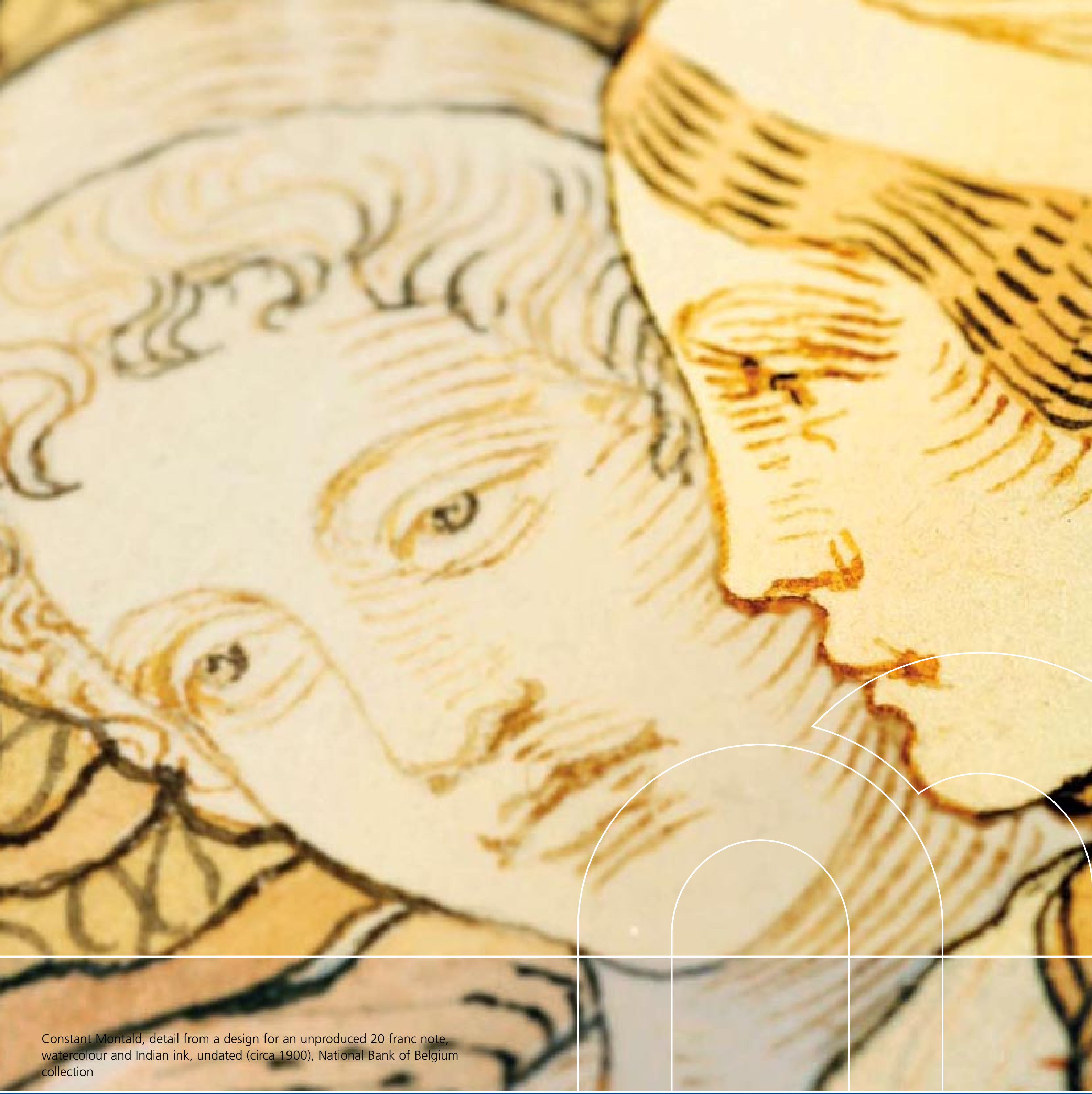

Constant Montald, detail from a design for an unproduced 20 franc note, watercolour and Indian ink, undated (circa 1900), National Bank of Belgium collection

Report presented by the Governor on behalf of the Council of Regency

1. The world economy suffered two severe shocks in 2008 : an accelerating rise in commodity prices up to the middle of the year, and a sudden intensification of the tensions in the financial system from mid September. Although they have their specific causes, both are also due to the financial excesses of previous years. They triggered a temporary surge in inflation and a sharp slowdown in activity. Various authorities are being called upon to devise coordinated strategies comprising emergency measures and more fundamental reforms, in order to contain the crisis, to prevent the repetition of past errors, and to set the economies on the road to sustainable development.

Causes of the shocks in 2008

2. Although some institutions, including the Eurosystem, had already drawn attention to dangers originating from the financial system even before the outbreak of the turbulence in 2007, the scale of the shocks which occurred in 2008 was largely unexpected. Their roots lie in a prolonged phase of expanding credit and liquidity, under-estimation of risks, and strong growth of financial markets and of some parts of the real economy : soaring commodity prices were the latest symptom of this, and the financial crisis constitutes a particularly abrupt correction.

3. The rapid development of finance arose from a macroeconomic environment with low interest rates in conjunction with inadequately controlled financial innovations. The relatively low level of short- and long-term interest rates worldwide is itself due to a combination of factors. Thus, following the bursting of the stock market bubble in 2000-2001, monetary policy in the United States remained accommodating for quite some time, since the credibility which it had acquired and imports of cheap products from emerging economies neutralised the upward pressure on consumer prices. Following the 1997-1998 Asian crisis, the accumulation of excess savings by the emerging countries, particularly China, whose official external assets have grown constantly as a result of the chosen exchange rate regime, also depressed interest rates, as did the surpluses of the oil-exporting countries. The low interest rates encouraged debt financing. Moreover, financial market players went in quest of higher returns without taking proper account of the risks, which a lengthy period of low macroeconomic volatility had concealed.

4. These tendencies were also underpinned by innovations permitting the apparent dispersion of the risks. The large-scale use of techniques for transferring risks off bank balance sheets, particularly securitisation and the proliferation of complex structured products backed by claims of variable quality, caused a general relaxation of vigilance and inappropriate pricing of a wide range of financial instruments.

5. The out-of-control financial activities of recent years contributed to the rising prices of commodities and property, though they were not the sole cause. While the sudden drop in oil prices in the second half of 2008 resembles the bursting of a bubble, it must be remembered that the preceding upward trend was based mainly on fundamental tension between the growing energy needs of emerging economies and supply constraints. Overvaluation can be

diagnosed with greater confidence in the case of property prices in certain countries, including the United States, where a correction has set in. It was in fact American households that ultimately absorbed a large proportion of the global surplus savings, as the financial sector used the mortgage loans which it had granted to offer securities which enjoyed a good rating and were sought after by foreign investors.

6. The increase in interest rates initiated by the US Federal Reserve in mid 2004 eventually exposed the vulnerability of this financial edifice. A property crisis erupted in the United States in 2006, risk premiums on subprime-mortgage-backed securities went up sharply in 2007 and financial turbulence became widespread from August in that same year, when it became apparent that European financial institutions were hard hit by the drop in value of American mortgages. The confidence crisis which broke out on the interbank markets, but also infected other markets, deepened further in March 2008 following liquidity problems encountered by the *Bear Stearns* investment bank in the United States. At the time, the US authorities managed to soothe the tension.

7. However, the problems suddenly became far more serious in mid September when those same authorities refused to rescue the *Lehman Brothers* investment bank from bankruptcy. They probably wanted to avoid encouraging the belief that they would always intervene if insolvency threatened institutions considered too big to be allowed to fail. That decision led to a fundamental review of counterparty risks, and most banks, wishing to preserve their liquidity, called a halt to their interbank lending. Within a few days, solvent banks saw all their sources of liquidity evaporate, not only in the United States but also in Europe. A negative spiral of financial institutions incurring losses, with the selling and depreciation of financial assets, accelerated and interacted with the deteriorating economic outlook. Share prices everywhere tumbled as a result of selling by financial institutions, the worsening situation of the latter, expectations of a recession and the acute increase in risk aversion.

Emergency measures to rescue the financial system

8. In 2008, the leading central banks continued and intensified the measures taken in the previous year to ease the interbank market tensions. From mid September, they responded to the paralysis on those markets by significantly expanding their intermediation role. The Eurosystem, which had reacted promptly to the August 2007 liquidity crisis, considerably augmented its lending in euro to credit institutions. In October 2008, the priority was to reduce the uncertainty facing banks, even though this meant that the Eurosystem had to take over the function of the failing money market. Thus, the ECB Governing Council modified the procedure for the refinancing operations by conducting fixed-rate tenders with full allotment and extended the list of assets eligible as collateral for Eurosystem loans. It also narrowed the corridor formed by the standing facility rates, enabling the banks to meet their daily needs, and above all to deposit their surplus liquidity with the Eurosystem on more favourable terms than previously. In December, however, the ECB Governing Council decided that, from 21 January 2009, it would again widen the spread between the standing facility rates in order to encourage the banks to resume their interbank market activities.

9. The central banks also cooperated more closely on liquidity management, thus responding to the needs of banks with substantial international activities. For instance, the swap agreements concluded with the Federal Reserve in December 2007 were renewed and reinforced, enabling the Eurosystem to grant loans in US dollar to banks in the euro area.

10. From the end of September 2008, alongside the Eurosystem's liquidity management operations, some national central banks including the National Bank of Belgium had to take emergency steps to supply additional liquidity in euro and in US dollar to financial institutions facing particularly severe pressure. Although the tensions initially affected mainly banks encountering specific problems, they rapidly spread to many other institutions, requiring decisive action on the part of governments to contain the contagion. The various national intervention programmes, including the Belgian one, comprised a range of measures designed to strengthen the banks' solvency and restore access to liquidity for financial intermediaries.

11. In an environment where financial markets have substantially raised their expectations regarding bank capitalisation, the governments of several countries have acquired a direct stake in the capital of large systemic institutions. In some cases, they have also assumed some or all of the risks associated with inferior quality asset categories held by certain credit institutions.

12. In order to restart financing operations on the professional markets, many countries granted a guarantee to cover new liabilities of major banks in their territory towards institutional investors. The as yet limited effects of these measures on market liquidity and the fear of a credit crunch led the authorities of some countries, notably the United States, to intervene more directly in supplying funds to the final borrowers. To reassure savers, deposit guarantee schemes were reinforced in the EU. In Belgium, the amount of the guarantee per beneficiary was increased from 20,000 to 100,000 euro, and that protection was also made available for certain insurance products.

Macroeconomic consequences of the shocks

13. In the first part of the year, global growth was curbed above all by the steep rise in commodity prices, while in the second part of the year, the deepening financial crisis took over as the main factor in putting a much sharper brake on economic activity. These two shocks had opposing effects on inflation.

14. Global economic growth dropped from 5 p.c. in 2007 to 3.8 p.c. in 2008. The slowdown in activity, which had initially hit the United States, became widespread and the hope of a "decoupling" of the emerging economies proved false. In particular, the financial crisis exposed the vulnerability of the economies of Central and Eastern Europe, where businesses and households make extensive use of credit – often in foreign currencies – and levels of foreign debt are high. In the euro area, growth declined from 2.6 to 1 p.c. Countries which had enjoyed strong expansion and a property boom in preceding years, such as Spain and Ireland, were particularly hard hit. The slackening of activity was a little less marked in Belgium than in the large European countries, with Belgian GDP growth down from 2.6 to 1.1 p.c. Employment, which takes some time to respond to cyclical fluctuations, still expanded by 1.6 p.c. compared to 1.8 p.c. in 2007. The harmonised unemployment rate continued to fall, dropping from 7.5 to 7.1 p.c., although there has already been a noticeable increase in temporary lay-offs.

15. However, all these annual figures conceal a sharp deterioration during the year. In the final quarter, in particular, economic activity slumped in many countries, causing forecasters to make substantial downward revisions to the growth outlook for the global economy in 2009. Banking crises are often followed by contractions in activity, which they influence in various ways. Confronted by losses, the need to boost their solvency ratio – or in other words, to reduce their leverage – and the rising cost of their own funding, banks tend to restrict the supply of credit by increasing their margins and tightening up other lending conditions. Moreover, plummeting stock markets, combined in some countries with the collapse of property prices, produce negative wealth effects on private consumption. In addition, they contribute to upward pressure

on corporate financing costs, as does the rise in risk premiums included in bank lending rates and corporate bond yields. Finally, the crisis damages the confidence of both consumers, who increase their precautionary savings, and business leaders, who defer investment and recruitment.

16. Inflation gathered pace almost everywhere until the third quarter of 2008, driven by soaring commodity prices. It then eased when those prices collapsed as a result of the sudden deterioration in the demand outlook.

Economic policy responses

17. The financial crisis, which can already be considered the most serious since the 1929 stock market crash, requires a response commensurate with the risks entailed and the inherent opportunities for reform. Above all, it is essential to ensure consistency between the short and the long term, and international coordination of the economic policy responses to the crisis.

18. Speedy action was and still is needed to stabilise the financial system and limit the effects of its contraction on the real economy. However, emergency measures must not compromise the future, and they must not nurture the seeds of future crises. On the contrary, they need to be accompanied by more fundamental reforms of the operation of the economic and financial system in order to prevent repetition of past errors and enable a stronger economy to develop for the benefit of all, without being based on excessive debt and with due regard for the environmental costs and ecological risks.

19. Faced with the sudden threat of a global depression, there is good reason to rescue the banks and ease monetary and fiscal policies, but not without conditions. First, a bank bail-out is not equivalent to a blank cheque. While the “stagflation” of the 1970s had cast doubt on the ability of the government to provide a systematic stimulus for growth via expansionary macroeconomic policies, and highlighted the benefits of competition as an engine of economic progress, the current crisis has seriously dented belief in the ability of the markets to regulate themselves. There is clearly a need to reform the regulation and supervision of the financial system, the aim of the public authorities being not to take the place of the financial markets but to allow them to operate more correctly for the benefit of the economy. Next, the conduct of monetary policy must continue to focus on the objective of medium-term price stability. The easing of this policy is not inflationary in so far as it is responding to an extreme preference for liquidity on the part of the private sector and a contraction in demand for goods and services. Once normality returns, it will give way to a tighter stance, so as not to fuel new excesses. Finally, fiscal policy must also be geared to the medium and long term, otherwise it would forfeit its effectiveness as a counter-cyclical instrument owing to the loss of confidence among economic agents. Measures intended to support activity and employment during the cyclical downturn must be temporary and so designed that the growth potential of the economy and its resilience to shocks are not imperilled but are, on the contrary, reinforced.

20. This truly global crisis has also demonstrated that the interdependence between continents and nations is greater than ever before, and confirmed the importance of emerging economies. It is vital to resist the temptation to revert to protectionism, which caused so much damage in the 1930s. International cooperation needs to be intensified, both to ensure that the measures taken do not have adverse repercussions for other countries or distort competition, and to guarantee the coherence of the reforms. The European monetary union, which has celebrated its tenth anniversary, has been successful in withstanding a lot of turmoil, and even today the euro is still protecting the states which adopted it from additional difficulties, since the banking crisis has not been accompanied by an exchange rate crisis in those countries. However, the

economic policy responses in the euro area need to be better coordinated. Finally, since the global food, financial and economic crisis has a serious impact on the poorest countries, there is a need to maintain or even speed up the expansion of development aid towards the target of 0.7 p.c. of GDP, according priority to those nations.

Monetary policy

21. The primary objective of the Eurosystem's monetary policy, like that of most other central banks, is to maintain price stability. In times of trouble, it is essential to remain firmly focused on this medium-term objective, because inflationary or deflationary derailment could seriously damage economic activity and employment. Thanks to its medium-term monetary policy strategy, the ECB Governing Council was able to avoid over-reacting to the direct effects of higher import prices and could take account of all available information in order to assess the threats to price stability, including those emanating from the malfunctioning of the financial system.

22. In the first part of the year under review, there were differences in monetary policy conducted in the leading OECD economies, due mainly to the risks to price stability posed by the higher cost of commodities, taking account of such factors as capacity utilisation levels, expectations of economic agents and the probable effects of the financial turbulence. In the United States, the United Kingdom and Canada, the easing initiated at the end of 2007 continued. In other countries such as Japan, the main policy rates were left unchanged. In contrast, in the euro area, Sweden, Norway and Australia, the central banks increased interest rates by varying degrees. In the case of the Eurosystem, the minimum bid rate of the main refinancing operations was raised from 4 to 4.25 p.c. on 3 July 2008, owing to deteriorating inflation expectations.

23. Differences in the monetary policy stance – and the underlying heterogeneity of the domestic situations – influenced foreign exchange markets. Thus, in mid July, the exchange rate of the euro against the US dollar reached a record high. Other factors contributed to this appreciation, such as the frequently noted sensitivity of this exchange rate to oil prices, attenuating their fluctuations to the advantage of the euro area.

24. When the financial crisis took a more dramatic turn, lessening the risk of inflation, all the central banks eased their interest rate policy. On 8 October 2008, six central banks including the ECB announced a coordinated reduction in their main policy rate. In the United States, the target federal funds rate was reduced in three stages from 2 p.c., the level at which it had been set on 30 April, to between 0 and 0.25 p.c. Moreover, the Federal Reserve pursued an accommodating policy in terms of both quantity – by considerably expanding its balance sheet – and quality – by substituting riskier loans for government debt securities on the assets side of its balance sheet. In the euro area, the rate of the Eurosystem's main refinancing operations was cut in four stages from 4.25 at the beginning of October 2008 to 2 p.c. at the beginning of January 2009. It is essential that this easing should be reflected in a reduction in debit interest rates and the maintenance of an adequate supply of bank lending.

25. The euro's depreciation against the US dollar from August 2008 mainly reflected the prospects of a deterioration in the European economic situation and the possibility of a reaction by the Eurosystem, whose interest rates were higher than those of the Federal Reserve. That depreciation, accentuated in October by the extreme tensions on all financial markets, was partly offset by an appreciation in December. If account is also taken of the movement in other currencies, such as the pound sterling, the effective exchange rate of the euro reached a peak in mid December.

26. Recent events ought to rekindle the debate over whether monetary policy should take account of asset price fluctuations. The equilibrium value of assets – property or equities – is difficult to ascertain, but that is not sufficient reason to ignore the question. The Eurosystem's monetary policy strategy, with its medium-term stance and the combination of economic and monetary analysis, has the advantage of paying attention to money and credit developments, and any imbalances which are not immediately reflected in pressure on consumer prices. However, the interest rate policy cannot in itself guarantee financial stability, and therefore needs to be backed by prudential policies.

Maintaining financial stability

27. The current financial market upheaval demands action by the authorities at several levels. In the immediate future, it is absolutely vital to restore confidence within the financial system, to enable it to resume its full role of intermediation between savers and borrowers, for the benefit of the economy as a whole. In a longer-term perspective, it is necessary to amplify the work which has already begun on devising fundamental reforms to remedy the structural defects exposed by the crisis. Finally, from a more institutional angle, a review of the organisation of prudential supervision is required in order to establish a more effective system of financial stability surveillance and crisis prevention and management.

28. National intervention programmes intended to stabilise the financial system have so far been based on fairly similar principles. Conversely, it has proved more difficult to coordinate the operational arrangements, particularly at European level. Allowance for the specific situation of individual banks has to be reconciled with the prevention of distortions of competition between institutions, products and markets. Moreover, the intervention of governments as both shareholders and guarantors of certain bank debts may complicate the assessment and pricing of the various credit risks. It is therefore important to design these support measures in such a way as to ensure that they are used effectively, but also to make it easy to dismantle them at a later date.

29. Apart from these emergency plans, the excesses and defects exposed by the current crisis must be corrected without introducing excessively onerous new regulations which would stifle financial innovation, while still acknowledging the limits of self-regulation. Both the EU roadmap and the report of the Financial Stability Forum on enhancing market and institutional resilience bear witness to a broad consensus on the need for reform.

30. The serious gaps apparent in the management controls of numerous institutions which nevertheless enjoyed a good reputation require, in the first instance, an improvement in financial risk surveillance and protection. In particular, there is a need for monitoring and much more regular reporting on liquidity situations or on the concentration of positions on a small number of counterparties. In view of the substantial contribution of financial infrastructures to the management of liquidity risks and counterparty risks concerning payments and securities settlement, this type of infrastructure should also be introduced for transactions currently effected on over-the-counter markets, such as credit derivatives. The Basel Committee is going to adapt capital requirements to improve the cover for certain specific assets or risks. It is also examining the advisability of a more general increase in the level and quality of banks' own funds, and modifications to the methods of forming provisions, in order to encourage the creation of a security buffer which should prevent the banks from amplifying business cycles in their attempts to correct a shortage of capital when there is a downturn in economic activity.

31. It must also be acknowledged that risk management shortcomings were aggravated by remuneration systems and incentive mechanisms which too often encouraged the pursuit of immediate results, to the detriment of the creation of lasting value. There is a need to improve

governance and profit-sharing structures within the institutions, but also to take account of the new methods of conducting financial transactions, which are often broken down into multiple components involving several operators – such as brokers, insurers or rating agencies – interposed between the final lenders and borrowers. The essential role which rating agencies perform requires not only an improvement in their governance with a view to preventing conflicts of interests, but also the establishment of an appropriate supervision framework by the prudential authorities.

32. The crisis has also highlighted the extreme complexity of many financial instruments. In order to enhance the transparency of the system, it is necessary to re-examine the valuation and accounting methods applied to these products, so that they can be used more consistently in all market situations. Greater clarity, but also stricter regulation and more rigorous control, are needed in regard to the risks associated with the transactions which banks carry out via off-balance-sheet structures and vehicles, and to the activities of bodies which are not subject to supervision, such as hedge funds. Transparency and stringent regulation, which are necessary more particularly in the context of new financial products, must be combined with better communication and financial reporting.

33. However, the revision of the regulations will not be fully effective unless supported by a good supervision structure. Central banks, which were in the front line when it came to tackling the paralysis on the interbank markets, were able to derive support from their day-to-day relationship with the money market and their position at the heart of payment and settlement systems. However, the speed with which the most acute phase of the liquidity crisis developed showed that these contact channels are insufficient. Moreover, in an environment where financial markets are tending to be concentrated in the hands of a few large operators, the distinction between a macroprudential approach, defining action by the central banks, and the microprudential supervision of credit institutions, which remains the exclusive preserve of the supervisory authorities, has clearly demonstrated its limits. Central banks must have direct access to information on developments which, though affecting individual institutions, could endanger overall financial stability.

34. This problem of information does not arise if central banks themselves are in charge of supervision. In countries where that is not the case, there has to be a system of very close cooperation between the two authorities, and the institutional structures must be regularly reviewed in the light of both any weaknesses found in the supervision of financial stability and the often very rapid changes in the configuration of markets and in banking services. Recent developments undeniably require such a review in Belgium.

35. The discussions on this subject need to take place in the context of a more general reform of the organisation of bank supervision in the EU, but also supervision over insurance companies and pension funds, and the crisis management arrangements. Despite the progress achieved in cooperation between national authorities, especially via the supervisory boards set up for cross-border banking groups, the crisis has exposed serious defects. These concern more particularly the allocation of the costs of any government intervention in support of banks important for the operation of the system, and the absence of a genuine European prudential supervision structure, equipped with a centre in charge of coordination between national bodies. Such an institutional set-up would clearly be extremely useful in the supervision of the small group of large, systemically important European banks.

Fiscal policy

36. Since the deepening of the financial crisis, the government has rightly accorded priority to stabilising the financial system in order to protect the public's deposits and avoid an excessively tight credit contraction. In contrast to the guarantees covering certain bank debts, mentioned earlier, the recapitalisation of financial institutions has already added to the public debt, by 6.3 p.c. of GDP in Belgium's case. However, this is an essential investment to avert the danger of collapse of the banking system, as happened in the 1930s, and to lay the foundations for a recovery, as demonstrated by the admittedly more local experience of the Nordic countries in the 1990s. While the very specific role of the banking sector in the economy justifies such an assumption of financial risks by the government, that action must be transparent, remunerated and temporary, and must be accompanied by the reinforcement of supervision referred to earlier.

37. A number of countries have also introduced fiscal measures to support demand and thus attenuate the effects of the financial malaise on the real economy. In order to absorb global current account imbalances which were one of the causes of the crisis, those countries with a surplus should be more active in stimulating their domestic demand than others.

38. To be effective, it is crucial that fiscal stimuli form part of a credible and sustainable strategy, vital to the preservation of confidence. Economic agents must be reassured that government deficits are transient and will not entail a significant increase in the future tax burden or impair the government's ability to meet the costs of population ageing, otherwise the fiscal stimuli will merely boost private savings. The recovery measures need to be selected on the basis of their short- and long term effectiveness, they must be fast-acting, and temporary in their impact on the budget.

39. In Europe, the Stability and Growth Pact provides the appropriate framework for such strategies, offering both the short-term flexibility required to stabilise the economy, especially in exceptional circumstances, and criteria which ensure the sustainability of fiscal policies. Apart from the operation of the automatic stabilisers – relatively important in Europe – such as the decline in tax receipts and the increase in unemployment benefit payments, discretionary measures can be taken so long as the government's financial position permits. The economic recovery plan adopted by the European Council in December provides for a fiscal stimulus of 1.5 p.c. of the EU's GDP – 1.2 p.c. of which would come from budgetary expansion by Member States – in order to revitalise demand. However, compliance with the Stability and Growth Pact presupposes that each country takes part in the coordinated action in accordance with its own starting position. While some, such as Finland, have achieved their medium-term objective, regaining the scope for more significant counter-cyclical measures, many of them have unfortunately failed to take sufficient advantage of the thriving economy of recent years to make structural improvements to their public finances, thus limiting their room for manœuvre in today's more challenging circumstances.

40. In Belgium, in particular, the fiscal policy pursued over the past ten years since the adoption of the euro has not permitted the accumulation of the necessary structural surplus which had been publicised. The government did not use the substantial margin created by the fall in interest rates to speed up debt reduction, but opted for higher expenditure or cuts in certain levies, one aim being to provide structural support for growth and employment. Budget targets have been systematically lowered and sometimes missed.

41. The year 2008 was no exception. The public deficit expanded, rising from 0.3 to 1.1 p.c. of GDP, partly as a result of the slowdown in activity, so that Belgium's stability programme target, even after being scaled back in April 2008 from a surplus of 0.5 p.c. of GDP to a balanced budget, was not achieved.

42. This led to wider deviation from the budget path recommended by the High Council of Finance, which aims to guarantee the sustainability of public finances in the context of population ageing and to ensure that the resulting costs do not become too heavy a burden for future generations. Moreover, the public debt ratio increased during the year under review for the first time since 1993, rising from 83.9 to 88.7 p.c. of GDP following the injections of capital into struggling financial institutions.

43. Given the severity of the deterioration in the economic situation, it is currently sensible to let the automatic stabilisers operate to full effect and consider carefully targeted economic support measures. In particular, the social security system must perform its task of protecting the most vulnerable and supporting demand. However, deviation from the medium-term path is acceptable only if it is limited and temporary. The widening of the spread between interest rates on government bonds in Belgium and the corresponding German rates is also reason for caution, even though it is due partly to a flight to the liquidity offered by the German government bond market, and is not an isolated instance in Europe. The government must ensure that any economic recovery measures can be reversed. It must be steadfastly committed to restoring a balanced budget as soon as more normal economic growth returns, and to creating surpluses thereafter by adopting a medium-term approach.

44. Moreover, the narrow fiscal scope should encourage the authorities at all levels of government to enhance both the quality and the effectiveness of public intervention, to ensure that revenues are properly collected, and to combat all forms of fraud. It does not prevent the government from choosing between various types of expenditure and revenue to ensure that public finances are better geared to boosting the economy's growth potential and sustainable development.

Prices and incomes

45. In the first ten years since the creation of the European monetary union, the inflation differentials between Member States were comparable to those between the regions of other large currency areas such as the United States. However, they have been more persistent. The cumulative divergences between inflation rates are a problem if they do not reflect the gradual convergence of prices resulting from the process of catching up with the level of productivity achieved by the most advanced economies in the area, but are instead a sign of a surge in domestic demand in some countries, accompanied by a loss of competitiveness. That appears to have been the case in Spain and Ireland, which are today experiencing a sharp correction. It is the task of the national government and social partners to prevent such imbalances.

46. In Belgium, growth and inflation have generally remained close to the euro area average. However, in 2008, Belgian consumer prices recorded one of the steepest increases: an annual average of 4.5 p.c., compared to 3.3 p.c. in the euro area. Energy prices account for 1.1 percentage points of that difference. Only a small part – 0.2. percentage point – is due to the stronger impact of international crude and refined oil prices, owing to the greater weight of petroleum products in the Belgian HICP and the lower level of lump-sum taxes on these products. Most of it – 0.9 percentage point – originates from a sharper increase in gas and electricity prices in Belgium. This was due to a combination of factors, some relating to methodology – such as the fact that the Belgian HICP takes account of monthly rather than annual tariffs – and others more real, concerning both the actual energy component and the transport and distribution charges, which were increased after the courts ruled against the reductions imposed by the federal energy regulator, the CREG, in 2007. While food price rises also outstripped those in the euro area, prices of other goods and services considered as a whole rose at the average rate for the euro area, namely 1.8 p.c. However, a relative deterioration set in during the year, and in the final quarter the year-on-year increase in these prices came to 2.4 p.c., compared to 1.9 p.c. in the euro area.

47. This could indicate the start of second-round effects – though they are doubtless far less significant than the dramatic effects in the 1970s – due to the increasing cost of commodities, the direct impact of which has already been more pronounced in Belgium. The system of automatic wage indexation specific to that country, and the formal or informal mechanisms for the indexation of other incomes and prices, especially in the branches relatively sheltered from foreign competition, increase the risk of a more marked transmission of import price increases, and consequently a loss of competitiveness for the Belgian economy. In that regard, it is reassuring that the fall in commodity prices in the second half of 2008 clearly tempered inflation expectations.

48. Meanwhile, the competitive position of Belgian firms has deteriorated. The predominant export focus on countries where demand is rather weak and the persistent losses of market share contributed to the disappearance of Belgium's current account surplus in 2008, although this was also due to the higher cost of imported raw materials and the relative resilience of domestic demand, particularly for investments. The reason for the decline in market share lies both in the adverse movement in relative costs and the insufficient specialisation in products which, thanks to their technology content and specific characteristics, are more in demand.

49. While it will take the resolute pursuit of structural policies to improve the more qualitative aspects of the Belgian economy's competitiveness, cost control is based on two pillars. On the one hand, the Competition Council and the network industry regulators, aided by the findings of the newly created Price Observatory, will simultaneously help to maintain consumer purchasing power and moderate business costs via more effective competition, e.g. in the trade sector, and a reduction in monopoly rents in various sectors, such as electricity, gas and telecommunications. On the other hand, the wage negotiations must be concluded in the spirit of the law on the promotion of employment and the safeguarding of competitiveness, another feature specific to Belgium. The wage norm agreed in that connection for the period 2007-2008 was exceeded because inflation was higher than expected. Overall, from 1996 to 2008, the increase in hourly labour costs in Belgium was around 4 percentage points above the reference value, namely the average increase recorded in the three neighbouring countries: Germany, France and the Netherlands. In the central agreement concluded in December 2008 for the years 2009 and 2010, the social partners set the scope for negotiation at a maximum of 250 euro per worker in standard operation, in addition to the application of the wage-indexation mechanism and scale increases. A maximum of 125 euro may be granted in 2009, either non-recurring or chargeable to that amount. Government support will facilitate a further reduction in business operating costs which could help to alleviate the competitive handicap. In a period when the economy is shrinking and the outlook for prices in Belgium and wages in the partner countries is more uncertain, the primary concern for the pay negotiators in individual sectors and firms must be to avoid aggravating that handicap and to protect employment.

Structural policy

50. At a time when the financial crisis and its implications are the main focus of attention, it is important not to neglect the Lisbon strategy and structural reforms designed to improve the efficiency of all markets and ensure sustainable development. The crisis itself will lead to restructuring, and while there is a need to attenuate the consequences, the primary consideration is to prepare the economy for the changes ahead.

51. Thus, the labour market in Belgium is bound to feel the impact of the contraction in global demand. In these circumstances, it is vital to ensure that the cyclical job losses do not result in structural unemployment and permanent retirement from the workplace, as happened in previous recessions, because such a derailment would compromise future growth potential. Efforts must be concentrated on helping victims of the crisis who lose their job, particularly

by ensuring that the job centres have the resources to implement a retraining policy geared to labour market requirements. More generally, there is a need to improve the monitoring and training of the unemployed. The augmentation of the assistance procedure for new job seekers will therefore be welcome. In order to prevent young people – especially those with few skills – from joining the ranks of the long-term unemployed, they must also be provided with support as soon as they leave school, and steered towards suitable training where appropriate, preferably in the form of apprenticeships.

52. Preparing for the post-crisis period also implies taking account of the demographic prospects and the structural mismatch between labour supply and demand, which could quickly lead to the recurrence of labour shortages in some market segments once activity picks up. Allowance must be made for the time required to implement the measures. Thus, the gradual raising of the female retirement age, initiated several years ago, is continuing to have a beneficial effect on the average employment rate of the population of working age. However, in 2008 that rate was still only 62.5 p.c. The efforts designed to encourage the participation of groups who are more difficult to integrate into working life, such as those over the age of 55 and those from non-EU countries, must be maintained. Improvements in basic and lifelong training remain crucial in order to give the maximum number of people a better chance of finding work and to make progress towards the knowledge economy. Both functional and geographical mobility must be encouraged.

53. The same concern for the future is required in regard to support for producers of goods and services. In the short term, the government will monitor financing conditions and take measures to ensure that businesses, particularly small and medium-sized firms, do not have to contend with funding constraints. The longer-term policies aimed at encouraging the establishment and development of businesses, stimulating innovation and creativity, and promoting forms of production and consumption which are better for the environment – particularly those which use less energy and other natural resources – must also be intensified ; they may help to find a way out of the crisis via the development of new activities.

54. A rise in the prosperity of the Belgian population will continue to depend on productivity gains in all sectors and on the development of a supply of ever-improving goods and services, of a quality appreciated by foreign markets. A microeconomic analysis of industry reveals that exports of goods from Belgium depend on a relatively small number of firms, which are larger and more productive than the average. It is important to ensure that the population of exporters is renewed and expanded by supporting entrepreneurial spirit and innovation. R&D efforts are also over concentrated and need to be augmented. Too often, foreign sales are confined to neighbouring markets ; greater advantage should be taken of demand from emerging economies. Where market services are concerned, Belgium's performance is relatively satisfactory in the case of business services : here, growth between 2000 and 2005 actually outpaced that in the United States, and productivity has benefited from substantial investment in information technology and telecommunications. That performance needs to be extended to all branches of activity, including non-market services. While innovation increasingly originates via participation in international networks, the strengthening of higher education and research hubs, and close cooperation between public authorities, research centres and enterprises, remain essential factors in comparative advantages. It is also essential to remove the barriers impeding the entry on the economic scene of new players with the potential to innovate and stimulate competition.

55. The year 2008 ended with a dramatic deterioration in the global economic situation. Today, the key issue is to restore confidence and find a route to recovery via a consistent package of speedy measures and fundamental reforms, in a framework of closer international and European cooperation. Belgium will not escape the repercussions of the financial crisis, but the quality of

the economic policy response will be decisive. It is vital to incorporate the shock prevention or attenuation measures in a strategy which does not lose sight of the longer-term objectives, and in which all economic decision-makers participate.

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