

Report 2009

Preface



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Foreword

by Guy Quaden, Governor



A year ago, when presenting the Bank's previous Report, I said that the recession which had begun in the second half of 2008, in the wake of the financial crisis, would probably be more severe than the other downturns in economic activity since World War II. But I also expressed the hope, and even the conviction, that thanks to the speedy and appropriate economic policy responses, this "great recession" would not degenerate, as in the 1930s, into a great depression, i.e. several years of negative growth.

The events of 2009 described in detail in this Report seem to confirm that scenario. However, there are no grounds to declare victory because, unless the recovery unexpectedly gathers speed, it will take quite some time to make up the loss of output suffered.

The authorities have learnt from the mistakes which followed the 1929 crash. Central banks responded to the escalating financial tensions, the risk of a credit crunch and the sudden deterioration in the economic situation by resorting to various non-standard measures and cutting their interest rates to extremely low levels (1 p.c. for the Eurosystem's refinancing operations). Apart from the assistance given to numerous financial institutions, governments made a major contribution towards supporting activity via their fiscal policy, in allowing the automatic stabilisers to operate (rising expenditure on unemployment benefits, falling fiscal and parafiscal revenues) and by implementing recovery plans. They also largely resisted the temptations of protectionism.

At the very least, that response halted a negative spiral. True, the 2009 growth figures are seriously in the red: around -1 p.c. for the world, -4 p.c. for the euro area and "only" -3 p.c. for Belgium. Yet these annual averages mask an even more dramatic deterioration at the beginning of the year, followed by a degree of recovery in the second half.

However, the recovery is fragile because it is based largely on fiscal stimuli and the rebuilding of stocks. Moreover, since firms still have excess production capacity, the crisis is unfortunately continuing to take its toll on employment and investment.

Price stability is the only area in which the 2009 results were satisfactory: inflation disappeared and deflation was avoided.

The priority must gradually shift away from crisis management towards future crisis prevention and consolidation of the foundations for sustainable growth.

Ending the exceptional measures too soon would risk a renewed decline in activity. Conversely, ending them too late would prepare the way for new financial derailment. In any case, a gradual approach is required.

Since the financial market situation has improved considerably, the Governing Council of the European Central Bank decided, at the end of 2009, to proceed with the initial dismantling of the non-standard liquidity management measures by announcing that certain longer-term operations would not be renewed in 2010. However, as the economic recovery is still precarious, and inflation expectations remain firmly anchored at a level consistent with the definition of price stability, the Governing Council did not adjust the particularly accommodating stance of its monetary policy, and kept the official interest rates at their very low level.

At budgetary level, governments will increasingly have to balance the desired economic stimulus against the budget deficits entailed, and the growing loss of confidence which they are liable to cause. Moreover, the restoration of growth will not be enough to wipe out these deficits, which are only partly due to the impact of the weakened economy.

In contrast to the 1980s, Belgium's public deficit (6 p.c. of GDP) is no higher than the average for its European partners. However, just when our country is about to face the fiscal consequences of population ageing, the spectre of the snowball effect has returned, namely the automatic effect of interest charges swelling the public debt, which will again exceed 100 p.c. of GDP in 2010. The modest reduction in the deficit provided for in the 2010 budget is welcome, but to enhance the credibility of the government's stated commitment to restoring a balanced budget by 2015, the proceeds from any economic growth windfalls in the years ahead will have to be used to speed up deficit reduction.

However, a long-term strategy cannot be based exclusively on fiscal consolidation. It must also include policies on innovation, employment and competitiveness to stimulate and support sustainable growth.

As noted by the Basel Committee on Banking Supervision, "the banking sector entered the crisis with an insufficient level and quality of capital, inadequate provisions, imprudent valuations, insufficient liquidity buffers, compensation policies that encouraged excessive leverage and risk taking, and excessive concentration of exposures among major financial institutions".

The words 'insufficient', 'inadequate' and 'excessive' clearly indicate the absolute necessity of improving the regulation and supervision of financial institutions and of the financial system. Various international bodies are addressing that issue, and that is indeed the level at which coordinated decisions should preferably be taken. In particular, the G20 has drawn up an ambitious road map, and the Basel Committee has proposed new regulatory requirements. However, the details of these proposals have yet to be defined.

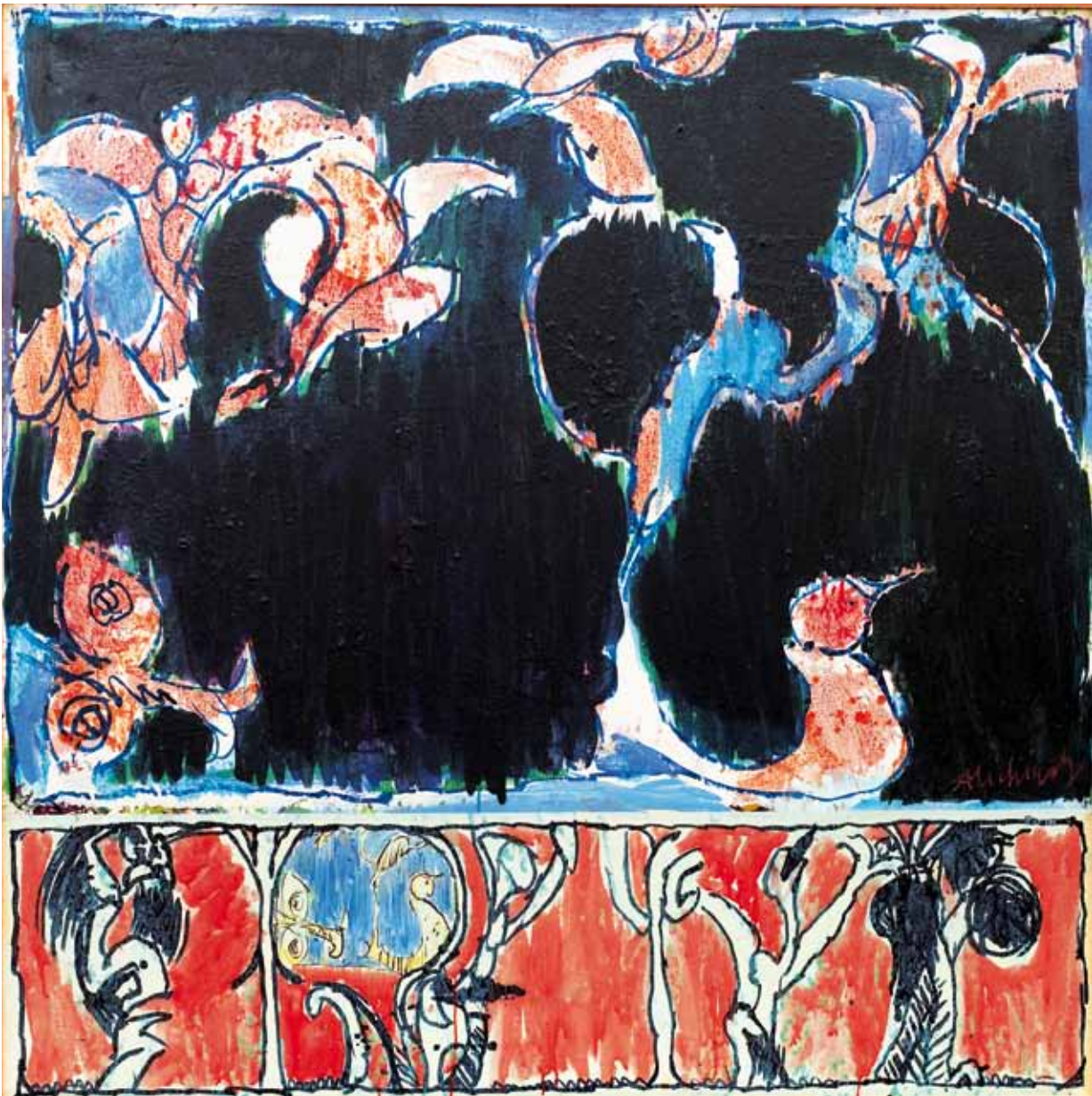
I know that it will be anything but easy to return to greater simplicity in the banking world. Moreover, the solution to many technical questions will take time. Finally, there is clearly a need to introduce some of the new rules gradually – especially the additional capital requirements – so as not to impede the flow of lending necessary to sustain the nascent recovery. Nevertheless, as a result of the crisis, there is now acceptance of the urgent need for radical reform of the financial sector and we cannot allow that mood to evaporate.

In fact, while the “exit strategy” concerning the public measures supporting demand and the financial sector is being hotly debated, we should also be aware of the need for an “entry strategy” for the introduction of new regulatory standards.

The rapid spread of the financial crisis must also serve as a lesson for the supervisory authorities. No supervisory architecture can offer an absolute guarantee against financial accidents. However, a growing number of countries has opted for the “twin peaks” system, in which the central bank takes charge of supervising individual financial intermediaries and the system as a whole, while another institution is responsible for supervising the smooth operation of the markets, and ensuring information and protection for investors and consumers of financial services. The Belgian government has decided to set up such a structure by 2011.

The dramatic events of 2008 showed that, in a serious liquidity crisis, there were mass appeals to the central banks (and as we know, there were many requests addressed to the National Bank of Belgium, in particular). Central banks therefore need to be kept constantly informed of the situation of the various financial institutions. European central banks have the additional advantage of forming a network, while the crisis also demonstrates the need to organise much better cooperation between national supervisory authorities for the purpose of supervising cross-border institutions.

Prudential supervision is a complex and thankless task, no matter which institution is in charge. When the Bank becomes responsible for this new duty, it will endeavour to perform it to the best of its ability.



Pierre Alechinsky (1927)

L'histoire se répète, Acrylic on canvas, 1972, 154 x 154 cm. ©SABAM Belgium 2010

1. The severe global recession which had begun in 2008 persisted at the beginning of 2009. Thanks to the resolute action of central banks and governments, activity picked up – albeit modestly – thereafter. Yet some risks remain, and unfortunately the crisis is still affecting unemployment. To foster a sustainable recovery it will be necessary, in a context of close international and European cooperation, to roll back at the appropriate moment and pace the measures to support the financial sector and stimulate demand, make improvements forthwith to the regulation and supervision of the financial sector, and move on from a recession exit policy to a strategy for growth and employment which the crisis has made more essential than ever.

Main macroeconomic and financial developments in 2009

2. Following the collapse of the Lehman Brothers investment bank in September 2008, the worst financial crisis since the Second World War reached its peak. It also triggered the deepest global recession of the past sixty years. Real GDP, which had started falling by the beginning of 2008 in the United States, in the spring in the euro area and in the summer in Belgium, contracted much more sharply in the last quarter of 2008 and the first quarter of 2009, owing to the slump in international trade and industrial output. Although the situation stabilised during the second quarter in the advanced economies, and a modest recovery emerged in the second half year, that severe recession explains why the figures for 2009 as a whole are decidedly negative, with global economic activity down by almost 1 p.c.; the fall is estimated at 4 p.c. in the euro area, and 3 p.c. in Belgium. Despite its great sensitivity to international trade and the difficulties experienced by the big banks, the Belgian economy proved more resilient than that of the euro area as a whole. With the benefit of a relatively low level of debt, households and businesses in fact made less marked reductions in their investments.
3. Policy makers throughout the world avoided repeating the errors made in the aftermath of the 1929 crisis. They took considerable steps to safeguard the financial system and support demand, and displayed a willingness for international cooperation. When the turbulence caused by the property crisis in the United States became widespread in August 2007, central banks had promptly expanded the supply of liquidity to the financial sector; they then responded to the worsening financial tensions which emerged in September 2008 and to the recession by slashing their interest rates to levels close to zero and resorting to various unconventional measures in order to support bank lending and the operation of the financial markets. Governments provided aid for systemically important financial institutions by means of capital injections and asset acquisitions, and by granting guarantees. They also adopted recovery plans, thus further stimulating demand – which is automatically supported by the increase in unemployment-related expenditure, the insensitivity of other public spending to the business cycle, and the decline in fiscal and parafiscal revenues.

4. These responses halted a negative spiral and averted the spectre of the collapse of the financial sector and a new Great Depression. From the spring onwards, there were signs of stabilisation followed by economic recovery, appearing first in the emerging Asian economies. The recovery remains fragile since it is based largely on fiscal stimuli and the rebuilding of stocks. The crisis is liable to have a prolonged impact on investment and employment, as firms will continue to face excess production capacity. In particular, employment in the euro area has suffered relatively minor damage as a result of the slump in economic activity, which suggests the risk of further job losses in the coming quarters. All the same, unemployment had already reached 9.4 p.c. in 2009, against 7.5 p.c. in 2008. In Belgium, where extensive use was made of the system of temporary lay-offs – which are not included in the unemployment statistics – the figure increased from 7 to 7.9 p.c. Moreover, demand is likely to be dampened for some time by the need for financial institutions, businesses and households in many countries to consolidate their balance sheet. In any case, following an unprecedented shock, the uncertainty surrounding the economic forecasts is particularly great.
5. The downward pressure on prices resulting from the fall in global demand was also contained by the action of the authorities, and did not kindle deflation expectations. In the euro area, the rise in the harmonised index of consumer prices dropped from an average of 3.3 p.c. in 2008 to 0.3 p.c. in 2009, primarily but not solely as a result of energy price fluctuations on the international markets during 2008. In Belgium, owing to the more pronounced transmission of those fluctuations, the deceleration was more marked: having risen by 4.5 p.c. in 2008, the index remained stable overall in 2009.
6. By mid March 2009, a degree of optimism was returning on financial markets. In general, financial institutions succeeded in restoring positive profitability, mainly thanks to rising prices of financial assets and low short-term interest rates. That recovery remains similarly fragile: while the capital losses on portfolios of structured products seem to have been largely written down, the banks' profit and loss accounts could yet be affected by losses on more traditional lending activities. Moreover, signs of prices getting out of control emerged towards the end of the year on certain markets, such as the stock markets of emerging Asian countries and the markets in gold and other commodities.

Economic policy at the crossroads

Resolving imbalances via international cooperation

7. The crisis demonstrated the strength of the real and financial linkages between nations: adverse shocks were rapidly transmitted, but it is clear that positive stimuli were also quickly passed on, as is evident from the contribution of the emerging Asian economies to the recovery in 2009. In these difficult times, it is vital not to give in to the temptation of protectionism, which did so much harm in the 1930s.
8. It is also essential to avoid the trap of competitive depreciation. Policy coordination does not imply the simultaneous abandonment of policies to support demand. The profile of the normalisation of macroeconomic policies has to be matched to the economic and financial conditions of each region of the world. That means, for example, that the emerging Asian nations should be among the first to adjust their monetary policy, which is currently highly expansionary, and should allow their currencies to appreciate. Stronger multinational cooperation, which recognises the ever-growing importance of these economies, notably via the G20, should serve to build a climate of confidence by assuring these creditor nations that the advanced countries will strengthen their financial system, withdraw in good

time the exceptional measures taken to support demand, and maintain control over their public finances.

9. The appreciation of certain Asian currencies could help to reduce the current account imbalances and improve the distribution of global demand. That rebalancing should also result from structural reforms promoting consumption in the emerging economies and savings in the United States, and reinforcing potential growth, particularly in Europe. The international coordination which this implies could also allow exchange rates to reflect fundamental trends and differences in the cyclical position of economies without disorderly or excessive fluctuations.
10. The euro has protected the countries which adopted it against additional disruption due to fluctuations in exchange rates vis-à-vis their European partners, or even a loss of monetary policy credibility. Nevertheless, monetary union does not solve all problems, and the crisis has revealed the vulnerability of certain countries, in particular Greece, where the sharp deterioration in public finances has impaired the confidence of the financial markets. It is up to the national authorities to prevent or correct imbalances and to make their economies more shock-resilient. Yet the European dimension is essential in the definition of a coherent response to the crisis. It is fortunate that the Lisbon Treaty, intended to improve the operation of the EU institutions, has been ratified.
11. Of course, international cooperation is also crucial for addressing the major challenges presented by climate change and the battle against poverty. Disappointing though it is, the agreement concluded at the Copenhagen climate summit bears witness to a gradual awareness of the threats to our planet. The undertakings given must be respected pending a more ambitious and binding agreement. The economically least advanced countries must also be helped along the road to faster and more sustainable development. In that connection, the Belgian government decided to devote 0.7 p.c. of GDP to official development assistance in 2010, in line with the target agreed at national and international level.

A timely exit, at an appropriate pace, from the policies supporting the financial sector and stimulating demand

12. The crisis management measures will have to give way to a policy geared to the prevention of future crises and consolidation of the foundations of balanced growth. That is a delicate exercise requiring accurate assessment of the private sector's ability to manage without public support. If the exceptional measures are terminated too soon, that will heighten the risk of another collapse: fresh problems for the financial institutions would interact with a further deterioration in the economic situation. Conversely, if the measures are retained too long, that will open the way to new financial excesses, as happened after the stock market bubble burst in 2000-2001. Since it is likely that the situation will only gradually return to normal, and uncertainty will remain high, it will probably be advisable to phase out the crisis measures in stages. In any case, an effective policy to support demand presupposes credible "exit strategies" entailing closer coordination, particularly in the European Union.
13. The Eurosystem's monetary policy must continue to focus on the objective of price stability. From August 2007 to July 2008, interest rate policy was intended to ward off risks of inflation, while liquidity management dealt with the dysfunctional money market. The sudden worsening of the financial crisis and the resulting deflationary pressures next prompted the ECB Governing Council to mobilise all instruments at its disposal in the same direction and resort to non-standard measures to support bank lending, the main source of funding for the euro area's economy. The Eurosystem's key interest rate was cut in seven stages from 4.25 p.c. in October 2008 to the unprecedented level of 1 p.c. in May 2009. In addition, the ample supply of liquidity drove down money market interest rates, and the overnight rate moved closer to that of the

Eurosystem's deposit facility, namely 0.25 p.c. from April 2009. The enhanced credit support consisted in fulfilling all requests for liquidity from the banks at the key rate, conducting refinancing operations over longer terms – up to one year –, extending the list of eligible collateral, supplying liquidity in foreign currencies for euro area credit institutions, and buying covered bank bonds in order to revitalise that market.

14. This resolute policy helped to ease financial market tensions and ward off the risk of deflation. A new phase began at the end of the year, when the Governing Council announced that the December 2009 12-month refinancing operations and the March 2010 6-month refinancing operations would be the last with those maturities. Prompted by the improvement in financial conditions, that adjustment to some of the liquidity management arrangements was intended to encourage the banks to restructure their portfolios and rely more on the market for their finance. It was not intended to trigger an increase in interest rates, as the under-utilisation of production capacity continued to hold prices down and justify exceptionally accommodating monetary conditions, especially as lending remained weak.
15. Since the price stability objective is a medium-term goal, it also enables monetary policy to act against the accumulation of financial imbalances which do not immediately result in pressure on consumer prices. Monetary analysis, which is one of the components of the ECB Governing Council's assessment of the risks to price stability, is useful in that regard. True, the link between the movement in the money stock M3 and prices appears to have weakened, but the expansion of the monetary and credit aggregates, if accompanied by a steep rise in asset prices, may herald the creation of financial bubbles which would endanger consumer price stability if they burst; that applies in particular to debt-fuelled property booms. Those considerations will doubtless gain importance in deliberations on the monetary policy stance. However, the interest rate instrument cannot on its own guarantee both price stability and financial stability. Monetary policy therefore needs to be backed by prudential policies.
16. As regards fiscal policy, it will not be sufficient to withdraw the exceptional measures applied during the crisis since, in most countries, the crisis will have augmented public debt and reduced GDP below the expected level for a considerable time. Credible fiscal consolidation strategies are necessary to lay the foundations for sustainable growth. Moreover, they could allow monetary policy to remain accommodating for a longer period. Combined with the measures to rescue financial institutions whose survival was essential to safeguard the system, the effects of the automatic stabilisers and the recovery plans have swollen the public debt, which has also increased as a percentage of GDP on account of the contraction of activity. Together, all these interventions were effective in averting a negative spiral, supporting lending and limiting the decline in growth potential. However, their effects will vanish very quickly if doubts emerge regarding the control of the public debt, leading to interest rate rises and increased household savings, or even the risk of a public debt crisis. Furthermore, the adjustment burden must not be passed on to future generations.
17. In the EU, the Treaty and the Stability and Growth Pact provide the framework for the consolidation programmes. The many countries facing an excessive deficit – in the euro area, the only ones not in that situation at the end of 2009 were Cyprus, Finland and Luxembourg – must draw up credible plans and take corrective measures as the economic climate improves, in order to bring that situation to an end and go on to attain the medium-term objectives ensuring the sustainability of public finances. On 2 December 2009 the Ecofin Council defined the consolidation course required for most of those countries.
18. When the crisis erupted, Belgium still had a substantial public debt, though well below its 1993 peak of 134.1 p.c. of GDP. In addition, the position of a budget close to balance, which prevailed during the period 2000-2007, concealed an erosion of the primary surplus, i.e. excluding interest charges, and the intention expressed back in the year 2000, concerning the

gradual creation of a structural surplus to prefinance the costs of population ageing, was not carried out. In these circumstances, the crisis not only undermined the plans for preparing public finances for the serious implications of demographic trends, it also revived the “snowball effect” – the endogenous increase in the debt fuelled by interest charges – which had not been seen since 1997. The public debt ratio, which had already climbed from 84.2 to 89.8 p.c. of GDP in 2008 owing to government intervention in certain struggling financial institutions, leapt to 97.8 p.c. in 2009. That increase was due to the decline in nominal GDP, but also and primarily to a substantial general government deficit of 6 p.c. of GDP. The deterioration in the deficit against the previous year, amounting to almost 5 percentage points, was entirely attributable to the primary balance, converted from a surplus of 2.6 p.c. of GDP in 2008 to a deficit of 2.3 p.c. If the policy remains unchanged, and according to the most likely macroeconomic scenarios, the return to nominal GDP growth will not prevent the endogenous increase in debt triggered in 2009 from persisting in the years ahead.

19. The level of Belgium’s public deficit is clearly untenable. Restoring the sustainability of public finances is vital to retain the confidence of investors, consumers and entrepreneurs, and to ensure that the government is capable of addressing the effects of population ageing. The general government budget must therefore be restored to balance within a reasonable period, not only to halt the “snowball effect” but also to start reducing the debt ratio once more. That is why, in Belgium’s September stability programme, the government confirmed the goal which it had already set in April of a return to a balanced budget by 2015 at the latest. The federal budget covering the years 2010 and 2011 is a first useful step in this consolidation process. The reduction of the general government deficit planned for 2010 contrasts with the increase predicted for the euro area. However, it should be noted that the deterioration was more marked in Belgium in the year under review. If the economy does better than expected, any gains should be allocated to speedier deficit reduction. If the macroeconomic environment improves in line with the latest forecasts, it should be possible to meet the intermediate objective recommended by the Ecofin Council of bringing the deficit back below 3 p.c. of GDP in 2012.
20. The task will not be easy, because it is unlikely to be aided by an almost continuous decline in the average interest rate on the public debt, as in the past twenty years. Structural measures will be necessary on both the revenue and the expenditure side, motivated by a desire for efficiency and selectivity. Revenues could be increased by more efficient collection of taxes and social security contributions and by an enlargement of the tax base, while the battle against tax evasion and social security fraud must be vigorously pursued. Expenditure could be curbed in various ways, such as an efficiency drive. The trend of the past decade must cease: in the period 1998-2009, the real structural increase in primary expenditure came to 2.7 p.c. per annum, and even reached 3.5 p.c. in 2009, a rate well above trend GDP growth, which itself declined following the crisis. The experience of the years 1984-1990 and 1994-2000 shows that, in a small open economy like Belgium, burdened by a high public debt, a fiscal consolidation programme does not have to mean weaker growth. But such a plan entails difficult choices, and cooperation at all levels of government, sharing responsibility for a return to sustainable public finances.

Radical reform of the financial sector to ensure dependable support for the economy

21. The financial crisis brought profound changes to the Belgian financial system and modified the structure of large systemic institutions. Not only have the latter scaled down their trading activities by reducing their portfolios of securities and their interbank transactions, they are also implementing massive restructuring plans, entailing their withdrawal from certain markets and disposal of large parts of their business. These measures should contribute to the lasting restoration of liquidity and solvency in the banking system. They should also enable

the institutions in receipt of government aid to manage without that support, in accordance with the European rules on the maintenance of competitive conditions. Moreover, the banks must continue to play their full role in financing the economy. The easing of the Eurosystem's monetary policy should be reflected in lending to households and businesses, particularly small and medium-sized enterprises.

22. Structurally, the gradual dismantling of the financial institution support measures will have to be combined with the gradual but resolute implementation of in-depth reforms which are needed to remedy the malfunctioning of the financial system and, in particular, to reduce the moral hazard involved in the systematic intervention by the authorities in cases where institutions over a certain critical size are at risk of failure. It is not acceptable to revert to the pre-crisis management models. The crisis demonstrated that the private sector had no incentive to take account of extreme systemic risks. It revealed the extent to which certain individual actions could generate collective effects owing to contagion and the interconnections between major market operators. It also highlighted tension between the national framework in which the supervisory authorities exercise their powers and the approach adopted by cross-border institutions, plus a lack of coordination between microprudential supervision and the effort to ensure macrofinancial stability. The difficulties of establishing a new structure for the supervision of the financial sector are both operational and conceptual. That warrants detailed deliberation and meticulous preparation, but cannot be used as a pretext for procrastination or for wasting the impetus and feeling of urgency generated by the crisis itself.
23. The defects which have appeared in the crisis management procedures have again emphasised the interactions between the three main pillars of control defined by the Basel Committee, namely regulation, prudential supervision and market discipline. Regarding legislation, in many countries, including Belgium, special recovery arrangements applicable to enterprises in the financial sector have recently been introduced or are pending to enable the government, in extreme cases, to proceed with the transfer of parts of the assets of credit institutions or securities issued by those institutions. On the supervision front, both the Financial Stability Board at global level and the European authorities are insisting that, for every large cross-border financial institution, there must be special coordination groups with representatives from the ministries of finance, central banks and supervisory authorities of the countries concerned. Finally, the financial institutions themselves should be obliged to set up structures and organisational arrangements which, in an emergency, will facilitate the dismantling of the institutions or their division into more homogenous entities.
24. Turning to crisis prevention, the three pillars of prudential control must be retained but the balance requires adjustment. In particular, recent events have engendered serious doubts about the markets' contribution to the maintenance of discipline. While it is true that effective supervision and regulation are inconceivable without the active contribution of financial institutions, failures and shortcomings have sapped confidence in the financial system's ability to regulate itself. Thus, in many cases incentive schemes and pay structures were biased in favour of immediate results, at the expense of longer term value creation, while the publication of clear and appropriate information – the cornerstone of the third pillar of the Basel framework – was often lacking.
25. Without wishing to act as a substitute for the financial markets, the authorities need to revise the regulations in order to make the system work better for the benefit of the economy. The rules need to be broader in scope, extending to institutions, instruments or markets not previously covered, once they acquire systemic importance. In order to strengthen the solvency and liquidity of credit institutions, the Basel Committee wishes to step up the regulatory requirements. The new system currently under examination would combine an increase in capital, a stronger reserve creation mechanism, and specific liquidity constraints. The calculation of the risk-weighted capital requirements, one of the great innovations of recent years, would

be revised, both to encourage the formation, during a boom period, of capital which could be mobilised during a recession, and to take account of the systemic risks associated with very large institutions or those holding a significant market share in certain segments of activity. An additional requirement would be introduced in the form of a leverage ratio, linking the capital base to the total assets held by the banks and designed, in particular, to curb the excessive use of the leverage effect. There must also be rules governing the remuneration systems of financial institutions, in order to ensure that bonuses based on short-term results never again encourage excessive risk-taking.

26. The implementation of this ambitious project will require rigorous planning. The many technical questions to be resolved must not be allowed to result, paradoxically, in the introduction of over-complicated rules, whereas the aim is to increase the transparency of the financial system. It will also be necessary to ensure that the structural changes which the reform aims to achieve, particularly a reduction in the size and complexity of financial institutions, do not lead to a shortage of credit, a fragmentation of markets – particularly the European financial services market – detrimental to their efficiency, or the exploitation by financial institutions of differences in regulations and a weakening of competitive positions.
27. A revised regulatory framework therefore needs to be implemented by resolute action on the part of the supervisors in order to tighten up the risk management standards applicable to financial institutions. Lessons must be learnt from the crisis, which originated much more from the propagation and generalisation of identical behaviour throughout the financial system than from the weakening of a small number of institutions. The need to safeguard the stability of the system as a whole must be reconciled with the need for efficiency, but also with better protection for the consumers of financial products and services. While no supervision model can offer an absolute guarantee against financial accidents, a growing number of countries are opting for the “twin peaks” system in which the central bank takes charge of supervising individual financial intermediaries and the stability of the system as a whole, while a separate entity is responsible for supervising the smooth operation of the markets, the conformity of financial products and services, and proper consumer information and protection. Such an arrangement has many advantages. It facilitates the independent performance of two key tasks, namely the maintenance of the soundness of individual institutions and the preservation of market integrity. It makes full use of the central banks’ strong points for the supervision of systemic risks: their day-to-day relationship with the money market, their activity within the payment and settlement systems, their macroeconomic analyses and, in the case of the EU central banks, their participation in a system which organises their cooperation. The Belgian government recently opted for such a dual structure which is to be established shortly in order to enhance the effectiveness of prudential supervision and market surveillance.
28. This new model will be integrated into an international institutional architecture which is itself in the midst of change. Following the recommendations of the de Larosière Report, a European Systemic Risk Board and a European System of Financial Supervisors will be established in the EU. At global level, the importance of the role of the IMF and of the Financial Stability Board in maintaining the smooth operation of the financial system has again been formally endorsed. Cooperation, at both national and international level, between the various parties responsible for maintaining financial stability presupposes the fulfilment of certain vital conditions. First, there must be speedy, full communication of the financial information and data forming the basis of prudential supervision. Next, the point of view of the supervisors, who place the emphasis on adherence to the rules and the establishment of risk management procedures and tools, must be reconciled with that of the central banks, which focus their approach on the examination of structural trends and cyclical developments throughout the system. Finally, the analysis of the financial stability conditions must lead to targeted recommendations and specific macroprudential policy measures.

More fundamental reforms to foster sustainable growth

29. The crisis must not be allowed to push the structural reforms into the background. On the contrary, it makes them all the more essential in heightening the risks which population ageing, globalisation and climate change already presented for growth and public finances. The crisis has in fact already placed a burden on public budgets, and in the absence of an adequate response it could curb potential growth for a number of years owing to a decline in the capital stock, a possible rise in structural unemployment, and less readily available funding for investment and expenditure on research and development. A long-term strategy therefore cannot be based exclusively on fiscal consolidation but must also include a policy on innovation, employment and competitiveness, providing sustainable support for growth. The fiscal choices can make a contribution by redirecting revenue and expenditure to promote investment and employment; for example, it is a question of encouraging job creation by an active employment policy, especially in relation to vulnerable groups and – in the current circumstances, particularly favouring young people – providing them with better assistance and training geared to jobs, improving the infrastructures which benefit economic deployment, and boosting investment in education and in research and development.
30. The supply-side reallocation will demand considerable efforts: what is needed is a shift in resources from more traditional activities towards the branches of the future, particularly those which will meet the needs of a more environment-conscious economy. Like other economies, Belgium will have to demonstrate flexibility and dynamism in developing new activities, and that requires the participation of everyone: entrepreneurs, employees and the government.
31. The transition to an innovation economy entails increasing expenditure on research and development – which is still well below the level in Germany and the Nordic countries, and too heavily concentrated on certain large companies –, but also making better use of the technological spin-off from research, encouraging closer links between enterprises and university centres, participating in international networks and enhancing Belgium's attractiveness for researchers. Innovation should make it possible to raise productivity and launch new products and services which are in demand on foreign markets. The need to produce and consume in ways that are less harmful to the environment should be seized as an opportunity for restructuring.
32. More generally, business leaders should constantly endeavour to modernise processes, products and outlets. Belgium is still over-specialised in capital-intensive products where there is competition from emerging countries, and has insufficient focus on new sophisticated products. Export firms, which need to increase in number, are still focused mainly on markets where growth is weak. Moreover, the conditions need to be conducive to the creation of new firms, a powerful source of innovation. However, there is not enough appetite for enterprise, the administrative formalities are still onerous, and appropriate funding for the various stages in the development of young businesses is sometimes lacking. Finally, the existence of legal or administrative obstacles and institutional complexity impede the access of new players on some markets.
33. The process of transforming the production structures requires efficient support on the labour market. It is therefore vital to avoid the potential loss of skills and competence resulting from the current increase in unemployment by effective guidance and training for those who lose their job because of the crisis. Defensive measures, such as the system of temporary lay-offs, which has succeeded in mitigating the social impact of the recession, must be accompanied by training measures in preparation for the exit from the crisis. An active employment policy, making use of everyone's talents via efforts concerning activation, training and mobility, will be the way to prevent cyclical unemployment from turning into structural unemployment, and to ensure that sufficient labour can be mobilised in the context of an ageing population. While

the proportion of young people with higher education qualifications is relatively large, the number leaving school with poor qualifications is falling too slowly, and life-long learning is still inadequate. The important thing is to develop everyone's capabilities throughout their career. Increasing the employment rate – for certain groups the rate is still particularly low compared to the European average – remains essential in order to support growth potential and the social security system. The participation of women in the labour market, which has already increased strongly, needs to be further encouraged, with respect for equality of treatment in relation to men. Finally, as elsewhere in Europe, it is necessary to ensure that the rise in life expectancy is accompanied by an extension of working life, while taking due account of the type of work in question and of the need to offer equal opportunities to older people and enable them to continue working for longer. It may take a long time to implement the measures necessary for that purpose, as is evident from the gradual raising of the retirement age for women, which has already been achieved.

34. The competitiveness of the Belgian economy and its ability to create jobs also depend on price and wage setting. Compared to the euro area, the negative inflation gap recorded in 2009 was smaller than the positive gap seen in the previous year. That is due in particular to permanent price increases in the gas and electricity sector, and the fact that prices of a number of food products responded even more asymmetrically than in the euro area to the movement in commodity prices. The Price Observatory established in 2009 is to provide detailed analyses for the Competition Council and the network industry regulators, which play a crucial role in combating monopoly rents. In addition, the influence of the adverse economic climate on prices of services and non-energy industrial goods seems to have been weaker in Belgium than in the euro area, probably owing in part to the existence of numerous formal and informal indexation mechanisms. On the other hand, since they incorporate lags for adjustment to movements in the reference price index, these mechanisms could exert a moderating influence on average inflation in 2010.
35. Measured by the relative movement in hourly labour costs since 1996 within the meaning of the law on the promotion of employment and the safeguarding of competitiveness, the wage handicap of Belgian firms is thought to have stabilised at around 3.5 p.c. in 2009. That figure takes no account of factors for which the data required for international comparison are lacking, such as wage subsidies in the form of reductions in payroll tax, which were granted in Belgium. However, in view of a more adverse movement in productivity in Belgium, unit labour costs have risen by much more than on average in the three main neighbouring countries over the same period. It will therefore be necessary to ensure that the expected slowdown in these costs – resulting from lower indexation, the pressure of unemployment on variable remuneration, and cyclical productivity gains – is sufficient to improve competitiveness and boost employment. Combined with the innovation efforts mentioned earlier, such cost moderation would help exporters to take full advantage of the global demand revival.

Conclusion

36. In the various regions of the world, the way in which the authorities in charge of monetary and fiscal policies responded to the most serious financial and economic crisis since the war was generally appropriate and avoided the worst. There is still a need to navigate between, on the one hand, the hazards represented by prolonged economic stagnation and a credit crunch, and on the other hand, new financial bubbles and ballooning government debt. Though the manoeuvre is delicate, it is clear that a steadfast course must be maintained towards the long-term objectives. Far from giving in to self-fulfilling pessimism, we need to confront the new realities with courage and clear understanding. To consolidate the economic recovery, it is necessary to strengthen international and European cooperation, continue to pursue policies

aimed at monetary stability, proceed with the gradual but resolute consolidation of public finances, implement fundamental reform of the financial sector and encourage innovation and employment. That is also the direction which economic policies in Belgium must take, while allowing for the specific characteristics of a high level of public debt and a very open economy. A coherent strategy will enable Belgium to capitalise on its many strengths, such as its position at the heart of Europe and its high level of skills, and to progress along the road to sustainable development.

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