to 1981. Belgium attempted to absorb the severe recession that followed the first oil crisis by expansionary demand policies. Public sector employment expanded sharply and massive sums were poured in subsidization of declining industries like steel, coal mines and shipbuilding. The consequence was a soaring debt ratio.

The devaluation of the BEF in the early eighties also marked a turnaround in the budgetary profligacy. The government embarked upon a restrictive budgetary policy by cutting government expenditures. However, this effort took place in a recessionary climate which neutralized the effects of the tougher budgetary stance. In effect, Figure 8 shows a further increase in the debt ratio between 1982 and 1986 which was only curbed when economic actitivity picked up in 1986.

The next years, from 1987 to 1991, offered a unique opportunity to achieve a major reduction in the debt. Strong real economic growth generated additional tax income that could have been used for debt relief. Unfortunately, the government did not seize this chance. The debt ratio stabilized but did not decline (see Figure 8). This left Belgian public finances particularly vulnerable when the country plunged into recession in 1992-1993. In Figure 8, the debt ratio is seen to move up again during those years.

What will the future bring ? The debate on this issue is dominated by Belgium's deep wish to participate in EMU. As is well known, the Maastricht Treaty on EMU contains two convergence criteria that are directly related to public finance. The yearly budget deficit of a successful candidate for EMU is not supposed to exceed 3 % of GDP. This criterion will be strictly applied. The other constraint relates to the government debt which should at most be equal to 60 % of GDP. Here there is some leeway since countries that do not reach this objective but show reasonable progress can be admitted to EMU by the other member states. Based on this loophole, Ireland was recently judged by the European Commission to be on the path towards fiscal solidity.

The Belgian government has repeatedly confirmed its firm intention to reduce the budget deficit to 3 % of GDP in 1996 when the intergovernmental conference on EMU takes place. A failure to achieve this objective would most likely imply the rejection of the Belgian candidacy for EMU by the other member states. To reach this goal, the federal government reduced the budgetary and social security deficits by an estimated 74 billion BEF (1 % of GDP) in 1992, 186 billion BEF (2.5 % of GDP) in 1993 and 136 billion BEF (1.8% of GDP) in 1994. For 1995 the figure of 100 billion BEF (1.4 % of GDP) of additional budgetary measures is often mentioned. All of this implies a substantial primarily surplus that is intended to reach 6.3 % of GDP in 1996. Whether those significant efforts will suffice to attain the 3% in 1996 is not certain and will depend on factors such as economic growth and the evolution of interest rates.

A budgetary deflation of this magnitude is a painful process. During the eighties expenditures on public infrastructure took the brunt of the cuts in government expenditures. This led to a deterioration of road infrastructure, the efficiency of the judicial system and of other vital aspects of public service. For instance, public expenditures on goods and services declined from 3.6 % of GDP in 1985 to 2.6 % in 1992. At that stage a further compression of this type of expenditure was deemed harmful for the functioning of the economy. Other sources of budgetary savings and government revenues

had to be found. Gradually, the attention shifted to a rethinking of the social security system, a theme which dominated the electoral campaign of early 1995.

Even if the 3 % deficit norm is attained by 1996, the debt ratio will exceed 60 %. It is simply impossible to bring down the debt ratio to the Maastricht norm before well into the next century. Simulations by De Grauwe (1995) indicate that with optimistic assumptions about interest rates and economic growth it will take until at least 2008 to reach the 60 % norm if the forecasted primary surplus for 1996 of 6.3 % of GDP is maintained afterwards. Note that with such a primary surplus the budget deficit will after some time turn into a gradually increasing budget surplus. Without any doubt, a sustained commitment to this policy will require a lot of political courage.

Summarizing, Belgium has a fair chance of satisfying the Maastricht deficit norm in 1996 but will not meet the debt criterion by 1996 nor by 1999. Will Belgium be allowed to join the EMU ? The Belgian official position sounds rather confident. In view of the substantial efforts of the last years, Belgium will qualify as a country with reasonable progress towards fiscal balance. Germany, France and the other Benelux countries will support Belgian membership as one of the core countries of the European integration process. Yet, not everyone shares this confidence. De Grauwe (1995) argues that EU member countries may take a critical attitude against "Maastricht sinners" because it is politically sensitive to allow in some countries that are not meeting all of the convergence requirements while leaving out other member states in a similar situation.

Suppose that a monetary union is created and that Belgium is not part of it. Surprisingly, this scenario has not been considered yet in the Belgian policy debate. Clearly, this would mean a major loss in reputation and trigger a confidence crisis in the Belgian economy. The Belgian Franc would come under severe pressure and would presumably undergo a significant depreciation. The nominal interest rate at which the Belgian government borrows on the capital market would soar, further aggravating the debt problem. To limit the damage, an immediate announcement to unconditionally peg the BEF to the DM would be the best strategy in this worst possible scenario.

4. STRUCTURAL PROBLEMS OF THE BELGIAN ECONOMY

In this section we take a longer term perspective at some of the structural challenges facing the Belgian economy in the next decade. Specifically, we first discuss the sectoral specialisation of the Belgian economy in an international context. Subsequently, we focus on the reform of the labor market and the social model.

4.1. What will Belgium produce tomorrow ?

The world economy is undergoing profound changes. Dynamic Asian economies are accounting for a rapidly increasing share of world economic activity. The opening up of Eastern Europe positions Western Europe next to a large pool of cheap and relatively productive labor. Increasingly, global competition is taking place between large trading blocks.

Those structural changes cause a deep-seated apprehension on the future prospects for the Belgian economy. Gloomy predictions on massive delocalisation of industrial companies to the emerging economies abound in the media, in political and in business circles. A recent study (Planbureau, 1994) indicates that the delocalisation of Belgian companies to Eastern Europe and Asia is taking place but should not be exaggerated. In spite of this finding, creative new thinking on the international position of Belgium in a changing world economy is appropriate and necessary. Recent publications by Vlaams Economisch Verbond (1994, 1995), Abraham et al. (1995) among others are quickly bringing this issue to the limelight of the economic policy debate.

In a nutshell, what are the main international strengths and weaknesses of Belgian international specialization ? For several years now, Belgium can be considered as a high labor cost country. This is a serious handicap in the light of the marked Belgian trade specialisation in mature or maturing industries (e.g textiles, automobiles, glass and steel) that are not seldom quite labor-intensive. Belgian industrial companies adjusted creatively by specializing in scale- and capital-intensive niches of those sectors. This allowed them to exploit economies of scale compensating for the higher labor costs.

This industrial strategy is vulnerable in the current globalised environment. Increasingly, scale- and capital-intensive production processes can be and are being copied by emerging economies who, unlike Belgium, benefit from a labor cost advantage. This forces Belgian firms to continuously boost labor productivity, leading to declining industrial employment and ever-increasing demands on the employed labor force.

To survive in the international competitive environment, firms must focus on innovative products and activities with a high value added. Where industrial innovation is concerned, Belgian ranks among the OECD countries with an average to low innovative specialization pattern. Research by Coe and Helpman (1995) demonstrates the strong dependence of Belgian macroeconomic productivity on Research and Development in other countries. As one could expect for a core country, Belgian clearly belongs to the European cluster dominated by innovations in Germany and France. Unfortunately, there is quite some evidence that this cluster has not been performing all that well in the last fifteen years (European Economy, 1993).

According to the available research (Tharakan and Waelbroeck, 1988, Schumacher, 1992), Belgian exporters do not specialize in activities with a high contribution of skilled labor. The human capital content of Belgian exports to the main trading partners is relatively low in comparison to the skilled labor embodied in Belgian imports from those countries. This finding is quite surprising in the light of the reasonably good education system and may reflect the export specialisation in mature industries. Alternatively, many high skilled professionals may choose the service sector instead of building a career in industry.

Belgium is also loosing some of its attractiveness as a location for foreign direct investment. While Brussels continues to attract business as the capital of Europe, foreign investors are scared away by excessive and opaque government regulation, high labor costs, congestion and inefficient telecommunication systems. In light of the renewed emphasis on cumulative regional agglomeration processes in an integrated area (see Krugman, 1991), the core position of Belgium cannot be taken as granted.

The picture is however not as bleak as the previous paragraphs may seem to suggest. Belgium is actively participating in the rapid internationalisation of services. In the more traditional industrial activities, many Belgium companies have successfully developed lucrative niches with innovative and high value added products. In doing this, they often relied on new technological opportunities to combine scale-intensive production processes

and product differentiation. Belgian companies are also active in several fast growing markets in Eastern Europe and Asia.

In short, Belgian companies will in the years to come undergo profound and sometimes painful adjustment processes. Quite likely, tomorrow they will not be producing any more what they produce today. There are hopeful signs that several companies are successfully adjusting to the changing environment. One can only hope that the institutional framework of the Belgian economy will show similar flexibility in this transition period.

4.2. The functioning of the labor market and the sustainability of the social model

An efficient labor market is an essential building block of a strongly performing economy. Wages and employment should adjust smoothly to changes in the economic environment. Those changes have been profound and favoured the position of well educated and creative labor at the expense of unskilled workers (see Reich, 1992 and others). In the U.S. this evolution led in the eighties to a widening income gap between the two types of labor accompanied by a substantial real wage decline for the less educated group. In Europe the erosion of the income position of the unskilled was deemed socially unacceptable. The relatively high labor cost of lowly educated labor resulted in high and sustained unemployment. The unemployment benefits were financed by taxes and social security contributions paid in large part by the favored income groups. In contrast to the U.S., the burden of the shifts in the international division of labor is thus placed on the groups who should have been favored by this evolution. This threatens to undermine the consensus on which the European model is built.

In this paper we do not intend to offer an in-depth analysis of the Belgian labor market. We do however maintain that the income maintenance of the disfavored labor force at the expense of the favored group is a key factor in understanding the sluggish Belgian labor market performance and the large numbers of long-term unemployed. In effect, the income position of the disfavored group was sheltered from the impact of international competition in several ways.

Table 5: Net replacement income in Belgium as % of the income when employed

Unemployment Duration		Unmarried	Married, head of the family two children, unemployed	
			Spouse not working	Spouse working
1 month	1989	70.0	66.2	78.5
	1990	69.4	66.5	78.8
13 months	1989	47.2	69.4	73.2
	1990	47.4	69.7	71.8
25 months	1989	47.2	69.4	67.0
	1990	47.4	69.7	66.5

Firstly, unemployed workers are entitled to unemployment benefits of unlimited duration. Table 5 computes the net replacement income as a percentage of the income when employed. While the income of unmarried workers is halved after two years of unemployment, the typical married household does not suffer a comparable decline in income. In fact, the married employee out of work still receives 66.5 % to 69.7 % of the net income after two years of unemployment depending on the employment position of the spouse. Considering that both spouses work in many married Belgian couples nowadays, that part-time unemployed workers are eligible for unemployment insurance, and that there are ample opportunities in the black market, the incentives to accept lower paid jobs are weak. Needless to say that the budgetary cost of the unemployment insurance system is substantial. As seen in Table 6, unemployment benefits in 1991 accounted for 2.07 % of GDP in 1991.

Secondly, early retirement schemes have been applied consistently in the last fifteen years in an effort to decrease the labor supply. Public expenditure on early retirement amounted to 0.75 % of GDP in 1991. Often, early retirement schemes are implemented in companies that face major restructuring or closure. It is becoming common practice that workers in their early fifties retire early when their company sheds labor as part of a restructuring plan. In general, the government bears a significant part of the financial cost of the early retirement schemes.

Table 6: Public expenditure on labor market programs, 1991 (expenditure as % of GDP)

	Belgium	Denmark[a]	France	Germany[a]	Netherlands[b]	Uk[c]	Spain[a]
1. Labor mediation	0.19	0.11	0.13	0.24	0.09	0.17	0.11
2. Training and education	0.14	0.40	0.35	0.59	0.21	0.18	0.08
3. Measures for the youth	-	0.26	0.23	0.06	0.07	0.18	0.06
4. Employment subsidies	0.55	0.39	0.11	0.52	0.05	0.02	0.32
a) private sector	0.05	0.28	0.05	0.07	0.03	-	0.13
b) unemployed starting up a firm	-	0.11	0.02	-	-	0.02	0.12
c) job creation in the public sector	0.50	-	0.04	0.44	0.02	-	0.07
5. Handicapped employees	0.16	0.40	0.06	0.24	0.63	0.03	-
6. Unemployment benefit	2.07	3.69	1.46	1.32	2.17	1.69	3.07
7. Early retirement	0.75	1.28	0.47	0.49	-	-	-
TOTAL	3.87	6.53	2.82	3.46	3.22	2.28	3.65

a 1992

b 1990

c 1992-1993

\- negligible

Source: OECD (1993), Employment Outlook, p. 73-78.

The system of wage determination is a third factor strengthening the position of the unskilled group of workers. Wage negotiations are conducted at the national and at the sectoral level with a smaller input at the company level. A few powerful unions negotiate minimum wage increases and minimum levels of social protection that become the standard for large parts of the economy irrespective of the specific conditions at the sectoral or the company level. Those minimum conditions primarily benefit the income position of the unskilled and lower paid workers while simultaneously hampering the wage moderation needed to protect their employment opportunities.

Finally, selective reductions in social security contributions for youngsters and long-term unemployed are an essential part of the unemployment policy of the Belgian government. Those measures are recommended by the Delors White Paper on growth and competitiveness are undoubtedly a valid instrument in combatting unemployment. Once more though, the reduced revenues of the social security system are likely to be made up by the employed labor force.

Those points raise the deeper question of what level of social protection Belgium can still afford in the world of today. In this kind of reflection careful attention should be paid to the division of the social costs and the benefits between the various groups of society. Also one should think of how the social model should be (re)designed as not to distort incentives in the labor market. In our opinion, a thorough reflection on those issues should be at the top of the policy agenda in the years to come.

5. BELGIUM AS A FEDERAL STATE

Belgium is a federal state with a complex structure. The country is divided in three regions (Flanders, Wallonia and Brussels) which constitute the building blocks of the federation. Belgium furthermore consists of a Flemish and French speaking Community accounting for approximately 60 % and 40 % of the population and counts a small German-speaking Community among its citizens. The difference in language conceals a deeper tension between a germanic and latin culture living together in one country. Most of the Flemish live in Flanders. The Walloon region is entirely french-speaking. Brussels is a bilingual city with a strong majority of french-speaking Belgians.

Evidently, the current situation cannot be understood without a comprehensive analysis of the historic, cultural and economic conditions in Belgium that goes far beyond the scope of this paper. Here we want to point to two main issues in Belgian federalism that carry wider implications for the building of a European federal state.

First, there is the division of competences between the federal and the sub-federal (regional) level. The theory of fiscal federalism advances *subsidiarity* as the guiding principle according to which government functions should be allocated to the decentralised level unless welfare gains can be reaped by centralisation. The division of powers follows this principle to some degree. For instance, education, culture and regional economic development are regional matters while monetary policy and defense are decided on the federal level.

The application of subsidiarity is however far from perfect due to the political struggle between the French and the Flemish language communities. On several issues the two communities take conflicting positions. On regular occasions, these diverging views culminate in a crisis at the federal level which threatens to bring down the federal government and to make the governing of the country unfeasible. The solution is often sought in "regionalisation" which means that the decision power on the contentious issue is transferred to the regional level. While this breaks the deadlock in the short run, it results in a "federalism à la carte" and strenghtens the position of the regions at the expense of the federal level. In the end, one risks to end up with an empty federal shell and little cohesion left among the regions.

Several parallels can be drawn with the situation in the European Union. As is the case in Belgium, the application of subsidiarity is far from perfect due to political tensions between the member states (the subfederal level in the European federal state). When a consensus cannot be reached, the competence is often allocated to the member states even when centralisation would be beneficial. Federalism à la carte is not far away when individual member states demand and obtain exceptions from the "Acquis Communautaire" (e.g. opt-outs from monetary union and the social chapter). In absence of a workable division of powers, the European Union risks one day to cross a point of no return for federalism.

A second important issue concerns *solidarity between surplus and deficit regions.* For several years now, there exists a serious imbalance between the Belgian regions. The prosperous Flemish region achieves a social security surplus of around 3 % of regional

GDP (Demeester, Yvergneaux and Van Rompuy, 1994). Regional revenues exceed expenditures by a factor of 10 to 20 %. In contrast, the Walloon region is plagued by substantial deficits year after year. Brussels turned from a surplus into a deficit region around 1980.

The Flemish region has compensated the deficits of the two other regions by transfers through the federally organized social security system (that is pensions, unemployment and health insurance). This unconditional regional solidarity is being questioned by the Flemish side. In the Flemish view, part of the transfers go to finance excessive medical consumption,unreasonably long sickness leaves and high absenteism in the Walloon region. For this reason, several Flemish politicians demand an elimination of the "abnormal" social security expenditures and, if not achieved, the transfer of the social security system to the regional level. Not surprisingly, this view is fiercely resisted by the French-speaking community who so far blocked any initiatives in this direction.

Again we see many similarities with the European debate on regional redistribution. Regional policy distributes funds from the richer to the poorer regions in the EU. Several richer member states criticize this regional aid as being wasteful and open to fraud. They plead for full tranparancy in the set-up of European regional policy. More fundamentally, they attempt to assess the degree of solidarity that is needed to maintain sufficient cohesion in the EU.

CONCLUSION

We started this paper with the central hypothesis that the size, the location and the openess of the Belgian economy as well as the participation in the European integration process are the keys for understanding the Belgian economic performance.

Size, openess and location matter because they explain the search for exchange rate stability with respect to the major trading partners. This resulted in the strong currency policy of following the DM. Involvement in international trade furthermore motivates the growing concern about delocalisation and the long run international specialization of the Belgian economy.

The long standing Belgian interest in European integration shows in the participation in the European Monetary System and the desire to join the European Monetary Union whenever it is created. This choice for Europe severely constrains monetary fiscal and income policies.

The far-reaching impact of European-wide developments does not prevent that the main policy decisions in Belgium profoundly affect Belgian economic performance. The most striking example is the budgetary mismanagement during a relatively short time period (1975-1981) that saddled the Belgian economy with a yet unresolved public debt problem. The labor market provides another example. At least part of the high and persistent unemployment is caused by a combination of unemployment benefits of unlimited duration, extensive early retirement schemes and high social security contributions to mention just a few factors.

What other lessons can be learnt from the Belgian experience ? Smaller European countries in particular may be interested in the close interdependence between exchange rate stabilization, income policy and international competitiveness. The Belgian exchange rate pegging constrains productivity-adjusted wage increases, expressed in a common currency, to the wage evolution of the major trading partners. Although formalized in a law, Belgium did not adhere to this principle from the second half of the eighties onwards. The emerging wage handicap deteriorated the international competitive position of the Belgian industrial sector.

Other insights come from Belgian federalism. The difficulties of developping a workable division of competences between the federal and regional authorities in Belgium are also being faced on the EU level by member states and EU institutions. The conflict between surplus and deficit regions in Belgium on the amount and conditions of regional aid mirrors the opposition on European regional policy between the richer North and the less developed South.

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