Creditreform Sovereign Rating

Creditreform Rating
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Rating Object	Rating Information	
KINGDOM OF BELGIUM	Assigned Ratings/Outlook: **AA /stable**	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	30-09-2016 28-07-2017 “Sovereign Ratings”

Rating Action

Neuss, 28 July 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “AA” for the Kingdom of Belgium. Creditreform Rating has also affirmed Belgium’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “AA”. The outlook is stable.

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Key Rating Drivers

1. Despite its complex structure of government, the sovereign’s institutional setup continues to be strong and the macroeconomic policy-making solid
2. Significant reform effort demonstrated since 2015; e.g. wage-setting process, taxes on labor, social security contributions, R&D and innovation
3. Economy characterized by very high levels of per-capita income and productivity; after a transitory setback we expect Belgium’s economy to gather pace on the back of robust investment and strengthening consumer spending
4. Very high government debt and repeated fiscal slippages; currently high debt affordability, but fiscal sustainability risks due to high interest rate sensitivity
5. Strong international investment position shielding Belgium’s economy from external shocks

Reasons for the Rating Decision

Our assessment of the Kingdom of Belgium’s very high creditworthiness continues to reflect the high quality of its institutional setting as well as its solid macroeconomic policy-framework. According to the World Bank’s World Governance Indicators, the sovereign still outperforms the euro area median by a considerable margin – in particular, as concerns the WGI dimensions Voice & Accountability and Control of Corruption. That being said, institutional quality is somewhat constrained by a complex governance system including three regions and three communities which have been given extended powers over the last decades, most recently enshrined in the Sixth State Reform. Thus, responsibilities are spread across the layers of government and are sometimes shared or overlapping, potentially impeding efficient governance.

The macroeconomic performance of the Belgian economy, which we regard as very wealthy and productive, also stands out as a key credit strength. The per-capita income posted at USD 45,047 in PPP terms (2016), comparing well to peers such as Germany, France and Austria. Moreover, Belgium remains one of the most productive economies in Europe. As measured by nominal labor productivity per person, its economy stood 29.3% above EU-28 average in 2016 (2015: 129.9% of EU-28 total), thus showing a higher productivity level than France or Germany (115.0 and 105.8% of EU-28 total, respectively).

At the end of last year, Belgian GDP was, in real terms, 9.2% above its trough in 2009, displaying a stronger recovery than peers such as France (8.3%), Austria (9.0%), Finland (4.4%) or the Netherlands (7.9%). Nevertheless, the ongoing recovery of the Belgian economy experienced a transitory setback in 2016 as the growth rate of real GDP growth decreased to 1.2%, down from 1.5% in 2015, mainly due to the negative effects of the terrorist attacks in Belgium and France. According to NBB Stat, economic expansion was mainly backed by domestic demand. Underpinned by rising profits in the corporate sector, high capacity utilization, and favorable financing conditions, investment activity contributed 0.5 p.p. to GDP growth, while net trade’s contribution was close to zero as vivid export growth was offset by equally strong import growth. Increasing by 1.2%, solid private consumption was also supportive to growth (0.6 p.p. GDP), with the adverse impact of constrained wage growth and increases in excise duties balanced by the positive development of the labor market.

Labor market conditions saw a notable improvement on the previous years. The unemployment rate declined for the first time in four years and stood at 7.8% in 2016 after averaging at around 8.5% in 2013-15. Likewise, the employment rate leapt to 62.3% (15-64y), thus reaching pre-crisis levels. However, it is worth pointing out a few aspects which appear to be masked by the recent favorable development and may drag on the labor contribution to potential growth going forward. Firstly, long-term unemployment has increased sharply to 51.6% of total unemployment (2009: 44.2%), well above the euro area average of 49.7%. Secondly, the activity rate is stagnating at a low level by euro area standards and the differential has widened (2016: 67.6 vs. 72.9%). Finally, labor market development varies strongly across different regions or population groups.

The authorities have intensified their reform efforts to facilitate a smooth functioning of the labor market and address its shortcomings. The law on “feasible and flexible work” was passed at the beginning of the year and will enter into force in October 2017. The law is targeted towards increasing flexibility in the labor market by giving employers more leeway in drafting employment contracts and reducing the administrative burden as well as enabling more flexible working time arrangements and working conditions for employees. It also involves exceptions to the minimum wage for younger workers.

Furthermore, while wage indexation was temporarily suspended in 2015-16, the government has recently overhauled the wage formation framework. The wage-setting system laid down in the Competitiveness Law of 1996 was revised by adopting the Act of 19 March 2017, which is geared towards closing the wage- and thus competitiveness gap with Germany, France and the Netherlands, while still allowing for wage adjustments in

line with the development in its neighboring countries. According to the new legislation, the calculation of the wage norm has been revised, i.e. additional correction mechanisms in the form of a safety margin and a 'historical gap' will be considered. Also, social partners have to agree upon an adjusted wage norm and provisions to ensure adequate enforcement of the norm have become more stringent. Notably, the new law has already been put into practice, as a new collective bargaining agreement has set the wage norm for 2017-18 at 1.1% on 21 March 2017 (CBA No. 119).

Looking forward, we believe that economic activity is set to accelerate. As indicated by the latest reading of quarterly GDP growth, the Belgian economy was able to grow at a faster pace, expanding by 1.6% on the previous year's first quarter, thus sustaining the momentum at the turn of the year. In this regard, private consumption spending was highly supportive, increasing by 1.8 y-o-y (Q3-16: 1.5%; Q4-16: 1.6%) and contributing 0.9 p.p. to GDP growth after an already strong H2-16.

We expect GDP growth to come in at 1.6% this year and average at around 1.5% in 2018-20. In our view, domestic demand will continue to be the main driver of output expansion, with investment and private consumption remaining robust going forward. Consumption spending is likely to be further constrained by inflation putting real wages under pressure, while the labor market should improve further, with employment growth remaining buoyant (Q1-17: +1.3%; Q4-16: +1.3%). Meanwhile, the high and rising capacity utilization in the industry sector, which increased to 81.4 in Q2-17 (1985-2016 average: 79.5%) bodes well for business investment. Financing conditions are also likely to remain supportive to business investment, as MFI interest rates for NFCs continued on their downward path and edged down to almost 2% (May-17; AAR). External demand should pick-up on the backdrop of the more favorable development of international trade and benign growth prospects for Belgium's main trading partners Germany (16.5% of total exports in 2016), France (14.9%) and the Netherlands (11.2%). Hence, net exports are likely to be only a slight drag on growth, as strong export growth should cushion vivid import growth.

More importantly, we believe that external demand – as well as private sector employment – will benefit from recent competitiveness gains. Mainly due to the government's wage moderation policies, real compensation per employee continued to decline, falling by 2.2% in 2014-16 (AMECO data). At the same time, 2014-16 saw only modest productivity growth as real labor productivity per person increased by 0.5%. Stagnating labor productivity and falling wages have led to a decline in real unit labor costs, which have decreased by 2.7% since 2014. This compares well to the euro area average (-0.9%), but also to the development in Belgium's main trading partners.

Still, a sizeable inflation differential remains in place which may undermine external competitiveness going forward. To be sure, the inflation gap with the euro area has begun to decline in Q2-17, as HICP inflation in Belgium came in at 2.2% compared with 1.0% in EA-19 (May-17) – similar HICP dynamics could be observed in its main trading partners. More importantly, we believe that the implemented measures to curb wages (see above) are likely to improve the economy's cost competitiveness and keep inflation in check.

In addition, government efforts geared towards the improvement of non-cost competitiveness are underway. In September 2016, the government envisaged the so-called National Plan for Strategic Investments to foster public and private investment activity in strategic sectors. The regional governments have proposed several measures to boost innovation and investment in R&D, e.g. the Flemish government has increased its budget for R&D and innovation and the Walloon government has enacted an infrastructure plan with a total budget of EUR 640m.

First signs of a modest improvement of Belgium's cost competitiveness are mirrored by the recent development of external performance indicators. The multi-annual decline of Belgium's global goods export market share came to a halt. In addition, the trade in goods balance turned positive in 2015 (0.6% of GDP) – for the first time since 2007 – and was up to 1.4% of GDP this year. However, this was more than offset by a lower surplus of trade in services and a widening deficit in primary income. As a result, the current account balance dipped into negative territory (2016: -0.4% of GDP). In general, we believe that Belgium's broadly balanced current account (averaging at -0.2% of GDP in 2012-16) complemented by a substantial net asset position (NIIP, 2016: 49.5% of GDP) provide the economy with sufficient buffers to weather adverse external developments – in particular, in view of the economy's high degree of openness (trade-to-GDP ratio, 2016: 166.5% of GDP) and its relatively strong focus on a few export markets.

By contrast, we continue to deem fiscal sustainability as the sovereign's key weakness. The costs of ongoing reform efforts weighed on public finances in 2016 as federal revenues were affected by measures adopted under the tax shift. Direct taxes declined by 2.8% as compared to last year, following a modification of PIT-rates, and an increase of lump sum business expenses. At the same time, lower social security contributions collected from employers negatively impacted government receipts. On the expenditure side, the automatic indexation of social benefits and public sector wages was triggered earlier than expected as inflation turned out to be higher than projected. Furthermore, discretionary spending related to the significant inflow of refugees, as well as security measures, was putting additional strain on the government's budget. As a result, budget consolidation stalled in 2016, with the headline deficit ticking up from 2.5 to 2.6% of GDP. Thus, Belgium narrowly missed the fiscal target laid out in its 2016 stability program (-2.5% of GDP).

Taking into account the repeated fiscal slippages in the recent past, the government's consolidation plans for 2017 appear fairly ambitious. With regard to this year, the Belgian administration envisages reducing the deficit sharply by 1 p.p. to 1.6% of GDP. According to the government's 2017 stability program, the budgetary adjustment should be mainly achieved via a containment of government expenditure – which we view as more growth-friendly against the background of an already stretched revenue-to-GDP ratio (2016: 50.7% of GDP). As measured by GDP, primary spending is expected to drop by 0.6 p.p. this year, with expenditure on healthcare, social benefits and public sector servants contributing to this development. Moreover, a further decrease in interest expenses should provide some relief to the 2017 budget.

What is more, the government intends to adopt a growth-enhancing corporate tax reform with lower rates and a broader tax base. At the moment, Belgium's corporate tax system is characterized by comparatively high rates and various exemptions. However, a revenue-neutral CIT-reform might prove challenging, even if most of the tax exemptions were eliminated.

Although a cooperation agreement between the different levels of government was put into place in 2013, its implementation continued to be challenging. Agreeing on enforceable fiscal targets for each government layer appears particularly important given that subfederal entities account for roughly half of total government spending in Belgium. However, no agreement between the state and local entities and the central government was achieved regarding the distribution of fiscal efforts in 2015-16.

At a high 105.9% of GDP, Belgium's debt-to-GDP ratio stabilized roughly at the previous year's level. As a result of its large debt stock, we view the sovereign as vulnerable to growth and interest shocks. Recently, debt sustainability risks were highlighted by the EU Commission, which estimated that a permanent increase of 100 bp. along the Belgian sovereign yield curve would drive up debt levels close to 110% of GDP by 2027. Thus, debt reduction could face headwinds in a scenario of rising rates. To be sure, Belgium is currently able to roll-over maturing and newly issued debt at favorable financing conditions. In July 2017 Belgian long-term debt yielded 0.93%, with spreads vis-a-vis German Bunds stable at around 35 bp.

Banks' asset quality and capitalization further improved over the course of 2016. NPLs decreased from 3.7 to 2.9% of total loans between Q1-16 and Q1-17, and the CET1-ratio increased from 11.9 to 13.1% (EU-28: 13.8%). Although we consider Belgian banks to be generally sound, the development of the mortgage market warrants close monitoring. Growth in mortgage lending somewhat decelerated last year after averaging at about 20% in 2015. Nevertheless, the mortgage market still posted vivid y-o-y growth between 7 and 10% in each month. Furthermore, the ESRB pointed out that newly originated mortgages display a significant share of risky borrowers with stretched debt service-to-income or LTV ratios. In the event of an economic downturn or a sharp correction of property prices, the repayment capacity of these households could be weakened, with negative repercussions on the domestic banking system. To be sure, we consider the households' balance sheets to be generally healthy, with net financial assets at a high 221.5% of GDP in Q4-16. Also, housing market risks are addressed by macro-prudential measures. To limit risky lending practices, the Belgian National Bank prolonged a 5 p.p. add-on capital buffer for mortgage loans in May-17.

Moreover, contingent liability risks, which can almost entirely be attributed to the financial sector, seem limited at the moment (public guarantees 2016: 9.65% of GDP). The Belgian state owns 100% of Belfius Bank and the insurer Ethia, and holds significant shares in Dexia and BNP Paribas. With regard to the latter, Belgium reduced its stake to 7.8% in May-17, selling shares worth EUR 2bn. The remaining stakes pose an upside risk to public finances, as proceeds from further divestments could be used to put the government's debt-to-GDP ratio on a steeper downward trajectory.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of AA is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

Our AA rating could be lowered if adverse developments lead to lower-than-expected medium-term growth. As a small, open economy, a prolonged stagnation in the euro area could adversely affect Belgian GDP growth given the economy's strong trade linkages with its neighboring countries. We could also consider a downgrade if the Belgian government should continue to fall short of its fiscal consolidation targets or if policies adopted to reduce the budget deficit fail to yield the expected results.

By contrast, our AA rating could be raised if the Belgian economy grows at higher-than-expected rates over the medium term. Higher growth rates would facilitate fiscal consolidation efforts of the Belgian government, putting the high debt-to-GDP ratio on a steeper downward trajectory after 2017. Furthermore, we could upgrade Belgium's rating if reforms turn out to have a stronger impact on growth and competitiveness than currently anticipated.

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Ratings*

Long-term sovereign rating	AA /stable
Foreign currency senior unsecured long-term debt	AA /stable
Local currency senior unsecured long-term debt	AA /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	1.8	0.1	-0.1	1.6	1.5	1.2	1.6
GDP per capita (PPP, USD)	41,0772	41,5355	41,9255	43,3072	44,2067	45,0469	46,552
Inflation rate, y-o-y change	3.4	2.6	1.2	0.5	0.6	1.8	2.2
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.6	80.4	80.6	81.3	81.3	n.a.	n.a.
Fiscal balance/GDP	-4.1	-4.2	-3.1	-3.1	-2.5	-2.6	-1.9
Current account balance/GDP	-1.1	-0.1	-0.3	-0.7	0.4	-0.4	n.a.
External debt/GDP	269.9	282.5	254.7	235.6	249.5	251.9	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of Creditreform Rating´s "Sovereign Ratings" methodology. Creditreform Rating AG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of Creditreform Rating´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in Creditreform Rating´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

Disclaimer

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