Report 2014

Preamble
Economic and financial developments
Prudential regulation and supervision

National Bank OF BELGIUM

Eurosystem

Foreword

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At 3.3 %, global growth once again fell short of expectations. Mounting geopolitical tensions in the Middle East and Ukraine are only part of the reason. The global economy is in fact struggling to leave the crisis behind and is still battling with excess capacity, or in other words under-employment, seven years after the crisis began. So is the global economy, or part of it, facing secular stagnation owing to a persistent mismatch between savings and investment ?

In the advanced economies, the risk of stagnation appears to be lowest in the United States and the United Kingdom, as the recovery has made most progress there. Monetary policy – which played a key role in bringing about the recovery – is now embarking on a gradual normalisation. That is in stark contrast to the situation in Japan which has been suffering from stagnation for a long time now, and where deflation is entrenched in the economy so that the policy of quantitative and qualitative easing had to be further reinforced.

In 2014, growth slowed in many emerging economies. In 2013 and early 2014, some countries faced a sudden reversal of capital flows, while others suffered from the slump in commodity prices, particularly crude oil prices. In China, growth dropped to 7.4 %, against the backdrop of a property market correction and heightened risks to financial stability. All the same, the intrinsic growth potential of the emerging economies remains considerable, despite some loss of momentum in recent years, and the associated scope for investment could, in principle, mobilise the surplus savings of economies with an ageing population. This global dimension is important in the secular stagnation debate, as the balance between savings and investment has to be achieved at global level.

The euro area – where the recovery faltered again from the second quarter, so that growth in 2014 came to only 0.8 % and the unemployment rate remains at 11.5 % – appears to be showing some symptoms of stagnation. It will take a comprehensive policy mix to overcome that, combining a macroeconomic policy to support demand with structural reforms to boost supply and a policy that facilitates the financing of the economy.

On the demand side of the economy, monetary policy must prevent an excessively long period of low inflation from impeding the recovery. Low inflation hampers the process of debt reduction and slows the adjustment of competitive positions between euro area countries. In addition, lower inflation expectations drive up real interest rates, leading to increased savings and weaker investment. The size and composition of the central bank balance sheet and its rate of expansion are policy parameters that can still be used even though the key interest rates reached their floor in the summer of 2014. In January 2015, the ECB Governing Council started down that road by launching an expanded programme of asset purchases amounting to € 60 billion per month.

Under the Stability and Growth Pact, which offers a degree of flexibility, fiscal consolidation must continue in a manner conducive to growth in the countries where the sustainability of public finances is compromised. However, where scope exists, it is equally necessary to adopt a more expansionary fiscal stance.

Above all, structural reforms are needed in two areas. First, the productivity and growth potential of the economy must be enhanced by encouraging innovation and reforming the labour and product markets. Such reforms will be beneficial in bolstering demand. Next, the economy must be financed more efficiently, both by facilitating market financing and by reaping the benefits of the substantial progress achieved in 2014 with the creation of the banking union. The single supervisory mechanism was launched in November 2014, following the successful completion of the comprehensive assessment, while the single resolution mechanism also took shape. These combined reforms will increase the return on investment and reduce the associated funding costs. That could give a significant boost to the expenditure component which has so far been the main factor behind the shortfall in demand in the euro area. The stimulation of demand and support for supply cannot be substituted for one another, as they are complementary. The euro area must grow and reform simultaneously.

Although the downbeat economic environment requires an accommodative monetary policy, the very low nominal interest rates could give rise to renewed excesses on the financial markets and depress the profits of financial corporations. That implies a challenge for the central banks, which need to encourage economic risk-taking while ensuring that the financial risks do not become excessive. This context has led the authorities to extend their range of instruments by implementing a macroprudential policy. That enables monetary policy to focus on its primary objective – the maintenance of price stability – which also has positive spillover effects on financial stability first of all, while macroprudential policy can curb the side effects of the accommodative monetary policy and the accompanying risks. Pursuant to the Law of 25 April 2014, the Bank is responsible for conducting this new policy in Belgium.

Six Belgian banks took part directly in the comprehensive assessment, while a number of subsidiaries of foreign groups were assessed via their parent company. The asset quality review confirmed that the accounting practices of the Belgian banks were generally prudent, as was evident in particular from the adequate credit risk provisions. The banks all stood up to the baseline scenario in the stress tests, although AXA Bank Europe and Dexia did not meet the required conditions in the second, much more adverse, scenario. However, a capital contribution from the parent company enabled AXA Bank Europe to meet the required solvency ratio, while Dexia is a special case since the bank is undergoing orderly dismantling and is backed by State guarantees, so that there is no need for additional measures.

It also became clear that the burdens of the past were still denting the banks' profitability. The Belgian banks are trying to focus on their traditional activities and their domestic market. Key features of that market are the considerable investments accumulated by Belgian households and disparities in the tax rules applicable to the various types of income from movable property. That tax wedge interferes with the business models of Belgian financial intermediaries because it encourages banks to concentrate their liabilities on savings deposits while also inhibiting the 'life' business of insurance companies. Moreover, it is part of the reason for the development of *bancassurance* groups, another specific feature of the Belgian financial landscape. Harmonisation of the tax on income from movable assets could neutralise these effects on the market structure.

The reversion to traditional lending, where default rates are currently modest, is no guarantee for the future. That is why the ECB stress tests allowed for a possible steep decline in house prices. Although the Belgian banks stood up well to that extreme scenario, the Bank remains vigilant about the consequences of any property price correction; for that reason it increased the risk weighting applicable to mortgage loans in the banks' internal models. Moreover, it is necessary to monitor

the impact of low interest rates on the profitability of financial institutions and on their risk-taking. The insurance sector, which is preparing for the introduction of the new "Solvency II" rules on capital requirements in 2016, proved very sensitive to the low interest rate environment in the stress tests. The guaranteed rates on life insurance contracts will have to be adjusted to the new market conditions. The prudential authorities could assist here by lowering the legal maximums currently in force for these guaranteed yields. Finally, the financial sector must endeavour to secure lasting profitability, either by cutting operating expenses, possibly via consolidation, or by applying realistic margins and systematic charges for the services offered.

In Belgium, economic growth also slowed from the second quarter. Annual growth came to 1 %, and the expansion of employment by 15 000 units was not enough to prevent the unemployment rate climbing to 8.6 %. Inflation dipped to 0.5 %, and the rise in hourly labour costs in the private sector subsided to 0.7 %. As well as facing a hesitant recovery, the Belgian economy has to contend with significant structural challenges, relating mainly to progressive globalisation and population ageing. Those challenges require strategic responses to strengthen not only demand but also supply in the economy.

On the demand side, Belgium is benefiting from the ECB's accommodative monetary policy, the impact of that policy on interest rates relevant to the real economy being less distorted in Belgium than in some other euro area countries. There is also a need for gradual but resolute fiscal consolidation conducive to growth. After the budget deficit was cut to 2.9 % in 2013 under the previous administration, it expanded again to 3.2 % in 2014, an election year. The new government has opted for a path leading to a structural balance by 2018. In that respect, it is necessary to ensure that the structural budgetary efforts conform to the Stability and Growth Pact, and that they are then actually implemented. If adjustments are needed, they will have to be made at the time of the March 2015 budget review. Fiscal consolidation must be based primarily on controlling expenditure, and there is some scope available for shifts on the expenditure side and more prioritisation to provide greater support for growth. Efforts to enhance the efficiency of public services and to steer consumption of those services more effectively by making wider use of price signals can create the scope necessary for such shifts without further expansion of the already particularly large public sector.

On the subject of structural reforms, new measures are being taken to support growth potential. Efforts are being made to restore competitiveness, extend working life and to create jobs by improving the efficiency of the labour market. These action points had already spearheaded the reforms initiated at the end of 2011. They will help to improve the labour supply, reduce the budgetary costs of ageing and eliminate the wage handicap, which diminished in 2014 for the first time since 2010.

All the same, there is still a lot of work to be done. Between now and the end of the wage freeze, it is necessary to examine with the social partners how wage-setting can best be linked to the movement in productivity so as to promote job creation. Hourly wage costs in Belgium are amongst the highest in the euro area and, not by chance, the domestic employment rate is one of the lowest. To foster employment, charges on labour need to be substantially reduced by switching to levies on consumption, pollution, wealth, capital gains or property incomes. Such a tax shift is essential to reduce the level of labour costs in Belgium and to make work financially attractive. An effort must be made to reform product markets, to encourage innovation, to attract foreign investment and to facilitate reallocation of resources, in order to boost productivity growth which, in the long term, is the main source of income creation.

There are strong interactions between these various spheres. The high level of public spending which, leaving aside interest charges, amounted to over 51 % of GDP in 2014, makes it hard for the economy to create jobs, because it is accompanied by severe fiscal and parafiscal pressure which, moreover, has a disproportionate impact on the factor labour. In addition, some of that expenditure discourages participation in the labour market, or even rewards early departure. The inability to

create sufficient jobs and growth – primarily in the private sector – undermines the economic basis necessary for maintaining a high degree of social protection and a wide range of public services. If nothing is done, that interdependence could lead to an untenable situation. Conversely, resolute action in each of the spheres mentioned could trigger a self-perpetuating positive spiral giving rise to sustainable growth, job creation in the private sector, and sound public finances, thus opening the way to a high standard of living and safeguarding the Belgian social model.

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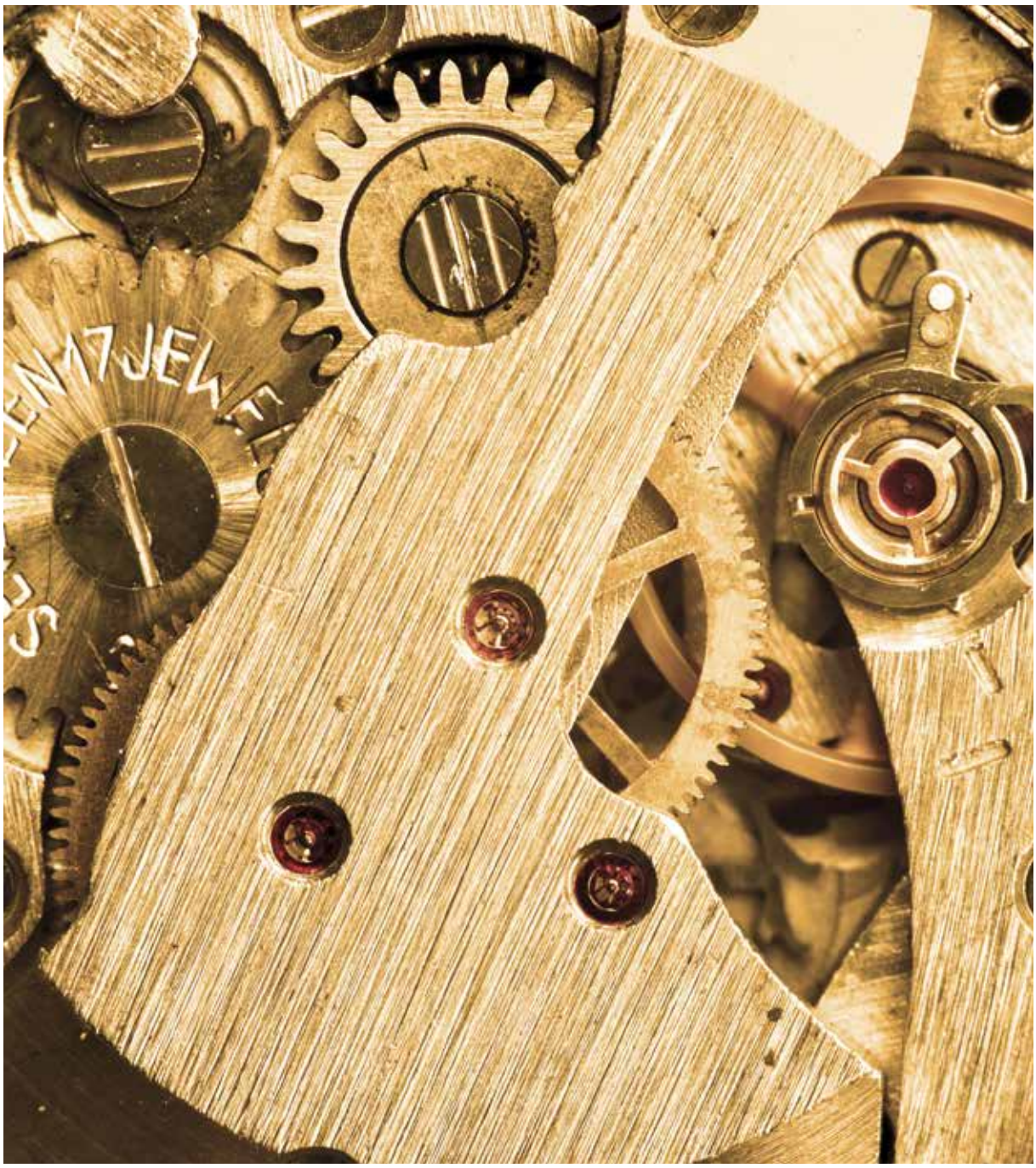

Report presented by the Governor on behalf of the Council of Regency

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

1. The complex interactions between short- and long-term challenges are weighing on the global economy, and especially the economy of the euro area

1. In 2014, as in the previous year, global growth amounted to 3.3 %, which was once again below expectations. The worsening geopolitical tensions in the Middle East and Ukraine were only part of the reason, as they have had little impact so far. Nonetheless, any further escalation would imply considerable risks, mainly via confidence effects and the impact on energy supply. Moreover, repercussions of the rising tensions are already being felt more acutely in a number of countries – many of them European – which have close trade links with Russia and Ukraine. Despite the turmoil, crude oil prices plummeted in 2014, especially in the second half of the year. Other commodity prices were also down. This was due partly to sluggish demand in the global economy, although favourable supply factors also played a role. While there was an increased supply of oil extracted by unconventional means – mainly from reservoir rocks and shale oil – the OPEC countries maintained their production, triggering a very steep fall in oil prices at a time of weak demand. These price falls could provide a boost for the advanced economies, most of which are net energy importers, because they imply a strong improvement in the terms of trade, stimulating disposable income and hence demand. Conversely, they may also complicate the conduct of monetary policy, especially if their influence on inflation extends beyond the direct effect. However, these price falls have an adverse impact on the oil-exporting countries and other emerging economies for which commodity exports are important.

2. The main reason for the mediocre performance of the global economy – which, seven years after the crisis began, is still battling with excess capacity, or in other words under-employment – is less obvious but no less fundamental. Broad swathes of the global economy are still suffering from the repercussions of the crisis, notably in the form of a high debt level. At the same time, there are long-term challenges linked both to the decline in growth potential resulting from slackening productivity and demographic trends, and to climate change. Complex interactions are emerging between these short- and long-term challenges, and in 2014 they continued to leave their mark on economic activity, particularly in the euro area.

* One of the Regents abstained over section 4. Another Regent did not endorse the recommendations put forward in section 4 and in the conclusion.

3. Is the global economy, or part of it, facing secular stagnation? This expression refers to a situation in which, precisely because of this combination of cyclical and structural factors, the balance between savings and investment can only be achieved if real interest rates are significantly negative. Conventional monetary policy has little scope for implementing such interest rates in view of the existence of a policy rate floor and the low level of inflation. Thus, savings may remain excessive and investment inadequate for a protracted period, threatening to consign the economy to virtually permanent stagnation and under-employment. Furthermore, these surplus savings and the accompanying low interest rates imply substantial risks for financial stability. In recent years, certain trends and developments seem to point towards such a secular stagnation, although it may not be equally severe everywhere. For example, Japan has been suffering stagnation for a long time now, while the euro area is beginning to show some symptoms of it. Yet the question is not only whether stagnation is a fact, but also what can be done to overcome it. That requires a broad policy mix, which must also be adapted to the specific circumstances of the various economies.

4. In the advanced economies, the risk of stagnation appears to be lowest in the United States and the United Kingdom, countries where the recovery has made most progress. The key role played here by the accommodative monetary policy of the Federal Reserve and the Bank of England shows that the limitations of conventional monetary policy – a major premise in the secular stagnation debate – can be overcome by resorting to unconventional instruments. Moreover, the United States in particular has benefited from speedier deleveraging in the private sector and stronger potential growth than in the euro area and Japan, alleviating the need for negative real interest rates despite the sharp cyclical downturn.

5. Meanwhile, monetary policy in the United States has embarked on a gradual normalisation. In October 2014, the Federal Reserve ended its programme of massive purchases of securities, and the expectation is that it might start gradually raising interest rates during 2015. That process should preferably continue to abide by the normalisation principles that the Federal Reserve has already announced, and be accompanied by appropriate communication. That would curb the uncertainty and volatility on the financial markets, since the normalisation process, taking place when other advanced economies are still heading in the opposite direction, is bound to affect the exchange rate configuration and international capital flows.

6. In 2013 and early 2014, a number of emerging economies had already experienced a sudden reversal in capital flows, causing a contraction of activity, even though it often followed a period of overheating, with rising inflation and current account deficits. However, the easing of financial conditions in the second half of the year benefited some countries, while others – especially Venezuela and Russia – came under additional pressure as a result of the slump in oil prices. In the aftermath, the rouble collapsed and both the government and large State enterprises and banks face a refinancing risk in foreign exchange.

7. In China – the world's second largest economy –, growth also flagged slightly in 2014 against a backdrop of a property market correction, risks in the shadow banking sector and uncertainty surrounding local government debt ratios. However, China benefited from the American economic recovery. Thanks to the additional support provided by fiscal policy in the form of investment in social housing and infrastructure, the provision of more abundant liquidity and a central bank interest rate cut, growth there still came to 7.4 %.

8. More fundamentally, it seems that the potential growth of the emerging economies has also declined. That is partly a reflection of a rebalancing in favour of more sustainable growth, as in China, but it also demonstrates that, in many countries, activity has been held back by supply side constraints and a lack of adequate infrastructure. Today, that is a weakness, but at the same time it is an opportunity for tomorrow's global economy. In fact, the continuing integration of emerging economies in Asia, Latin America and Africa, where the population is still growing

and where both the needs and the catching-up potential are huge, will in principle offer great scope for investment capable of mobilising the excess savings of economies with an ageing population and opening up new markets. Of course, this presupposes that the countries with catching-up potential establish a stable and efficient economic and institutional framework which can nourish investment and sustainable growth, and that the international financial system functions efficiently to channel the capital into the most productive projects. This global dimension and the ensuing policy implications are important in the secular stagnation debate, as the balance between savings and investment has to be achieved at global level.

9. In Japan, the policy of quantitative and qualitative easing aimed at ending deflation had to be stepped up at the end of October owing to emerging doubts about the credibility of the increase in inflation expectations towards the 2 % target. That shows the importance of preventing deflation from becoming ensconced in the economy, because this process is quite obviously difficult to reverse. The VAT rise in April triggered another fall in growth, so that a second increase initially planned for 2015 has been postponed to 2017. There is practically zero scope for providing fiscal support for the economy. Conversely, a long-term plan could safeguard the sustainability of public finances, while structural reforms could also boost the particularly low growth potential of the Japanese economy.

10. The economy of the euro area is also caught between the legacy of the past and the challenges of the future. Since the second quarter of 2014, the recovery has lost momentum. Year-on-year growth came to just 0.8 %, and the forecasts had to be revised downwards again. The possibility that growth in the euro area could grind to a halt is currently a serious risk for the global economy.

11. The economic and financial crisis left the private and public sectors with huge debts and also weakened balance sheets in the banking sector. In addition, it highlighted the need for rebalancing and caused a surge in unemployment. Furthermore, the sovereign debt crisis led to marked financial fragmentation along national borders, seriously disrupting the transmission of monetary policy and prompting the banks to tighten their lending criteria, whereas bank intermediation specifically plays a major role in financing the euro area's economy, and more particularly the many SMEs.

12. Today, these factors are still hampering the recovery. In 2014, almost all components of domestic expenditure remained below their 2008 level. Net exports alone made a positive contribution to growth, swelling the current account surplus to more than 2.5 % of GDP. Since the savings ratio was down slightly, private consumption declined by less than disposable income, which was hit mainly by wage moderation, job losses and fiscal austerity during the period 2010-2013. This last factor also depressed public investment, which dipped sharply between 2008 and 2014. After the residential property market bubbles had burst in a number of countries, investment in housing actually fell more steeply, while business investment in 2014 was also almost 10 % below its 2008 level. This situation is attributable to the weak outlook for demand, the continuing low level of capacity utilisation, the high debt ratio of non-financial corporations and the tight credit conditions applied by the banks, although greater recourse to market financing brought some respite for large companies.

13. Nevertheless, a number of positive developments emerged in 2014. It was possible to slow the rate of fiscal consolidation, and employment picked up slightly, even though the unemployment rate still stood at 11.5 % at the end of 2014. In addition, the financial fragmentation moderated. In the wake of the significant narrowing of spreads on government bonds, bank financing costs also improved in the countries hardest hit by the crisis. During the year, their borrowing conditions eased slightly for the first time, and retail interest rates on loans to non-financial corporations are evidently responding again to the downward pressure exerted by monetary policy. For the first time in a long while, most of those countries also returned to

positive growth. The slackening of economic activity that began during 2014 in the core euro area countries shows that the crisis is deeply rooted in the euro area and that there is no easy way of combating it.

2. Policy challenges in the euro area : demand, supply and financing of the economy

14. The contraction of economic activity has persisted for so long that it is creating complex interactions between the cyclical downturn and long-term potential – i.e. between demand today and supply tomorrow – which, without an adequate response, may give rise to stagnation. Thus, the high unemployment and weak investment, though initially cyclical, may impair growth potential since talents are liable to be lost for ever on the labour market and there is insufficient expansion of the capital stock. Following the distortions which emerged in the period preceding the crisis, the erosion of demand was also very marked in certain branches of activity, necessitating a substantial reallocation of resources and a rebalancing of supply. Conversely, a depressed growth potential also has significant implications for current demand. It affects permanent incomes and confidence and therefore drags down consumption and investment. Moreover, it reduces the real equilibrium interest rate, making the problem of the policy rate floor more acute. That problem may be further exacerbated if structural reforms designed to remedy the weakness of growth potential curb demand in the short term and produce deflationary effects. This all shows the need for a comprehensive policy mix, combining a macroeconomic policy aimed at encouraging demand with structural reforms to revitalise supply and a policy that facilitates the financing of the economy. The stimulation of demand and support for supply cannot be substituted for one another, as they are complementary. The euro area must grow and reform simultaneously.

15. Monetary policy clearly has a key role to play in encouraging demand. The substantial under-utilisation of production capacity has in fact led to a sharp fall in inflation, although the downward movement in energy and food prices and, until recently, the exchange rate appreciation have also played a part. Inflation was even slightly negative in December, and if the most volatile components are excluded, core inflation was no more than 0.7 %. In addition, during 2014, inflation expectations were revised downwards in the short and medium term, and – later in the year – even in the long term. An excessively long period of low inflation is now looming, potentially jeopardising the recovery, because the decline in inflation expectations drives up real interest rates, thus reducing consumption and investment. What is more, low inflation hampers the ongoing debt reduction process in the private and public sectors and slows the adjustment of competitive positions between euro area countries. It is therefore not enough to avoid deflation ; it is necessary to quickly restore inflation to 2 %, in accordance with the ECB Governing Council's definition of price stability.

16. In order to combat disinflation, the Governing Council cut the key interest rates in June and September. Both the rate on the main refinancing operations and the deposit facility rate, which becomes more relevant in an excess liquidity situation, were reduced by 10 basis points at a time, to 5 and –20 basis points respectively. The key interest rates thus reached their floor. In addition, a series of targeted longer-term refinancing operations (TLTROs) was announced in June, and programmes for the purchase of asset-backed securities (ABSs) and covered bonds were launched in September. These additional measures are intended – each via their own specific channels – to stimulate bank lending to the non-financial private sector because the weak expansion of lending continues to hamper the recovery.

17. At its first monetary policy meeting in 2015, the Governing Council decided to include the above-mentioned purchases of securities issued by the private sector in an expanded asset purchase programme. From March 2015 onwards, bonds issued by euro area central

governments, agencies and European institutions will also be purchased on the secondary market. Combined monthly purchases will amount to € 60 billion. These asset purchases are intended to be carried out at least until September 2016 and in any case until there is evidence of a sustained adjustment in the path of inflation – in line with the target of achieving inflation rates of below, but close to, 2 % over the medium term. This programme will influence not only the yield on the assets purchased but also the price of other assets, via portfolio reallocation, and it will encourage banks to grant more loans, thus permitting a more general easing of financial conditions. What is more, it will play a key signalling role and reinforce the Governing Council's forward guidance indicating that the policy rates will be held at their current low level for quite some time yet. This signal is all the stronger in that the policy of credit easing pursued up to now is supplemented by a significant quantitative component: the size of the central bank's balance sheet is no longer determined by demand for refinancing operations on the part of credit institutions – which is why the balance sheet has contracted considerably in the past eighteen months – but is actively managed by the monetary authority itself via purchases of securities. The size and composition of the balance sheet and its rate of expansion are monetary policy parameters which remain available even when the key interest rates have reached their floor. Furthermore, by explicitly linking use of these parameters to the objective of restoring inflation close to 2 %, they have a bigger impact on inflation expectations.

18. Although the impact on short-term interest rates has been limited – owing to the policy rate floor – this has nevertheless led to a substantial flattening of the yield curve for risk-free debtors. For instance, the yield on ten-year German government bonds dropped to around 0.4 % at the end of January 2015. Moreover, the low interest rate environment has triggered a quest for yield, which has continued to depress the premiums incorporated in riskier financial asset prices. This trend became even more marked at the beginning of 2015 following the announcement of the expanded asset purchase programme. In addition, as the monetary policy stance increasingly diverged from that of other leading advanced economies, the movement in long-term interest rates in the euro area became totally decoupled from that in the United States, and the euro depreciated sharply between May 2014 and January 2015. All these factors could bolster the recovery and support inflation. Against this backdrop, inflation expectations showed the first signs of turning round in January.

19. Owing to the weakness of demand in the economy, fiscal policy also needs to exploit any available scope, especially as that policy becomes more efficient when the key interest rate reaches its floor. Nonetheless, it must be borne in mind that the scope is limited, not only because of the existence of the Stability and Growth Pact and the associated governance, but also because the average debt ratio in the euro area has now already climbed to nearly 95 % of GDP and is even well above 100 % in a number of countries. The Pact must be respected, because – in the specific context of Economic and Monetary Union – it enables the authorities to retain their credibility, not only in the eyes of the financial markets but also for households and businesses. With that in mind, in its assessment of the budget plans for 2015, the European Commission warned that seven countries, including Belgium, France and Italy, risked failing to satisfy the provisions of the Pact, while stating that Germany had considerable scope – approximately 1 % of GDP – for reviving public investment. By concentrating on the structural balances, the Pact also gives free rein to the automatic stabilisers, and interest charges and the primary balance can function as communicating vessels so that the accommodative monetary policy stance facilitates the work of the fiscal authorities in a very direct way. The fiscal policy mix must also be more conducive to growth by lowering charges and shifting them towards tax sources that are less harmful for employment, as well as steering expenditure towards investment. Finally, the European Commission's investment plan may also stimulate economic recovery and national authorities will be encouraged to get involved in it via favourable treatment under the European fiscal framework. Public investment should preferably be based on the existing infrastructure, which is often in need of maintenance and modernisation, while new initiatives could give

priority to continuing to develop the connections between the network industries of the various Member States and reducing greenhouse gas emissions.

20. In the context of a high debt ratio in both the public and the private sector, progressive population ageing, slow productivity growth, and the risk of higher structural unemployment, there is also a need for reforms to strengthen the supply side of the economy. Those reforms will enhance the effectiveness of the support for demand, because an improvement in future prospects will shorten the deleveraging process, create more scope for expenditure by households, businesses and governments, and encourage investment. Moreover, these reforms will ensure that demand is channelled towards the right sectors, and the emphasis on the quality of the labour supply and on activation will enable employment to respond more promptly to rising demand. In addition, resolute commitment to structural reforms could lessen the uncertainty about the future, encouraging a decline in precautionary savings.

21. It is in the countries hardest hit by the crisis that reforms have made the most progress. That process is beginning to yield results, as those countries are returning to economic growth. Nonetheless, in strongly focusing on bringing about internal devaluation, those reforms have curbed demand in the short term. By reforming the labour and product markets too, and trying to boost productivity by innovation rather than relying solely on cost reductions, the structural reforms will be more expansionary. If such reforms are also implemented in the core euro area countries which are trailing behind in that respect, that will not only amplify their impact but will also create more markets for the countries which have already carried out reforms, so that they can valorise their improved competitiveness. Such a global, more balanced approach will also secure broader support in society.

22. The rebalancing of financial positions is another important aspect of the structural adjustments needed to develop growth potential in Europe. The crisis has shown how the economic agents can cause derailments by excessive borrowing, and what damage the financial institutions themselves can cause by following suit and exploiting loopholes in the regulations to make excessive use of leveraging. In recent years, governments have endeavoured to prevent the excesses by massive reform programmes, but they also need to ensure that the return to an over-cautious approach does not cause obstructions for both borrowers and financial intermediaries, preventing credit from playing its full part in the economic recovery.

23. Setting up the banking union will be a cornerstone of this restoration of confidence. By conducting a full appraisal – the comprehensive assessment (CA) – of the quality of assets held by banks and their ability to absorb economic and financial shocks, the ECB intended to ensure that the single supervisory mechanism (SSM) for which it is responsible could start on a sound basis. In addition to the lessons that the assessment yielded for individual countries and institutions, the general conclusions were well received. By further clarifying provisioning policies and procedures for the restructuring or repeated renewal of loans, the asset review should improve the allocation of financial resources in the euro area via its positive influence on lending practices and the monitoring of bank loans. The stress test results were in line with expectations, especially as many banks had anticipated the conclusion of the CA and increased their capital in the initial months of 2014. The markets also appreciated the ECB's transparent and exhaustive approach to publishing the data. This communication effort concerned not only the results but also the specific recovery measures to be taken by institutions failing to meet the required minimum standards.

24. The standardisation of national rules and practices and the alignment with best supervisory practice need to be combined as effectively as possible with the intimate knowledge of banks that the national supervisory authorities have built up via their close contact with individual institutions. To that end, two major coordination structures have been set up. On the one hand, each of the 130 banks subject to direct ECB supervision is monitored by a joint supervisory team

directed by an ECB coordinator and comprising staff from the ECB and the national authorities. Also, a number of transverse functions concerning such matters as licensing, the organisation of on-site inspections, examination of internal models, supervision policies and the development of methodology, will each be discussed separately by networks of national experts in order to pool experience and define more precisely the procedures to be applied.

25. Creation of the SSM is inconceivable without a unified structure for resolving bank crises, otherwise there is a risk that taxpayers in one country alone would be saddled with the consequences of decisions which will from now on be taken at supranational level. That is precisely the rationale for the other two elements of the banking union, one of which – the introduction of a common deposit guarantee system – is still only at the stage of harmonising national systems, while the other – the establishment of a single resolution mechanism (SRM) – formed the subject of an EU Regulation dated 15 July 2014. This new mechanism is based on a resolution board responsible for adopting resolution plans and schemes for all banks subject to direct ECB supervision, and a resolution fund consisting of contributions from the banks via national compartments which will be gradually pooled. In compliance with this Regulation's requirement for each Member State to set up a national resolution authority, a new body, the Resolution College, was established under the NBB's Organic Law. That body, chaired by the Governor, is responsible for carrying out this new task.

26. The establishment of the banking union does not cover all financial intermediation activities. Indeed, the predominance of the banks in Europe is often seen as one of the structural handicaps facing the EU, in comparison with other economies, especially that of the United States, which make much greater use of the stock markets to diversify the options for borrowing and attracting savings. The European Commission therefore wants to launch a project for unifying the capital markets, thus confirming that the many harmonisation measures which it has already introduced in the context of the Single Market have not been enough to develop a genuine alternative to bank funding. The financial centres of Europe remain divided by many discrepancies, not only with regard to market regulations but more broadly in accounting standards, audit assignments, bankruptcy law, taxes on income from movable property, and the processes for the operation and supervision of financial infrastructures. In a sector less clearly defined than banking, it will be necessary to reconcile the efficiency gains offered by more fluid markets with the need to prevent the development of activities or the emergence of intermediaries whose sole purpose is to circumvent the prudential regulations.

27. Although the downbeat economic environment requires an accommodative monetary policy, the very low nominal interest rates could give rise to renewed excesses on the financial markets and depress the profits of financial firms. To maintain their profitability, those firms may be tempted to seek the extra yields offered by poorer quality assets. Central banks thus face the challenge of trying to stimulate economic risk-taking while ensuring that the financial risks do not become excessive. This context has led the authorities to extend their range of instruments by implementing a macroprudential policy. This means that monetary policy can focus on its primary objective – the maintenance of price stability – which also primarily has positive spillover effects on financial stability, while macroprudential policy can curb the side effects of the accommodative monetary policy and the accompanying potential risks.

28. The development of this new policy, long confined to the conceptual stage, recently entered an operational phase. Many euro area countries have lately introduced macroprudential measures, either to reduce the danger of excessive credit expansion in certain specific sectors such as property, or to protect against a strong concentration of risks relating, in particular, to the presence of a few very large operators who have acquired a systemic position on the markets. This targeted use of macroprudential policy also has the advantage of being able to focus on potential sources of instability.

29. Macroprudential policy remains closely linked to microprudential policy, with which it shares a large proportion of its means of action. Moreover, circumscribed use of macroprudential measures usually involves a concept of geographical coverage which will have to be reconciled with the desire to preserve and develop what the EU has achieved in the banking union and the Single European Market. The existence of these various interdependencies may explain – though it cannot justify – the current complexity of the European rules on the implementation of macroprudential policy. The Bank, which – pursuant to the Law of 25 April 2014 – is responsible for conducting this new policy in Belgium, has had to conform to these provisions in introducing its first two macroprudential measures concerning mortgage loans and trading activities. The EU arrangements, which not only list the types of instruments that can be used but also specify detailed notification and authorisation procedures, absolutely have to be simplified to ensure effective coordination in the conduct of this new policy between the ECB, the national macroprudential structures and the European authorities.

3. The Belgian economy in 2014: hesitant recovery, falling inflation and low interest rates

30. In Belgium, the economy grew by 1 % in 2014, outpacing growth in the previous two years. Nonetheless, as in the euro area, growth faltered during the year. Employment was up by 15 000 units, providing support for disposable income and private consumption which grew by around 1 %. That said, job creation was not enough to offset the expansion of the labour force. The unemployment rate thus climbed to 8.6 %. Investment in housing and business investment also returned to positive growth, but remained below their pre-crisis levels. Non-financial corporations are still not inclined to embark on major investment projects, as is also evident from the fact that they want to take on fewer new commitments and their liquidity buffer remains very substantial. The negative contribution of stock-building to growth is likewise a sign of the doubts surrounding the sustainability of the recovery. The weakening of demand on foreign markets during the year and the associated flagging of exports are certainly factors here.

31. Inflation continued to fall, dropping from 1.2 % in 2013 to 0.5 % in 2014. At the end of the year, it was actually negative. That situation is due to the movement in prices of food and particularly energy – taking account of the slump in crude oil prices and the reduction in VAT on electricity – whereas core inflation, at 1.5 %, remained almost as high as in 2013. In fact, the wage increases during the period 2012-2013 take some time to be reflected in prices, and for a range of services it is still common practice to index link prices on the basis of past (high) inflation. In 2014, however, the rise in hourly labour costs in the private sector slowed down sharply, declining to 0.7 % after successive increases of 3.2 and 2.4 % in 2012 and 2013. The lower inflation caused a significant reduction in the indexation component, while as a result of the wage freeze there were no negotiated pay increases in excess of the index, and the wage drift remained very modest on a rather sluggish labour market.

32. The low interest rate environment had a major influence on the consumption and saving patterns of the various economic agents and on their financial transactions and their wealth. The effect nevertheless varies according to whether they have net financial assets or net liabilities. Moreover, the composition of the assets and liabilities also plays a role. At the end of September 2014, the Belgian economy as a whole had net financial assets equivalent to 35 % of GDP. That reflects substantial net assets for households – amounting to 225 % of GDP – whereas businesses and the government have net liabilities.

33. In recent years, the decline in interest rates has therefore eroded households' capital income. However, since much of that income is traditionally saved, the impact on private consumption has been smaller. In fact, in parallel with the reduction in income from property, the overall savings ratio has fallen. The fact that lower interest rates discourage savings and generate a

positive wealth effect may also have favoured that decline. In the past five years, the increase in the net wealth of households may in fact be partly attributable to higher valuations of both financial assets and property, driven partly by the fall in interest rates. During 2014, households put some of their new investment into riskier assets in order to maintain their yield. In view of the persistently high uncertainty, however, they still hold a large proportion of their savings in short-term liquid assets, despite the very low level of short-term interest rates, particularly for savings deposits. The fall in mortgage interest rates has enabled some households to refinance their existing mortgage loans on more attractive terms. This was also one of the factors behind the albeit hesitant revival of investment in housing.

34. In contrast to households, non-financial corporations have substantial net financial liabilities, so that the lower interest rates reduce their borrowing costs and thus bolster the economy. In 2014, it was mainly long-term bank credit interest rates and corporate bond yields that continued to decline. For large Belgian companies with a good credit rating, the issuance of corporate bonds and listed shares was once again an attractive alternative to bank finance in 2014; at the same time, the availability of credit from the banks also improved, even for SMEs. The low interest rate environment poses significant challenges for financial institutions and for the stability of the financial system, challenges that will be examined below.

35. Faced with a gross debt ratio of more than 106 % of GDP in 2014, the government saw its interest charges diminish as a result of the fall in interest rates. During 2014, interest rates on short-term securities issued by the Belgian Treasury actually became slightly negative, while the ten-year rate dropped to around 0.6 % in January 2015. Compared to 2008, interest charges on the public debt were thus already down by 0.7 % of GDP, and a further fall is in the offing for the coming years. The full impact is in fact not expected until the whole of the debt financed at higher interest rates has reached maturity. This will bring into play a key stabilising factor for the sustainability of public finances, helping to buffer the impact on the debt ratio of both a cyclical deterioration and any possible disinflation. This last factor could be felt even more keenly in Belgium in the years ahead owing to wage moderation.

36. Despite the further decline in interest charges, the public deficit continued to grow, rising from 2.9 % of GDP in 2013 to 3.2 %. The process of fiscal consolidation which began at the end of 2011 and improved the structural balance by almost 1 percentage point during 2012-2013 was interrupted in 2014, an election year. In addition, the fiscal effort for the whole period 2011-2014 remained very modest compared to that of the euro area. In fact, under the Stability and Growth Pact, Belgium opted for a gradual process of fiscal consolidation which, except for the second half of 2011, has so far continued to benefit from the financial markets' confidence. Conversely, many other euro area countries have been obliged to frontload the effort, making their fiscal policy highly pro-cyclical, just at a time when financial fragmentation also excluded them from the easing of monetary policy. The fact that this has enabled Belgium to introduce a less restrictive macroeconomic policy mix is part of the reason why the Belgian economy has withstood the crisis better up to now.

37. All the same, the Belgian economy faces some major challenges, particularly in relation to progressive globalisation and population ageing. For example, by reducing the labour supply, this latter factor has significant implications for future growth potential as well as entailing substantial budgetary costs. The Study Committee on Ageing estimates the costs at almost 6 % of GDP by 2040, and the European Ageing Working Group whose projections are based on different assumptions predicts an even bigger rise in expenditure. Such challenges require strategic responses. Safeguarding the sustainability of public finances is part of that, and the gradual approach in recent years implies that much of the effort has yet to be made. In addition, the particularly low employment rate – only two in three people of working age have a job – needs to be addressed urgently. Finally, a third priority lies in raising the growth potential and productivity of the Belgian economy via innovation and competitiveness. There

are close interactions between these various spheres. The high level of public spending which, leaving aside interest charges, amounted to over 51 % of GDP in 2014, is accompanied by severe fiscal and parafiscal pressure that, besides, has a disproportionate impact on the factor labour, hampering the economy's capacity to generate employment. Moreover, some of that expenditure discourages participation in the labour market, or even rewards early departure. The inability to create sufficient jobs and growth – primarily in the private sector – undermines the economic basis necessary for maintaining a high degree of social protection and a wide range of public services, though both these factors are among society's choices. If nothing is done, that interdependence could lead to an untenable situation. Conversely, resolute action in each of the spheres mentioned could trigger a self-perpetuating positive spiral giving rise to sustainable growth, job creation in the private sector, and sound public finances, thus opening the way to a high standard of living and safeguarding the Belgian social model.

4. Sustainable growth, job creation and sound public finances lay the basis for a high standard of living and safeguard the Belgian social model

38. In the previous legislature, the government had already tackled the structural weaknesses of the Belgian economy. It embarked on fiscal consolidation, implemented reforms of pensions and the labour market, and adopted measures to boost competition in the network industries and to make firms more competitive. The new federal government – which won the confidence of Parliament in October 2014 – and the governments of the Communities and Regions are planning further steps in that direction.

39. Pension reform again holds a central position. The statutory retirement age will be raised to 66 years in 2025 and to 67 years in 2030. The rules on early retirement are also being further tightened, as is necessary to continue rapidly narrowing the gap between the statutory pensionable age and the actual retirement age. In addition, a points system will be introduced for calculating pensions, greater account will be taken of the proportion of periods worked, and civil service pensions will be brought into line with the system in the private sector. The specific implementing provisions have yet to be determined, following consultation in the forthcoming National Pensions Advisory Committee. Here, it is a question of ensuring that an adequate pension package and access to health care can be guaranteed. Extending working life is a structural reform that has a favourable impact not only in the long term but also in the short term.

40. In the long term, it helps to maintain the labour supply, supporting potential growth. However, for this reform to be as effective as possible, attention must also focus on remuneration, and firms must attend to the conditions for extending working life. In fact, in some cases remuneration increases with seniority, but without reflecting a proportionate increase in productivity. Working arrangements are not adequately geared to retaining older workers. If the reform is to succeed, it is therefore crucial to give some thought to the productivity, employability and specific job characteristics of older workers. In this respect, the social partners have a vital role to play because, thanks to their practical knowledge, they are well placed to define the qualitative content for the necessary extension of working life and to enhance its efficiency from both the economic and the social point of view.

41. Since it also reduces the budgetary costs of ageing, a longer working life can also offer some breathing space for fiscal policy in the short term. The high level of ageing costs is in fact the reason why, according to the European budget framework, Belgium needs to aim at an ambitious medium-term objective – namely a structural surplus of 0.75 % of GDP. Although it is still too soon to calculate precisely the impact of the pension reform on the budgetary costs of ageing, and hence to examine its implications for the medium-term objective, it will

nevertheless have a beneficial influence on the sustainability of public finances. Moreover, greater clarity over the exact content of the reform will eliminate a factor of uncertainty for households, which could therefore reduce their savings for old age.

42. Jobs and competitiveness are a second weakness of the Belgian economy. There is an urgent need to create more jobs in the market sector because, since 2000, much of the net job creation has been outside that sector and has been funded mainly by the government. In this area, too, there have been new moves in the right direction, but the challenge is so great that every lever must be used.

43. In a small, open economy like Belgium, in order to stimulate demand for labour, it would be appropriate to continue the policy of wage restraint. To that end, wage indexation has been temporarily suspended via the "index jump", and pay rises in excess of indexation will continue to be moderated during the period 2015-2016, unless competitiveness in relation to the three neighbouring countries is restored in the meantime. According to estimates based on the Bank's macroeconomic models, which assume a proportionate impact on prices, the index jump could boost employment in the private sector from 2016 onwards and benefit economic growth from 2017. That effect would be further reinforced in subsequent years since the initial negative impact on domestic demand will be increasingly offset by the favourable effects of competitiveness gains and job creation. However, in this respect it is assumed that the wage moderation resulting from the index jump will not be counterbalanced by higher pay rises excluding indexation. Moreover, the reductions in charges under the Competitiveness and Employment Pact for 2015 and 2017 respectively will be implemented in 2016. While the one planned for 2017 will be brought in early, the 2015 reduction will be postponed for a year, as the government has opted to raise the allowance for flat-rate professional expenses straightaway in 2015 and to allocate a budget to lessen the impact of the index jump on the purchasing power of the lowest incomes. It has also been announced that employers' contributions are to be cut to 25 % by the end of the legislature.

44. According to the Central Economic Council's technical report, the hourly labour cost gap which has developed since 1996 in relation to the average in the three neighbouring countries stood at 4.2 % in 2013, excluding the impact of wage subsidies and the movement in productivity. This situation is due to a serious wage handicap in relation to Germany, whereas the movement in hourly labour costs in Belgium has been more moderate than in the Netherlands and France. In 2014, the gap narrowed for the first time since 2010, contracting to 2.9 %. That was the result of wage moderation in Belgium and the return to bigger pay rises in Germany. Nonetheless, the problem of labour costs as a barrier to job creation has not been resolved, as the level of labour costs in Belgium is still among the highest in the EU, mainly but not solely on account of the heavy burden of labour charges. Undoubtedly, the high labour costs correspond largely to the remuneration of a high level of productivity. However, the fact that hourly labour costs in Belgium have risen faster than in the three neighbouring countries since 1996 is certainly not attributable to stronger productivity growth. Quite the contrary : the cumulative wage gap per unit of output since 1996 is even larger, around 10 %, once again owing to a wide discrepancy in relation to Germany. High labour costs force less productive workers out of the market, primarily penalising low-skilled workers and that is one of the reasons for the extremely low employment rate of certain risk groups.

45. By the end of the wage freeze, it is necessary to ascertain how wage-setting can best be aligned with productivity, to maximise the benefits for job creation. The revision of the Law of 26 July 1996 on the Promotion of Employment and the Preventive Safeguarding of Competitiveness, announced by the government, offers the opportunity for that. Together with the social partners, a new balance must be achieved between the advantages of coordinating wage-setting at macroeconomic level and the need for greater differentiation according to

developments specific to the various sectors and firms. Furthermore, the productivity of the Belgian economy can be reinforced by putting more emphasis on training and innovation.

46. Since the level of labour costs is also determined to a large extent by the heavy charges on labour, appropriate wage-setting – important though it is – cannot resolve all the problems. There is therefore a need to reduce labour charges by turning to other revenue sources that are less detrimental to job creation, i.e. to implement what is known as a "tax shift". The government agreement already makes provision for such a shift, up to a certain point. The reductions in charges in 2015 and 2016 have in fact already been partly funded by an increase in certain indirect taxes and certain capital levies. However, there is still some available scope for proceeding further down this route. Excise duties and environmental taxes – especially energy taxes – are quite clearly lower in Belgium than in other European countries. The standard rate of VAT is close to the European average, but the application of reduced rates for a significant part of the consumption basket needs to be reviewed. These levies can be used not only to reduce the burden on labour but also to steer consumption patterns towards greater sustainability. Attention should also focus on a shift in levies towards property incomes, capital gains or wealth itself, and on how to increase the standardisation of taxes on the various wealth components. The tax shift is justified from the economic perspective, as is also borne out by the recommendations of national and international organisations alike.

47. A shift in charges could also push up net wages, thus stimulating not only demand for labour but also the labour supply. That is precisely the effect intended by the higher allowance for flat-rate professional expenses. It is proportionately larger for low-income earners who are precisely the ones most affected by the problem of unemployment/inactivity traps. In addition, making unemployment benefits more degressive and encouraging mobility further reinforces the incentives to work. Effective assistance for the unemployed in their search for a job is another way of encouraging activation. The government has decided to develop a community service scheme for the long-term unemployed. Care must be taken to ensure that reforms to the unemployment system do not lead to any less assistance to job-seekers.

48. Certain risk groups merit particular attention, as they evidently have great difficulty in gaining access to the labour market. Not only does under-employment of the most vulnerable section of the population entail considerable economic costs, it is also a cause of poverty and social exclusion. There is a need for an inclusive approach and measures to combat all forms of negative discrimination. Above all, the focus must be on training, guidance and easing the transition from school to work. Greater availability of traineeships in firms could make a contribution here. In this respect, targeted reductions in labour costs could also be an appropriate policy instrument. The sixth State reform transferred many of the political levers in this sphere to the Regions, enabling them to conduct a consistent policy and respond to the specific needs of their own area. At the same time, those bodies need to work closely with one another to remove the barriers to labour mobility between the Regions. In Belgium, there are actually wider variations in unemployment between the three Regions than within each Region. The Brussels Capital Region, where over 19 % of the labour force is unemployed, has the most to gain from that. Finally, it is also necessary to ensure that those in work maintain their employability. Life-long learning must enable workers to adapt to rapid technological innovations and adjustments to the work process.

49. Restoration of Belgium's competitiveness will also boost growth potential, since it will enable firms to slot readily into global value added chains. Not only will these firms thus be able to tap fast-growing markets, even if they are not directly active there, but they will also gain access to the most efficient and innovative production techniques. This could be a valuable catalyst for accelerating the growth of total factor productivity (TFP). That growth is weak in Belgium, and has slowed further in recent years, whereas in the long term it is the main source of wealth

creation. In view of the importance of TFP, the Bank devoted a conference to the subject in the autumn of 2014.

50. TFP growth benefits first of all from innovation, hence the importance of investing in R&D, especially for industry. Such investment is low in Belgium, particularly on the part of the government, and is also heavily concentrated on a few branches of activity. But innovation is a broader concept which is also linked to the organisation of businesses, management, marketing and the rapid integration of new techniques – primarily concerning ICT – into existing processes so as to create spillover and multiplier effects. Moreover, at macroeconomic level, TFP growth benefits from the ease of reallocating resources from less productive to more productive firms. This means that new companies can be established quickly, but it also means that activities which perform less well and lack future potential can be readily closed down. This reallocation process can be supported both by the elimination of administrative, legal and fiscal hurdles and by a smoothly operating labour market and efficient financial intermediation. Finally, the quality of the production factors – both labour and capital – is a vital engine of TFP growth. Labour skills and life-long learning are therefore crucial factors here, too. For their part, investment maintains the quality of the capital stock in facilitating the integration of the most innovative technologies. Furthermore, it is in Belgium's interests to attract foreign investment, as that is a powerful vehicle for disseminating technical and organisational innovations and can strengthen entrepreneurship.

51. More competitive market structures also stimulate TFP growth by encouraging efficiency gains. Consequently, there is a need for new product market reforms, particularly in the network industries and in the service sectors which are still protected. These reforms will boost cost competitiveness, not only by their impact on productivity but also by reducing prices. In addition, competitive markets encourage the transmission of wage moderation to sales prices and prevent the expansion of margins, thus accentuating the effect on growth and employment. Potential growth and TFP also benefit from an efficient infrastructure. Both the risk of a black-out which became apparent in 2014 and the extent of the country's transport problems similarly illustrate the scale of the challenges here. Economic efficiency must be reconciled with ecological considerations in the search for solutions. There is also a need to consider the relative contributions of the private and public sectors. In order to mobilise private investment in projects requiring large amounts of capital and extending over a very long period, it is essential to have a stable and predictable legal framework.

52. Fiscal consolidation conducive to growth must be the final piece in the strategy for meeting the challenges that face the Belgian economy. To that end, in its draft budget plan, the federal government mapped out a path towards structural balance in 2018, which is two years later than under the plan defined by the previous administration in April 2014, though that plan was only tentative. Since Belgium is strongly committed to structural reforms and the restoration of competitiveness, and since each of those factors also benefits the sustainability of public finances in the medium term, there is in principle some scope for a more gradual approach which may also support the economy's recovery. All the same, it is necessary to ensure that the structural efforts conform to the European framework and that they are then implemented in full. In its assessment of the draft budget plan, the European Commission warned that the path might not correspond to the requirements of the Stability and Growth Pact. It will review the situation in March 2015, in the light of the actual implementation of the budget and the structural reforms which have been announced. Any necessary adjustments will have to be made.

53. The restoration of a sound budget must be based primarily on judicious control of expenditure, as new taxes need to be used as a priority to permit a reduction in the levies on labour. Nonetheless, it is necessary to strive for the proper collection of taxes and to combat tax avoidance, tax evasion and social security fraud. Close international collaboration and an

assiduous exchange of data are recommended in that regard, as well as coordination on a European scale. The draft budget plan places the emphasis on pruning expenditure, and this also applies to the contribution of the Communities and Regions towards consolidation. That course must be maintained. However, on the expenditure side, there is also scope for shifts and greater prioritisation, in order to provide better support for growth. From that perspective, the first thing to be done is to invest in infrastructure, training and sustainable development, but the attenuation of extreme social inequalities could also help to boost economic growth. An OECD survey in fact shows that marked inequality – particularly at the lower end of the income scale – is detrimental to growth because it compromises investment in training for the most vulnerable section of the population. Efforts to enhance the efficiency of public services and to steer the consumption of those services more effectively by using price signals more frequently can create the scope necessary for such shifts without further increasing the already particularly large size of the public sector.

5. The stability of the Belgian financial system

54. Taking stock of the state of affairs in the European banking sector under the comprehensive assessment (CA) was seen as vital for the successful launch of the SSM, but that assessment based on an asset quality review and stress tests can also serve as a guide for the future action plans of both individual firms and the prudential authorities. In Belgium, six banks were directly involved in the CA, namely Argenta, AXA Bank Europe, Bank of New York Mellon, Belfius, Dexia and KBC Group, while a number of subsidiaries of foreign groups, including in particular BNP Paribas Fortis and ING Belgium, were assessed via their parent company.

55. The asset quality review confirmed that the accounting practices of the Belgian banks were generally prudent and in line with international standards, as was evident in particular from the adequate credit risk provisions. An initial stress test showed that these banks could withstand a baseline scenario combining the very weak growth expected in Europe in the coming years with the gradual introduction of the stricter solvency rules laid down by the Basel Committee, as the banks remain well above the minimum 8 % core capital (common equity Tier 1) set by the CA methodology. The second test, based on a much tougher scenario involving a downturn in growth, rising unemployment, a widespread increase in interest rates and a sudden slump in property prices, produced more variable results. Four of the banks were still well above the required minimum of 5.5 % of CET1, but AXA Bank Europe and Dexia failed to meet that requirement. However, a capital contribution from the parent company enabled AXA Bank Europe to fulfil the stipulations, while Dexia is a special case since the bank is being dismantled and is backed by a State guarantee. The ECB took these characteristics into account, and concluded that the results for that institution did not cast doubt on the plan approved by the EC, so that it did not stipulate additional measures.

56. Of course, for a prospective analysis, it is necessary to go beyond these global data and refer to the more detailed CA results, while avoiding the traps of aggregation and shortcuts in comparisons between banks, especially as, for these tests, each participating country continued to apply national waivers still permitted by the European prudential rules. In the case of Belgium, one of the first lessons of the tests is that the burdens of the past, whether they are due to risky strategic choices or the acquisition of overvalued assets, are still denting the banks' profitability and are probably the main reason for the variations between individual outcomes. However, despite these divergent positions, most Belgian banks are adopting fairly similar approaches, trying to focus on their traditional activities and their domestic market which they understand the best, by exploiting the structural characteristics of the national economy.

57. These characteristics include the substantial investments that Belgian households have accumulated. Since financial intermediaries compete fiercely to attract these savings, the market

is very sensitive to the smallest differences in yields, including those due to distortions resulting from the system of taxes on income from movable property. That differentiation factor is one of the key determinants of the recent trend in the two main categories of financial assets held by households : savings deposits and insurance products. Not only are savings deposits covered up to € 100 000 by the deposit guarantee system, the income on them is exempt from the withholding tax with full discharge up to a maximum limit the constraining effect of which declines as interest rates fall. Conversely, even though premium payments for life insurance contracts are tax deductible under certain conditions, the increase in the tax on these premiums to 2 % in 2013 is all the more disadvantageous for that type of product because the current low level of interest rates increases the penalising effect of this tax on payment of the premium. This tax wedge interferes with the business models of Belgian financial intermediaries. On the one hand, it encourages banks to concentrate their liabilities on a single product which can, furthermore, be readily marketed by foreign banks taking advantage of the preferential tax status of savings deposits to collect resources in Belgium for the purpose of funding activities on other markets. It also impedes expansion of the "life" business of insurance companies, whose profitability is therefore based increasingly on the development of non-life business. Harmonisation of the tax on movable assets could neutralise these effects on the structure of the markets.

58. To some extent, Belgian financial institutions have internalised the competition between banking and life insurance products by creating bancassurance groups which make optimum use of the retail networks. However, this model is not used very much in the new SSM, and the CA stress tests showed that the ECB is keeping a close eye on compliance with the solvency standards applicable to these conglomerates. Moreover, this combination of activities does not prevent competition either from foreign players or from direct intermediation via the issuance of securities, a strategy adopted by a growing number of Belgian firms under current market conditions.

59. For Belgian financial institutions, the way in which household deposits are used is a key issue, especially as these funds exceed the borrowing needs of resident firms. Belgian banks have long used this surplus primarily for subscribing to Belgian government loans, which has enabled them to constitute a large buffer of liquid assets. During the years preceding the crisis, they also used these resources to fund the development of foreign activities. At the time, that expansion ultimately created financing needs far in excess of the surpluses collected in Belgium, so that the Belgian banks had become very dependent on the international interbank markets.

60. When the banks refocused on their domestic market, that did remedy the problem but it also raises the question of finding a use for these funds which offers an attractive return for an appropriate risk, in a context in which low interest rates mean fiercer rivalry on all financial markets. The quality of the banks' assets was examined in depth during the CA, not only in terms of asset valuation but also in the stress tests for credit risks and market risks. These analyses confirmed that the main vulnerabilities were connected with portfolios of loans and securities abroad, particularly in certain countries where the debtors' position deteriorated, such as Ireland and Hungary.

61. Conversely, the more traditional loans to Belgian firms and households currently feature modest default rates, reflecting the banks' good knowledge of this market plus the provision of sound collateral in many cases. However, the low level of past losses is no guarantee for the future, as is evident from the example of a number of euro area countries which have suffered a property crisis in recent years. In conducting the stress tests, the ECB wanted to take account of such an eventuality by supposing a 25 % cumulative fall in house prices over three years in Belgium, which would trigger a sharp rise in default rates. The Belgian banks stood up well to that scenario, one of the toughest applied to the various countries taking part in the tests, and totally out of scale with anything that has happened in the past, even in the periods of severe

tension on the property market. This extreme assumption has not been borne out by the latest developments, which show prices stabilising. Nonetheless, the Bank continues to monitor the consequences of a possible property price correction, and that has prompted it to increase the risk weighting coefficients of the internal models that the banks use to manage their mortgage loan portfolios.

62. The banks have adjusted their new lending conditions to take account of these stricter regulatory requirements, but those conditions also reflect the decline in interest rates which, over recent months, has led a very large number of borrowers to apply for refinancing. This last factor will diminish the profitability of mortgage loans, especially as expansion of the loan volume has slowed considerably, despite a very short-lived surge at the end of the year when many prospective buyers tried to pre-empt the Flemish government's decision to cut the maximum tax relief under the housing bonus from the beginning of 2015.

63. Up to now, the adverse effect of the level of rates on the banks' interest income has been offset by the positive impact of the interest rate movement, as the continuing decline has generated capital gains. But this source of income is set to dry up as rates have fallen to a historical low. From now on, banks will feel the full force of the loss of the advantage offered by the availability of unremunerated sight deposits, with no offsetting effect. Insurance companies will also come under pressure, because market rates have dropped well below the guaranteed yields on many life insurance contracts dating from previous years. True, in the short term, they may escape that constraint thanks to capital gains made on portfolio securities and to yields still being received on the oldest bonds acquired in years when interest rates were much higher. But it is vital that they take advantage of this breathing space to adopt a preventive strategy, by allocating most of their capital gains to covering their contractual obligations, preferably for the payment of dividends or profit shares, and by adjusting the guaranteed rates to the new market conditions from now on. The prudential authorities could make a contribution here by lowering the legal maximums currently in force for these guaranteed yields.

64. In view of the severe constraints on intermediation activities, financial institutions need to explore various ways of developing a model which can ensure their lasting profitability. The first option is to reduce operating expenses, if appropriate via consolidation, because the cost structure still bears the hallmarks of the arrangements set up for the purpose of the previous expansion strategies. A second approach is to adapt the characteristics of existing products, by maintaining realistic margins between debit and credit interest rates, by more systematic charges for the services offered, more in line with the true cost of the business, or – in the case of insurance companies – by transferring certain risks to the policy-holders by using contracts under which the returns are linked to investment fund yields. In the more specific case of financial market infrastructures, it would be better for the activities to be remunerated directly via fee payments, rather than indirectly in the form of interest income obtained by investing the deposits of users of these infrastructures.

65. The banks also generate non-interest income in addition to the intermediation margin. Its proportion of banking income has contracted recently, down from more than 50 % in 2006 to around 30 % in 2014. That income has two very different components, namely the results of trading activities and fee income. The crisis revealed that the additional income from own account market transactions was highly volatile and that it could rapidly turn into heavy losses. That danger led the Belgian authorities to introduce a structural measure to prohibit the principle of own-account trading by banks, while – subject to certain conditions and, if appropriate, additional capital requirements – they authorised that type of activity if it was intended to cover risks or to offer products and services directly to customers.

66. The fees that banks charge come from a very wide range of activities which, apart from asset management relating, for example, to offering alternative investment options for customers, include payment or settlement services in connection with securities transactions. These are often specific services provided by specialist institutions, market infrastructures that have a leading position in the Belgian financial landscape. These settlement and clearing institutions perform a vital role as a channel for ensuring the successful completion of financial transactions, but owing to their central position they can also heighten the risk of contagion. That prompted the authorities to impose appropriate regulation on these infrastructures. Thus, the European Market Infrastructure Regulation (EMIR) specifies central clearing obligations, risk attenuation techniques and disclosure requirements for transactions. The EU Regulation on central securities depositories (the CSD Regulation) which came into force in September 2014 standardises the prudential rules applicable to the licensing, supervision and organisation of these institutions and the settlement deadlines for transactions on regulated markets. These various measures are meant to ensure close supervision of these infrastructures in order to avoid concentration risks in the event of the failure of institutions in this category.

67. These provisions form part of the long-term project for progressive harmonisation of the European financial rules, in which the next major step will be the introduction of the Solvency II Directive in the insurance sector, scheduled for 1 January 2016. Under these new rules, the capital requirements will have to be calculated with due regard for all the risks facing both the assets and the liabilities. In addition, it should be noted that the technical provisions will from now on be valued by reference to market rates. Since this abandonment of valuation at historical prices will greatly increase the sensitivity of the capital to fluctuations in interest rates and prices, provision has been made for adjustment and correction mechanisms, called the Long-Term Guarantee measures, in order to attenuate this excess volatility.

68. The potential impact of the new Solvency II regime on the capital requirements of insurance companies was assessed during the second stress test exercise conducted by the European Insurance and Occupational Pensions Authority (EIOPA) in 2014. In all, 19 Belgian firms were involved in whole or in part. Before the shock scenarios were applied, the coverage rate of the new solvency capital requirement (SCR ratio) based on the standard formula averaged 204 % for these companies, which is well above the statutory minimum. The scenarios covered three main aspects. First, they tested two series of market shocks concerning interest rate risks, credit risks, and risks relating to fluctuations in stock market prices and property prices. Next, they checked the sensitivity to specific insurance risks, particularly the mortality risk, the risk of longer life expectancy, disaster risk, the inflation risk confronting claims reserves, and contract cancellation risk. Finally, they subjected the firms to a low interest rate scenario, sub-divided into two modules : one corresponded to a very long period of very low rates, like that in Japan, and the other reflected the inversion of the yield curve. While all firms withstood the specific insurance risks, the most severe market risk scenario brought the average SCR ratio very slightly below the 100 % threshold. Finally, while the sector was able to withstand the low interest rate scenario without too much trouble, there were wide variations between companies, with about 20 % of them failing to meet the future regulatory requirements.

69. The introduction of new rules for both financial infrastructures and insurance companies will demand special attention, both from these sectors and from the Bank. The Bank still retains full responsibility for supervising insurance companies, and will continue to play a dominant role in the supervision of the large financial market infrastructures based in Belgium ; that is no longer the case for credit institutions, for which supervision is now partly centralised at the ECB. But even in the latter case the Bank will retain important functions. Apart from supervising smaller institutions for which the national authorities remain primarily responsible, it will have to play an active part in the multinational teams set up by the ECB to supervise the main Belgian credit institutions as well as subsidiaries based in Belgium belonging to large euro area banking groups.

6. Conclusion

70. The global economy is struggling to overcome the crisis, and the euro area faces the threat of stagnation. Nonetheless, an appropriate policy mix could improve the situation, actually more so in the euro area than elsewhere. Demand needs to be stimulated, and that is primarily a task for monetary policy which has to ensure that an excessively protracted period of low inflation does not hamper the recovery. The size and composition of the central bank balance sheet and its rate of expansion are monetary policy parameters which are still available for that purpose, even after the key interest rates have reached their floor. At its first monetary policy meeting in January 2015, the ECB Governing Council chose this path by launching a € 60-billion-a-month expanded asset purchase programme. Under the Stability and Growth Pact, which offers a degree of flexibility, fiscal consolidation must continue in the countries where the sustainability of public finances is compromised. However, where scope exists, the fiscal stance should likewise be more expansionary. At the same time, there must be structural reforms in two areas. First, it is necessary to boost productivity and growth potential. Also, the economy must be financed more efficiently, on the one hand by facilitating market financing and on the other by reaping the benefits of the substantial progress achieved in 2014 with the creation of the banking union. By thus increasing the return on investment and cutting funding costs, it will be possible to give significant impetus to the expenditure component which, up to now, has been the main factor behind the shortfall in demand in the euro area.

71. That is also in broad terms the policy mix that the Belgian economy needs. On the demand side, Belgium is benefiting from the ECB's accommodative monetary policy, the pass-through of that policy to interest rates relevant to the economy being less distorted in Belgium than in some other euro area countries. There is also a need for gradual but resolute fiscal consolidation conducive to growth. After the budget deficit was cut to 2.9 % in 2013, under the previous administration, the new government has opted for a path leading to a structural balance by 2018. In that respect, it is necessary to ensure that the structural budgetary efforts conform to the Stability and Growth Pact, and that they are actually implemented. If adjustments are needed, they will have to be made at the time of the March 2015 budget review.

72. On the subject of structural reforms, new measures are being taken to support growth potential. They thus also help to consolidate the economic basis for the high degree of social protection and the wide range of public services, both factors that form part of Belgian society's choices. Efforts are being made to extend working life, to restore competitiveness and to create jobs by improving the functioning of the labour market. These action points also spearheaded the reforms initiated at the end of 2011. They will help to improve the labour supply, reduce the budgetary costs of ageing and gradually reduce the wage handicap. All the same, there is still work to be done. Between now and the end of the wage freeze, it is necessary to examine with the social partners how wage setting can best be linked to the movement in productivity so as to promote job creation. The charges on labour also need to be reduced by switching to levies on consumption, pollution, wealth, capital gains or property incomes. Such a tax shift is essential to reduce the level of labour costs in Belgium – which is among the highest in Europe – and to make work financially attractive. In addition, an effort must be made to reform product markets, to encourage innovation, to attract foreign investment and to facilitate a reallocation of resources, in order to boost productivity growth which, in the long term, is the main source of income creation. Any delay will only increase the effort to be made subsequently. Along this route to a better future, the various governments, the social partners and all other stakeholders have to play their part. The measures undeniably require efforts in the short term, but cooperation can only benefit their effectiveness.

Brussels, 28 January 2015

Board of Directors

1 **Luc Coene,** GOVERNOR
2 **Mathias Dewatripont,** VICE-GOVERNOR
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4 **Marcia De Wachter,** DIRECTOR – TREASURER
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7 **Pierre Wunsch,** DIRECTOR
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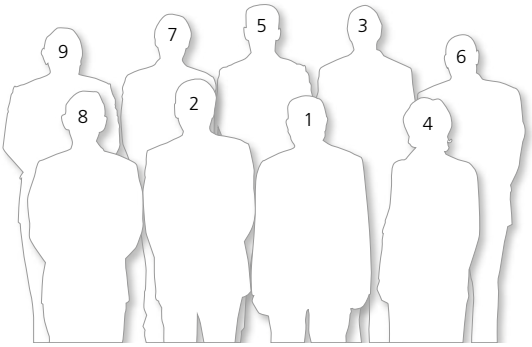

(1) Director De Batselier ended his term of office on 24 December 2014. Mr Tom Dechaene was appointed to the post of Director on the same date.

Council of Regency

[1] Luc Coene, GOVERNOR
[2] Mathias Dewatripont, VICE-GOVERNOR
[3] Jan Smets, DIRECTOR
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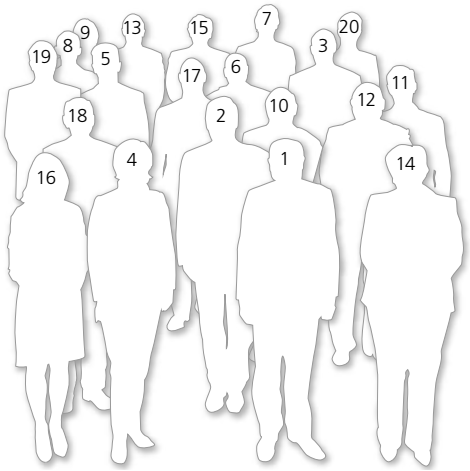
[16] Sonja De Becker, REGENT
[17] Marc Leemans, REGENT
[18] Jean-Louis Six, REGENT
[19] Pieter Timmermans, REGENT
[20] Hans D'Hondt, REPRESENTATIVE OF THE MINISTER OF FINANCE



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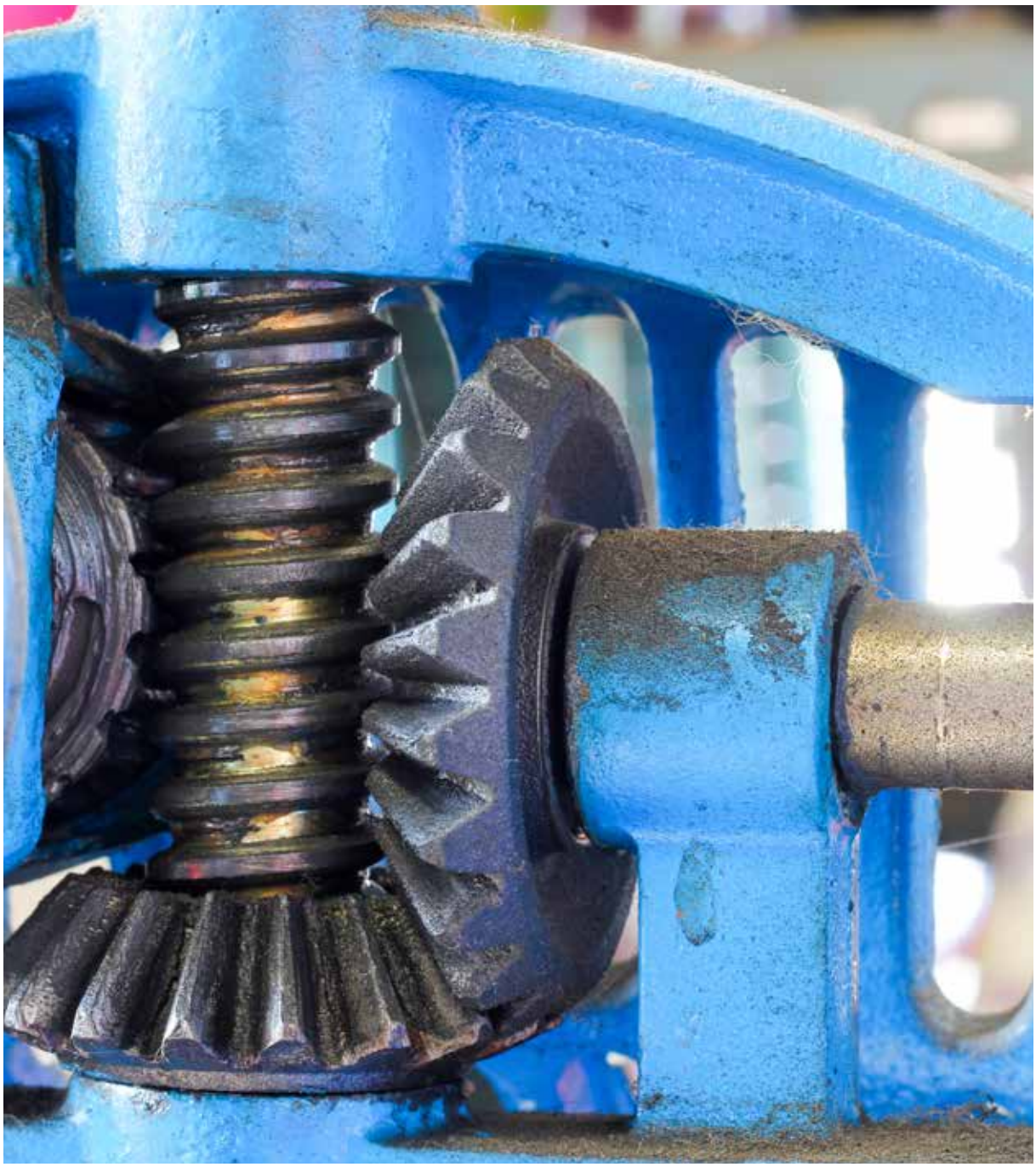
Economic and financial developments



Global economy and euro area

1. Global economy and euro area

In 2014, the growth of global activity was moderate and patchy. The economic upturn was most evident in the United States and the United Kingdom. In China, growth slowed slightly owing to a residential property market correction and risks in the shadow banking sector, while commodity producers suffered from the slump in prices. Like Japan, which slipped back into recession, the euro area trailed behind the other economies. Although its GDP grew by 0.8% on average over the year, following a 0.5% fall in the previous year, activity slowed from the spring despite the accommodative monetary policy stance, the improvement in financing conditions and the less restrictive fiscal policy. Inflation continued to decline more steeply than expected, dropping to 0.4% in 2014. While most economies that had made radical adjustments began expanding again, growth was generally sluggish in the euro area, as was potential growth. In view of the downward trend in risks to price stability in the euro area, the ECB Governing Council cut the key interest rates on two occasions in 2014, bringing the rate on the main refinancing operations to 0.05% and taking the deposit facility rate into negative territory. In its forward guidance, the Governing Council constantly repeated that, in view of the assessment of the economic outlook, the key rates would remain low for an extended period. In addition, the Eurosystem conducted targeted longer-term refinancing operations to boost lending by the banks. From October, it also began purchasing assets – asset-backed securities (ABSs) and covered bonds issued by euro area banks – to achieve a further easing of monetary policy. In January 2015, the Governing Council decided to include these transactions in an expanded asset purchase programme covering government bonds as well, amounting to € 60 billion a month. These asset purchases are expected to be made until the end of September 2016 and in any case will be continued until there is evidence of a sustained change in the inflation trend in line with the price stability objective.

1.1 Global economy

Moderate and patchy revival of global activity…

The revival of global activity that had been fairly widespread in 2013 continued at a modest pace in 2014. The lack of vigour contrasted with the plainly more optimistic sentiment which still prevailed on the financial markets. It also reflected the varying strength of the recovery across the different economic regions.

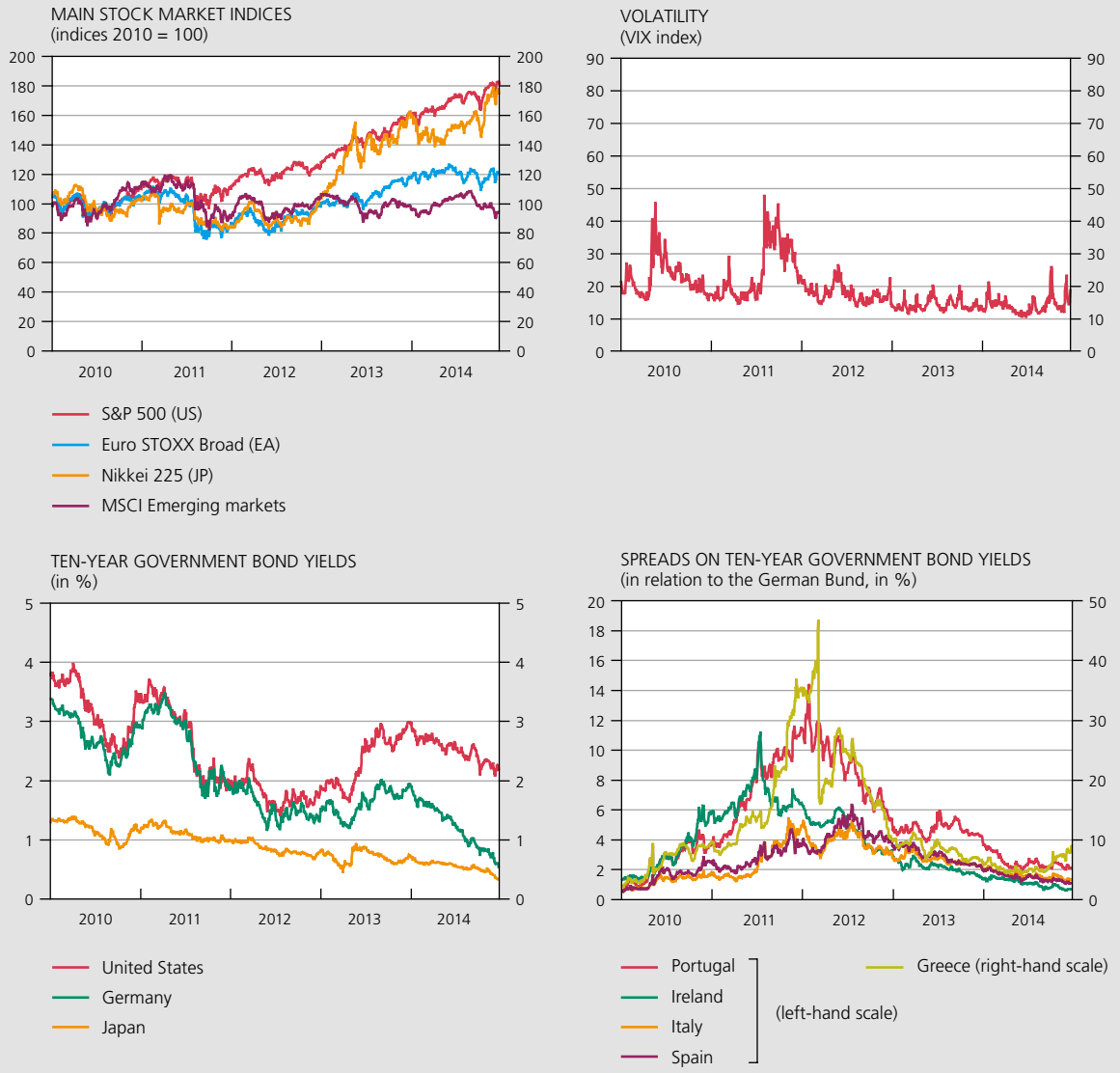
The clearest signs of economic recovery were seen in the United States and the United Kingdom. Although the emerging countries still record the highest average growth rates, their growth was nevertheless lower than in 2013, following a sometimes marked slowdown in a number of countries. In contrast, Japan slipped back into recession during the course of the year, and the recovery in the euro area that had begun in the spring of 2013 weakened significantly after the first quarter. The euro area therefore lagged seriously behind the other economies, not only because of a larger exposure to heightened geopolitical risks in neighbouring regions, but also owing to its difficulty in overcoming the effects of the great recession and the sovereign debt crisis.

… in a generally favourable financial market climate

During the year under review, financial markets were greatly influenced by the still highly accommodative – albeit increasingly divergent – monetary policy stance in the advanced countries. That situation continued to exert downward pressure on long-term government

CHART 1 INTERNATIONAL FINANCIAL MARKET DEVELOPMENTS

(daily data)



Source: Thomson Reuters Datastream.

bond yields. The low interest rates and the likelihood that rates would remain low for a long time also gave rise to a persistent search for yield among investors. That had begun in mid-2012 after a number of important measures – the ECB's introduction of outright monetary transactions (OMTs), the establishment of the European Stability Mechanism (ESM) and, later, the agreement on the European single supervisory mechanism (SSM) for credit institutions – eased the tension generated by the sovereign debt crisis in the euro area. Stock markets in the advanced countries therefore began rising again, and that trend was clearly maintained in the year under review. At the same time, premiums on riskier financial assets, such as high-yield government bonds in the peripheral euro area countries or in emerging countries, subsided in 2014 to their lowest levels since the crisis.

However, there were several periods of financial turbulence during the year, a reminder that the markets could still react nervously to heightened geopolitical tensions and ultimately minor changes to growth forecasts. But these phases were short-lived, and the contagion effects were generally limited. Overall, the losses were also fairly soon made good.

At the end of 2013 and at the beginning of the year under review, investors reassessed the situation in the emerging economies, in view of the deteriorating macroeconomic conditions – even though the outlook was improving in the advanced economies – and the imbalances present in some of them. Mounting uncertainty also emerged in China over the slowdown in the manufacturing industry and the worsening financial risks. Spreads between the government bonds of those countries and US Treasury bonds began to widen, and stock markets fell, as did exchange rates. The pressure escalated on 23 January when the central bank of Argentina devalued the peso by more than 10 % against the US dollar. The central banks of the countries affected responded by raising their interest rates or dipping into their exchange reserves. Thanks to that vigorous response, most of the losses on the stock and currency markets were made good by February. The impact on stock markets in the United States, Japan and the euro area was limited, although government bond yields declined as a result of the shift towards these safe-haven investments.

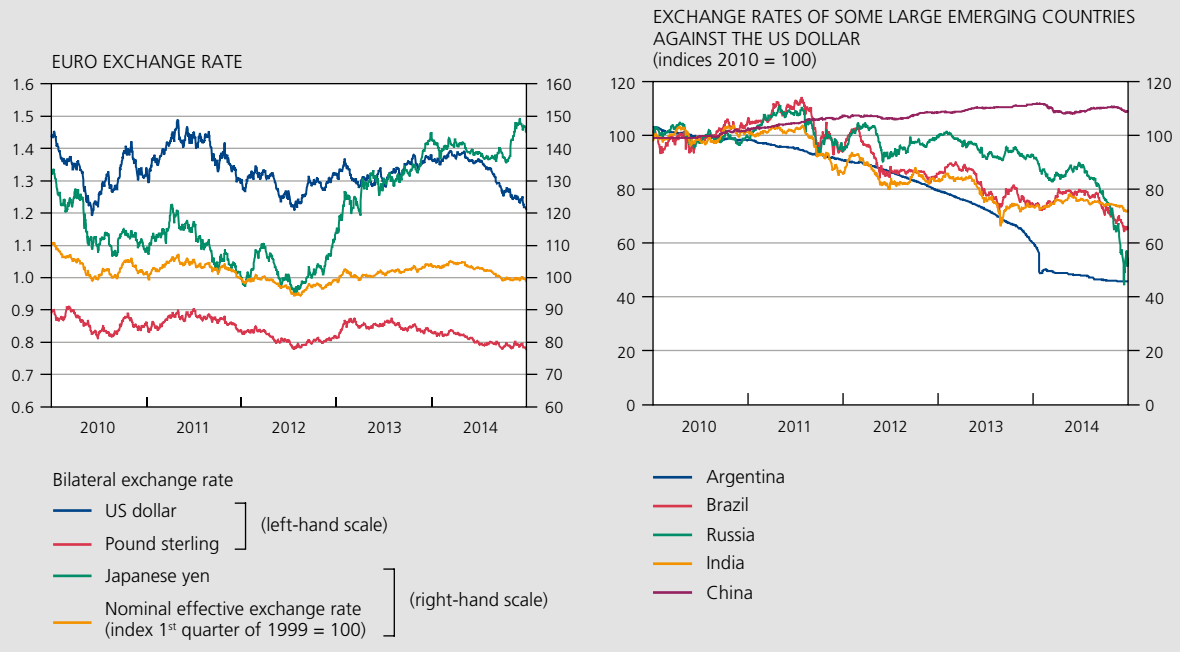
Apart from these temporary effects, for the euro area, the downward trend in sovereign bond yields reflected not only the effect of a further easing of monetary policy but also disappointing economic figures, a fall in long-term inflation expectations, and uncertainty caused by the increased geopolitical tensions. In the United States, too, the yield on ten-year government bonds diminished, though to a lesser degree than in the euro area, partly on account of expectations of a speedier normalisation of monetary policy. In Japan, the yield on government bonds was more or less stable at a very low level, in view of the expectation of a long period of accommodative monetary policy.

Following the market turmoil in January, stock markets resumed their upward trend. It was the American market indices that recorded the biggest rise – the S&P 500 having surged by more than 10 % during 2014 – and reached an all-time high. In Japan, the rise came to around 7 %. Stock markets also rose in the euro area. Over the year as a whole, the Euro STOXX index was up by around 2 %, after having peaked in June.

Towards the end of the second quarter, adverse macroeconomic figures – low inflation, waning confidence and a downturn in economic activity – began to depress the European markets. In addition to these factors, there were escalating geopolitical tensions when, on 29 July, the EU

CHART 2 EXCHANGE RATES

(daily data)



Source: Thomson Reuters Datastream.

announced new economic sanctions against Russia. At the beginning of September, however, most of the losses had been wiped out, notably on account of the expected continuation of the accommodative monetary policy in the euro area.

In October, the markets were again jittery. After disappointing macroeconomic figures had been published, concerns about the weakness of global growth mounted, and stock markets plummeted simultaneously throughout the world, falling by almost 10 %. In the United States and Japan, they soon climbed back, following the emergence of encouraging macroeconomic data in the US and the decision by the Bank of Japan to ease its already very accommodative monetary stance still further. The losses on European stock markets took longer to make good, against the backdrop of mediocre growth rates published for the euro area. In regard to bond yields, it was mainly US Treasury notes that saw a marked fall in yields, partly because investors believed that the monetary tightening in the United States would take place more slowly than initially planned, since the recovery appeared more hesitant than expected at that time, and partly because investors were somewhat dubious about the euro area. Subsequently, the yield began rising again following the emergence of positive economic data for the US.

During the year under review, the peripheral euro area countries also benefited from investors' declining risk aversion and their search for yield. Spreads between government bonds of those countries and the German Bund thus continued to narrow, and reverted to their lowest level since the crisis. It is striking that the periods of increased turbulence on the financial markets had no adverse contagion effects in that respect. It was only in October, during the period of maximum volatility, that the spreads widened in Greece after the Greek government had announced that – by the end of 2014, on expiry of the EU programme – it wanted an early exit from the IMF financial assistance programme which was scheduled to run until March 2016. The exit from the EU programme, originally planned for the end of 2014, was postponed by two months.

Once the turbulence early in the year had abated, capital flows to the emerging economies revived and were generally steady for the rest of the year under review. In that context, exchange rates in emerging countries such as China and India remained stable overall. In the first part of the year, the euro area also benefited from capital inflows; their effect in bolstering the exchange rate reinforced the impact of growing current account surpluses. From the summer, the euro's appreciation that had begun in mid-2012 went into sharp reverse when the ECB announced new monetary easing measures. Conversely, the euro appreciated considerably against the yen following the Bank of Japan's announcement at the end of October that it was expanding the programme of quantitative and qualitative monetary easing. The value of the rouble began falling steeply against the US dollar, especially in the second half of the year under review, on account of persistent geopolitical tensions in Ukraine and western sanctions against Russia. The pressure on the rouble intensified at the end of the year, owing to a persistent decline in the oil price on the international markets and the announcement of new sanctions by the United States. In Brazil, the depreciation of the real from September reflects the declining investor confidence in the Brazilian economy, further exacerbated by the election result at the end of October.

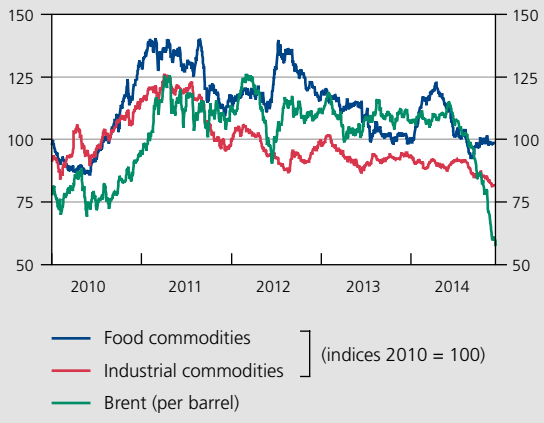
Weak global demand depresses commodity prices and international trade

Partly as a result of the still rather weak macroeconomic climate and the slump in global demand, commodity prices fell in 2014, and the expansion of world trade slackened pace.

Prices of energy commodities displayed the most striking movement, as the price of Brent crude oil in US dollars plunged by almost 50 % in 2014, despite rising geopolitical tensions. While the production of unconventional oil in North America and the substantial reserve capacity in Saudi Arabia more than made up for the interruptions in provisioning from Libya and Iraq, thus maintaining

CHART 3 COMMODITY PRICES

(daily data, US dollars)



Source: Thomson Reuters Datastream.

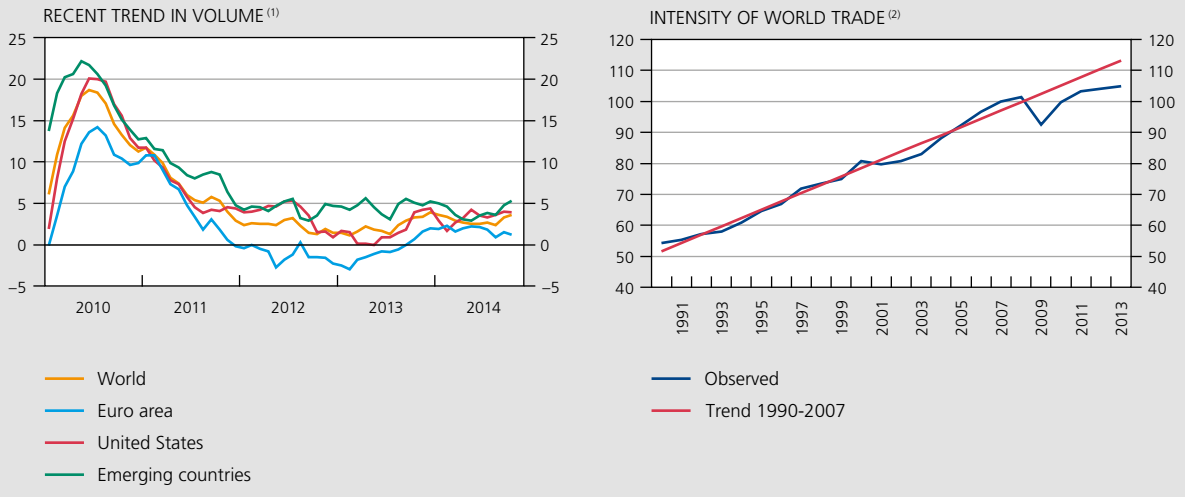
abundant supplies, the level of global demand remained weak. That was particularly true of demand from China and the other emerging economies, which had stepped up their consumption very sharply in the previous decade, but it was also true of Europe. The fall in oil prices on the international markets accelerated after the OPEC meeting on 27 November 2014, when it was decided to leave the production quotas unchanged.

As had already happened in 2013, anaemic world demand also depressed the prices of non-energy commodities. Food commodity prices declined during the year, although they did increase at times on account of bad weather in certain countries and concern caused by the situation in Ukraine, which is a major exporter of cereals. Industrial commodity prices contracted, essentially as a result of the rebalancing of growth in China in favour of less commodity-intensive activities.

After a temporary surge in the second half of 2013 following a lengthy period in the doldrums, the growth of world trade slowed again from 2014, in parallel with slackening economic activity. The decline was most marked in the emerging economies of Asia, and was reflected mainly in a sharp fall in Chinese imports, but the persistently weak demand from the euro area also played a part.

This decline originated both from cyclical factors – notably the marked slowdown in the growth of highly world-trade-intensive demand components, such as business investment, and the weakness of euro area industrial activity that generally involves substantial international trade in goods – and from more structural factors. Thus, in recent decades, some of the drivers of the strong expansion of world trade have become less powerful. The awakening of the emerging countries in the 1990s and 2000s was accompanied by a rapid expansion of world trade as a result of a combination of institutional, technological and organisational developments in production methods. The growing number of countries joining the World Trade Organisation has led to a reduction in regulatory and tariff barriers to trade, while the cost of transport and data exchange has come down considerably. In these circumstances, firms in western countries outsourced a growing proportion of their production to the emerging countries, where labour costs were much lower. These conditions favouring the very rapid expansion of international trade in goods are tending to fade away. For instance, wages in China and Eastern Europe have risen relative to those in the advanced economies over the past ten years. The extension of global production chains also appears to be slowing down. In some cases, those chains are actually tending to shorten again, as experience has shown that local problems can cause serious disruptions in the outsourcing process. The said factors seem to have weakened the elasticity of international trade to economic growth. Thus, according to the data and estimates currently available, it seems that the growth of world trade was hardly any higher than GDP growth in 2012-2014, whereas it had been double that figure in the first half of the 2000s.

CHART 4 INTERNATIONAL TRADE



Sources: CPB, OECD.
(1) Seasonally adjusted three–month moving average of exports and imports by volume; percentage change compared to the previous year.
(2) International trade as a percentage of global GDP, by volume.

TABLE 1 GDP OF THE MAIN ECONOMIES[1]

(percentage changes in volume compared to the previous year, unless otherwise stated)

	2012	2013	2014	p.m. Contribution to global GDP growth[1] 2014	p.m. Share of global GDP[1] 2008	p.m. Share of global GDP[1] 2013
Advanced countries	1.2	1.3	1.8	*0.8*	*48.8*	*43.6*
of which:						
United States	2.3	2.2	2.4	*0.4*	*18.0*	*16.5*
Japan	1.5	1.6	0.1	*0.0*	*5.2*	*4.6*
Euro area	–0.7	–0.5	0.8	*0.1*	*14.6*	*12.2*
United Kingdom	0.7	1.7	3.1	*0.1*	*2.7*	*2.3*
Emerging countries	5.1	4.7	4.4	*2.5*	*51.2*	*56.4*
of which:						
Central and Eastern Europe	1.4	2.8	2.7	*0.1*	*3.5*	*3.5*
Russia	3.4	1.3	0.6	*0.0*	*3.8*	*3.4*
Emerging Asia	6.7	6.6	6.5	*1.9*	*23.1*	*28.7*
of which:						
China	7.7	7.8	7.4	*1.2*	*12.0*	*15.8*
Latin America and Caribbean	2.9	2.8	1.2	*0.1*	*8.8*	*8.7*
World	3.1	3.3	3.3	*3.3*	*100.0*	*100.0*
World excluding the euro area	3.6	3.6	3.6	*3.2*	*85.4*	*87.8*
p.m. World trade[2]	*3.0*	*3.4*	*3.1*			

Sources: EC, IMF, OECD.

(1) For regions outside the euro area, GDP is calculated according to the IMF definitions and on the basis of purchasing power parities.

(2) Average of exports and imports of goods and services.

United States[1]

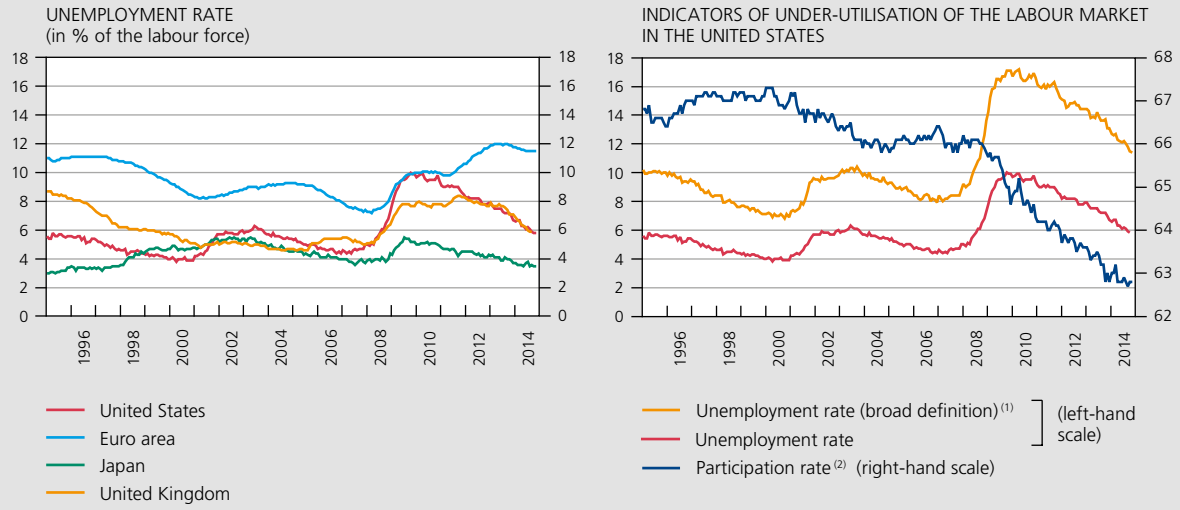
The US economy continued to recover in 2014. Following a slight, temporary fall in GDP in the first quarter, attributable primarily to severe weather, the expansion of economic activity was supported mainly by domestic demand. Private consumption, which grew at the same rate as in the previous year, was stimulated by the expanding job creation and the improvement in households' wealth position resulting from the rise in asset prices and the fact that the deleveraging process begun in the aftermath of the financial crisis was more or less complete. Household debt declined from 96 % of GDP in 2007 to 79 % in 2013. The continuing positive demand outlook, favourable financing conditions and improvements in competitiveness and profitability resulting partly from the fall in energy costs due to the exploitation of shale oil and gas and moderate wage pressure, are all factors that contributed to the faster growth of business investment. Under the policy of restricting public expenditure that had been in force for two years, government consumption spending remained stable in real terms, and public investment declined.

However, fiscal policy was much less restrictive and had a less adverse effect on economic growth than in previous years, even though the structural primary deficit contracted further from 2.3 % of GDP in 2013 to 1.3 % of GDP during the year under review. Thus, following a deterioration of 5.5 percentage points of GDP between 2007 and 2009, at the height of the crisis, the structural primary balance improved by 6.2 percentage points between 2009 and 2013. In the euro area, the movements were on a smaller scale, the decline of 2.3 percentage points of GDP giving way to a 3.8 percentage point improvement since then. The American public debt remained more or less stable at 109.7 % of GDP.

The recovery on the US labour market produced a stronger expansion of employment and a sharp fall in the unemployment rate, down from around 7.4 % in 2013 to

(1) The main macroeconomic variables for the large economies are presented in table 1 in the statistical annex.

CHART 5 LABOUR MARKET INDICATORS IN THE MAIN ECONOMIES



Sources: Labour Statistics, EC, Thomson Reuters Datastream.

(1) The broad definition refers to the U-6 unemployment rate which also includes unemployed persons who have stopped looking for work on account of the economic situation (discouragement), all persons who have actively looked for work in the past year – but not necessarily in the past four weeks – and persons working part-time for economic reasons.

(2) Proportion of employed and unemployed as a ratio of the labour force aged 16 years and over.

below 6 % at the end of 2014. All the same, the labour market still showed clear signs of under-utilisation, as the decline in unemployment is also due to the lower participation in employment among the population of working age. In fact, the participation rate dropped from around 66 % before the crisis to less than 63 % in 2014. That was due partly to structural factors such as the ageing of the labour force or non-availability on account of illness or training, and partly to cyclical factors such as the deteriorating job prospects and the resulting discouragement that deters some sections of the population from presenting themselves on the labour market. Although the gap between the standard unemployment rate and the rate based on a broader definition did narrow during the year under review, it still remained considerable, and is actually bigger than in previous recessions. This unused labour reservoir explains why the upward pressure that wages should exert on prices remained modest in 2014.

In that context, the Federal Open Market Committee (FOMC) of the Federal Reserve adopted an approach to communication intended in particular to avoid any unnecessary financial market volatility by abandoning its threshold-based forward guidance in March 2014 together with the explicit reference to the unemployment rate, which had become of limited informative value. From then on, the FOMC based its forward guidance on broad qualitative information including a vast range of labour market indicators, so as to assess correctly how far the US economy still had to go to achieve full employment.

In addition, the FOMC took the first steps on the road to normalisation of its monetary policy, against a backdrop of stronger growth of economic activity and employment and rising inflation, even though the latter remained below the long-term objective of 2 %. In accordance with the decision of the FOMC in December 2013, the process of tapering purchases of securities was launched in January 2014. Since then, the rate of asset purchases, which originally stood at $ 85 billion per month, was cut by $ 10 billion after each FOMC meeting. At its October 2014 meeting, the FOMC decided to suspend the purchases as of November 2014.

In September 2014, the monetary policy normalisation principles, the first version of which dated from June 2011, were also updated. Those principles clearly state that monetary policy will be tightened by use of the interest rate instrument rather than by actively influencing the size or composition of the central bank balance sheet.

The FOMC will therefore tighten monetary policy by raising the range of the federal funds rate. The overnight money market interest rate will be guided by increasing the interest rate payable since October 2008 on the excess reserves that US depository institutions hold with the

Federal Reserve. Since this rate is currently higher than the overnight money market rate, potentially hampering the smooth transmission of the policy rates to short-term market rates, the FOMC created reverse repos accessible to money market funds as well as to traditional counterparties such as depository institutions and government-sponsored agencies. The interest rate on these reverse repos is an additional floor rate for monetary policy. According to the Federal Reserve, the tests conducted in 2014 on its use as an additional floor rate were conclusive.

In regard to the size of the balance sheet, the monetary policy normalisation principles also stress that there will be no reduction in the balance sheet so long as there is no rise in interest rates. Following these initial increases, there will be a review of whether it is appropriate to restrict or suspend altogether the reinvestment of the amounts reaching maturity.

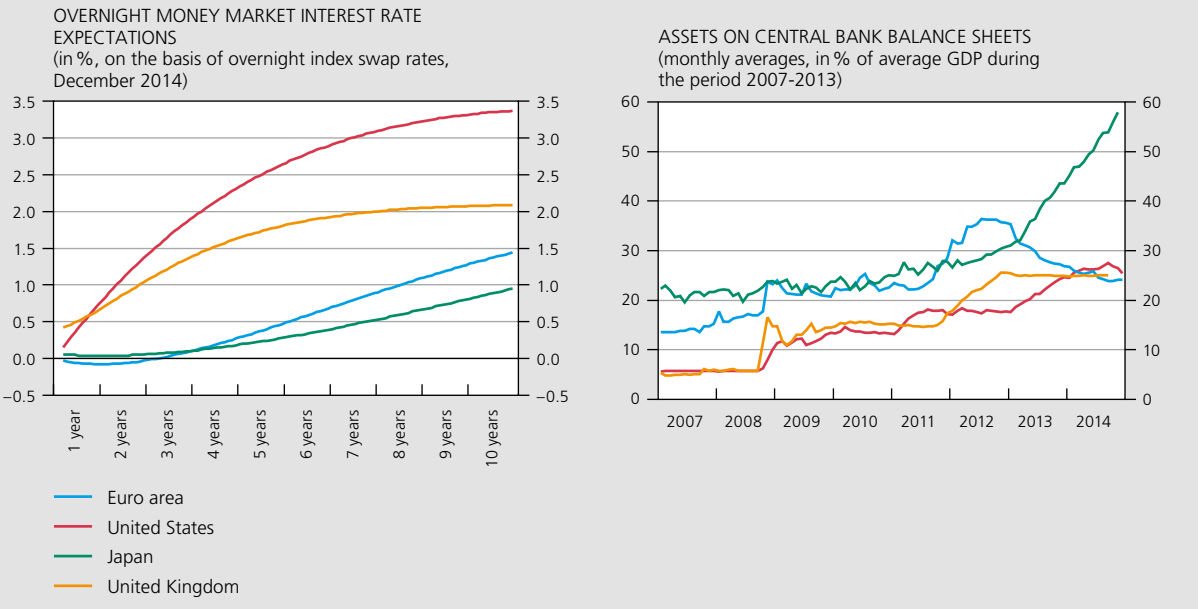
United Kingdom

In 2014, the United Kingdom's real GDP growth came to 3.1 %, outpacing its historical trend and recording the highest growth rate among the advanced economies. The clear revival of consumer confidence coupled with favourable financing conditions bolstered private consumption, while business investment increased to cater for the strengthening of domestic demand, particularly in the services sector. In manufacturing industry, investment lagged behind somewhat on account of the weak exports. As the euro area is the UK's main trading partner, external demand remained subdued, driving the external current account deficit up to 4 % of GDP. The exceptional surge in employment combined with an increase in the labour supply is noteworthy. In general, the unemployment rate continued to fall, subsiding to 6.2 %. Nonetheless, pay rises remained limited since many of the jobs created were in the low-skilled segment. In this situation, the persistent negative growth of real wages restrained the disposable income of households.

The government's medium-term fiscal consolidation programme continued in 2014. However, fiscal revenues were disappointing, particularly as a result of the slower pace of wage increases, the decline in property transactions and the reduction in gas and oil revenues. Nevertheless, the budget deficit fell by 0.4 percentage point to 5.4 % of GDP. Britain's public debt increased to 89 % of GDP.

The rise in consumer prices was down to 1.5 % in 2014, against 2.6 % in the previous year, as a result of the fall in prices of energy and food. Similarly, the low level of inflation in the euro area, the source of a large share of

CHART 6 OVERNIGHT MONEY MARKET INTEREST RATE EXPECTATIONS AND ASSETS ON THE BALANCE SHEET OF THE MAIN CENTRAL BANKS



Sources: Bank of England, Bank of Japan, Federal Reserve, Thomson Reuters Datastream, ECB, own calculations.

British imports, and sterling's appreciation against the euro held prices down in the United Kingdom. Moreover, unit labour costs declined compared to the previous year. In view of the low inflation below the 2% target and the weak upward pressure on prices in the short term, the Bank of England was able to keep its policy interest rate at 0.5 % while leaving the outstanding total of its asset portfolio unchanged at £ 375 billion.

Japan

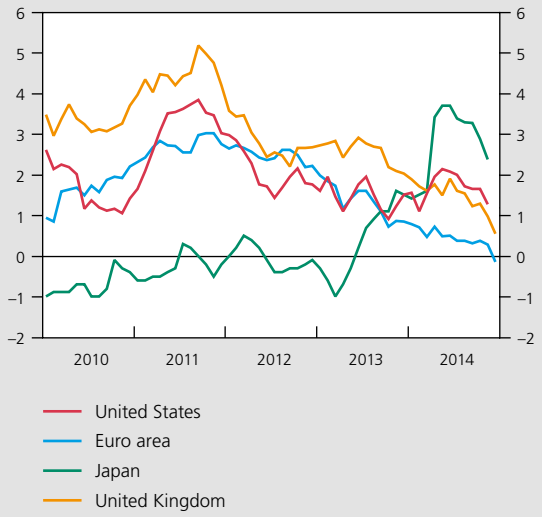
In Japan, the April VAT rate increase from 5% to 8% caused some volatility in real GDP growth at the beginning of the year. A vigorous first quarter boosted by early purchases to avoid this higher rate gave way to a particularly weak second quarter, particularly on the private consumption front. However, that gloom persisted in the third quarter, taking the economy into a technical recession situation, defined as a fall in GDP for two consecutive quarters. In all, the real growth of activity slowed significantly over the year as a whole, down from an average of 1.6 % in 2013 to 0.1 % in 2014. Nonetheless, buttressed by a revival in business confidence and comfortable profit margins due, in particular, to a cut in the corporation tax rate from 38 % to 35 %, non-residential investment supported the expansion of activity. Employment also continued to grow, causing a tightening of the labour market despite the rise in the female participation rate resulting partly from targeted structural reforms. That tightening brought a fall in the unemployment rate, which was down to 3.6 %, while – according to the Tankan survey – firms increasingly reported a labour shortage. For the moment, these developments have not triggered any large increases in nominal wages. Such rises are traditionally seen mainly in variable components of wages, such as overtime pay and bonuses.

For the first time in a long while, Japanese fiscal policy adopted a restrictive stance, partly owing to the first VAT increase. Under its medium-term fiscal consolidation strategy the Japanese government is planning a second increase, but has postponed it from the end of 2015 to 2017 in view of the adverse impact on consumption and activity that it caused in 2014. However, the primary deficit of 7.2 % recorded in 2014 was still remote from the aim of a balanced budget to be achieved by 2020.

Headline and core inflation rose to 2.7 and 1.7% respectively, mainly as a result of the VAT increase. In that connection, while inflation expectations declined in the third quarter and doubts about the economic recovery intensified, the Bank of Japan extended its programme of quantitative and qualitative easing. In so doing, it aimed to demonstrate its determination to achieve the 2% inflation target. On 31 October, it decided to step up the annual expansion of the monetary base, which increased from around 60-70 trillion yen to some 80 trillion Japanese yen. On the assets side of its balance sheet, the outstanding amount of Japanese government bonds will increase further, and their residual maturity will go up from an average of 6-8 years to 7-10 years. Furthermore, the annual rate of purchases of equity funds or property funds will triple. At the same time, the Government Pension Investment Fund – which currently manages 129 trillion yen – announced that it was adjusting its investment strategy in favour of national equities and foreign assets rather than Japanese government bonds. This decision should support the Japanese stock market and weaken the Japanese currency.

CHART 7 INFLATION IN THE MAIN ECONOMIES

(monthly data, changes in the consumer price index compared to the corresponding period of the previous year)



Source: Thomson Reuters Datastream

Emerging economies

In the emerging economies, growth continued to lose momentum in 2014, falling to 4.4 %, compared to 4.7 % in 2013. Geopolitical tensions combined with various types of structural impediments which curbed the increase in productivity were among the reasons for the lower growth. However, the easy financing conditions, export growth and the recovery of domestic demand in some countries contributed to a rebound in the second half of the year, though the aggregate result conceals ever greater divergences between regions and countries.

In China, the stated GDP growth target of about 7.5 % was virtually achieved. In the first quarter, however, the expansion of investment slowed more sharply than expected after the People's Bank of China had taken steps to tighten financial conditions for shadow banking and for unproductive projects. The government and the central bank responded immediately by respectively proposing selective incentives for investment in social housing and social infrastructure, and the provision of specific liquidity for bank loans to SMEs and the agricultural sector. Nonetheless, in the second half of the year under review, growth slackened further owing to the persistence of the correction on the housing market, which put a damper on investment and consumption. At the end of November, the People's Bank of China decided to revise its interest rates downwards for the first time since 2012. Moreover, the recovery in the United States brought a strong rise in Chinese exports, which were the main driver of economic activity in the second half of 2014. In value terms, imports increased more slowly owing to the fall in commodity prices and the anaemic demand from heavy industry, so that the current account surplus expanded from 2 % in 2013 to 2.4 % in 2014.

The consolidated public deficit is estimated at 1.1 % of GDP in 2014, implying a stable debt ratio of around 50 % of GDP. In recent years, the financial situation of Chinese local authorities has given reason for some concern. Those authorities traditionally play a key role in funding infrastructure projects, which had expanded rapidly in the immediate aftermath of the global financial crisis, but they were generally financed off-budget by means of ad hoc vehicles. The local authority debt ratio is estimated at just over 30 % of GDP, compared to around 20 % for the central government. The new budget law promulgated in August is viewed as a major reform designed to remedy this situation. That law, which establishes a framework for greater transparency and accountability, gives local authorities the power to issue their own debt securities, and outlaws the funding of public investment by *ad-hoc* vehicles. It was supplemented by a no-bail-out clause.

Growth slowed most sharply in **Latin America**, where it fell from 2.8 % in 2013 to 1.2 % in 2014. A major commodity producer, the region was hit by the widespread fall in prices and the weakness of demand, particularly that from China. The disappointing situation in Argentina and the structural problems confronting Brazil, particularly as regards infrastructures, also exerted additional downward pressure. At 2.7 %, average growth in **Central and Eastern Europe** was relatively stable compared to the previous year, supported partly by the vigour of domestic demand. The impact on the region of the conflict between Russia and Ukraine – namely the array of import restrictions imposed by Russia in response to western sanctions – and the effect of the economic stagnation in both countries was generally confined to a few small countries. **Emerging Asia** remained the most dynamic region, with growth averaging 6.5 %, despite a temporary dip at the start of the year. In general, activity was underpinned by exports, favourable financial conditions, and the return to a supportive macroeconomic policy stance, once the budgetary scope had been restored in the preceding years and inflation was back under control. Specific factors also played a part, such as the gathering pace of exports by China, which has a central position in the region's production chains, the evident optimism in India following the elections, and the stabilisation of the political situation in Thailand.

Box 1 – The "secular stagnation" concept

Origin

The term "secular stagnation" is not new, since it dates back to the 1930s, the era of the Great Depression. It is attributed to the American economist Alvin Hansen, from Harvard, who used it for the first time in 1938 in a speech about the link between economic progress and declining population growth[(1)].

(1) Hansen A. H. (1939), "Economic Progress and Declining Population Growth", American Economic Review, vol. XXIX, No. 1, Part I, March.

At the time, Professor Hansen was interested in the changes in the structure of the economy and their effects on the economic cycle. He was particularly concerned about the risks of under–investment and slower real income growth which in his view accompany declining population growth and the decelerating rate at which new territories are opened up, either by establishment of businesses there or by the exploitation of the territory's resources. In fact, he considered that, in the context of the day, the declining population growth was a key factor behind the inability of the economic recovery to generate full employment, suggesting the possibility of a self-perpetuating depression that would maintain unemployment at an abnormally high level. While he doubted the ability of an interest rate cut to stimulate investment, he advocated measures such as encouraging innovation in order to revive private investment and to strengthen public investment, though he acknowledged the latter's limits.

Professor Hansen's worries appeared largely unfounded, as events at that time contradicted the idea of secular stagnation. Immediately after the Second World War, the United States consolidated its global economic dominance in the context of a baby boom, a marked expansion of investment and sustained economic growth. Nonetheless, the fundamental idea that changes in the structure of the economy may prevent a lasting revival in activity following a recession, and lead to persistence of an abnormally high level of unemployment, has not entirely disappeared.

The modern view

It was another Harvard economist, Lawrence Summers, who actually resurrected the expression "secular stagnation" when speaking at an IMF conference at the end of 2013 (1). Since then, in view of the limited, hesitant and patchy recovery in the advanced economies, the idea has attracted great attention and elicited comments from numerous renowned economists (2). While interpretations of the concept differ to some extent, there appears to be a consensus that "secular stagnation" refers to a situation in which the economy is bogged down in zero or feeble growth that prevents it from achieving full employment.

Such a situation arises if, owing to a combination of structural and cyclical factors, the propensity to save increases and/or the propensity to invest declines to the point where the real interest rate which balances saving and investment at the level of full employment – also known as the real equilibrium rate – becomes significantly negative. In those circumstances, the effective real interest rate that can stimulate the economy may prove unattainable, and traditional monetary policy is therefore impotent. It is not actually feasible for the nominal interest rate to fall significantly below zero, given the possibility of replacing book-entry money with paper money which does not attract any remuneration. The emergence of a disinflationary – or even worse, a deflationary – trend reduces the ability of monetary policy to provide impetus in that it counteracts the policy's effects by exerting upward pressure on the effective real interest rate. Thus, an economy where output is below its potential level and under-employment prevails may be condemned to a protracted period of stagnation.

In the extreme case, there could be a situation in which a recession is self-perpetuating. If there is no way of providing a stimulus, a decline in output and a simultaneous rise in unemployment are liable to drive down prices in the economy, causing the real interest rate to rise and triggering a further contraction in activity. That raises the spectre of a recessive vicious circle and a deflationary spiral. It is also conceivable that a protracted recession may damage an economy's labour force and its productivity, thereby reducing its production potential. Such a "hysteresis" effect in turn depresses the real equilibrium interest rate.

Finally, even if it remained possible to stimulate the economy via a real interest rate compatible with full employment, it should be noted that the slightest decline in employment may entail risks for financial stability,

(1) Summers L. (2013), IMF 14th Annual Research Conference In Honor Of Stanley Fisher, International Monetary Fund, November 8.
(2) See for example Teulings C. and Baldwin R. (2014), Secular stagnation: facts, causes and cures, VoxEU.org ebook.

as the effective real interest rate would need to be lowered to stimulate the economy. Yet low interest rates tend to favour inappropriate lending and encourage investors to take risks, as well as having the potential to create bubbles.

Possible solutions

In principle, a decline in the real equilibrium interest rate and/or a disinflationary trend posing the threat of secular stagnation call(s) for three types of strategy. A first option is to acquire the means to reduce the effective real interest rate further, e.g. by using unconventional monetary policy instruments or by raising the central bank's target inflation rate. Although such an approach is necessary, it does have a potential cost in terms of financial stability. An alternative, as advocated by Hansen in his day, might be to encourage investment and consumption at the expense of saving. While there are many ways of doing that, such a strategy could involve expansion of public investment combined with measures to encourage private investment and a policy to reduce inequalities that generally depress the propensity to consume. That approach aims to raise the real equilibrium interest rate. It therefore favours output and employment without damaging financial stability. Finally, measures aimed at boosting the economy's growth potential, such as structural reforms, generally also promote a rise in the real equilibrium interest rate and are therefore equally desirable. However, the best measures to adopt for protecting against secular stagnation depend on the specific characteristics of each economy.

1.2 The economy in the euro area and its Member States

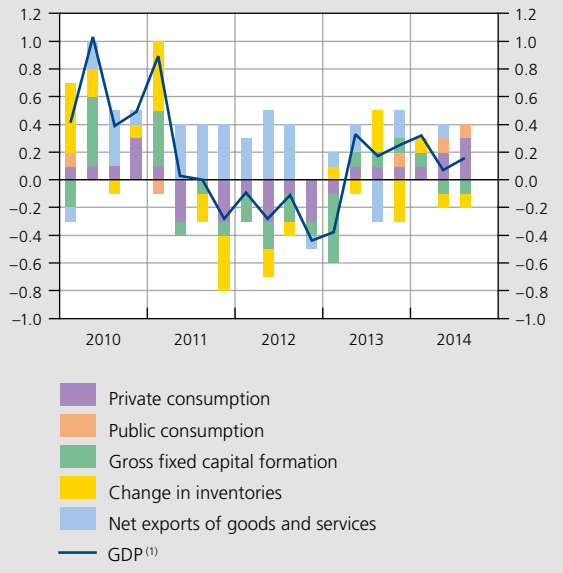
Although the euro area is seeing renewed growth, the economic situation remains fragile

In 2014, the development of activity again revealed an intrinsically fragile economic situation in the euro area. Although growth was slightly positive, it fell short of the expectations aroused by the, albeit modest, recovery that had begun in 2013. On average, the volume growth of GDP came to 0.8 % in 2014, after a 0.5 % contraction in the previous year. However, that outcome was due largely to the temporary revival at the end of 2013 and in the first quarter of 2014 when quarter-on-quarter growth reached 0.3 %. In the second and third quarters, it declined to 0.1 and 0.2 % respectively, destroying hopes of a gradual improvement.

This new slowdown occurred despite the accommodative monetary policy stance, improved financing conditions and a less restrictive fiscal policy. True, it is attributable partly to temporary adverse factors, such as the increased geopolitical risk caused by the crisis in Ukraine, but more fundamentally it also reflects the economy's low potential

CHART 8 QUARTERLY PROFILE OF GDP AND THE MAIN EXPENDITURE CATEGORIES IN THE EURO AREA

(data adjusted for seasonal and calendar effects; contributions to the change in GDP by volume compared to the previous quarter; in percentage points, unless otherwise stated)



Source: EC.
(1) Percentage changes compared to the previous quarter.

growth and hence its lack of ability to overcome the after-effects of the great recession and the sovereign debt crisis. Those after-effects are still evident in the high debt ratios of the private and public sector, the decline in bank lending to businesses and households, and the persistently high level of unemployment and chronic under-utilisation of production factors.

On the whole, economic growth picked up in the peripheral countries during the year under review, though admittedly from a still low level of activity. Thus, real GDP growth exceeded 4 % in Ireland, after having remained more or less stable in 2013. Spain and Portugal managed to convert the previous year's contraction of GDP into positive growth at least equalling the euro area average. Even Greece achieved positive growth again for the first time since the very severe recession that it had suffered. In those countries, the renewed momentum of activity was generally supported both by the further expansion of exports and by a gradual strengthening of domestic demand.

In the so-called core euro area countries, growth was less marked. In Germany, GDP remained more or less unchanged in the second and third quarters of 2014, after a sharp rise at the beginning of the year. In France, growth was once again very modest, while in Italy, Finland and Cyprus it was negative.

Inflation continues falling to a low level

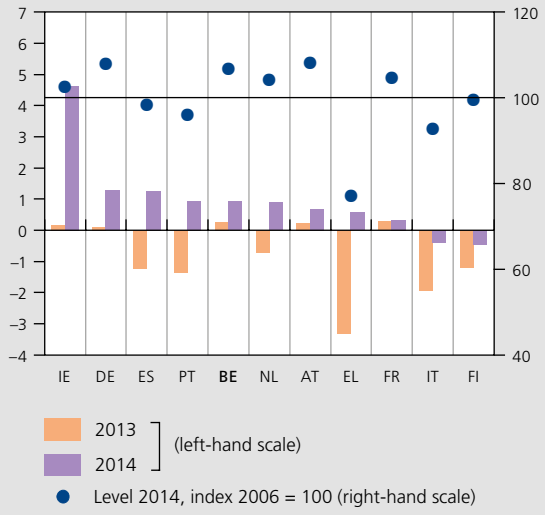
In parallel with the slackening of activity, inflation continued to fall sharply in the euro area in 2014, thus maintaining the downward trend that had begun at the end of 2011. Inflation declined from 1.3 % in 2013 to an average of 0.4 % in 2014, and even dipped to –0.2 % in December.

This marked deceleration was due mainly to a fall in energy prices and more moderate increases in food prices. In a sluggish economic environment, core inflation – which excludes those two components – also declined, although less sharply, dropping from 1.1 to 0.8 %. The main reasons were that price rises in the services sector continued to ease and prices of non-energy industrial products only rose slightly. The low level maintained by core inflation throughout the year included the effect of the increase in indirect taxes, estimated at around 0.2 %. As in the case of economic activity, the rise in prices was therefore much weaker than expected as the months went by, owing to both imported deflationary pressure and the effects of the sluggish economy in the euro area.

The decline in inflation throughout the euro area was accompanied by a marked reduction in the variations in inflation between Member States. In almost all countries, the rise of the HICP slowed to a greater or lesser degree,

CHART 9 GDP IN A SELECTION OF EURO AREA COUNTRIES

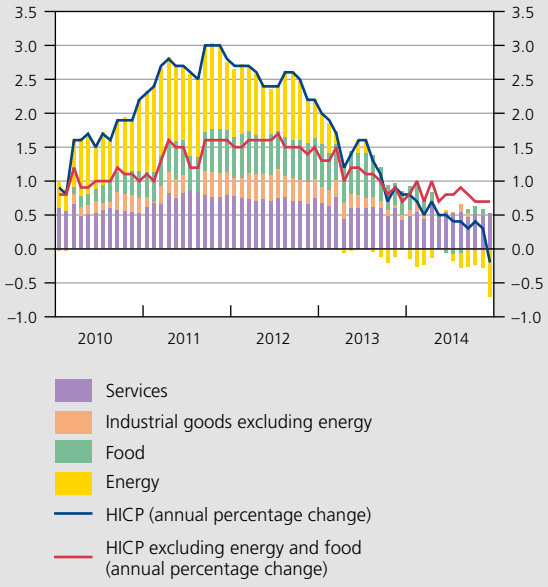
(percentage changes compared to the previous year, unless otherwise stated)



Source: EC.

CHART 10 INFLATION IN THE EURO AREA

(contributions to the annual percentage changes; percentage points, unless otherwise stated)



Source: ECB.

TABLE 2 OVERVIEW OF THE MAIN MACROECONOMIC VARIABLES IN THE EURO AREA

(percentage changes compared to the previous year, unless otherwise stated)

	2012	2013	2014
GDP	–0.7	–0.5	0.8
Final household consumption	–1.3	–0.6	0.7
Final government consumption	–0.2	0.2	0.6
Gross fixed capital formation	–3.2	–2.5	0.6
Change in inventories[1]	–0.7	–0.1	0.1
Net exports of goods and services[1]	1.4	0.4	0.1
Exports	2.5	2.1	3.1
Imports	–1.0	1.2	3.2
Inflation	2.5	1.3	0.4
Unemployment rate[2]	11.3	11.9	11.6
General government fiscal balance[3]	–3.6	–2.9	–2.6
Gross public debt[3]	90.8	93.1	94.5

Source: EC.
(1) Contributions to the change in GDP, percentage points.
(2) Ratio between the number of persons unemployed and the labour force, in %.
(3) In % of GDP.

dropping to between 0 and 1 %. However, consumer prices in Greece fell sharply again by around 1.5 %.

After contracting for two years, domestic demand picks up

The recovery of economic activity apparent in 2014 for the euro area as a whole, though fragile and uncertain, was primarily attributable to domestic demand.

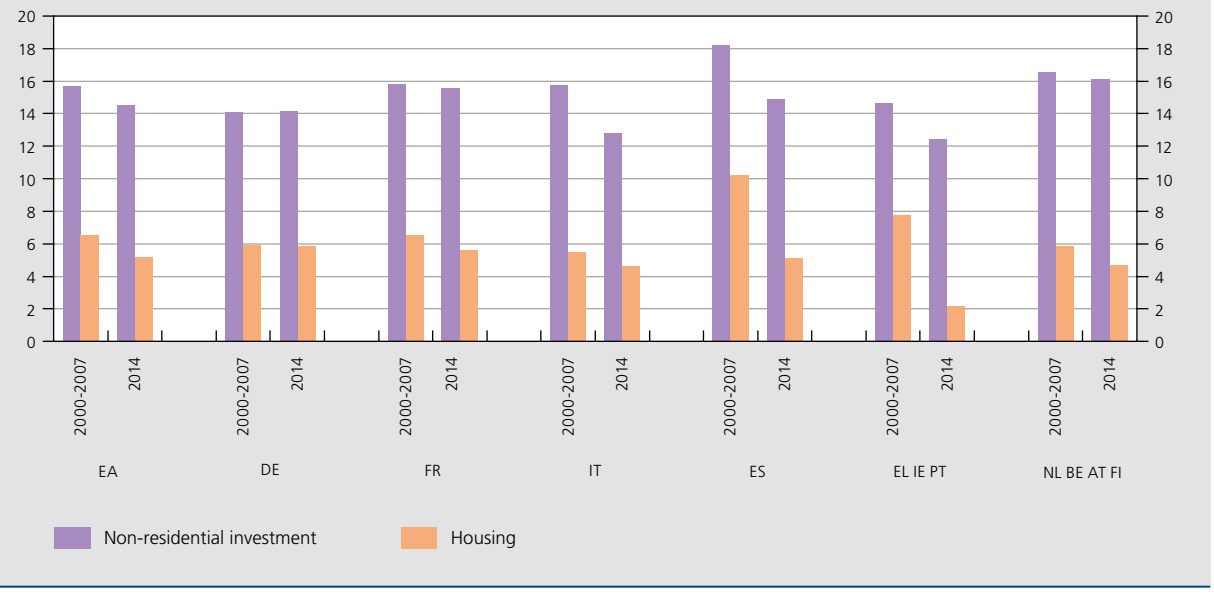
Private consumption, which had fallen in the previous two years in the aftermath of the sovereign debt crisis, began rising again. That growth was in line with the modest improvement in the real disposable incomes of households in a context of falling inflation and a virtually stable savings ratio. Conversely, the obstinately high unemployment rate and necessary household deleveraging continued to depress household spending.

Public consumption continued to recover, though still slowly on account of the narrow budgetary scope in almost all Member States, so that it made only a meagre contribution to annual GDP growth.

Like private consumption, investment also returned to positive growth in 2014 throughout the euro area.

CHART 11 INVESTMENT IN THE EURO AREA

(volume data, in % of GDP)



Source: EC.

This revival was based on the acquisition of capital goods, while expenditure on construction continued to fall, albeit less steeply than in previous years. In a fragile economic context, the expansion of investment remained hesitant, as it was still curbed by the low level of production capacity utilisation, modest demand, limited bank lending and renewed uncertainty.

Thus, although the renewed momentum in 2014 was a turn for the better, it was nothing like enough to wipe out the negative effect that the economic and financial crisis had produced for the formation of the stock of physical capital in the economy. In relation to GDP, the investment rate for the euro area as a whole was in fact still below the average for the period 2000-2007, both for investment in housing and for all other investment. Some countries, such as Germany, maintained their gross fixed capital formation at the pre-crisis level. Conversely, in other core euro area economies the investment ratio declined. That was the case in the Netherlands, Austria and Finland, while the decline was even steeper in Italy, Spain and the countries subject to an adjustment programme. In most of the countries in this last group, investment was stable or even picked up in 2014 after having fallen for several years.

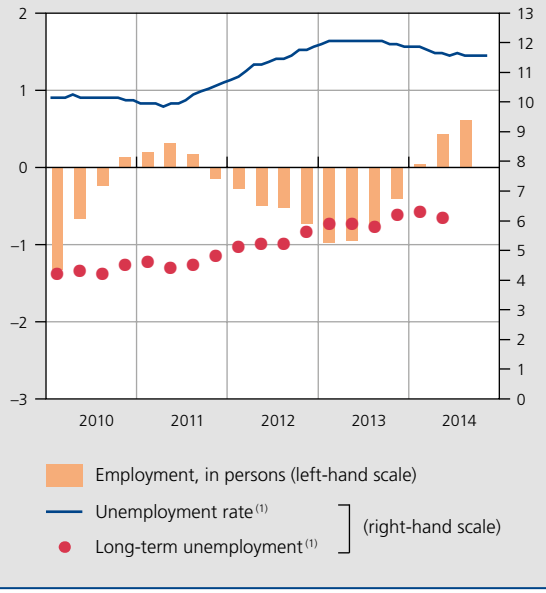
In a context of gradually expanding foreign markets, the euro area's exports also gathered pace during the year. The reforms implemented in the countries with an adjustment programme helped to restore their competitiveness, which had been seriously impaired. The delayed effect of the earlier appreciation of the euro probably still had some adverse impact in 2014, before the second half of the year brought a sharp decline in the value of the euro against the US dollar and the pound sterling. Nonetheless, the net exports of the euro area as a whole made only a meagre contribution to GDP growth overall as imports also began rising faster.

The reforms aimed at strengthening growth potential need to be consolidated and continued

Along with the strengthening of activity, the labour market situation also improved somewhat in the euro area. While employment had continued to contract sharply in the preceding two years, net job creation was restored from the beginning of 2014, bringing a slight increase in employment, on average, over the year amounting to 0.4 %. The unemployment rate subsided a little during the first half of the year, but still came to 11.6 % of the labour force in 2014, against 11.9 % the year before.

CHART 12 LABOUR MARKET IN THE EURO AREA

(percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources: EC, ECB.
(1) Ratio between the numbers of unemployed and the labour force, in %.

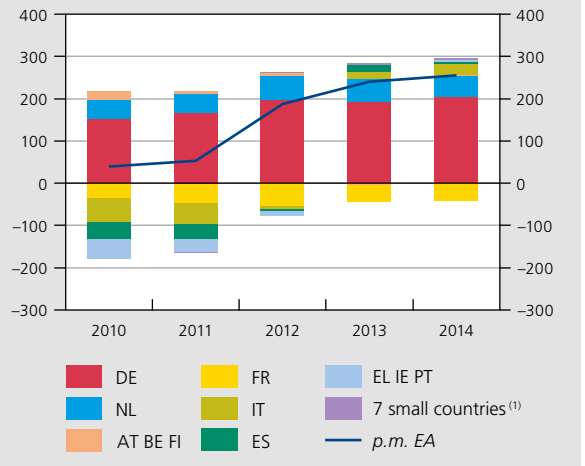
That level is still high, not only compared to the other large global economies but also in relation to the average unemployment rate in the euro area over the past two decades. In that respect, it should be noted that long-term unemployment has risen almost continuously since the financial crisis and therefore represents a growing proportion of total unemployment.

The unemployment rate declined mainly in the peripheral euro area countries, especially in Ireland and Portugal, and to a lesser extent in Spain and Greece. With the exception of Ireland, however, unemployment remained high. Greece and Spain recorded the highest unemployment rates, in the region of 25 % of the labour force. In Greece, this mainly concerned the long-term unemployed.

In the euro area, the persistently anaemic domestic demand, and in particular weak investment, since the financial crisis was accompanied by a growing current account surplus on the balance of payments, amounting to 2.5 % of GDP in the year under review. On the one hand, the peripheral countries which had recorded a large current account deficit before the crisis have greatly reduced that deficit since then or even turned it into a surplus. The reforms which they implemented helped to make them more competitive. Also, the sluggishness of domestic demand and the slump in investment in those countries depressed

CHART 13 BALANCE OF PAYMENTS CURRENT ACCOUNT BALANCE

(annual data, in € billion)

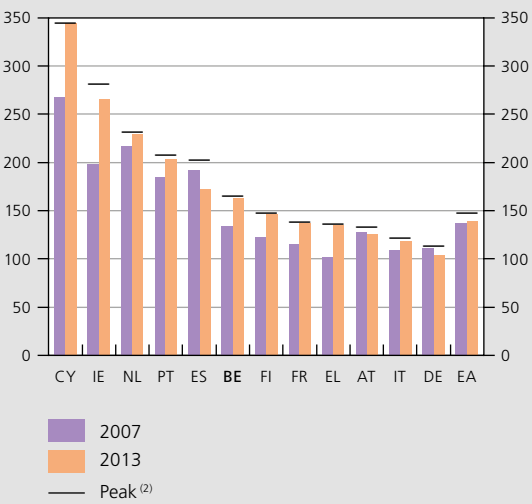


Source: EC.

(1) Slovakia, Luxembourg, Slovenia, Latvia, Estonia, Cyprus and Malta.

CHART 14 CONSOLIDATED DEBT OF THE NON–FINANCIAL PRIVATE SECTOR IN THE EURO AREA (1)

(outstanding amount at the end of the year, in % of GDP)



Source: ECB.

(1) The countries are ranked in descending order according to the peak debt of the non-financial private sector.

(2) Peak debt of households and non-financial corporations over the period 2007-2013.

their demand for imports. This last factor also does much to explain why the current account deficit was transformed into a surplus in Italy. Conversely, France is still posting a large current account deficit. On the other hand, in the countries traditionally in surplus, the current account balances have not diminished. For instance, the surplus still came to 7 % of GDP in Germany, and even reached nearly 8 % in the Netherlands. However, in an improving economic climate with domestic demand gradually picking up in the peripheral countries, the rebalancing of current accounts in the euro area slowed slightly during the year under review. Thus, the current account balances grew by less than in previous years in Ireland, Portugal and Italy while they actually deteriorated slightly in Spain and Greece.

The economic reforms in the countries with an adjustment programme are beginning to yield results. However, there are various factors that may hinder the economic recovery. For instance, the total debt of households and non-financial corporations in the euro area as a whole, measured on a consolidated basis – i.e. excluding mutual financial assets and liabilities within the same sector – still amounted to around 139 % of GDP at the end of 2013, slightly below the peak of 146 % of GDP reached in 2009. For comparison, the debt reduction process in the United States was more marked, even though the debt level of the non-financial private sector is still higher there. The debt ratio in the United States declined from 165 % of GDP at the outbreak of the crisis to 147 % at the end of 2013.

In the euro area, despite sometimes substantial adjustments, the debt level is still well above the average in Ireland, Portugal, and the Netherlands, where household mortgage debt far exceeds that in most other Member States. In Cyprus, the debt of the non-financial private sector is now by far the highest in the euro area. In addition, many euro area countries face a large public debt. Although the debt level of the non-financial private sector is relatively low in Greece and Italy, the public debt ratios in those countries are the highest in the euro area. In Cyprus, Ireland and Portugal, the heavy public debt comes on top of the non-financial private sector's debt.

Fiscal consolidation slows in the euro area

After the public sector borrowing requirement in the euro area as a whole had declined sharply between 2010 and 2013, fiscal consolidation slowed down in 2014. Although the budget deficit continued to fall, dropping from 2.9 % of GDP in 2013 to 2.6 %, the improvement was slower than in previous years. Furthermore, it was attributable partly to the more favourable economic climate, since the structural public deficit – namely the net financial balance adjusted for cyclical and temporary factors – declined only very marginally from 1.2 % of GDP in 2013 to 1.1 % in 2014.

TABLE 3 GENERAL GOVERNMENT BUDGET BALANCE AND DEBT IN THE EURO AREA
(in % of GDP)

	General government net financing balance		General government structural balance		Public debt	
	2013	2014	2013	2014	2013	2014
Germany	0.1	0.2	0.6	0.7	76.9	74.5
France	–4.1	–4.4	–3.3	–3.0	92.2	95.5
Italy	–2.8	–3.0	–0.8	–0.9	127.9	132.2
Spain	–6.8	–5.6	–2.3	–2.2	92.1	98.1
Netherlands	–2.3	–2.5	–0.6	–0.5	68.6	69.7
Belgium	**–2.9**	**–3.2 e**	**–2.7**	**–2.8 e**	**104.5**	**106.5 e**
Austria	–1.5	–2.9	–1.3	–1.1	81.2	87.0
Greece	–12.2	–1.6	3.1	2.0	174.9	175.5
Finland	–2.4	–2.9	–0.7	–1.1	56.0	59.8
Ireland	–5.7	–3.7	–4.8	–3.8	123.3	110.5
Portugal	–4.9	–4.9	–1.9	–1.3	128.0	127.7
Slovakia	–2.6	–3.0	–1.4	–2.1	54.6	54.1
Luxembourg	0.6	0.2	2.0	1.1	23.6	23.0
Slovenia	–14.6	–4.4	–1.8	–2.5	70.4	82.2
Latvia	–0.9	–1.1	–1.0	–1.5	38.2	40.3
Estonia	–0.5	–0.4	–1.1	–0.8	10.1	9.9
Cyprus	–4.9	–3.0	–2.1	–0.8	102.2	107.5
Malta	–2.7	–2.5	–2.7	–2.7	69.8	71.0
p.m. Euro area	*–2.9*	*–2.6*	*–1.2*	*–1.1*	*93.1*	*94.5*

Sources: EC, NBB.

Except for Germany and Luxembourg, where the budget was practically balanced, the governments of all euro area Member States had a net borrowing requirement. In some countries the deficit increased in 2014, while it remained stable in Portugal and diminished sharply in Ireland, Spain and Greece, as it did in Slovenia and Cyprus. In this latter country as well as in Ireland and Portugal, this was accompanied by a substantial fall in the structural public deficit. In Greece, where the costs of recapitalising the banks had swollen the budget deficit to 12.2 % of GDP in 2013, the public deficit dropped to 1.6 % of GDP in 2014, as a result of the tax reform and spending cuts.

In all, according to the European Commission's (EC) autumn forecasts, the public deficit was still well above the limit of 3 % of GDP in Spain, Portugal, France, Slovenia and Ireland. Apart from those countries, Cyprus, Greece and Malta were still subject to an excessive deficit procedure (EDP) at the end of the year under review. In November 2014, when the EC assessed the budget plans for 2015, it found that, on the basis of the information available at that time, France had not taken effective action to comply with the Council's recommendations under the EDP for achieving the budget targets for 2014. The EC will determine its position on that at the beginning of March 2015. As regards the other euro area countries, the Ecofin Council ended the procedures against Belgium, the Netherlands, Austria and Slovakia during the year under review.

The public debt of the euro area as a whole continued to grow, reaching 94.5 % of GDP at the end of 2014. However, that increase was smaller than in previous years owing to a primary budget balance that was more or less in equilibrium, and a weakening of the snowball effect caused by interest charges. The increase was more or less universal, affecting most of the euro area countries. The decline in the public debt ratio in Ireland is due mainly to

the liquidation of the Irish Bank Resolution Corporation, initiated in 2013. In contrast, the public debt in Austria increased as a result of the government taking over problem assets of a bank which was being wound up.

Box 2 – Structural reforms in the euro area

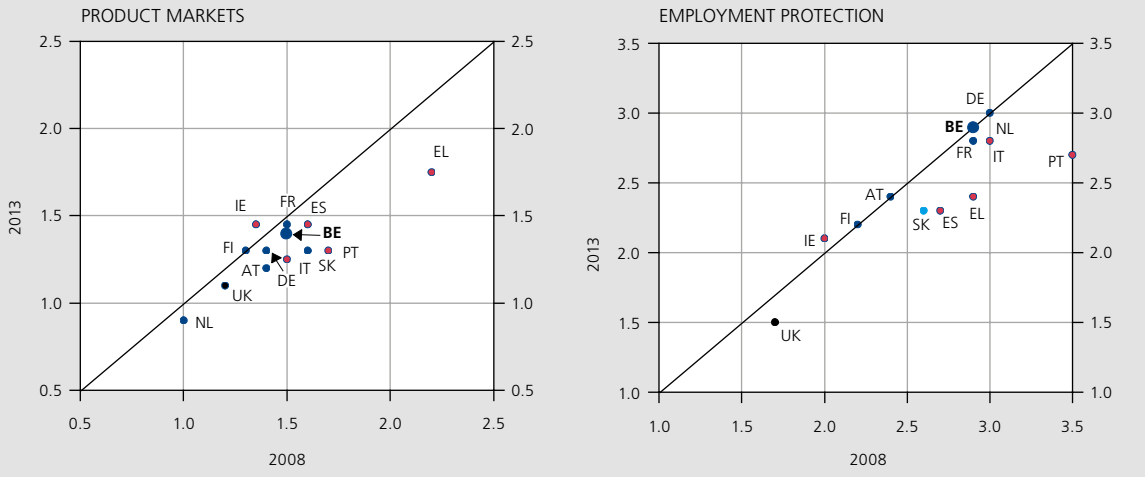
The hesitant and fragile economic situation evident again in the euro area in 2014, against the backdrop of a still highly accommodative monetary policy and a less restrictive fiscal policy, is a clear demonstration of how difficult it is for the euro area to maintain sustainably robust and resilient growth. In parallel with the measures taken since the crisis to consolidate public finances, stabilise the financial sector, reform the pension systems and – in some countries – to restore the seriously impaired competitiveness, it is absolutely essential to make radical improvements to the general operation of the economy. That is all the more urgent for the smooth functioning of the monetary union, because the spillover effects between the Member States are considerable and those countries are no longer able to correct macroeconomic imbalances *ex post* by devaluing their currency.

These lessons have now been well learnt, and European economic governance has been reinforced by the introduction of the macroeconomic imbalance procedure (MIP) under the European Semester and the specific recommendations formulated for the countries, many of them related to structural policies.

From now on, the priority must be to ensure the actual implementation of the reforms in the Member States. In the most vulnerable countries, the pace of reform has in fact been speeded up, particularly under pressure from the financial markets and the Troika, which supervises compliance with the conditions attached to the aid programmes implemented in a number of those countries. Conversely, in the core euro area countries, the pressure for implementing radical reforms has often been lacking.

SYNTHETIC INDICATORS OF MARKET REGULATION IN EUROPE

(scale from 0 to 6, from less restrictive to more restrictive)



Source: OECD.

Structural reforms of the labour and product markets: progress so far

Smoothly functioning labour and product markets permit a more efficient allocation of capital and labour, favouring their use in the most productive firms. If such reallocations operate flexibly, it is possible to limit the degree and duration of the loss of output and jobs in a recession.

The scale of the measures taken since the great recession varies from one country to another. In regard to the product markets, the measures were more radical in the programme countries, namely Greece, Spain and Portugal, but also Slovakia and Italy. They were less significant in the core euro area countries, especially France, Germany and Belgium. The completion of the Single Market in services and its exposure to increased competition is proving to be a particularly complicated and long drawn-out process.

In addition, almost all the euro area countries have stepped up their initiatives to reform the organisation and operation of the labour market. Those initiatives mainly concerned an increase in the financial incentives to work, activation of the unemployed, and the rules with regard to unemployment benefit and early retirement schemes. Conversely, they hardly affected the process of wage-setting. Some Member States simplified the procedures relating to mass and individual redundancies and/or reduced redundancy pay in order to stimulate employment while combating the segmentation of the labour market. Portugal, Spain, Greece and Slovakia undertook ambitious reforms.

Impact of structural reforms

The IMF and the EC recently carried out two simulation exercises to estimate the impact of a series of structural reforms on growth in the regions (IMF) or individual countries (EC) of the euro area. Those simulations assume that all euro area countries implement the reforms simultaneously. They model the structural reforms as changes in a number of structural indicators of the labour market and the product markets, but do not establish any link with the policy measures that may be behind them. Next, they adopt a distance-to-frontier approach to quantify a country's reform potential for each structural indicator in the model on the basis of the difference between the

POTENTIAL IMPACT OF STRUCTURAL REFORM PACKAGES ON POTENTIAL OUTPUT

(deviations in % from the baseline scenario)

	After one year	After five years	After ten years	In the long term [3]
IMF [1]				
Euro area	1.2	4.1		12.3
Core (euro area, excl. periphery)	1.1	3.7		10.6
Periphery (EL, ES, IE, IT, PT)	1.4	4.8		15.4
EC [2]				
Core (BE, DE, FR, NL, AT, FI)		3.2 (DE) – 5.5 (BE)	5.5 (DE) – 10.4 (BE)	8.7 (DE) – 17.9 (BE)
Periphery (EL, ES, IE, IT, PT)		2.4 (PT) – 4.5 (EL)	5.5 (PT) – 9.7 (EL)	10.0 (ES) – 17.6 (EL)

Sources: IMF (2014), "Jobs and growth: Supporting the European recovery", (Chapter 7), and Varga J. and J. in 't Veld (2014) "The potential growth impact of structural reforms in the EU: A benchmarking exercise", European Economy Economic Papers 541, December.

(1) The IMF uses the GIMF model and assumes that a set of reforms concerning the product markets, the labour market, and the tax structure will be phased in during the first five years. These reforms lead to halving of the gap in relation to the best performing OECD country (which varies according to the criteria).

(2) The EU uses the QUEST model and assumes that a set of reforms concerning the product markets, the labour market, and the tax structure, R&D expenditure and the skills structure will be phased in. These reforms lead to halving of the gap in relation to the average of the three best performing EU Member States (which vary according to the criteria).

(3) The long term extends until 2060 for the IMF calculations while it is 20 years for the EC calculations.

score of the country in question and that of the best performing country, regarded as the benchmark. Finally, it is assumed that a country will take a series of measures which, for each indicator considered, will lead to a linear halving of the gap in relation to the benchmark over five years. The estimated impact on potential output is determined *inter alia* by the design of the models used, the structural indicators included and the definition of the benchmark. The results must therefore be interpreted and compared with caution.

Structural reforms have an impact mainly in the medium and long term, but a beneficial influence may still be felt in the short term as a result of the restoration of confidence. Logically, the countries or regions which, on average, have a bigger gap to close in relation to best practices have the most to gain from ambitious structural reforms. As already mentioned, that gap is larger, on average, in the periphery than in the core euro area, although there are wide variations between countries within each group. For instance, in the periphery, Greece still has a long way to go while Ireland has a high degree of flexibility.

According to the EC, if a country implements reforms unilaterally, the impact after 20 years will be around 3 percentage points lower than in the above scenario in the case of small open economies such as the Netherlands, Belgium and Austria. In contrast, for closed economies such as Greece and Portugal, the difference will be negligible. In the joint reform scenario, the positive contagion effects resulting from stronger demand among trading partners therefore appear to outweigh the gains in competitiveness in relation to trading partners in the scenario where only one country conducts reforms.

In the current context of zero nominal interest rates, structural reforms may have a slightly negative impact on growth at first, owing to their influence on the real interest rate, as noted by the EC in a recent publication[(1)]. However, the EC stresses that this is no reason to postpone the reforms since the costs associated with the resulting loss of credibility would probably be much higher. On the contrary, resolute commitment to structural reforms will alleviate uncertainty about the future, which may lead to a reduction in precautionary savings.

(1) EC (2014), *Special issues on the euro area economy*, *Quarterly Report on the Euro Area*, Vol. 13, N° 3.

1.3 Monetary policy of the Eurosystem

Downside risks to price stability

Economic analysis

Whereas optimism prevailed at the beginning of 2014, the Governing Council later faced a steady deterioration in the economic outlook for the euro area. That was particularly marked in the fourth quarter, despite some signs of a stabilisation of activity at the end of the year. In that situation, the expectation was that the absorption of the excess production capacity would be a slow and gradual process.

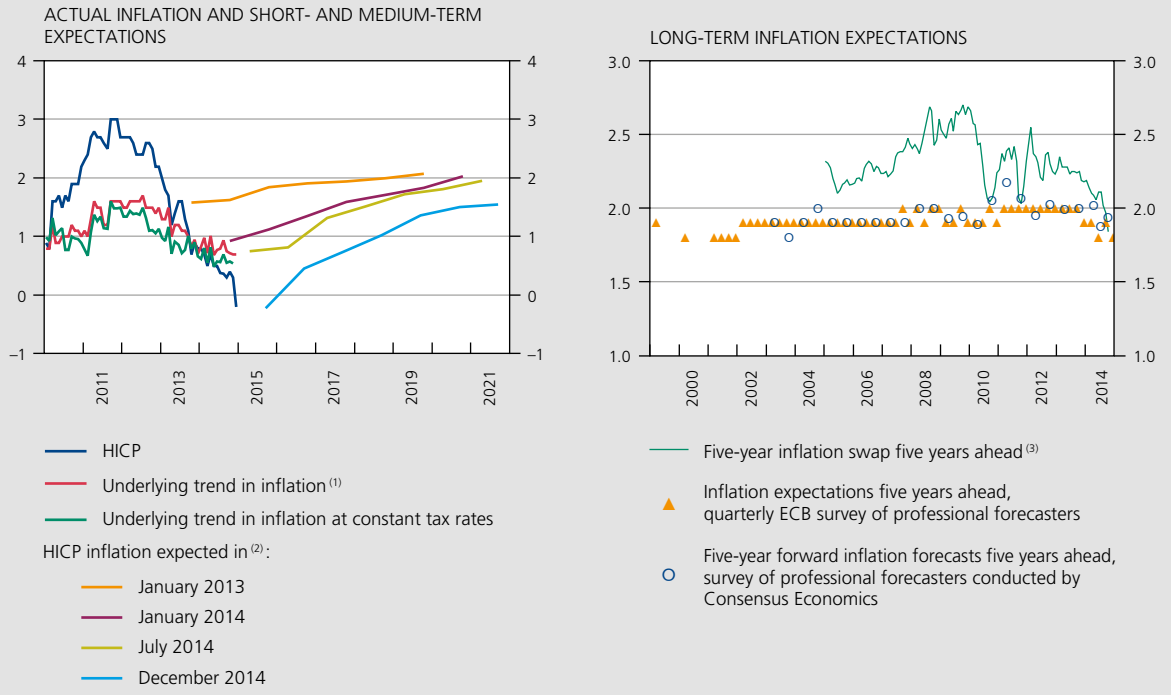
As the months went by, actual inflation proved significantly weaker than expected, as did economic activity, and the corresponding projections were also systematically revised downwards. At the end of the year, inflation fell to particularly low levels, a long way from the Governing Council's medium-term objective of an inflation rate below but close to 2 %.

In addition, throughout the year, the Governing Council considered that these economic prospects were subject to downside risks, relating in particular to geopolitical developments, insufficient structural reforms in the euro area countries, and the still faltering recovery. From April onwards, it also systematically noted risks relating to an excessively long period of low inflation. As explained in the box below, while deflation was still considered an unlikely prospect, a situation in which inflation is too low also implies a whole set of risks and problems.

Short- and medium-term inflation expectations in the private sector confirmed and even reinforced the Governing

CHART 15 INFLATION AND INFLATION EXPECTATIONS IN THE EURO AREA

(year–on–year percentage changes)



Sources: EC, Bloomberg, Thomson Reuters Datastream, ECB.

(1) HICP excluding food and energy.

(2) Measured on the basis of the implicit forward rate for an inflation swap. Since consumer price indexes are published after some delay, inflation swap contracts reflect the inflation expected in the month three months ahead of their due date. For instance, one–year contracts dated December 2014 reflect inflation rates expected in September in subsequent years.

(3) Implicit inflation rate derived from swaps covering the inflation risk in the euro area, for a period of five years beginning five years after the conclusion of the contract.

Council's assessment, as they foresaw only a slow and very gradual return to inflation levels compatible with the definition of price stability. Following a series of surprisingly low inflation figures, expectations were also down sharply over the year as a whole. Long-term expectations based on financial data likewise displayed a downward trend, reaching an all-time low at the end of the year. This led to fears that inflation expectations might become disanchored, a worry which was reinforced by the relatively low level of long-term expectations derived from the survey data. Those data are available less frequently than the financial data, but they do not incorporate risk premiums. Although the decline is very small, it is worrying in that these data are typically stable in the context of a monetary policy geared to price stability.

Box 3 – Why is persistently low inflation a problem?

The ECB's primary aim is to maintain price stability, defined as inflation below but close to 2 % in the medium term in the euro area. If price trends are stable and predictable, that in fact helps the economy to function better. Conversely, unexpected fluctuations in inflation may lead to sub–optimal macroeconomic results, e.g. owing to distortion of the signal given by individual price–setting, arbitrary redistribution of income and wealth, or the resulting uncertainty surrounding long–term decisions. However, not all fluctuations in inflation are equally harmful, nor do

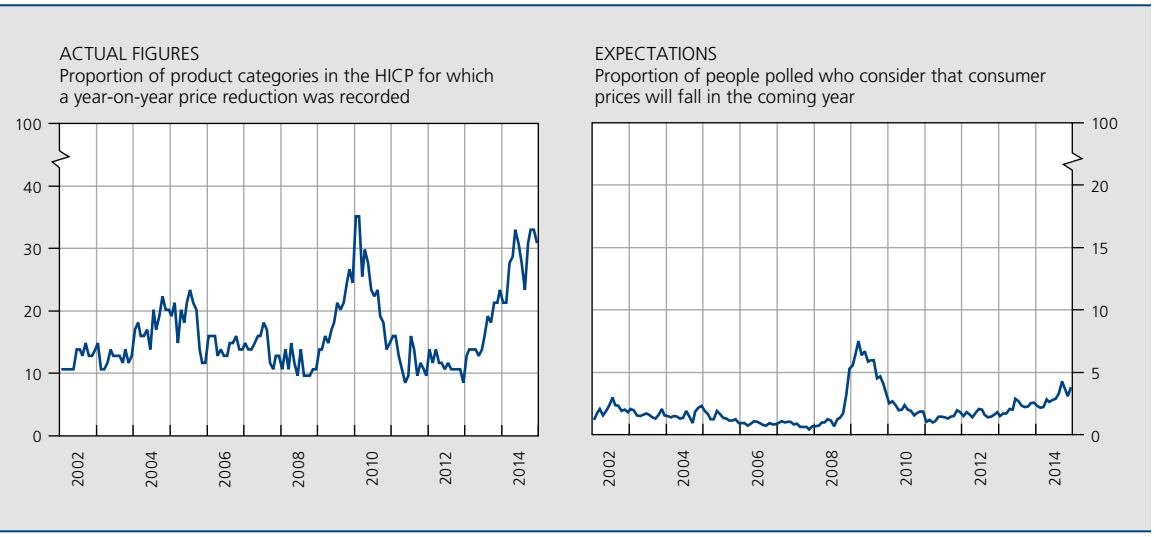
they all require a monetary policy response: much depends on the type of shock generating such movements. For instance, in the case of a negative demand shock, both inflation and economic activity come under downward pressure. A swift response by monetary policy is then recommended since a monetary stimulus stabilises the two variables. Conversely, in the case of a positive supply shock – which exerts downward pressure on inflation but at the same time supports economic potential – monetary policy faces a dilemma. A more gradual response may then be advisable, at least if inflation expectations remain firmly anchored. If that last condition is not met and if the positive supply shock is not accompanied by an increase in demand, and therefore generates persistent downward pressure on inflation, intervention by monetary policy is required.

Various factors account for the downward trend in inflation in the euro area since the end of 2011. At global level, commodity prices have fallen sharply while the rise in food prices has been modest. Moreover, the resulting downward pressure on import prices was reinforced by the euro's appreciation, which continued until the beginning of May 2014. By supporting consumers' purchasing power, these external supply factors have a favourable influence on the economy of the euro area. In addition, a rebalancing process is taking place within the euro area, with the peripheral countries endeavouring to restore their competitiveness with the core countries, notably by means of structural reforms. The decline in inflation in the peripheral countries resulting from those reforms at the level of the economy's production potential can be considered necessary and beneficial. Apart from these factors, however, the persistence of low inflation is due essentially to the flagging demand in the euro area, which is depressing economic activity, wages and profits, and hence also prices. Unlike the lower inflation caused by a reduction in import prices, that is not a source of increased purchasing power.

Thus, inflation in the euro area has for a long time been below a level compatible with price stability, and is expected to rise only very slowly towards 2 %, as indicated by the persistent decline in inflation expectations in the short, medium and long term. Nonetheless, the ECB Governing Council considers that there is little risk of deflation (defined as a self–perpetuating fall in prices which threatens to lead to the postponement of purchases) in the euro area. Although the proportion of goods and services in the consumption basket recording a year–on–year decline

SCALE OF PRICE REDUCTIONS IN THE EURO AREA

(monthly data, in %)



Source : EC.

in prices did increase in 2014, it did not exceed the 2009 level. Also, the EC's monthly survey shows that only a very small number of consumers expect consumption prices to fall over the next twelve months.

Even without a general fall in prices, an excessively long period of low inflation causes damage, particularly if it is due to a decline in demand and is accompanied by inflation expectations becoming disanchored. An unexpected fall in inflation increases the real value of outstanding debts, since the real interest rate proves to be higher *ex post* than was expected *ex ante*. When inflation remains persistently below the target, there is therefore a redistribution of wealth from debtors to lenders. The opposite is also true in the event of inflation persistently exceeding the target. However, if inflation is too low, it is liable to have an additional adverse impact on demand, as in principle borrowers – who face a higher real interest rate – have a greater propensity to consume than lenders. If the debt is substantial, as is the case for the euro area, an unexpected decline in inflation may curb the economic recovery because it hampers debt reduction and may exacerbate the fall in demand. In that connection, it should be noted that the peripheral euro area countries are the ones facing the biggest challenge: they have the lowest inflation combined with the heaviest debts.

As already mentioned, the low inflation in the peripheral countries is to some extent an indication of the success of the structural reforms implemented in order to restore competitiveness. However, it is not offset by an increase of more than 2 % in wages and prices in other countries, so that on balance, inflation in the euro area as a whole is still too low. That situation complicates and delays the adjustment process, which requires a relative decline in wages and prices, i.e. only in relation to the rest of the euro area and not necessarily in absolute terms. Thus, with inflation close to 2 % on average in the euro area, a price and wage freeze in the peripheral countries could be enough to achieve a fairly rapid adjustment in relative prices. Conversely, in a low inflation situation, it is necessary to make absolute cuts in wages and prices to achieve that adjustment. For various reasons, workers and businesses display reluctance in that respect[1], thus slowing the adjustment process in the peripheral countries, driving up unemployment and further eroding demand. It is therefore hard for the structural reforms on the labour market and on the product markets to produce their beneficial effects.

Finally, in a low inflation environment, it may be more difficult to pursue a sufficiently accommodative monetary policy, as the nominal interest rate – which corresponds to the sum of the expected inflation rate and the real interest rate – has a floor of around 0 %. Once the policy interest rate has reached that low point, as is currently the case in the euro area, the central bank loses the instrument that in normal times enables it to lower the real interest rate further in the short term. If inflation expectations are firmly anchored, the situation need not be a problem so long as the negative real interest rate thus obtained is sufficiently accommodative. However, this scenario still entails risks. For example, even if the real interest rate is already negative, it may still be too high in relation to the level of the real equilibrium rate[2], e.g. because of an additional, persistent fall in demand. Moreover, inflation expectations that are no longer firmly anchored and exhibit a downward trend will exert upward pressure on the real interest rate and lead to a monetary policy that is unintentionally more restrictive. Traditional monetary policy might then be incapable of restoring economic activity to its potential level. That would aggravate the risk of very weak growth persisting for a prolonged period, a phenomenon known as "secular stagnation"[3], causing lasting damage to growth potential.

Admittedly, a central bank faced with such an environment can still resort to alternative measures. Even if the policy interest rates are at their minimum level, those measures must make it possible to conduct an accommodative policy to restore inflation and inflation expectations to a stable level close to the target, in order to limit the negative effects described here. The measures adopted by the Eurosystem should in fact be viewed in that light.

(1) For studies of *inter alia* the downward rigidities in wages and prices in the euro area, see the work of two Eurosystem working groups, namely the Wage Dynamics Network and the Inflation Persistence Network.

(2) The real equilibrium rate is the rate prevailing when output reaches its potential level. It is also a benchmark for the monetary policy stance: if the real interest rate is higher than the real equilibrium rate, monetary policy is restrictive, whereas if it is lower than that rate, monetary policy is accommodative.

(3) For a general view of the subject, see Box 1.

Monetary analysis

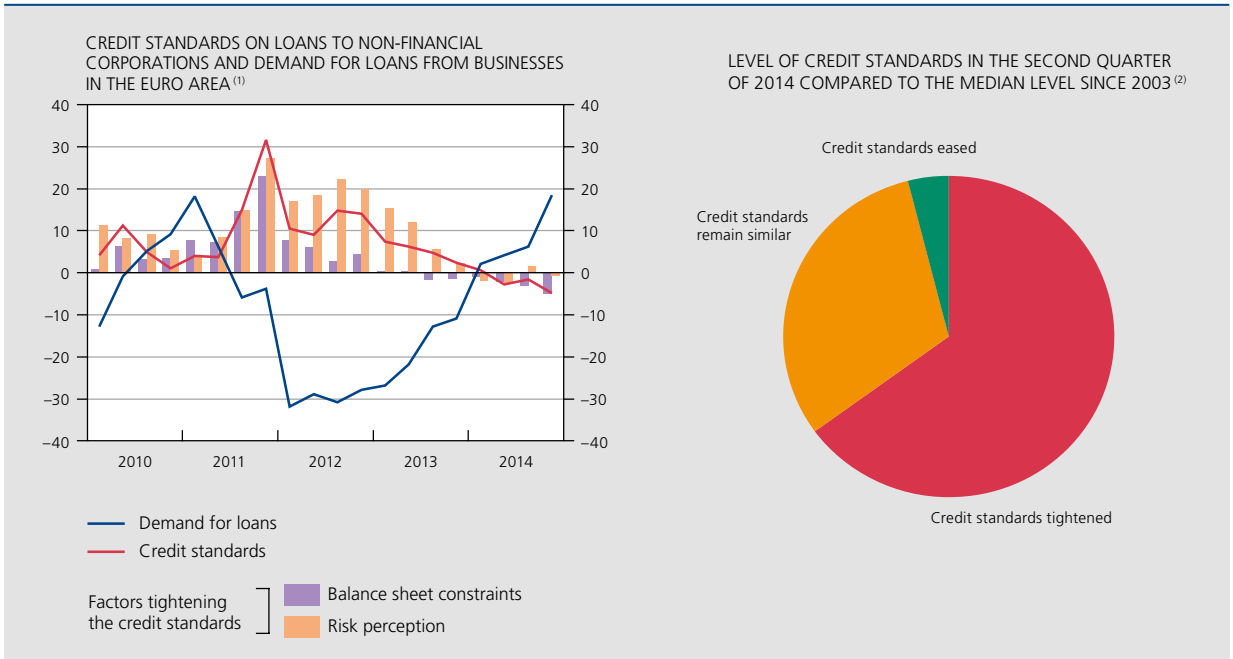
The scenario in which inflationary pressure is expected to remain particularly low for a long time was largely borne out by developments in the money supply and in lending.

Bank lending to the private non-financial sector remained sluggish, and was restrained in particular by the weak economic activity and the ongoing balance sheet adjustment. However, during the first quarter there were signs that lending was picking up. Year-on-year growth of lending to businesses thus increased from –3.2 to –1.3 % between February and November, although it remained decidedly negative, while the growth of lending to households was up from 0.2 to 0.7 % between January and November. In line with these developments, the results of the bank lending survey (BLS) indicate a slight easing of credit standards and a rise in demand for both business loans and home loans. Nonetheless, it must be borne in mind that the level of the credit standards remained restrictive in historical terms, especially in the peripheral economies. In a calmer financial environment, it was mainly the reduction in balance sheet constraints that contributed to the easing of standards in 2013 and 2014, while in view of the still uncertain macroeconomic context, risk perception continued to be a source of concern for banks in their lending. The slight increase in the growth of bank lending to the private sector was evident in many countries, but there were still substantial differences in terms of level between the centre and the periphery of the euro area, bearing witness to variations in macroeconomic dynamics and debt levels. At the same time, debit interest rates continued to display wide variations, although they did diminish overall as a result of new measures adopted by the ECB Governing Council. The disparity in bank financing costs between countries is due mainly to divergences in banks' funding conditions and capitalisation, but also to variations in credit risk from one country to another.

The modest revival in lending to the private sector during the year under review was accompanied by a steady expansion of the money supply. After having declined to a low of 0.8 % in April, the year-on-year growth of the broad monetary aggregate M3 thus gradually gathered pace to reach 3.1 % in November. That growth indicates an increased preference for liquid assets, given the low level of interest rates. In that context, the annual expansion of M3 continued to be supported by its most liquid components, and especially sight deposits, as their opportunity cost is very low in an environment where other risk-free assets offer meagre remuneration.

CHART 16 EUROSYSTEM'S BANK LENDING SURVEY FOR THE EURO AREA

(quarterly data)

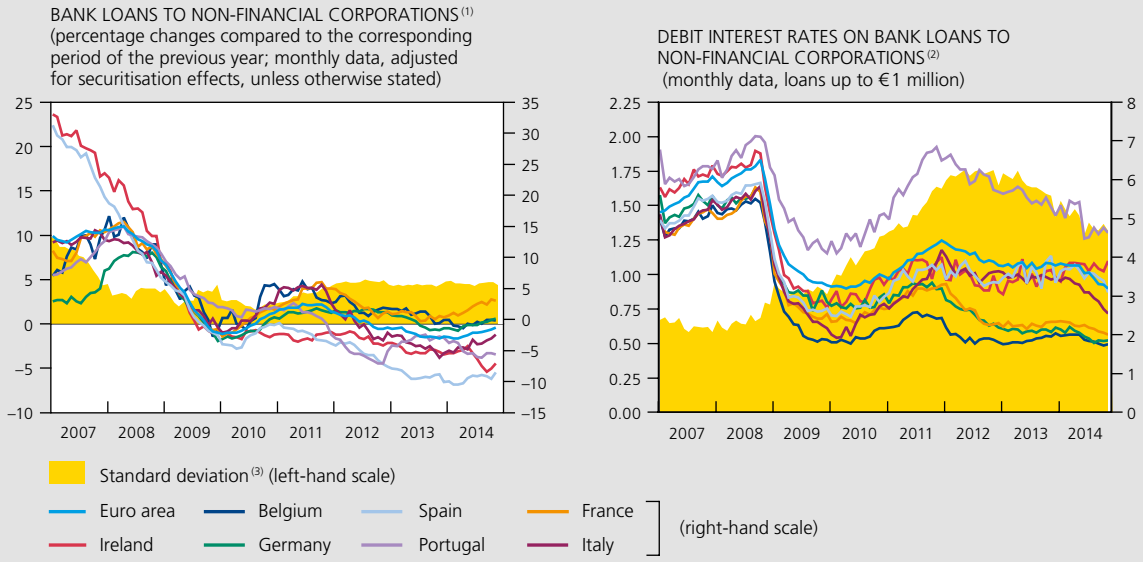


Source : ECB.

(1) Net percentages of replies from banks to the Eurosystem's bank lending survey indicating the degree of tightening (+) or easing (–) of credit standards and the movement in demand for loans.

(2) Net percentages of replies from banks.

CHART 17 BANK FINANCING OF NON–FINANCIAL CORPORATIONS IN THE EURO AREA



Sources: ECB, NBB.

(3) All maturities together. The data for Belgium are adjusted for securitisation over the whole period. Those for the other countries are adjusted from February 2010, except for the data for Italy which are not adjusted.

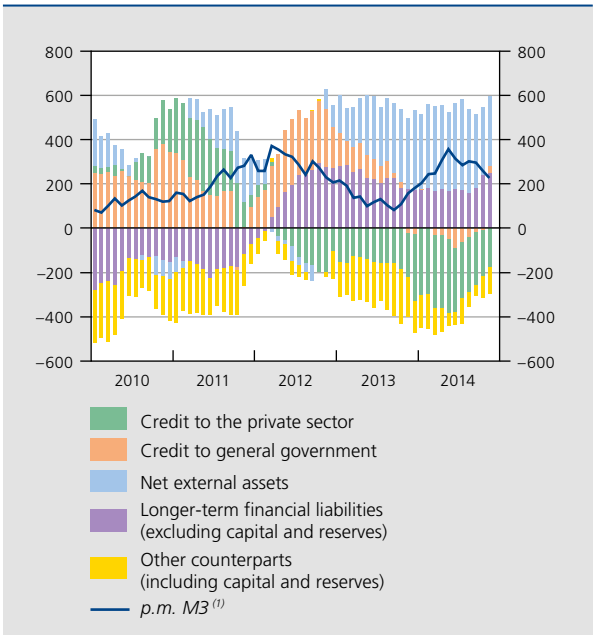
(4) Interest rates offered on new loans for an initial term of less than one year.

(5) Standard deviation for the twelve euro area Member States on 1 January 2002, with the exception of Luxembourg.

In general, the decoupling of M3 growth from the expansion of lending to the private sector persisted, as other factors contributed to the growth of the broad monetary aggregate, headed by the increase in the net external position of the banks and the continuing contraction of their longer-term financial commitments. The first factor reflects the surpluses on the euro area current account and the net inflow of capital into the euro area. Although it has been the main driver of M3 growth since mid-2013, its dominance diminished a little from the summer of 2014 following a slight fall in investors' demand for euro area securities. That reduced preference was probably due to yield considerations relating in particular to the reinforcement of the accommodative monetary stance. The second factor reflects the reduction in the financing needs of banks in the euro area and the tendency towards a funding strategy centred on deposits, as encouraged by the current regulation. It also reflects the particularly flat shape of the yield curve, which is causing savers to keep their liquidity in the form of deposits. Taking account of these factors, the underlying growth rate of the money supply in the broad sense thus remained very low, even though it accelerated slightly.

CHART 18 COUNTERPARTS OF M3

(annual flows, amounts in € billion, seasonally adjusted data)



Source: ECB.

(1) M3 corresponds to the sum of the various counterparts. Since longer–term financial liabilities (excluding capital and reserves) are liabilities of the banking sector, they are shown with a negative sign.

Monetary policy measures adopted in 2014

The developments revealed by economic and monetary analysis – the two pillars forming the basis of the Eurosystem's monetary policy strategy – prompted the Governing Council to adopt a range of new conventional and non-conventional measures during the year under review. Although they were staggered throughout the year, these various measures all form part of the same programme designed to reinforce the accommodative monetary policy stance and give greater support to lending to the real economy in the euro area.

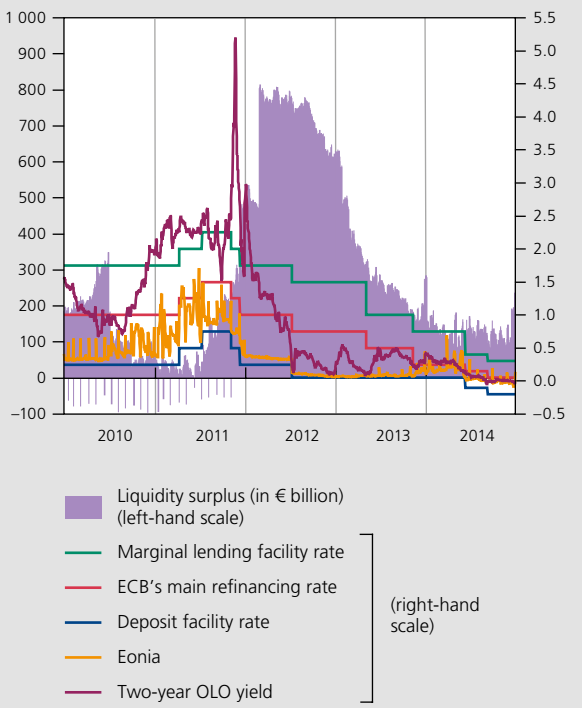
Reduction of key interest rates and maintenance of forward guidance

In view of the persistently languishing economic activity, the steady and unexpected decline in inflation and the weak underlying inflationary pressures in the medium term, the Governing Council cut the key rates on two occasions in 2014.

On 5 June, it was decided to cut the rate on the Eurosystem's main refinancing operations by 10 basis points to 0.15 %, and to reduce the marginal lending facility rate by 35 basis points, to 0.40 %. The deposit facility rate was cut by 10 basis points, thus taking it into negative territory at –0.10 %. To avoid arbitrage, the Governing Council also decided that the current account balance held in excess of the reserve requirement would in future be remunerated at the deposit facility rate and not at a zero rate as had previously been the case. In view of the persistently weak inflation outlook and signs that growth was slowing down in the summer, the Governing Council considered at its meeting on 4 September that its policy interest rates needed to be reduced further. It thus agreed to cut all the rates by a further 10 basis points, bringing the interest rate on the main refinancing operations to 0.05 %, the marginal lending facility rate to 0.30 % and the deposit facility rate to –0.20 %. Following these cuts, it was announced that the interest rates had reached their floor so that there would be no further reductions.

The decline in the main refinancing rate reduced the cost of Eurosystem refinancing for banks in the euro area, while the reduction in the deposit facility rate exerted pressure on money market rates. In a situation of excess liquidity, which has very often prevailed since the fixed-rate tenders with full allotment were introduced on 15 October 2008, the floor policy rate in fact plays a key role in determining the overnight Eonia rate, for which it is a lower bound. However, although the overnight money market rate did fall, it was still significantly above the deposit facility rate and only descended briefly into negative territory. This limited transmission of the movements in the policy rate to the Eonia rate is attributable to a lower level of liquidity surplus and to the reluctance of a segment of the euro area banking system to effect transactions at (too) negative interest rates.

CHART 19 INTEREST RATES, MONEY MARKET RATES AND LIQUIDITY SURPLUS IN THE EURO AREA



Sources: Thomson Reuters Datastream, ECB.

It should be noted that the banks are generally willing to pay a negative interest rate to deposit their liquidity with the Eurosystem because the other options are also expensive or less secure. The alternative of holding paper money, on which the nominal remuneration is zero, thus entails banknote transport and storage costs, while investment in more remunerative assets is not in principle risk free. In this context and owing to the banks' arbitrage strategies, yields on risk-free short-dated assets such as certain sovereign securities also became negative.

Apart from the aim of easing monetary policy, the simultaneous adjustment of the interest rates on the main refinancing operations and the deposit facility are intended to maintain a constant corridor between the two lower key interest rates, and therefore not to discourage

trading on the interbank market. The decision to make a bigger cut in the marginal lending facility rate reflects the desire to narrow the gap between that rate and the central policy rate in order to limit the potential upward volatility of the money market rates. The interest rate on the marginal lending facility is in fact an absolute ceiling for Eonia. This therefore curbed the periodic peaks in the overnight money market rate in the first half of the year under review, which – in a situation of lower liquidity surplus – indicated that the banks want to conserve liquidity at the end of a month or quarter in order to embellish their financial position.

According to the Eurosystem's forward guidance introduced in July 2013, the policy interest rates will remain low for an extended period in view of the assessment of the economic outlook. That forward guidance has been continuously reaffirmed, and has helped to reduce the interest rate expectations and the uncertainty surrounding them.

Towards more active balance sheet management

Since the summer of 2012, following the adoption of the OMTs and with the prospect of a revision of European economic governance, financing conditions in the euro area had already been getting better, particularly for government securities. That improvement continued in early 2013. Spreads on government bonds became steadily narrower, as did the spreads on private sector instruments, confirming the easing of financial fragmentation. At the same time, the liquidity surplus which had diminished considerably in recent years remained at a relatively low level, indicating that the Eurosystem was playing a smaller role in intermediation, that role being increasingly taken over by the interbank market. Despite these favourable developments, recourse to Eurosystem liquidity remained concentrated on the countries which had been at the heart of the sovereign debt crisis. Bank lending conditions – the most relevant for the transmission of monetary policy to the real economy in the euro area – therefore remained very disparate and relatively restrictive in some jurisdictions. That situation, which reflected a persistent disruption of the transmission of the monetary policy signal to the real economy, threatened the recovery of activity and the maintenance of price stability.

In these circumstances, to maintain access to liquidity for all banks in the euro area and thus bolster lending, the Governing Council announced at its meeting on 5 June that it would continue to conduct the Eurosystem refinancing operations in the form of fixed-rate tenders with full allotment for as long as necessary, and at least until December 2016. It agreed that the central policy rate would continue to apply to the main refinancing operations, and that the interest rates on the longer-term refinancing operations would remain equal to the average of the rates on the main refinancing operations conducted during the period of the operation concerned. Given their minor role in a procedure for granting unlimited liquidity at a fixed rate, the operations whose term coincides with a reserve maintenance period – or around one month – were terminated, while the weekly fine-tuning operations to sterilise the provision of liquidity under the Securities Markets Programme (SMP) were suspended. This last decision had only a small, temporary impact on the liquidity surplus, as it was more than offset by a fall in demand for funds via other operations; that confirms the reduced role of the Eurosystem in intermediation.

Targeted longer-term refinancing operations

The Governing Council also took measures to safeguard the effective transmission of the accommodative monetary policy stance to lending conditions. Thus, June also saw the announcement that the Governing Council would conduct a series of targeted longer-term refinancing operations (TLTROs). These offer banks long-term financing – up to four years – in exchange for new lending to businesses and households, with the exception of home loans. The interest rate on these operations was initially set for the entire duration of the loan at 10 basis points above the rate on the main refinancing operations prevailing at the time of the operation. Thus, subject to certain conditions, the TLTROs make it possible to obtain cheap finance up to September 2018, regardless of the movement in the main policy interest rate.

On the occasion of the first two operations in September and December 2014, banks were allowed to request liquidity up to a maximum of 7 % of their total outstanding loans to the private non-financial sector of the euro area as at 30 April 2014. The additional amounts which can then be borrowed each quarter between March 2015 and June 2016 will depend on the banks' lending activities in excess of the benchmarks defined specifically for each bank. The amounts that institutions can request from the Eurosystem must not exceed three times the difference between the net amount of loans granted since 30 April 2014 and the benchmark at the time of the request. The benchmark takes account of the institutions' need for deleveraging and balance sheet adjustments. Banks which have recently scaled down their lending are therefore encouraged above all to slow the pace at which they shrink their loan portfolio. Banks which fail to meet their

benchmark by 30 April 2016 will be required to repay all their borrowings in full in September 2016.

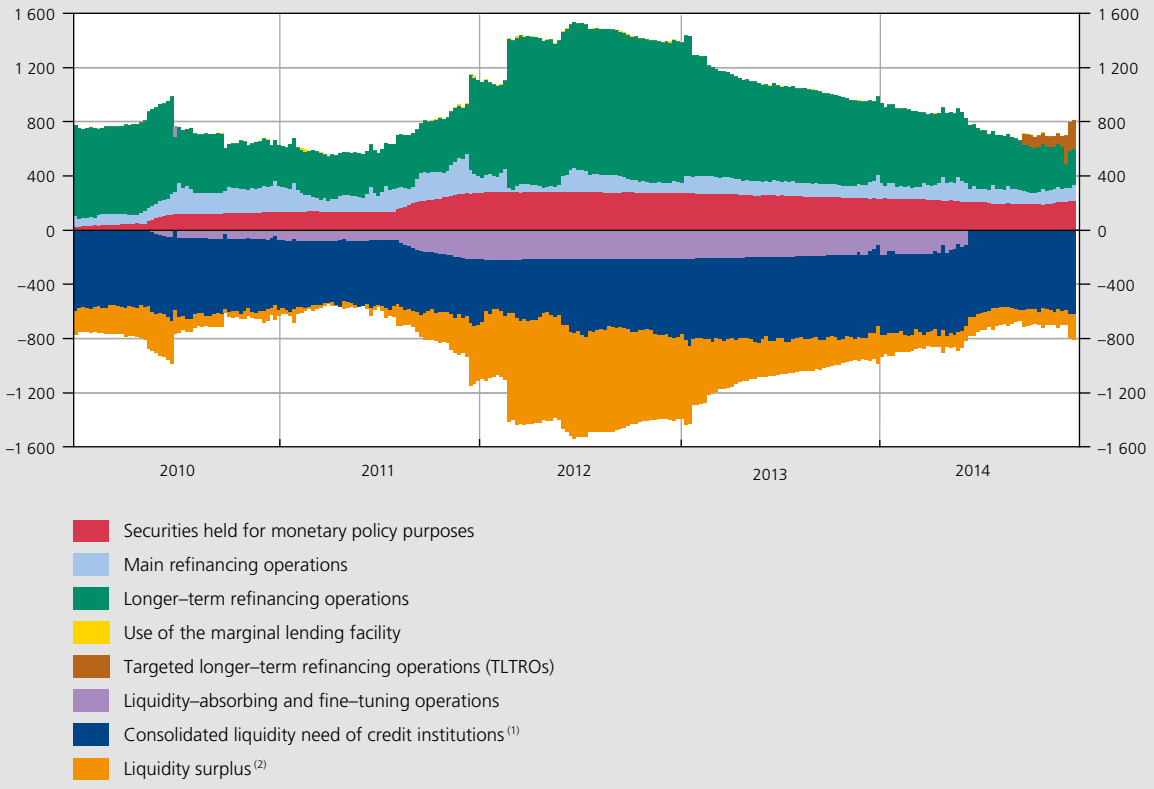
In contrast to the long-term refinancing operations previously introduced by the Eurosystem, these operations thus comprise an incentive mechanism to encourage the banks to ease their credit standards and stimulate their loan volumes. Since these operations are conducted at a fixed rate, they also implicitly signal the Eurosystem's intentions regarding the policy interest rates and its commitment to maintaining an accommodative policy in the future.

Despite fairly advantageous conditions, the demand for liquidity in the first two operations conducted respectively on 18 September and 11 December was at the lower end of the expected range. While the potential cumulative total came to around € 400 billion, only € 212.4 billion was requested. There are two possible reasons for the relatively weak demand for liquidity in the TLTRO. First, the announcement of securities purchase programmes at the beginning of September (see below) may have dissuaded some banks from borrowing, as the prospect of obtaining liquidity under the Eurosystem securities purchase programme may have convinced credit institutions to reduce their demand for liquidity in the refinancing operations. Also, the signs that the recovery was losing momentum in the second half of the year potentially implied a weaker outlook for demand for loans from the real economy, and hence lower financing needs for the banks.

While € 82.6 billion was lent in September, the December figure was € 129.8 billion. This stronger demand at the time of the second operation can be explained in three ways. First, the publication in October of the results of the comprehensive assessment probably gave banks in the euro area more certainty about their balance sheet capacity to expand their lending. Next, as the three-year longer-term refinancing operations (LTROs) conducted at the end

CHART 20 LIQUIDITY IN THE EUROSYSTEM

(outstanding amounts, weekly data, in € billion)



Source : ECB.

(1) Liquidity need due to "autonomous factors" (such as demand for banknotes) and reserve requirements.

(2) The liquidity surplus is equal to the difference between the outstanding amount of the operations leading to the expansion of liquidity – namely the refinancing operations, purchases of securities for monetary policy purposes, and use of the marginal lending facility – and the sum of the outstanding amount of the liquidity-absorbing operations and the consolidated liquidity need of the banking system. It corresponds to the sum of the amounts placed on the deposit facility and on current accounts in excess of the reserve requirements.

of 2011 and in early 2012 and maturing respectively on 29 January and 26 February 2015 offered an interest rate equal to that on the main refinancing operations, namely 0.05 % and 10 basis points below the TLTRO rate, it was advantageous to wait for the second operation to substitute the targeted refinancing for the three-year financing. Finally, some banks may have needed more time to be operationally ready to request funds under the TLTROs.

In accordance with the reduced intermediation role of the Eurosystem, the TLTRO allotments had a limited impact on liquidity. Overall, taking account of the other lending operations conducted by the Eurosystem during the tendering periods and the repayments under the three-year LTROs, liquidity amounting to around € 47 billion, in net terms, was injected as a result of the first operation, while the second provided a net amount of around € 84 billion.

Private sector asset purchase programmes

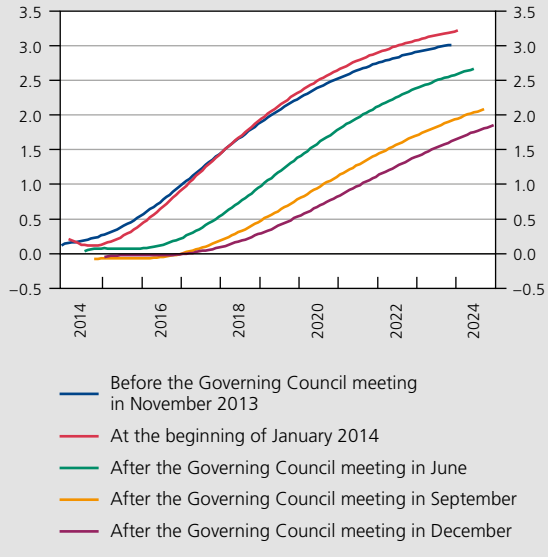
At its meeting on 4 September, the Governing Council considered that it needed to reinforce the measures taken in the spring and ease its monetary policy still further to avert the threats to the recovery and to the anchoring of inflation expectations. It therefore decided to embark on asset purchases, a logical step towards monetary stimulation when interest rates have reached the lower bound. First, after the June announcement that the relevant preparations would be stepped up, it was agreed that the Eurosystem would acquire a large portfolio of simple and transparent asset-backed securities (ABSs), with the underlying assets being claims on the non-financial private sector of the euro area. It was also announced that the Eurosystem would likewise acquire a massive portfolio of euro-denominated covered bonds, issued by banks incorporated in the euro area, under a third covered bond purchase programme (CBPP3). As had already been the case in 2009 and 2011, these securities were targeted because they are key financing instruments for the banks in a number of euro area countries, and because the market is large enough to acquire substantial volumes. Initially, the two programmes were set up for a minimum period of two years with the aim of injecting liquidity into the money market, revitalising the securities markets concerned, stimulating issues and supporting the underlying lending.

The Governing Council said it expected the purchases of securities, in combination with the TLTROs, to have a significant impact on the balance sheet of the Eurosystem. The decision to resort to outright asset purchases in fact gives the Governing Council more direct control over the growth of this balance sheet. The programmes adopted therefore mark a break with the previous situation in which the growth of the monetary base depended mainly on the behaviour of the banks, which determine recourse to euro area liquidity in the context of a full allotment liquidity procedure. Although it did not mention any figures, the Governing Council indicated that the Eurosystem balance sheet was expected to be restored to the size it had been at the beginning of 2012. At that time, just after the two three-year LTROs, the balance sheet exceeded € 3 000 billion, a historically high level and about € 1 000 billion above the September 2014 figure.

All these new measures taken in September show that the Eurosystem is adopting a new approach to strengthen its accommodative monetary stance in an environment where interest rates have reached the lower bound. In such a situation, the monetary policy stance in fact depends on the size and composition of the central bank's balance sheet.

Transactions under the covered bond purchase programme started on 20 October and acquisitions had reached € 29.6 billion by the end of the year. ABS purchases began on 21 November and totalled € 1.7 billion at the end of December. The relatively low volume of ABS purchases can be explained by the fact that there is only a very small market for them.

CHART 21 IMPLICIT EXPECTATIONS REGARDING THE OVERNIGHT INTEREST RATE IN THE EURO AREA (1)



Sources: Bloomberg, NBB.
(1) Measured on the basis of the implicit overnight interest rate derived from interest rates on Eonia swaps with varying maturities.

The Governing Council has constantly and unanimously reaffirmed that, if necessary, it is ready to take new measures to address the risks of an excessively long period of low inflation. In particular, it indicated at its meeting in December 2014 that in early 2015 it would review the degree of monetary easing already attained, as well as the growth of the balance sheet and the outlook for inflation.

The measures adopted in 2014 put downward pressure on nominal interest rates and the exchange rate

The measures adopted in 2014, together with the statements issued by the Governing Council bearing witness to its determination to take new action if necessary, have certainly not been ineffective.

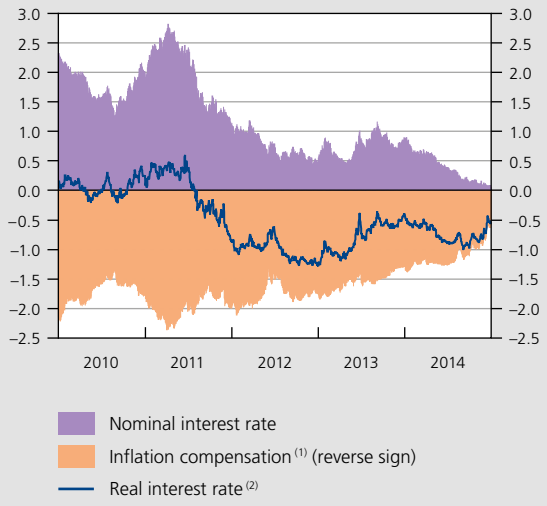
Combined with the forward guidance, the cuts in the key interest rates led to a lowering of expectations regarding the Eonia rate and hence longer-term money market interest rates. The decision to conduct liquidity-providing operations with a maturity of up to four years and the decision to buy assets also reinforced the flattening of the interest rate term structure by lowering expectations in respect of both interest rates and term premiums. Expectations of a possible upcoming reinforcement of the monetary policy measures adopted during the course of the year under review – and most notably the prospect of a further expansion of the securities purchase programmes – fuelled the downward trend in interest rates. Towards the end of the year, the forward rate curve thus reached a historically low level, taking all maturities together. The Eonia rate was expected to remain negative until early 2017 and was unlikely to exceed the current central policy rate, namely 0.05 %, before September of that year. Yields on sovereign bonds of a number of countries, including Belgium, had become negative for maturities up to two years, and had dipped below 0.85 % for maturities up to ten years. The yield on the German ten-year Bund, the benchmark risk-free asset in the euro area, dropped below 0.60 %. The search for yield in a low interest rate environment had also increased the attraction of more remunerative financial products, causing a further decline in risk premiums.

However, since the decline in nominal interest rates largely offset the fall in inflation expectations, real interest rates rose slightly. For example, the five-year interest rate, relevant for private sector decisions on consumption and investment, edged up to –0.5 % during the closing months of 2014 from a trough of –1 % at the end of September.

As regards the later – crucial – stage of monetary transmission, the bank interest rates on new loans to the private sector declined after a long period of relative stability. These developments tally with the responses to the BLS concerning the third and fourth quarters of the year. Questioned about the TLTROs, the banks stated that they

CHART 22 REAL INTEREST RATE IN THE EURO AREA

(5-year swap rate; daily data, in %)

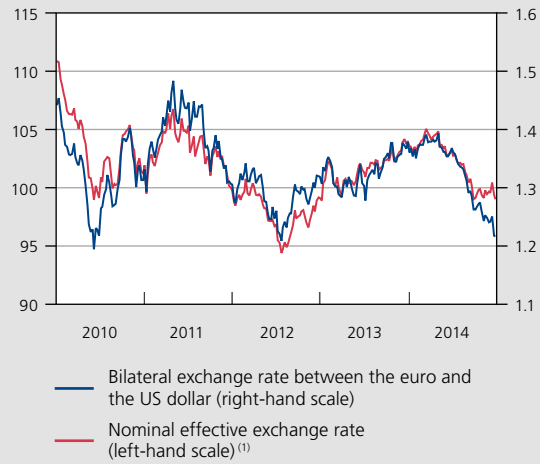


Source: ECB.

(1) Measured on the basis of swap contracts covering the inflation risk in the euro area for a 5-year period.

(2) Calculated as the difference between the nominal interest rate and the inflation compensation.

CHART 23 EURO EXCHANGE RATE



Sources: Thomson Reuters Datastream, ECB.

(1) Nominal effective exchange rate against the 19 main trading partners of the euro area.

were notably going to use the liquidity obtained to ease their lending conditions.

On the foreign exchange markets, the euro depreciated sharply against the dollar and in nominal effective terms against the main trading partners of the euro area. Whereas the euro had appreciated by around 10 % against the dollar between June 2012 and April 2014, reflecting the restoration of confidence in the euro area, it thus fell by as much as 13 % between the beginning of May and the end of December. This picture reveals the effects of the decline in interest rates, pushing investors to rebalance their portfolios in favour of assets in foreign currencies offering higher yields. In that context, the euro's depreciation can be considered welcome in that it should help to drive inflation higher in the euro area and bolster exporters' competitiveness.

Expanded asset purchase programme launched at the beginning of 2015

At the beginning of 2015, the Governing Council noted, on the one hand, that inflation dynamics had turned out to be persistently below expectations. While the main factor behind this trend is the sharp and prolonged drop in oil prices, it felt that there was now a greater risk of second-round effects on wage- and price-setting. This assessment was also corroborated by a further drop in inflation expectations. On the other hand, the Governing Council felt that, beyond their effect of shoring up prices on the financial markets, the monetary policy measures adopted between June and September 2014 had not had the desired quantitative impact. It therefore reached the conclusion that the degree of monetary policy easing was not sufficient to address the risks inherent in an excessively prolonged period of low inflation and that a forceful response was needed.

On 22 January 2015, the Governing Council thus decided to launch an expanded asset purchase programme, encompassing the existing programmes for buying up ABSs and covered bonds introduced in 2014, and also including the acquisition of bonds issued by euro area central governments, agencies and European institutions. The new asset purchases will start in March and will amount to a total of € 60 billion per month. They are expected to be continued until September 2016 and in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its objective. This decision is fully in line with the approach that it has taken since September 2014, which involves more direct control over the size and composition of the Eurosystem balance sheet.

The new purchases will be made on the secondary market, against central bank money. The liquidity obtained in this way will be able to be used by credit institutions to acquire other assets and to lend to the real economy. On top of its direct impact on the interest rates on the bonds acquired, by triggering portfolio reallocations, the asset purchase programme should also have some effect on yields of other assets and help support credit conditions in the entire economy. It also amplifies the signal that the Eurosystem intends to keep its key policy rates low for an extended period of time. And last but not least, the impact on inflationary expectations is reinforced by the explicit reference to the aim of bringing inflation back up to around the 2 % mark.

In addition, the Governing Council has announced that the interest rates applicable to the six remaining TLTROs would be brought down to the rate of the Eurosystem's main refinancing operations (MROs) prevailing at the time when each TLTRO is conducted. This decision to eliminate the 10 basis point spread over the main refinancing operation rate should support the effectiveness of these operations by reflecting the reduction in funding costs for banks that has been observed since the TLTROs were first announced on 5 June 2014.

These two decisions aim to bring about a further and considerable easing of monetary and financial conditions in the euro area. By easing financing conditions, the implementation of the new monetary policy instruments should support consumption and investment in the euro area. The decisions also aim to ensure that inflation expectations remain firmly anchored, in both the medium and long term. It is expected they will help to restore the inflation rate to a level close to 2 %. The box below presents some indications of the potential macroeconomic impact of the recent balance sheet measures on the basis of the effects of the measures adopted between 2008 and 2013.

It must be said that, though monetary policy has an important role, it cannot on its own pave the way back to a sustainable growth path in the euro area. In that connection, the Governing Council has constantly reiterated that, together with monetary policy, the other economic policies must also be activated to help restoring inflation to its target level as quickly as possible.

On the demand side, the Governing Council has insisted that fiscal policy must be coordinated with the macroeconomic situation in the euro area, while complying with the Stability and Growth Pact, as this pact is the anchor point for confidence in public finances, vital for the promotion of private consumption and investment. The

existing rules are flexible enough to deal with the weakness of the recovery and offer some scope for funding structural reforms. On the supply side, as the Governing Council has often repeated, these reforms are essential to improve the operation of product and labour markets and the business environment. They need to encourage investment and economic activity, thus helping monetary policy to produce the maximum effect.

While the Governing Council has given assurances that it would do everything necessary to restore inflation rapidly to around 2 % and thus fulfill its mandate, it has effectively called on all euro area economic policy-makers to shoulder their responsibilities.

Box 4 – Impact of the balance sheet measures adopted between 2008 and 2013 and the role of banking sector capitalisation

The non-conventional measures adopted by the Governing Council in the year under review and at the beginning of 2015, such as the TLTROs and the asset purchases, will have a considerable influence on the size of the Eurosystem balance sheet. The aims of these measures are clear : to facilitate lending to the non-financial private sector and to contribute to the easing of monetary policy. However, it is not easy to assess their specific impact on the economy of the euro area, especially as the euro area has relatively little experience of this type of policy.

Nevertheless, this situation is not entirely new to the Eurosystem, because since the autumn of 2008 various decisions have been approved leading to changes in the size and composition of its balance sheet. Those measures, which aimed to safeguard financial stability and the effective transmission of monetary policy, took various forms, such as the adoption of a procedure for granting unlimited liquidity at a fixed rate, extension of the range of assets accepted as collateral, extension of the maturity of the refinancing operations, and purchases of securities. Among other things, they led to a substantial expansion of the Eurosystem balance sheet amounting to around € 1 800 billion between the end of 2007 and the June 2012 peak. The potential impact on the real economy of the measures taken in 2014 can therefore be estimated according to the impact of the earlier decisions.

An analysis using a structural vector autoregression (SVAR)[1] makes it possible to quantify the dynamic effects of non-conventional monetary policies separately from the effects of conventional policy measures, namely changes in the key interest rates, and to identify their transmission channels. This model was estimated for the euro area and its various constituent countries for the period from January 2008 to December 2013.

For various reasons, the results based on the earlier policy measures must be interpreted with caution in the context of the recent measures. First, the model studies the impact of a general expansion in the size of the Eurosystem balance sheet, without differentiating between the various possible sources. For example, the impact of balance sheet expansion due to purchases of sovereign securities under the SMP cannot be separated from the impact of expansion on the same scale resulting from an extension of the range of collateral accepted or lengthening of the maturity of the refinancing operations. Next, the previous balance sheet measures aimed mainly to ensure the appropriate transmission of monetary policy decisions, whereas the latest measures are intended primarily to ease the policy stance. In addition, between 2008 and 2014, the change in the size of the Eurosystem balance sheet mainly reflected fluctuations in the banks' demand for liquidity, whereas the growth now envisaged will be due more directly to decisions by the central bank concerning the volume of securities that it will purchase. Finally, the model does not include the adoption of the OMTs in the summer of 2012. Although that measure had no impact on the balance sheet as no securities were purchased, its macroeconomic effects may still have been considerable.

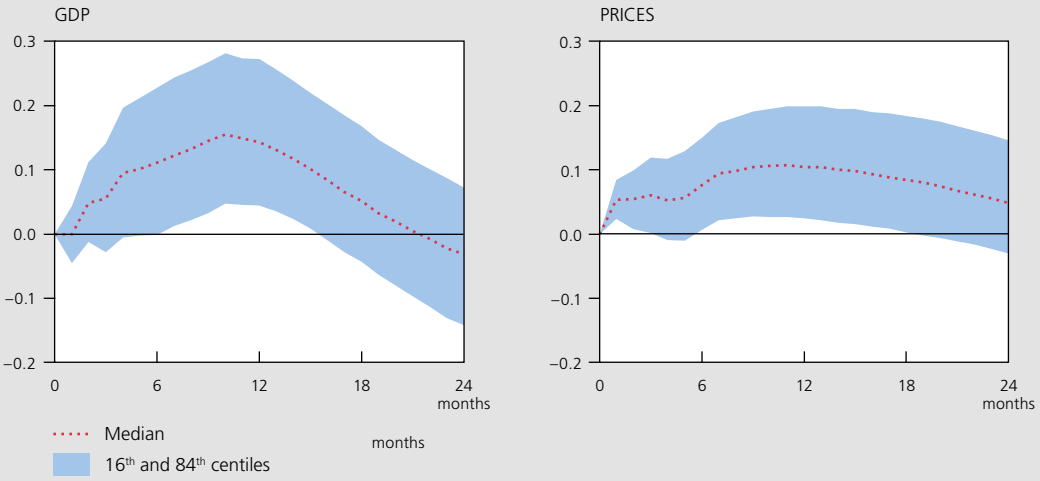
In order to assess the effect on the economy of the expansion of the Eurosystem balance sheet, it is necessary to observe the impulse responses derived from the model. Those responses indicate how the different variables

(1) Boeckx J., M. Dossche and G. Peersman (2014), *Effectiveness and transmission of the ECB's balance sheet policies*, NBB Working Paper 275.

considered change on average over the period in question following an exogenous expansion of the balance sheet due solely to non-conventional policies.

These impulse responses show that non-conventional shocks have a positive effect on economic growth and inflation. More specifically, an unexpected shock of around 2 % of the Eurosystem balance sheet boosts GDP by an estimated 0.15 percentage point and raises prices by up to 0.1 point. It is also evident that this impact is similar in quality to the impact of conventional monetary policies. Finally, the authors show that non-conventional policies seem to act by reducing financial market tension and – via the bank lending channel – by leading to a fall in debit interest rates and growth in the volume of lending.

IMPACT ON GDP AND PRICES OF A POSITIVE SHOCK OF 2 % ON THE EUROSYSTEM BALANCE SHEET
(in %)



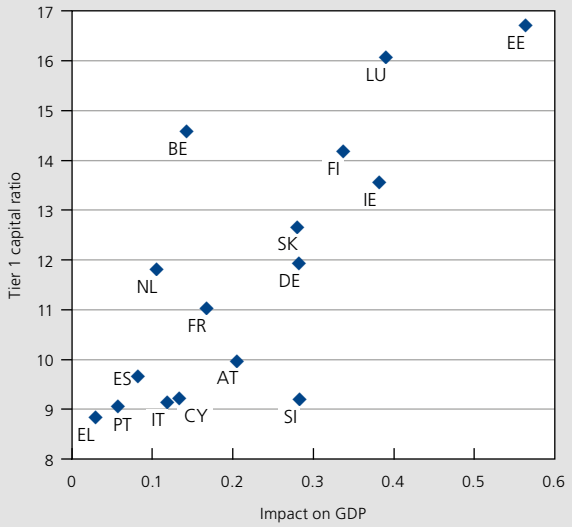
Source: Boeckx J., M. Dossche and G. Peersman (2014).

Although these measures have a clearly positive impact on the GDP of the euro area as a whole, their effect appears to vary from one country to another. In general, the effects of the Eurosystem balance sheet measures are less marked in the countries where, owing to the greater fragility of the banking sector, the transmission of monetary policy via the bank lending channel is less smooth. Less solvent banks appear in fact more risk averse and, when confronted by balance sheet constraints, seem more reluctant to grant loans. There is therefore a strong positive correlation between the maximum impact on a country's GDP of a shock concerning the size of the Eurosystem balance sheet and the average Tier 1 capital ratio of the banking sector in that country.

Since correlation does not necessarily imply causality, these results must be interpreted with caution. However, they are consistent with the movement in bank lending to the non-financial private sector in recent years in the various countries of the euro area. A similar connection is also evident at the level of the debit rates charged by the banks and their capitalisation ratio, which supports the theory that the health of the banking system is crucial to both the volume and the price of lending. The health of the banking system is therefore a vital factor in the transmission of both conventional and non-conventional monetary policy measures, especially as the banking sector plays a major role in the financing of the euro area's economy. The comprehensive assessment of the main banks in the

CORRELATION BETWEEN THE MAXIMUM IMPACT ON GDP OF A EUROSYSTEM BALANCE SHEET SHOCK AND THE TIER 1 CAPITAL RATIO OF THE BANKING SECTOR IN THE EURO AREA COUNTRIES

(in %)



Source: Boeckx J., M. Dossche and G. Peersman (2014).

euro area, conducted jointly by the ECB and the national competent supervisory authorities, thus emerges as a key factor in restoring the efficient transmission of monetary policy, as it identified the institutions with a delicate balance sheet position and encouraged them to reinforce their capital. Against that backdrop, there is reason to hope for a more uniform transmission of the balance sheet measures adopted most recently.

Economic developments in Belgium

2. Economic developments in Belgium

Belgium's gross domestic product (GDP) increased by 1 % in 2014. However, as the year progressed, the recovery that began in 2013 lost pace amidst the weakening economy in the euro area, major geopolitical uncertainties and doubts about the ability of Europe's economies to develop sustainably. Employment showed a tentative recovery, rising by 15 000 units, but the net creation of jobs failed to prevent a renewed increase in the number of job-seekers. Unemployment reached 8.6 % of the labour force as a result. Against the backdrop of weak demand, inflation continued the decline started in 2011. Falling to a year-on-year average of 0.5 %, inflation even reached a low of –0.4 % in December. Whereas the slowing rate of inflation is due to lower energy prices, underlying inflation appeared to be more robust, at 1.5 %. The marked drop in inflation had a significant impact on hourly wage costs, their growth slowing to 0.7 %. According to the Central Economic Council's technical report, the higher cumulative cost of labour in Belgium relative to its three most important neighbouring countries (since 1996) dropped from 4.2 % in 2013 to 2.9 % in 2014. Growth in economic activity in 2014 may be attributed primarily to a pick-up in domestic demand, excluding stock adjustments. Private consumption rose relatively strongly, in tandem with trends in purchasing power. Business investment continued to grow. The current account on the balance of payments increased on the strength of the effect of higher net exports in volume terms.

2.1 Economic situation

Economic activity somewhat slower since the spring

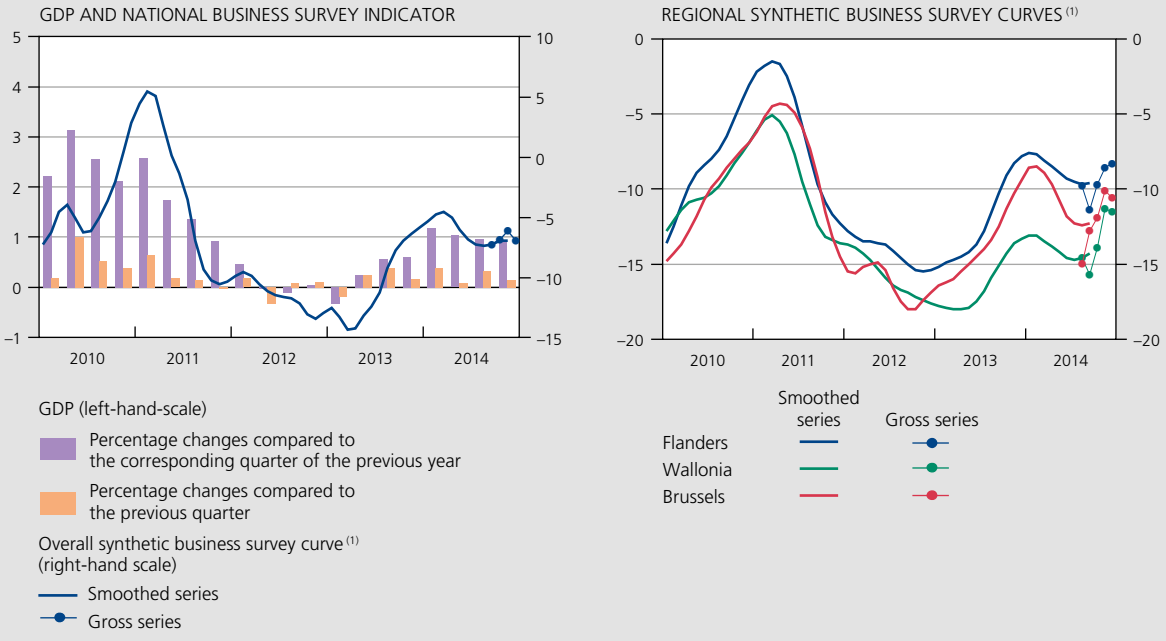
In 2014, economic developments in Belgium were comparable to those in other euro area countries. After two years of virtual stagnation, Belgium's GDP – like that of the euro area – showed clear growth, albeit modest. In volume terms, GDP was up by 1 % on average over the year, compared with very slight increases of 0.1 % and 0.3 % respectively in the previous two years. Growth for the year as a whole may be attributed mainly to increased economic activity at the start of the year, as was the case elsewhere in the euro area. Contrary to expectations, the economic recovery that got underway in the spring of 2013 actually lost pace in the year under review. Quarter-on-quarter growth remained positive, but the rate of growth dropped by almost half, to 0.2 % on average, compared with the first quarter of 2014.

Slackening economic activity during the course of the year gave rise to uncertainty. Business confidence clearly deteriorated in the spring and stabilised at a relatively low level in the summer. Recent months have seen a slight renewed recovery. It is worth noting that the weakening confidence was visible in all three of the country's Regions. The fact that business confidence is lower in Wallonia than in the two other Regions is due mainly to the fact that its economy did not improve as strongly during the short-lived economic upswing of 2013.

The flare-up in uncertainty was a phenomenon shared by Belgium's European partners. It was fuelled by perceptions of increased geopolitical risks, especially in the wake of the heightened conflict in Ukraine in the first half of the year, the subsequent deterioration of relations with Russia and the ever-intensifying clashes in the Middle East. Both in Belgium and in the euro area as a whole, the negative impact on the economy of battered confidence seems to have been stronger than actual trade flows would suggest. These risks may well have stirred up latent doubts about the ability of Europe's economies to show sustainable growth and about the robustness of the global economy against the backdrop of lacklustre international trade.

In Belgium, economic uncertainty does not seem to have had too great an impact on domestic demand, which

CHART 24 GDP IN BELGIUM AND CONFIDENCE INDICATORS



Sources : NAI, NBB.
(1) Balance of replies to the monthly surveys, non calendar adjusted data.

declined markedly less than production. The downturn in production is attributable mainly to the relatively modest growth in exports, which were hard hit by low economic growth, in particular among Belgium's major trading partners. Another factor at play here was the renewed negative effect of stock adjustments. Despite the significant statistical uncertainty of this variable, it seems that in light of the uncertain economic environment, companies did not boost their production volumes as strongly as would otherwise have been possible, considering that domestic demand was still relatively robust.

Decline in market services and industrial sectors

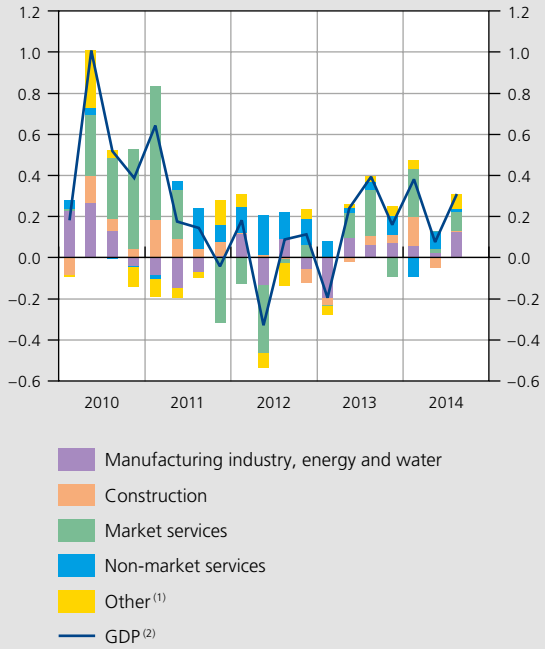
Industry typically responds strongly to changes in actual demand or fluctuations in demand expectations. This sector, which accounts for around 17 % of the Belgian economy's value added, often operates in highly integrated international production chains, making its foreign markets absolutely vital. The manufacturing industry's synthetic business survey indicator may have edged down only slightly and even showed signs of revival by the end of the year, but key sub-indicators, which are more closely correlated with the value added generated by companies in the sector, recorded steeper falls. Demand forecasts, and the assessment of total order books especially, have dipped well below the synthetic indicator, for instance, and industry's value added suffered a temporary dip in growth relative to the increase recorded in the spring of 2013. In the first half of 2014, value added growth in the industry edged down temporarily compared to the increase notched up in the spring of 2013.

The market services sector, which comprises trade, accommodation and food service activities, transport and communication, and financial, real estate and business services, and which accounts for a much bigger proportion of Belgium's total value added – around 52 % – likewise reported a significant economic slowdown from the spring, following a strong first quarter. Trade was hit hardest, but business services also experienced a steep decline in confidence and in demand forecasts.

Economic activity in the construction industry – which has seen its share of total value added gradually edge up in the past few years to reach nearly 6 % in 2014 – was boosted in the first quarter by an exceptionally mild winter. Partly because of this unusually robust first-quarter showing, it subsequently fell, while quarterly value added growth remained weak or negative, as had been the case in the two previous years. Developments in construction are typically

CHART 25 VALUE ADDED OF THE MAIN BRANCHES OF ACTIVITY

(contributions to the change in GDP compared to the previous quarter, unless otherwise stated; volume data adjusted for seasonal and calendar effects)



Source: NAI.

(1) Namely the "Agriculture, forestry and fishing" branch and product-related taxes net of subsidies.

(2) Percentage changes compared to the previous quarter.

dominated by factors specific to the Belgian economy, which nevertheless tend to differ for residential and commercial property and for infrastructure. In that respect, confidence in structural building took a singularly different path from that in civil engineering and road works in 2014. Confidence in the latter sub-sector again deteriorated sharply and continued the trend seen since 2011, in the wake of sharply contracted government investment as part of fiscal consolidation – a factor exacerbated in 2013 and 2014 by the traditional downtrend following local elections. By contrast, confidence in structural building would seem to have stabilised in 2014, in parallel with the tentative recovery in residential housing investment, after a lengthy downward movement (albeit less marked).

Fiscal consolidation at federal and regional levels also restrained value added creation in non-market services in 2014. This sector, which includes education, public administration, health care and social work, typically records strong increases irrespective of economic conditions. This time, however, its growth was weaker than in previous years.

2.2 Labour market

Tentative recovery in employment in 2014

Even though it was fragile, the recovery that started in 2013 had a favourable effect on the labour market. Heightened economic activity first led to improved productivity, as is often the case. Productivity per hour worked increased from the start of the upswing and this improvement was sustained throughout 2014. That said, it was a modest increase given that the level of productivity at the end of 2014 remained below that observed before the crisis, in early 2008. Labour volumes quickly followed suit, rising by 0.4 % on average for the economy as a whole during 2014. This was due mainly to an increase in working hours per person. After this initial increase, however, average working hours edged down. Labour volume growth was therefore reflected in a rise in job numbers of 0.3 %.

The drop in average working hours, particularly pronounced in the second quarter, may be attributed primarily to the construction and manufacturing industries. Additionally, the higher numbers of temp agency workers, who these days are contracted for ever shorter periods, is also resulting in reduced average working hours. To an extent, the fact that employers have increasingly been using temp agency workers since the end of 2013 reflects their reluctance to take on permanent employees in times of economic uncertainty, as well as a need for labour market flexibility.

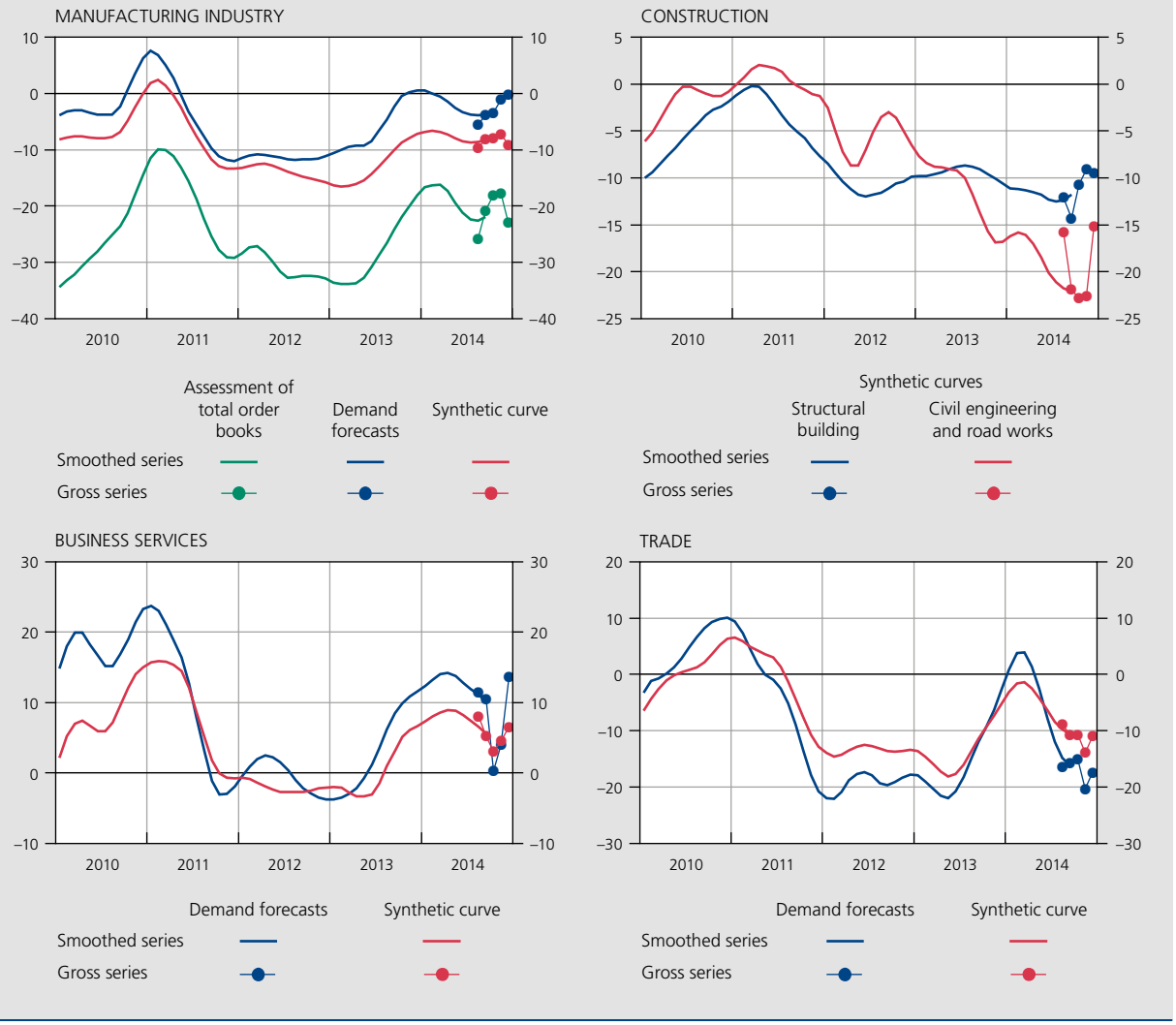
Meanwhile, the number of days of temporary lay-offs came down in 2014 – markedly so at the beginning of the year, continuing a trend that had started to emerge as early as the second half of 2013. Companies had been trimming their workforces in that year in the wake of stagnating economic activity in 2011 and 2012, reducing the number of days of temporary lay-offs. In 2014, employers in branches hit by the embargo on fruit and vegetables exports to Russia compensated for the steep fall in their business by using temporary lay-offs. Companies in the construction sector widely used the same option in the third quarter, citing unfavourable weather conditions in the summer months.

Against this backdrop, domestic employment increased by an average 15 000 people in the year under review, after having recorded a fall of 12 000 people in 2013, that is to say an even stronger decline than during the great recession.

Providing jobs for the majority of all workers, employers in branches of activity sensitive to the business

CHART 26 BUSINESS SURVEY INDICATORS FOR THE MAIN BRANCHES OF ACTIVITY

(balance of replies, seasonally adjusted data)



Source : NBB.

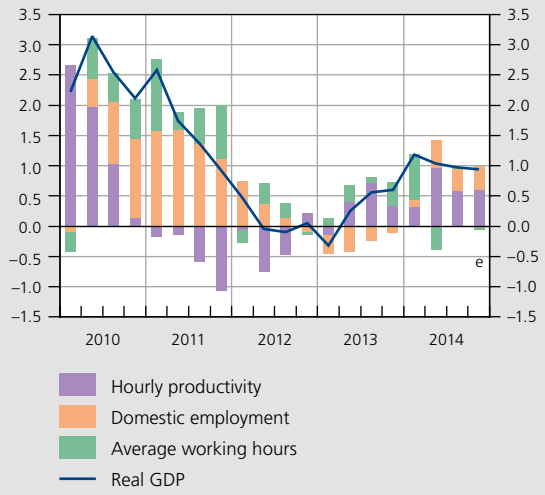
cycle – primarily industry, construction and the market services sector – did not contribute to these higher numbers, cutting 1 800 jobs. In 2013, these industries saw over 23 000 jobs lost. Trends nevertheless diverge within this group. So, companies in industry, construction and financial services reduced their workforces by 12 900, 6 400 and 1 200 in the first three quarters of 2014, with industry thus confirming a strong downward trend and financial services continuing the decline that had started in 2002. Conversely, workforce numbers in market-services companies, comprising temporary work and a significant proportion of service voucher jobs, were up by 17 100. Of these new jobs, nearly 4 000 are estimated to come under the service voucher scheme. However, the scheme's growth looks to be decelerating due to a gradual saturation of demand and the higher hourly cost to its users, as well as the recruitment problems facing providers of these services (see Box 5).

In 2014, the highly subsidised activities that make up "other services" (primarily health care and social services) further contributed to rising employment by adding 9 600 jobs.

By contrast, in the "public administration and education" branch, job numbers stagnated, as budgetary measures resulted in a proportion of employees not being replaced upon retirement.

CHART 27 EMPLOYMENT, WORKING TIME AND PRODUCTIVITY

(contribution to annual growth of GDP, percentage points, data adjusted for calendar effects)

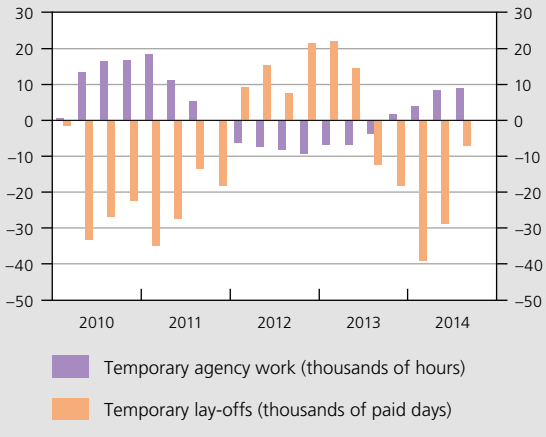


Sources: NAI, NBB.

Lastly, self-employment grew faster than average at around 1 %, corresponding to 7 300 extra people. This is in keeping with the consistent increase in self-employment as a share of employment since 2008.

CHART 28 TEMPORARY AGENCY WORK AND TEMPORARY LAY-OFFS

(changes compared to the corresponding quarter of the previous year)



Sources: Federgon, NEO.

Job creation failed to prevent unemployment from inching up

2014 witnessed a continuation of the gradual slowdown in growth of the working age population seen since 2007, with an increase of 10 500 people as compared with record growth of 70 200 in 2007. The labour force grew by 28 900 people in the year under review, at a faster pace than in the two previous years. But the modest upturn in employment was not enough to absorb the growth of the labour force, and joblessness rose further. A total of 14 000 extra job-seekers were recorded, an increase that was well below the 2013 surge. On annual average, though, the 600 000 jobless mark was nearly breached in 2014.

This upsurge was visible in the harmonised unemployment rate, which, at 8.6 %, has reached its highest level since 1999. Based on the labour force survey and the definitions of the International Labour Office, this indicator expresses the relationship between the number of job-seekers – i.e. unemployed people available for work and actively looking for jobs, regardless of whether they are registered as benefit claimants with the National Employment Office (NEO) – and the labour force. In November 2014, the Belgian unemployment rate was 3 percentage points below the figure for the euro area. However, the euro area rate – though diverging strongly between countries – has been on a downward trajectory since the start of 2013, whereas Belgium's unemployment levels have remained virtually static.

The rise in administrative unemployment varies across the country's three Regions. If year-on-year changes are taken into account – in order to iron out seasonal effects –, the number of job-seekers grew strongest in Flanders in 2014, in both absolute and relative terms. Wallonia, by contrast, has been seeing a gradual reduction in the number of unemployed job-seekers since the middle of 2014. In December 2014, Flanders recorded nearly 252 000 job-seekers, Wallonia 230 000 and Brussels 108 000.

Youth unemployment declined in the year, after shooting up in 2012 and 2013. As in the past, the young were quicker to benefit from recovering growth, while they had been hit first by the crisis because of their lack of experience. That said, there were still 111 000 unemployed job-seekers under the age of 25 by December 2014, accounting for nearly one-fifth of the total.

In contrast, the over-50s age group among unemployed job-seekers continued to swell, if slightly more moderately than before, continuing the trend started in the early 2000s. To a degree, the rise reflects successive

TABLE 4 LABOUR SUPPLY AND DEMAND

(calendar adjusted data; annual averages, unless otherwise stated)

	2010	2011	2012	2013	2014 e
	(percentage change)				
Labour volume in hours	1.0	2.2	0.4	–0.1	0.4
Domestic employment in number of people	0.7	1.4	0.3	–0.3	0.3
	(change in thousands of persons)				
Population of working age	55.3	45.3	21.9	12.0	10.5
Labour force	44.7	42.9	27.9	11.5	28.9
National employment	31.0	62.8	13.5	–13.0	14.9
Frontier workers	0.8	–0.3	0.3	–0.7	–0.1
Domestic employment	30.2	63.0	13.2	–12.4	15.0
Employees	23.9	53.3	4.3	–19.1	7.8
Cyclical sectors	2.5	31.8	–7.5	–23.4	–1.8
Agriculture	0.2	0.6	0.1	1.4	0.3 (2)
Manufacturing	–18.9	–1.3	–6.3	–12.4	–12.9 (2)
Construction	1.0	4.0	–0.5	–5.5	–6.4 (2)
Market services	20.3	28.5	–0.9	–6.9	15.9 (2)
Public administration and education	7.5	3.8	–1.6	2.2	0.0
Other services	13.9	17.8	13.4	2.1	9.6
p.m. Service vouchers	*15.2*	*11.5*	*8.1*	*8.5*	*5.2*
Self-employed	6.3	9.7	8.8	6.7	7.3
Unemployed job-seekers	13.7	–19.8	14.5	24.6	14.0
p.m. Harmonised unemployment rate (1)	*8.4*	*7.2*	*7.6*	*8.5*	*8.6*

Sources: DGS, NAI, NEO, NBB.
(1) In % of the labour force between 15 and 64 years.
(2) Average of the first three quarters, according to the NAI.

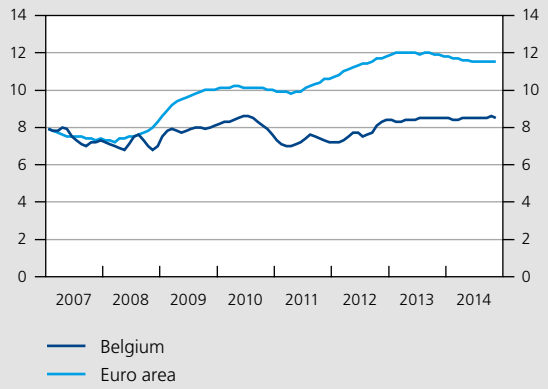
tightening of the criteria granting older unemployed people exemptions from looking for work. The minimum exemption age has gone up from 50 in 2002 to 60 in 2013. From 1 January 2015, all unemployed people, irrespective of age, will be subject to the same rules governing availability and active job-searching. Exemptions will continue to apply to people who were registered as unemployed and had turned 60 before the end of 2014. In December 2014, Belgium recorded 145 000 unemployed job-seekers aged 50 and over, 60 000 of them in Flanders, 62 000 in Wallonia and 23 000 in Brussels.

The number of unemployed workers receiving an employer top-up has edged down slightly since 2010. This trend continued into 2014, with the overall number standing at 100 000 in November, compared with 118 000 in early 2010. Under the October 2014 coalition agreement, the eligible age for the scheme will go up to 62 from 60 with effect from 1 January 2015, and for restructuring companies from 55 to 60 years of age from 2017. The social partners have agreed a government-approved option to deviate from these new rules until the end of 2017, provided they do so in a collective labour agreement (CLA) before 30 June 2015. By the same token, companies can also agree to postpone the increase from 55 to 60 of the eligible age for taking end-of-career time credit.

In keeping with the steady increase in the share of older unemployed workers, there has been an uninterrupted rise in long-term unemployment since mid-2013, as measured by the number of unemployed job-seekers looking for work for two years or longer. Unlike other categories of unemployed people, this group did not see the upward trend decelerate but rather pick up in the year under review. By December 2014, the long-term unemployed accounted for over one in three job-seekers

CHART 29 HARMONISED UNEMPLOYMENT RATE IN BELGIUM AND THE EURO AREA

(seasonally adjusted monthly data, in % of the labour force, aged 15 and over)

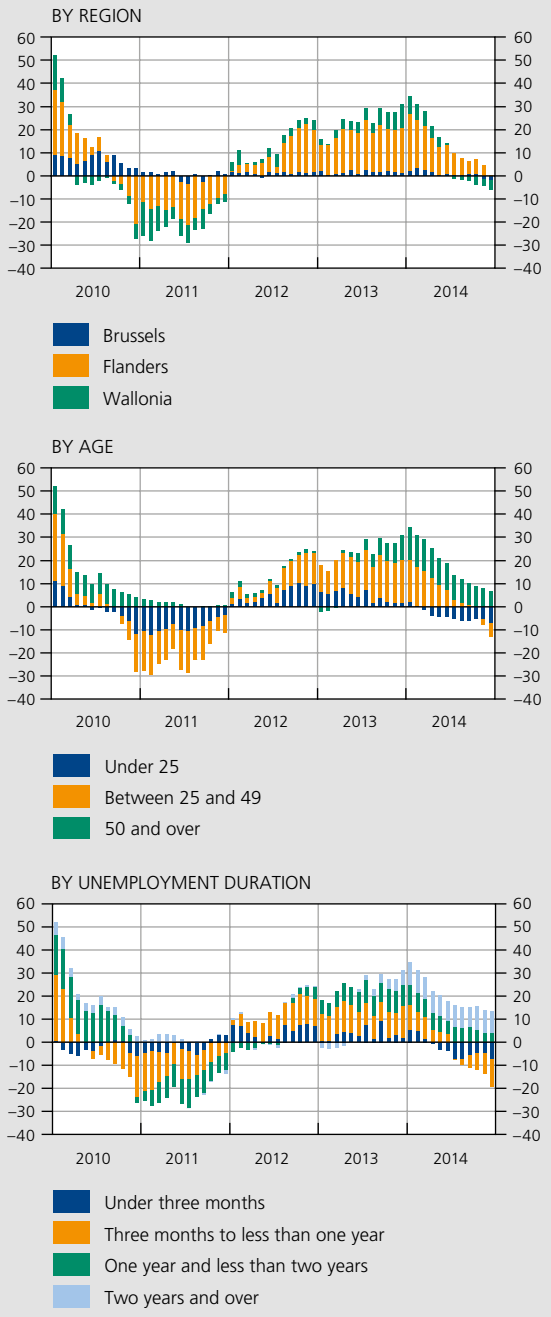


Source: EC.

and totalled 211 000. In terms of knowledge, skills and attitudes, these people are the furthest removed from the labour market and the hardest to re-employ, even when economic activity revives. Slower unemployment growth in the year under review is primarily attributable to a fall in very short-term unemployment (under three months) and short-term unemployment (between three months and less than a year). If these trends continue, structural unemployment might rise and depress the economy's growth and employment potential.

CHART 30 UNEMPLOYED JOB-SEEKERS IN BELGIUM

(changes in thousands of people compared to the corresponding month of the previous year)



Source: NEO.

Box 5 – The development of the service voucher scheme

The service voucher scheme, which was introduced by the Law of 20 July 2001 and came into effect on 1 January 2004, aims to promote neighbourhood services and jobs, these being primarily held by low-skilled workers, and to regularise some of the work done in the shadow economy. Under the scheme, private individuals buy home help services from authorised companies and pay with special vouchers that they buy from the voucher issuer. Authorised companies return to the issuer all vouchers paid to these employees for the hours worked, for which they are reimbursed. The amount reimbursed equals the nominal value of the service vouchers, plus an addition from the government to defray the cost to the employer of one hour of work as well as structural costs, such as administrative expenses and supervision of the employees.

Service vouchers were initially priced at € 6.20, an amount that has been incrementally raised since 2004 to reach € 9 in 2014 for the first 400 vouchers purchased and € 10 for any subsequent purchases. Voucher users enjoy tax breaks, calculated at a tax rate of 30 % (so they end up paying only € 6.30 for a € 9 service voucher). Since 1 January 2014, the tax deduction on service vouchers has been capped at € 1 400 per person a year. Authorised companies receive a total of € 22.04 per voucher, implying that the government pays € 13.04 (or € 12.04 as the case may be) towards every voucher used. In its 2013 annual review, Idea Consult put the total gross costs of the scheme in 2012 at € 1.8 billion (0.5 % of GDP). Factoring in the direct payback effects – the unemployment benefits that do not need to be paid, social security contributions and income taxes levied on employee wages – in addition to the indirect first-order effects such as tax receipts from supervisory staff, takes around 45 % off the cost.

NUMBER OF EMPLOYEES IN THE SCHEME AND SERVICE VOUCHER PRICES

	Number of employees (annual averages, in thousands)	Price of a service voucher (on 1 January, unless otherwise stated, in €)
2004	3	6.2 – 6.7 (1)
2005	12	6.7
2006	24	6.7
2007	37	6.7
2008	56	6.7 – 7.0 (2)
2009	74	7.5
2010	90	7.5
2011	101	7.5
2012	109	7.5
2013	118	8.5
2014 e	123	9.0

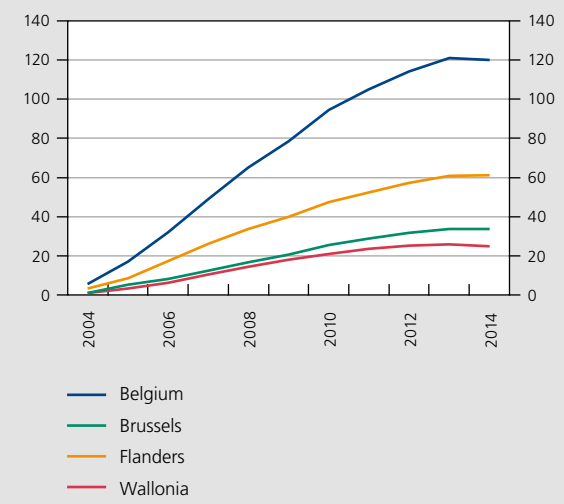
Sources : NSSO, NEO, NBB.
(1) Raised in November 2004.
(2) Raised in May 2008.

The number of workers paid under the scheme has steadily risen from an average of 3 000 in 2004 to 118 000 in 2013 according to the latest data provided by the National Social Security Office (NSSO) and to 123 000 in 2014 under the NBB's forecasts, continuing the slowdown in jobs growth that started in 2010. In the early days, a large proportion of jobs thus created replaced work in the informal economy or were a conversion of services previously provided by local employment agencies, and the net effect on employment was less than it is today. Idea Consult reports that a majority of these workers are women (97 %), one-fifth are under 30 years of age and another one-fifth 50 or over. The workforce breaks down into 56 % low-skilled – a primary school certificate or lower secondary school at most – and 40 % medium-skilled. Lastly, nearly three in four workers are Belgian nationals, with 20 % nationals of another EU27 country and 8 % from outside the EU27.

The total volume of hours worked under the scheme, as measured by the number of reimbursed vouchers according to NEO statistics, has exploded since its implementation, from 6 to 121 million for Belgium as a whole in 2013, with Flanders accounting for the bulk (61 million hours). However, the rise in the volume of work has been slowing down for years, because of gradual demand saturation and the increase in the price users pay per hour. In 2014, for the first time, the number of reimbursed service vouchers even declined slightly.

NUMBER OF REIMBURSED SERVICE VOUCHERS

(in millions of units)



Source : NEO.

Following the sixth State reform, the Regions were put in charge of the service voucher scheme. They have the power to authorise the service voucher companies located in their territories, decide what activities they will allow under the scheme and set the price of the service vouchers, including the tax deduction percentage. To ensure continuity of the scheme, the NEO will run it until the Regions are operationally able to take over.

2.3 Inflation and labour costs

Consumer price trends

Inflation even slower in 2014…

During the year under review, inflation measured by the year-on-year change in the harmonised index of consumer prices (HICP) declined for the third year running, averaging 0.5 % in 2014, compared with 1.2 % in 2013 and even dipping to –0.4 % in December. Having begun in the closing months of 2011 and due mainly to the fall in energy prices, the downward trend was accelerated by moderating food prices. Underlying inflation, by contrast, went up a little on the back of higher services prices.

The fall in total inflation in Belgium is largely in line with European trends, and in the past two years it has closely mirrored those in the euro area or the average of the three main neighbouring countries, which serves as a benchmark for calculating the wage norm. However, this comparable overall figure is the result of a much sharper fall in consumer energy prices in Belgium, whereas the modest 0.1 percentage point increase in underlying inflation contrasts with an equally large fall on average in the three neighbouring countries.

…despite persistent underlying inflation trends…

While underlying inflation, as measured by the HICP excluding food and energy, has steadily moved down in the three main neighbouring countries since the last quarter of 2013, Belgium saw it accelerate in the first six months of 2014, in line with a trend that had started in the third quarter of the previous year. Underlying inflation did come down in the second half of the year, but remained quite a bit higher than the average for the neighbouring countries. Taken over the full year, these percentages worked out at 1.5 % in Belgium, compared with 1 % in the neighbouring countries. In 2013, they stood at 1.4 % and 1.1 % respectively.

The (albeit very slight) revival of the underlying inflationary tendency in Belgium reflected rising services prices, which added 2.3 % in 2014, compared with 1.9 % in 2013. Non-energy industrial goods, by contrast, saw underlying inflation edge down to 0.5 % from 0.8 %.

TABLE 5 HARMONISED INDEX OF CONSUMER PRICES AND LABOUR COSTS

(percentage changes compared to the previous year)

	2010	2011	2012	2013	2014	*p.m. Three main neighbouring countries*[1] *2014*
HICP	2.3	3.4	2.6	1.2	0.5	*0.7*
Energy	10.0	17.0	6.0	–4.6	–6.0	*–1.6*
Unprocessed food[2]	3.5	0.2	3.4	4.4	–1.3	*–0.9*
Processed food	1.0	3.1	3.1	3.2	2.2	*1.6*
Underlying inflation[3]	1.1	1.5	1.9	1.4	1.5	*1.0*
Non-energy industrial goods	0.8	1.0	0.9	0.8	0.5	*0.1*
Services	1.4	1.9	2.5	1.9	2.3	*1.6*
p.m. Health index[4]	*1.7*	*3.1*	*2.7*	*1.2*	*0.4*	–
p.m. National index	*2.2*	*3.5*	*2.8*	*1.1*	*0.3*	–
Labour costs in the private sector						
Per unit of output	–0.6	2.5	4.0	2.2	0.0 e	*1.4*[5]
Per hour worked	0.8	2.3	3.2	2.4	0.7 e	*1.9*[6]

Sources: EC, OECD, CEC, DGS, NAI, NBB.

(1) As in the other tables and charts in this section: HICP, weighted average based on private consumption; labour costs, weighted average based on GDP.

(2) Fruit, vegetables, meat and fish.

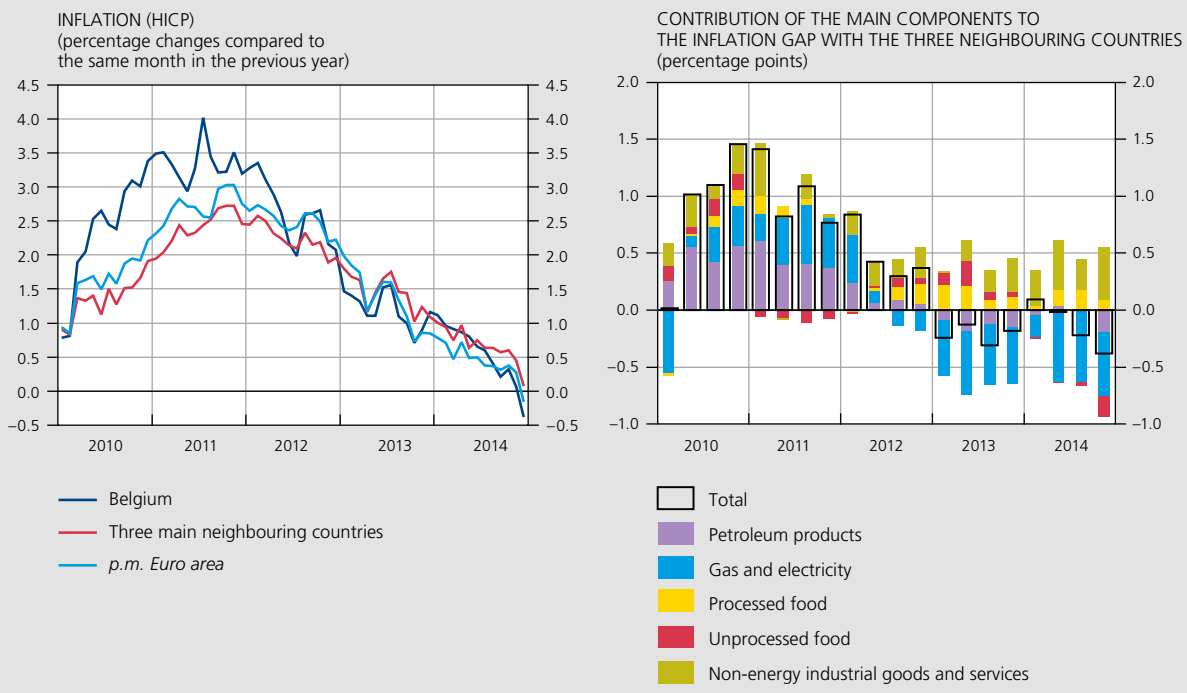
(3) Measured by the HICP, excluding food and energy.

(4) National consumer price index excluding products deemed harmful to health, i.e. tobacco, alcoholic beverages, petrol and diesel.

(5) Average of the first three quarters; business sector (NACE sectors B to N); source: EC.

(6) Annualised CEC estimate.

CHART 31 INFLATION IN BELGIUM AND IN THE THREE MAIN NEIGHBOURING COUNTRIES



Sources: EC, NBB.

This latter downward movement mirrors the prevailing gloomy economic climate in Belgium and Europe, as industrial goods prices are more sensitive to international trends than services prices. These prices are a slightly watered-down reflection of lower import prices – regardless of whether imports are used immediately or serve as input for goods intended for consumption – and unit labour costs.

Slowing unit labour costs benefit service providers even more than manufacturers of goods. However, whether any cost gains are passed on to consumer prices depends on companies' approach to margins. Wage moderation can help rebuild margins, particularly if these have recently narrowed, as had been the case between 2011 and 2013. With non-energy industrial goods subject to more international competition, opportunities for bolstering margins are fewer than for services. It would seem that the latter sector is the main contributor to the rigidity of the underlying trend, coupled with wage cost trends that are more pronounced than in the three main neighbouring countries.

Services whose prices have contributed to higher underlying inflation include volatile categories such as tourist trips and hotels and restaurants, with the latter accounting for a larger weighting in Belgium's HICP than the average for neighbouring countries. In 2014, numerous councils also raised the rates of some price-regulated services, such as waste collection and waste water treatment. Meanwhile, the HICP category related to residential maintenance reflected the increased prices for service vouchers from January 2014. And then there are a lot of services whose prices are routinely linked to the general consumer price index, the health index or other benchmarks, and which reduces the transmission of price dynamics onto underlying inflation.

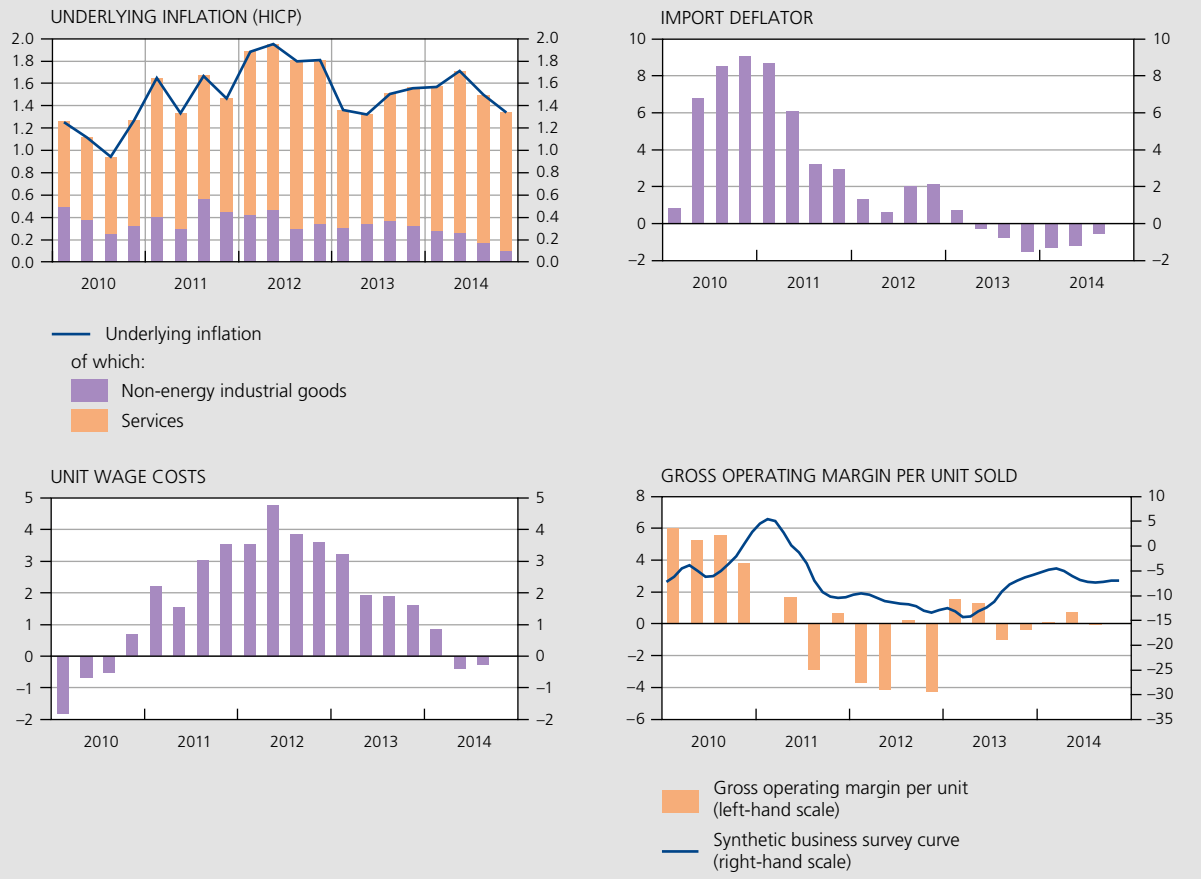
Lastly, underlying inflation was also influenced by a number of methodological changes, particularly relating to the registration of rent payments. These adjustments aim to provide a better view of implicit price increases when new leases are signed, in addition to rent being linked to the health index as is the case with existing contracts.

… related to food prices

Unprocessed food claims but a modest weighting in the HICP basket, and yet the 0.7 percentage point drop

CHART 32 UNDERLYING INFLATION AND COSTS

(percentage changes compared to the previous year)



Sources: EC, NBB.

in inflation in 2014 is mostly down to this category. Prices here fell by 1.3 % on average, compared with a hefty 4.4 % increase in 2013. Two factors came into play: supply conditions were not as dreadful in 2014 as they had been in 2013, as fruit and vegetable harvests benefited from favourable weather conditions. Secondly, a proportion of food exports intended for Russia ended up on the Belgian market because of the Russian embargo on food imports, pushing down prices.

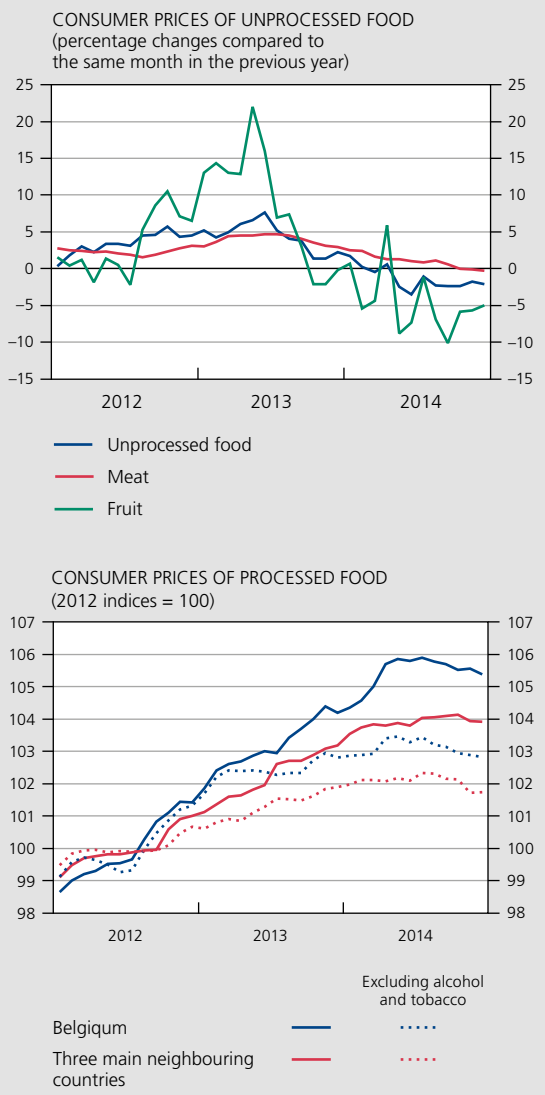
Price rises for processed food also slowed in 2014, to 2.2 % from an average 3.2 % in 2013 or, excluding alcohol and tobacco, whose prices are heavily influenced by changes in excise duty, from 2.4 % to 0.7 %. However, the pricing of processed food in Belgium continues to be asymmetrical. After the renewed upswing in international food commodity prices in 2012, Belgium had recorded steeper food price increases than neighbouring countries, adversely affecting the inflation gap in 2013. Yet the reverse did not happen when food commodity prices started to come down in the course of 2013. Ignoring alcohol and tobacco, this led to an unfavourable effect of 1.1 percentage points in 2013, while the same gap worked out at barely 0.1 percentage points in Belgium's favour in 2014, despite lower commodity prices and the impact of base effects.

Energy prices still on a downward path …

Energy retail prices slid by a further 6 % in 2014, following a significant 4.6 % fall in 2013. In Belgium, this downward trend had been fuelled both by price swings in oil-derived products – as also seen in the neighbouring countries – and a reduction in retail prices for gas and electricity, which was more specific to Belgium.

In 2014, prices per barrel of Brent continued their downward trajectory for the second year running, falling by an

CHART 33 CONSUMER PRICES OF FOOD



Source: EC.

average 9 % (annualised) in the wake of lower US dollar prices. On average, the euro exchange rate against the dollar stayed close to its 2013 level. Prices for oil-derived energy products such as heating oil and motor fuels declined by 7.1 % and 3.7 % respectively. Consumer prices for all these products displayed similar trends in the main neighbouring countries.

However, other retail energy resources contributed greatly to narrowing the inflation gap with neighbouring countries. Retail gas prices reflected the sharp falls in market prices for gas, which since 2013 have served as the benchmark for the quarterly index-linking of variable-price contracts offered by gas suppliers. As a result, gas prices have fallen by an average 5.6 % per year, compared with barely 0.4 % in the three neighbouring countries. In its December 2013 Pact for Competitiveness and Employment, the government had moved to cut the VAT rate on household electricity to 6 % from 21 %, effective from April 2014. This measure, whose direct impact on electricity prices works out at –12.4 %, has vastly accelerated the rate reductions linked to lower prices on the international electricity markets. Retail electricity prices nosedived by an average 9.6 % in 2014, but would have gone down by a mere 1.5 % had the old VAT rate stayed in place. In the neighbouring countries, electricity prices have gone up by 2.9 % on average – admittedly less than in 2013. Rate rises in Germany were primarily to blame, as a higher tax was levied to finance subsidies for energy generation from renewable sources.

… and having a moderating effect on the health index

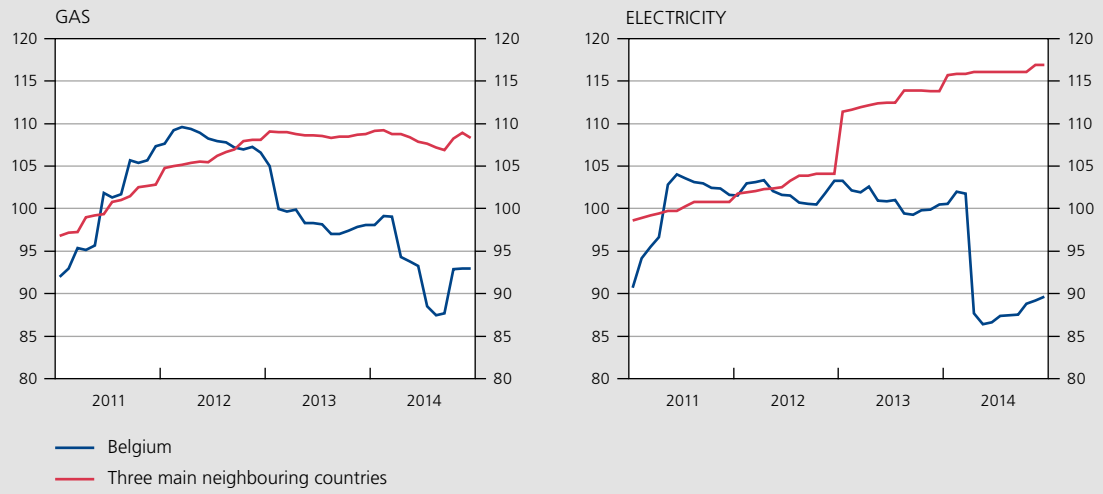
Although the health index basket excludes motor fuels – as it does alcohol and tobacco – in order to limit the effects of excise duties and, above all, oil shocks, it does include other energy products. As a result, the index, which is used for the automatic indexation of not just wages and social benefits and contributions but also of the prices of a number of services, remains highly sensitive to fluctuations in energy prices – all the more visible in the year under review, when gas, electricity and heating oil recorded massive price falls. On average, then, the health index barely rose, by 0.4 % on average in 2014. This compares with 1.2 % in 2013, which had already seen significant declines on the two previous years.

As it is derived from the national consumer price index (NCPI), the health index was also influenced by the methodological changes that came into effect in January 2014 as part of the complete overhaul of the NCPI. In addition to an extensive review of the basket of products and their weights to better reflect today's consumer patterns, NCPI now also factors in consumer tendencies to switch to cheaper product ranges, yet the basket of products is unchanged throughout the year. Methods for recording rent and telecom services rates were likewise adjusted. These reforms did not fail to affect the health index, particularly in the twelve months after their implementation, but their precise impact cannot be estimated on the basis of current data releases. The methodological changes are described in greater detail in an article published in the NBB's June 2014 Economic Review[1].

(1) Langohr J. (2014), "The new national consumer price index", NBB, *Economic Review*, June, pp. 45-60.

CHART 34 GAS AND ELECTRICITY CONSUMER PRICES

(2011 indices = 100)



Source: EC.

Labour costs

Nominal growth of labour costs slows

The marked decline in inflation, and more specifically the health index, had a major impact on labour costs in 2014. Hourly labour costs in the private sector recorded a much slower increase in growth to an average 0.7 % in the business sector as a whole, compared with 2.4 % in 2013 and 3.2 % in 2012. Public sector pay was much the same. With no indexation in 2014 as the key index has not been exceeded since the end of 2012, hourly labour costs rose by a mere 0.8 % in 2014, whereas they had gone up 3.1 % in 2013.

Much as in the public sector, private sector labour cost increases primarily reflect automatic indexation, which worked out at 0.7 % in 2014, below the levels of the three previous years. Given the time lags relating to the indexation mechanisms applied by the relevant joint committee, the significantly lower increase in the health index since the end of 2013 proved the key determinant for average wage indexation. And the index's more rapid slowdown since the second quarter of 2014 has yet to be fully reflected in wages.

The real agreed adjustments in the private sector are governed by a Royal Decree freezing real wage increases for 2013-2014. As had already been the case for the previous two-year period, the government pushed through the draft interprofessional agreement that some unions had refused to approve. While a margin of 0.3 % had been available in 2012 for agreed adjustments in excess of indexation, that margin was set at 0 % for 2013 and 2014, the aim being to narrow the wage gap with the three main neighbouring countries.

The "wage drift and other factors" item covers increases and bonuses granted by companies in excess of the interprofessional and sectoral collective bargaining agreements (including pay-scale increases), the effects resulting from changes in the employment structure, and measurement errors. On balance, these factors were neutral in 2014.

Employers' contributions had a similarly neutral effect on labour costs. With previously agreed measures to reduce labour costs coming into force or being expanded, the scale of cuts in social security contributions increased by nearly € 200 million to € 5.7 billion, or 3.7 % of the total private sector wage bill. Overall, these measures had a slight downward effect on labour cost trends.

With measures to reduce payroll tax not significantly different in 2014, these did not substantially affect changes in total labour costs. Accounting for € 2.7 billion or 1.8 % of the total private sector wage bill, they comprise a general reduction together with subsidies designed to

TABLE 6 LABOUR COSTS

(calendar adjusted data; percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e
Labour costs in the private sector					
Gross hourly wages	0.8	2.6	3.2	2.5	0.8
Collectively agreed wages[1]	0.7	2.7	3.0	2.0	0.7
Real agreed adjustments	0.1	0.0	0.2	0.1	0.0
Indexations	0.6	2.7	2.8	1.9	0.7
Wage drift and other factors[2]	0.0	–0.1	0.1	0.5	0.1
Employers' social contributions[3]	0.0	–0.3	0.1	–0.1	–0.1
Social security	0.0	0.1	–0.1	–0.1	0.0
Other contributions[4]	0.0	–0.4	0.1	0.0	–0.1
Hourly labour costs in the private sector	0.8	2.3	3.2	2.4	0.7
p.m. Unit labour costs in the private sector	*–0.6*	*2.5*	*4.0*	*2.2*	*0.0*
Hourly labour costs in the public sector	1.7	3.8	3.9	3.1	0.8
of which: indexations	0.5	2.7	2.5	2.3	0.0
Hourly labour costs in the economy as a whole	1.0	2.6	3.4	2.5	0.7

Sources: General notes on the budget; FPS Employment, Labour and Social Dialogue, NAI, NSSO, NBB.

(1) Wage increases fixed by joint committees.
(2) Increases and bonuses granted by companies over and above those under interprofessional and sectoral collective agreements; wage drift resulting from changes in the structure of employment, and errors and omissions; contribution to the change in labour costs, percentage points.
(3) Contribution to the change in labour costs resulting from changes in the implicit social security contribution rates, percentage points.
(4) Actual social contributions not paid to the government, including premiums for group insurance, pension funds or occupational pension institutions, and imputed contributions, including redundancy pay.

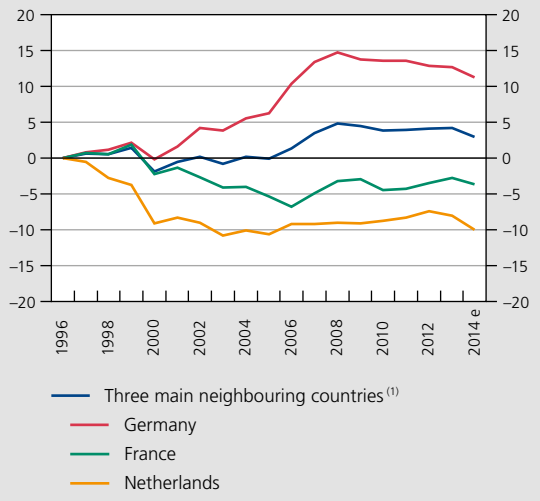
support R&D activities and certain specific forms of employment, such as shift work, night work and overtime. According to the national accounts methodology, these reductions are recorded as subsidies and are not deducted directly from labour costs.

Wage gap narrows on favourable productivity and, to a lesser degree, hourly labour cost trends

According to the technical report released by the Central Economic Council (CEC) secretariat, the wage gap with Germany, France and the Netherlands – Belgium's three main neighbouring countries and its key trading partners – narrowed to 2.9 % after having risen by 4.2 % between 1996 and 2013. This wage gap, called the "wage handicap" in Belgium, is mostly down to the cumulative difference of over 10 % compared with wages in Germany, as trends in labour costs were much less significant in Belgium than in France or the Netherlands. None of these figures – either in Belgium or in its three neighbours – allow for the effect of wage subsidies that the Belgian government will review in consultation with the social partners.

CHART 35 BELGIUM'S WAGE HANDICAP IN TERMS OF HOURLY LABOUR COSTS IN THE PRIVATE SECTOR, ACCORDING TO THE CEC

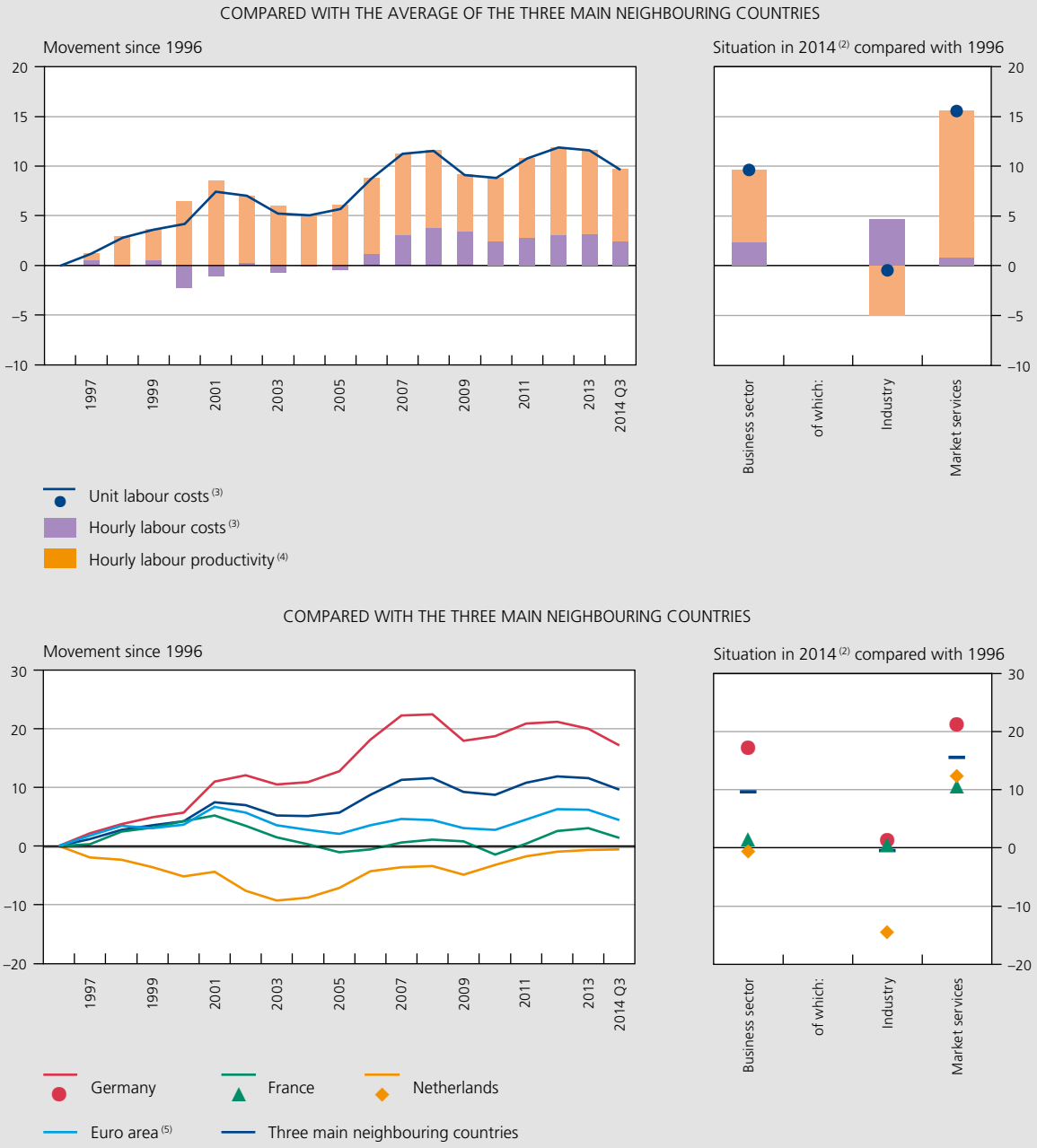
(cumulative percentage differences vis-à-vis the three main neighbouring countries, since 1996)



Source: CEC.
(1) Weighted average based on relative size of GDP.

CHART 36 UNIT LABOUR COSTS IN THE BUSINESS SECTOR IN BELGIUM

(percentage differences, cumulative since 1996)



Source : EC

(1) The business sector comprises NACE categories B to N and so includes industry, construction and market services, serving as a proxy for the private sector.

(2) Average of the first three quarters.

(3) A positive sign implies that unit labour costs and hourly labour costs are rising faster in Belgium than the average for the three main neighbouring countries.

(4) A positive sign implies that labour productivity is rising more slowly in Belgium than the average for the three main neighbouring countries.

(5) Figures for the 1996-1999 period were retropolated on the basis of the national accounts (ESA 95).

In 2014, growth in nominal wages slowed more rapidly in Belgium than in the neighbouring countries, while the country's productivity trends have been rather more favourable since 2012. The analysis of unit labour costs in the business sector, which takes account of these two factors, confirms this improvement relative to the three main neighbouring countries. In fact, the differential has narrowed from 11.6 % in 2013 to 9.6 % in the first three

quarters of 2014. Over the full 18-year review period since 1996, however, the cumulative difference remains significant.

This observation is also confirmed when subsidies to help ease the cost of labour are factored in – subsidies that are not deducted from labour costs in the national accounts – such as targeted cuts in employers' contributions and reductions in payroll tax. As envisaged in the October 2014 coalition agreement, preserving cost competitiveness will require additional measures both to ensure a structural reduction of labour costs and to enhance the wage-setting mechanism, in order to strengthen the link with productivity trends.

The widening of the wage handicap at the level of the business sector since 1996 is down primarily to the market services sector, and more particularly to "trade, transport and hotels and restaurants" and "information and communication". It was largely caused by less favourable productivity trends, but hourly wages were also a contributing factor. In industry, by contrast, the productivity difference is in Belgium's favour and largely offsets the hourly labour cost-related cumulative gap, especially so in relation to Germany. For several reasons, this analysis should be interpreted with caution, as this sector is the most exposed to international competition and companies will only survive if they manage to offset cost disadvantages with greater productivity improvements. Such international competition is not limited to the three main neighbouring countries, but also includes the other countries in the euro area, including those in the periphery, some of which have greatly improved their relative labour cost positions. What is more, the services sector's lack of cost competitiveness might also weigh down on industry indirectly, as it limits synergy perspectives that enable an effective set-up of production in cross-border value chains – companies using such services as input could suffer from higher costs. But even ignoring competition effects, high labour costs directly depress job creation opportunities.

2.4 Demand and income

Growth still solidly supported by domestic demand, excluding change in inventories

In 2014, economic activity primarily expanded on the back of higher domestic demand, excluding changes in inventories; the most striking feature perhaps being the investment revival. In 2013, investment had still contracted significantly on average in volume terms, but the recovery got underway as the year progressed and pushed up gross fixed capital formation. This trend continued into 2014 and was accompanied by higher investment in residential property construction. The government then moved to scale back its investment even further, and fiscal consolidation caused public consumption to grow more slowly than it had in the previous year.

Net exports of goods and services still made a sizeable contribution to year-on-year GDP growth, even though this was solely down to a positive spillover effect from their dynamic trend at the end of 2013. In 2014, exports clearly lost momentum, with key markets weakening while imports continued to grow more strongly. The significantly negative contribution to growth by changes in inventories also tied in with the situation at the end of 2013. The absence of a reversal in 2014 suggests that companies continued to exercise caution in raising production and instead ran down their inventories in the face of a persistently challenging economy and despite rising investment.

Private consumption and household income are growing

Economic activity may have slowed in 2014 but private consumption grew steadily, if moderately. Average consumption growth in the year worked out at 1 %, quite a bit more than in 2013. Once again, consumption trends proved less volatile than GDP, and by the end of 2014 it was already 6 % higher than before the crisis – compared with a GDP increase of only 2 % – despite a brief period of negative growth during the great recession.

Households' greater willingness to consume matches the increase in their purchasing power and is also reflected in improved retail sales, which had slumped in 2013. A slight drop in joblessness fears may have something to do with this: after peaking at the beginning of 2013, this sub-indicator in the Bank's consumer survey plunged – reflecting a more positive assessment – before stabilising at around its average showing since 1998 during the larger part of 2014; to move back to just below the average since November. By then, the general synthetic consumer confidence indicator had slid down further. Statistical analyses suggest that the sub-indicator is better correlated with household consumption than the general indicator. What is more, a tentative recovery throughout the year may be gleaned from indicators in the survey measuring people's intentions to purchase consumer durables. That said, this trend is not apparent in new car registrations, which are still well below the average in recent years. More specific factors might explain these lower levels, such as early 2012 changes in the tax treatment of passenger cars – e.g. the discontinuation of subsidies

TABLE 7 GDP AND MAIN EXPENDITURE CATEGORIES

(calendar adjusted volume data; percentage changes compared to the previous year, unless otherwise stated)

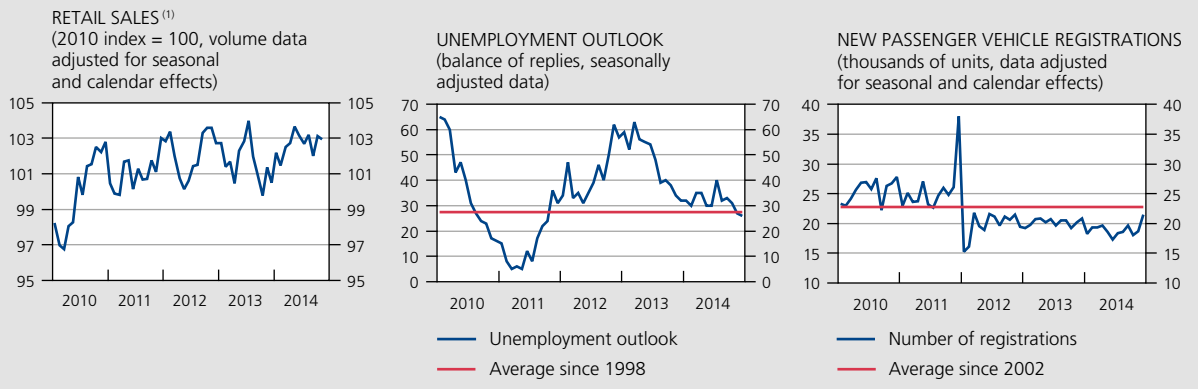
	2010	2011	2012	2013	2014 e
Private consumption	2.8	0.6	0.8	0.3	1.0
General government consumption	1.2	0.8	1.4	1.1	0.5
Gross fixed capital formation	–0.1	4.0	0.0	–2.2	4.7
Housing	3.3	1.4	–0.5	–3.5	0.9
Enterprises	–1.9	5.2	–0.3	–1.2	6.6
General government	3.6	2.5	3.4	–5.4	0.7
p.m. Final domestic expenditure (1)	*1.7*	*1.4*	*0.8*	*–0.1*	*1.7*
Change in inventories (2)	0.3	0.8	–0.8	–0.7	–1.0
Net exports of goods and services (2)	0.5	–0.5	0.1	1.0	0.4
Exports of goods and services	10.0	6.6	1.9	2.9	4.0
Imports of goods and services	9.6	7.4	1.8	1.7	3.6
GDP	2.5	1.6	0.1	0.3	1.0
p.m. Final demand	*5.4*	*4.1*	*0.9*	*0.9*	*2.2*

Sources: NAI, NBB.
(1) Excluding the change in inventories; contributions to the change in GDP compared to the previous year, percentage points.
(2) Contributions to the change in GDP compared to the previous year, percentage points.

previously granted on the purchase of environmentally friendly cars – or a change in car trade-in habits, as reflected in the steady increase in the average age of the fleet, to a little over eight years in 2013 (last available figures).

Household purchasing power is a key determinant of private consumption trends, and real gross disposable income rose by 1.3 % in 2014 – the first increase since 2009. Its slump in previous years primarily reflected shrinking capital income: in 2013, this was still more than 15 % below 2008 levels in nominal terms. Steep interest rate falls are to blame, coupled with the fact that the level of profit paid out by companies was heavily eroded by the financial crisis and the need to rebuild

CHART 37 PRIVATE CONSUMPTION INDICATORS



Sources: EC, FEBIAC, NBB.
(1) Excluding motor vehicles.

TABLE 8 DETERMINANTS OF HOUSEHOLD GROSS DISPOSABLE INCOME, AT CURRENT PRICES

(percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e	*p.m. In € billion* *2014 e*
Gross primary income	2.2	3.1	2.1	1.6	1.6	*289.9*
Compensation of employees	2.0	4.4	3.4	2.1	1.1	*209.7*
Volume of labour of employees	0.9	1.9	0.1	–0.5	0.3	
Labour costs per hour worked	1.0	2.6	3.4	2.5	0.7	
Gross operating surplus and gross mixed income	2.9	1.5	1.6	2.7	2.4	
Capital income[1]	2.2	–2.6	–5.6	–3.7	4.4	*29.5*
Interest (net)	–8.3	–5.7	2.4	–15.8	–7.0	*4.4*
Dividends received	5.1	–6.3	–11.4	0.7	17.2	*15.1*
Net current transfers[1]	6.6	6.7	2.2	4.1	–0.3	*–52.2*
Current transfers received	1.7	3.3	4.7	3.7	2.0	*91.8*
Current transfers paid	3.4	4.6	3.8	3.9	1.2	*144.0*
Gross disposable income	1.3	2.3	2.1	1.0	2.1	*237.7*
p.m. In real terms[2]	*–0.4*	*–0.8*	*–0.1*	*–0.2*	*1.3*	
Savings ratio[3]	16.1	14.7	13.9	13.5	13.8	

Sources: NAI, NBB.

(1) These are net amounts, i.e. the difference between income or transfers received from other sectors and those paid to other sectors.

(2) Data deflated by the household final consumption expenditure deflator.

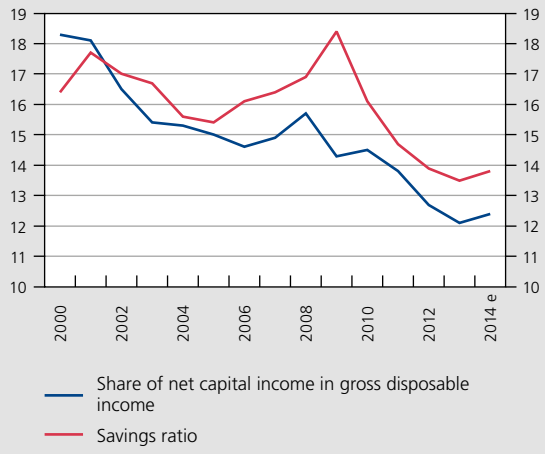
(3) In % of disposable income in the broad sense, i.e. including changes in households' entitlements to additional pensions accruing in the context of an occupational activity.

their balance sheets. In 2014, these weaker capital income figures reversed into an increase on the back of dividends received.

Consumption profiles are more strongly influenced by labour income, however, as people put much less of their earnings towards savings. In the year under review, the wage bill rose slightly in real terms, i.e. adjusted for the private consumption deflator, as a result of as yet moderate growth in the number of employees. Since 2008, it has gone up by over 4 % in real terms, while real GDP has grown nearly 3 %. The gap widened sharply at the time of the crisis, particularly in 2009, when economic activity slumped. Lastly, other primary income, such as the earnings of self-employed people, moved ahead more rapidly, one reason being that self-employment has again risen faster than employee numbers. In terms of transfers to other sectors, with those to the government accounting for the biggest proportion by far, social benefits have grown much more than tax receipts on income or capital, so that net current transfers by private individuals have inched down.

CHART 38 SAVINGS RATIO AND CAPITAL INCOME

(in % of gross disposable income[1])



Sources: NAI, NBB.

(1) In % of disposable income in the broad sense, i.e. including changes in households' entitlements to additional pensions accruing in the context of an occupational activity.

Given that not all income immediately readjusts, rapidly falling inflation is generally also supportive of purchasing power. This includes income earned by self-employed people.

In 2014, the savings ratio edged up to 13.8 % of disposable income, in sharp contrast to the relentless falls of the past years following 2009's peak of 18.4 %. In that year, consumption contracted temporarily as uncertainty flared up, while incomes were still growing around 2 % in real terms. Over the following years, individuals did not adjust their consumption levels to negative growth in disposable income; instead, the savings ratio plumbed historic lows of 13.5 %.

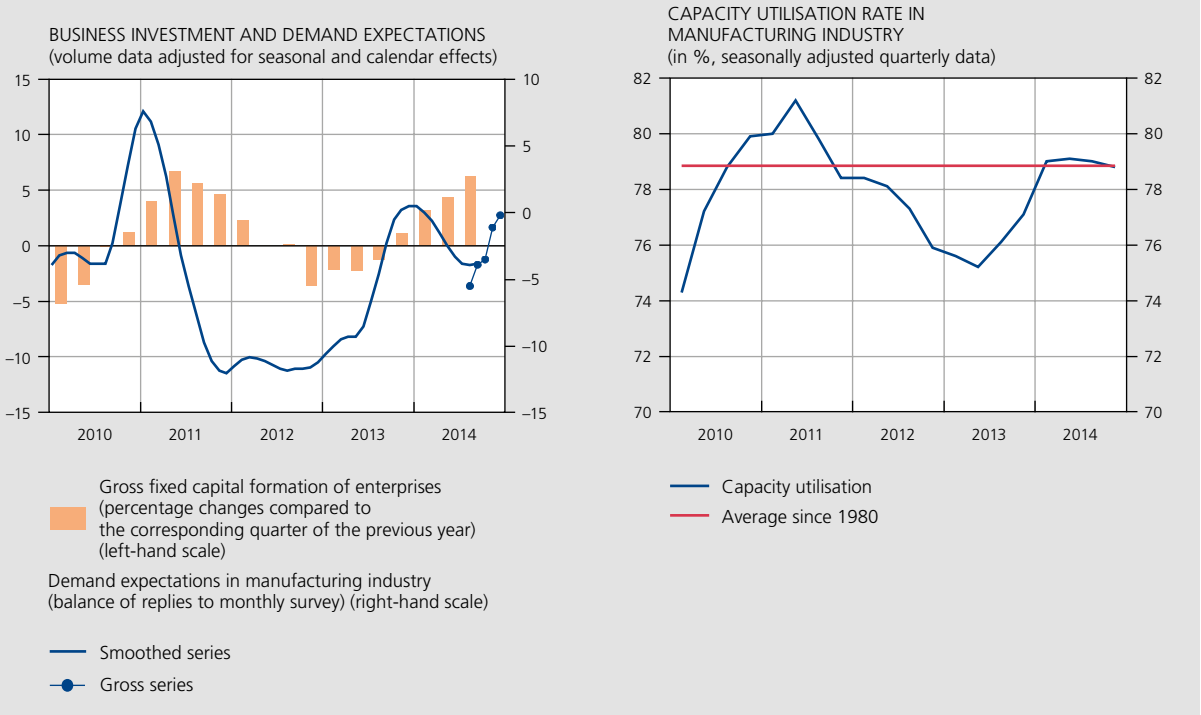
As Box 5 of the NBB's 2013 Annual Report noted, the savings ratio is largely determined by the breakdown of income and, more specifically, by the share of income from capital, as households typically save a larger proportion of property income than they do from their labour income. The past years' crumbling income from capital thus squeezed the savings ratio.

After coming down further in 2012 and 2013, much as it had done throughout the great recession, investment in housing inched back up in 2014, although volumes still languished around 10 % below those recorded before the recession.

In addition to higher disposable incomes, this tentative revival also draws on less fear among people of losing their job and its related income, while exceptionally low mortgage rates were an influence as well. Other factors were the changes in the law and tax rules related to the tax treatment of mortgage loans, which resulted from the federal government transferring authority to the Regions under the sixth State reform. When the Flemish Region announced it would sharply cut tax relief on mortgage loans – the housing bonus – from January 2015, households were quick to decide to buy homes in order to take advantage of the still existing, more favourable tax scheme. With housing construction and renovation looking at longer lead times for logistical reasons, anticipation primarily drives the secondary market. And indeed, housing investment was further bolstered by the significant increase in the number of secondary market transactions in the second half of 2014, as registration fees are stated in the national accounts on the dates of these transactions.

Business investment picked up strongly at the beginning of 2014 and gathered momentum from one quarter to the next, taking average growth to 6.6 % (annualised).

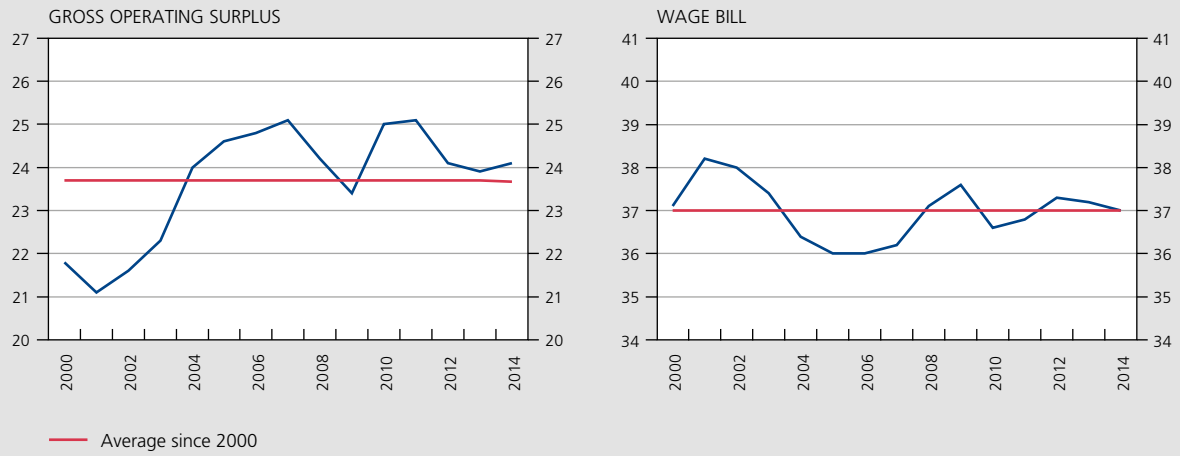
CHART 39 BUSINESS INVESTMENT



Sources: NAI, NBB.

CHART 40 GROSS OPERATING SURPLUS AND WAGE BILL OF COMPANIES

(in % of GDP)



Sources: NAI, NBB.

The extent to which this growth boosted economic activity has to be qualified, however, as it partly reflected specific transactions such as a big licence contract for one company and major purchases of ships abroad – which caused an equivalent increase in imports. But even ignoring this exceptional factor, business investment recovered in the year under review, on the back of improved demand forecasts. After a strong rebound in 2013, capacity utilisation in manufacturing hovered around its average showing since 1980 throughout the year. Together, these two factors could support both expansion and replacement investment. The slowdown that emerged as

TABLE 9 DETERMINANTS OF THE GROSS OPERATING SURPLUS OF COMPANIES (1), AT CURRENT PRICES

(percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e
Gross operating margin per unit of sales (2)	5.2	–0.1	–3.0	0.3	–0.2
Unit selling price	4.1	3.5	1.8	0.5	–0.2
On the domestic market (1)	3.6	2.9	2.3	1.5	0.6
Exports	4.6	4.1	1.3	–0.4	–0.9
Costs per unit of sales (1)	3.9	4.2	2.7	0.5	–0.2
Imported goods and services	6.3	5.1	1.5	–0.5	–1.0
Costs of domestic origin per unit of output (2) (3)	–0.6	0.7	4.1	1.7	0.4
of which:					
Unit labour costs (4)	–1.2	1.8	3.6	1.9	0.2
Unit net indirect taxes	0.8	–1.0	7.2	0.1	0.9
Final sales at constant prices	6.1	4.5	0.9	0.9	2.3
Gross operating surplus of companies	11.6	4.4	–2.1	1.2	2.0

Sources: NAI, NBB.
(1) Private and public companies.
(2) Including the change in inventories.
(3) In addition to wages, this item comprises indirect taxes minus subsidies, and gross mixed income of self-employed people.
(4) Unit labour costs are expressed in units of value added of the business sector and are not calendar adjusted.

the year progressed appears to have had only a limited influence, either because of the time-lag between designing and implementing investment projects or because companies did not consider it a structural threat to the recovery.

Companies were able to defray their investment expenses from a solid level of own resources, coupled with favourable external financing conditions.

Funds generated through company activity rose by 2 % in 2014 and were slightly ahead of GDP growth in nominal terms, with companies' gross operating surplus accounting for a slightly higher proportion of GDP. This figure stood at 24.1 %, barely higher than the average since 2000. Conversely, wages accounted for a slightly lower share of GDP in 2014 and likewise remained a touch above the average of the past 15 years. The fact that operating surplus and wages both ended up above their average shares had more to do with tax on production less subsidies going down. Overall, as in 2013, movements in the share in income of the various factors of production – whether upward or downward – were very small in 2014, i.e. almost 0.1 % of GDP. This suggests that tighter wage restraint and falling inflation – both consumer prices and the GDP deflator – were on a similar trajectory.

The increase in gross operating surplus was primarily due to 2.3 % higher final sales volumes, including the change in inventories. This percentage does not however reflect real sales developments, as sales demand was partly met by a contraction of inventories rather than by an increase in production.

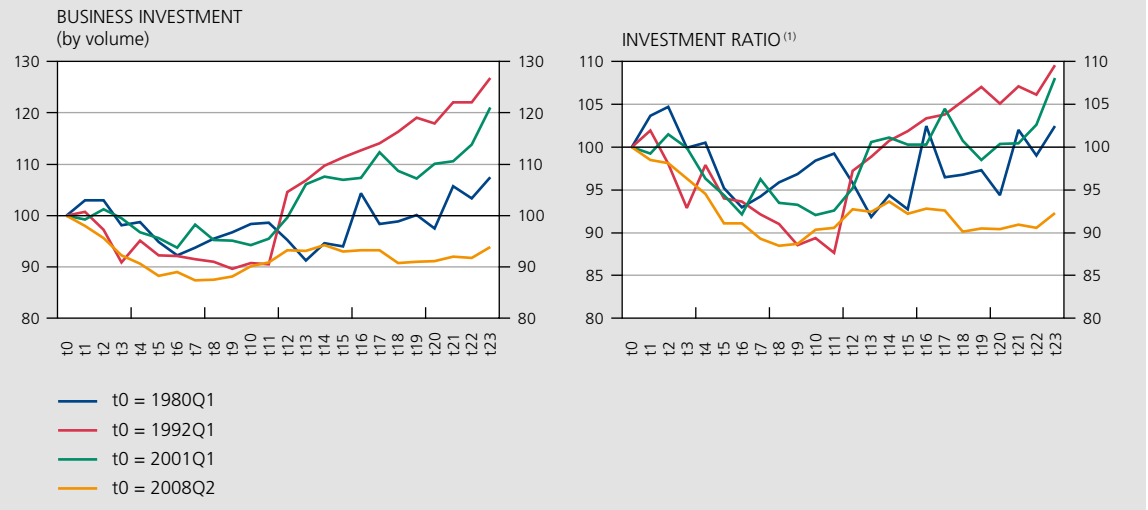
Gross operating margin per unit of sales contracted in 2014, albeit in a very minimal way. Selling prices fell, but this was exclusively down to lower export prices due to international competition in combination with lower input

Box 6 – Business investment slowly recovers

Much like the euro area at large, Belgium has seen business investment struggle to recover from the depths plumbed during the great recession. Six years after the recession took hold, investment volumes were still

BUSINESS INVESTMENT IN BELGIUM

(data adjusted for seasonal and calendar effects; indices, pre-recession high = 100)



Sources: NAI, NBB.
(1) Investment as a ratio of GDP (by volume).
ti: Quarters since the start of the relevant recession period.

around 6 % below the all-time high of the second quarter of 2008. Compared with the previous recessions of 1980, 1992 and 2001, business investment fell very hard and very fast at the nadir of the economic and financial crisis. And the decline has proved very stubborn indeed : in each of the three previous recessions, business investment exceeded pre-crisis levels within six years.

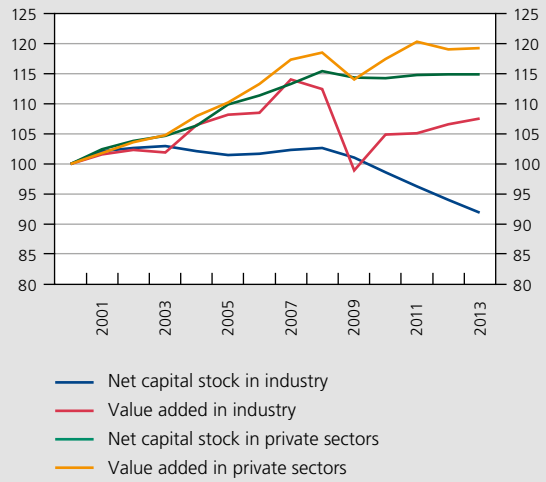
Of course, the slower revival of business investment after the latest recession period is partly down to the lacklustre recovery in economic activity. Granted, GDP has been back at pre-crisis levels since 2011 but it has hardly moved since, whereas economic activity bounced back much more strongly after earlier recessions. The tentative feel of the recovery has made investors wary of new investment projects, particularly in view of uncertain return prospects.

Today's recovery is clearly also weaker than previous post-recession recoveries when looking at the investment ratio, i.e. business investment as a ratio of real GDP. Macroeconomic uncertainty was not the only determinant of this ratio : financial conditions during the period also had a part to play. Lenders sharply tightened conditions for investment project funding during the financial crisis, while relatively high gearing levels in those turbulent days may also have squeezed investment plans. And it is always possible that companies considered it was not necessary to increase capacity to meet future demand, as growth prospects for the longer term were being revised downwards.

The languishing recovery of business investment also affects capital stock in the Belgian economy. Ignoring government and housing construction sectors, capital stock volumes grew by an average 1.9 % per year between 1995 and 2008. In the post-great-recession recovery, capital stock has virtually stagnated, as the level of investment barely offsets impairments of existing assets. The sharp contraction in manufacturing is one reason for the shortfall, as traditional industry with its extensive, capital-intensive machinery is losing ground. This is only partly offset by the increasing

NET CAPITAL STOCK (1) AND VALUE ADDED

(volume data adjusted for seasonal and calendar effects, indices 2000 = 100)



Sources : NAI, NBB.
(1) Excluding housing.

proportion of the cumulative net value of R&D investment. There are a few exceptions: in the pharmaceuticals industry, for one, innovation has been a key driver of capital stock, even during the crisis.

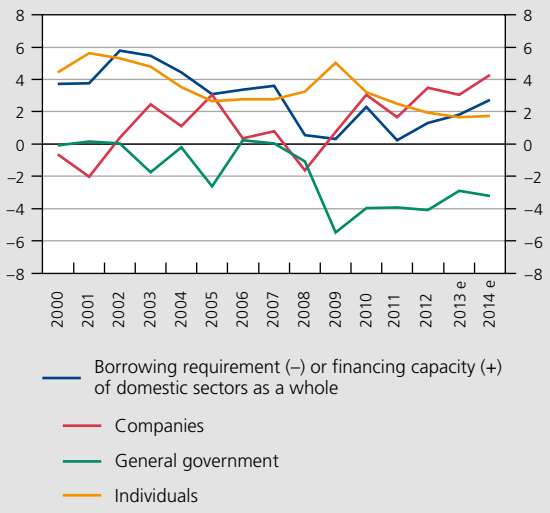
Both in manufacturing and – to a lesser degree – in market activities at large, value added has been growing a bit faster than capital stock since the great recession, also in the longer term. The shift identified earlier (from investment to other sectors and other types of assets) would appear to have had a modestly upward effect on the average productivity of capital assets.

prices, for commodities among other things. Prices of imported goods and services and, more broadly, costs per unit of sales fell even more sharply than company selling prices, lower oil prices compared with 2013 being a major factor. Domestic costs, by contrast, were up, but only moderately so. Unit labour costs recorded their lowest growth rate of the past four years, reflecting the combined influence of moderate wage growth and productivity gains.

In addition to extremely low real returns on the financial markets, which have significantly lowered break-even point for investment projects, business investment also benefited from the increase in the gross operating surplus and the relatively high level of cash held by non-financial corporations, some 29.1 % of GDP. And even ignoring lower interest rates, survey responses about lending suggest that banks also eased other credit conditions a little in the course of 2014.

CHART 41 FINANCING BALANCE OF DOMESTIC SECTORS AS A WHOLE

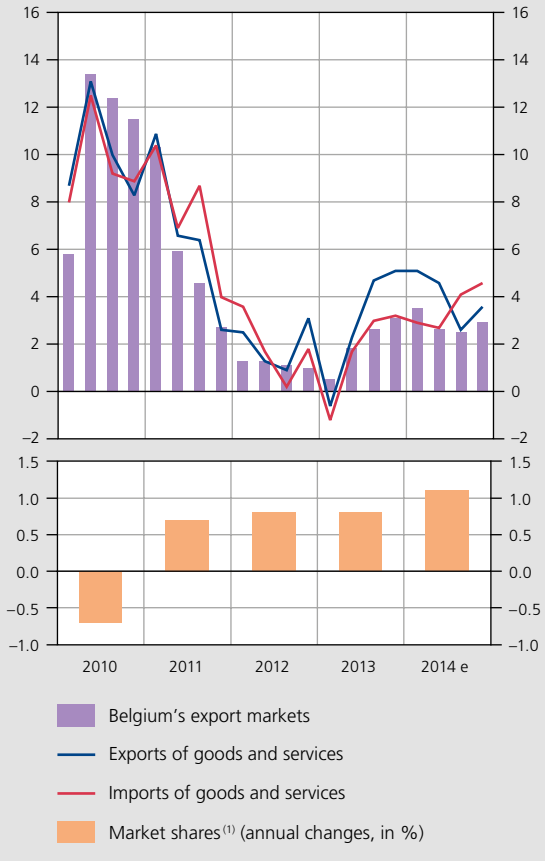
(in % of GDP)



Sources: NAI, NBB.

CHART 42 EXPORTS AND IMPORTS OF GOODS AND SERVICES, BY VOLUME

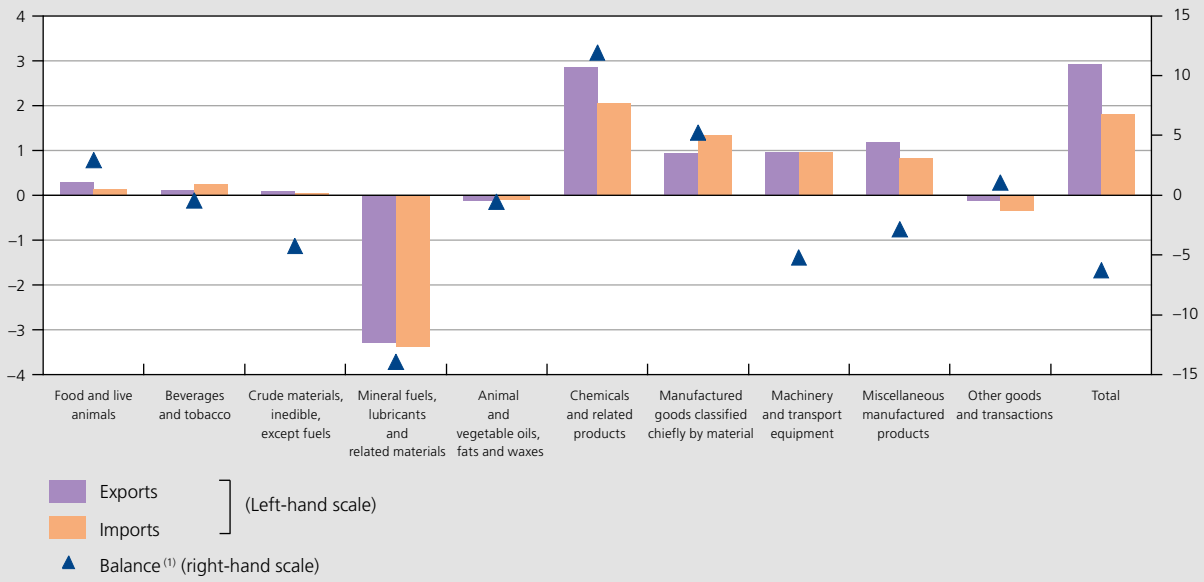
(data adjusted for seasonal and calendar effects; percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources: ECB, NAI, NBB.

CHART 43 EXPORTS AND IMPORTS OF GOODS IN VALUE BY PRODUCT CATEGORY

(national concept, in € billion, change in the first nine months of 2014 compared to the corresponding period of 2013, unless otherwise stated)



Source: NAI.

(1) Balance in € billion for the first three quarters of 2014.

TABLE 10 BALANCE OF PAYMENTS AND NET LENDING TO THE REST OF THE WORLD

(balances; in € billion, unless otherwise stated)

	2010	2011	2012	2013	2014 e
1. Current account					
Goods and services	4.3	−2.9	−3.3	−0.6	0.0
Goods	−3.8	−10.1	−10.6	−7.7	n.
Services	8.1	7.3	7.2	7.1	n.
Primary income	6.6	3.9	6.6	9.1	11.3
Earned income	4.9	5.0	5.1	5.4	5.4
Investment income	2.3	−0.5	2.1	4.3	6.5
Other primary income	−0.6	−0.7	−0.6	−0.6	−0.6
Secondary income	−5.4	−6.0	−6.7	−7.9	−7.8
General government	−4.1	−4.1	−3.8	−4.8	−4.7
Other sectors	−1.3	−1.9	−2.9	−3.1	−3.1
Total	5.5	−5.0	−3.4	0.6	3.6
p.m. Idem, in % of GDP	*1.5*	*−1.3*	*−0.9*	*0.1*	*0.9*
2. Capital account	−0.9	−0.4	2.3	−0.1	−0.4
3. Net lending to the rest of the world (1 + 2)	4.6	−5.4	−1.1	0.4	3.2
p.m. Idem, in % of GDP	*1.3*	*−1.4*	*−0.3*	*0.1*	*0.8*

Sources: NAI, NBB.

Improved current account balance

Taken as a whole, the country's economic sectors recorded a financing capacity ratio of 2.7 % of GDP in 2014, compared with an estimated ratio of 1.8 % in 2013[1]. Households' net financing capacity, traditionally positive, remained stable in 2014 at 1.8 % of GDP, as individuals' gross savings increase was offset by higher capital spending, including investment in housing. As chapter 4 explained, the government's borrowing requirement rose slightly and the improved financing balance was the outcome of an increase in companies' financing capacity to nearly 4.3 % of GDP, thanks to higher gross savings derived from a slight increase in their gross operating surplus coupled with reduced inventories. All this adds up to a consistent financing capacity on the part of companies since 2009.

The increase in the economic sectors' overall financing capacity is also reflected in a higher current account surplus, which partly derives from an improved goods and services balance. Indeed, as explained earlier, annualised imports lagged behind exports in real terms, resulting in higher net exports in volume terms. Also, the terms of trade stabilised, as the improvement recorded during the last couple of months of 2014 on the back of tumbling oil prices had offset the deterioration observed at the beginning of the year.

As in the three previous years, the increase in exports was again supported by higher market share (in volume terms) in 2014. According to available estimates when this Report went to press, exports from Belgium grew faster than import demand from the main trading partners, weighted by its export structure. Belgium would appear to have won market share in markets both within and outside the euro area in the past year.

According to balance of payments data, the latest improvement in the balance of international goods and services reflected a lower goods transaction deficit coupled with an unchanged services surplus. The consolidation in services was the result of positive developments in goods for processing, construction and financial services.

As far as goods trade is concerned, foreign trade statistics for the first three quarters of 2014 reveal improved net figures for chemicals and related products on the back of a significant increase in exports. This product category alone accounted for 25 % of total Belgian exports in the nine months, and its growth mainly reflects net exports of medicinal and pharmaceutical products. Lower exports in terms of value of mineral fuels, lubricants and related materials were offset by a comparable contraction in imports. In the end, trends in this product category had only a limited net effect on the total value of goods imports and exports – which stayed negative for the first three quarters of the year under review.

Retaliatory sanctions imposed by Russia, and more specifically the import ban on most foods from Europe, have only had a slight immediate effect on the Belgian economy. Trade flows covered by the Russian embargo account for less than 0.1 % of GDP. However, individual companies and sectors have been harder hit, for example in fruit and vegetables, dairy and meat products.

Russia is in fact only Belgium's 15th largest trading partner for goods exports, accounting for € 3.3 billion or 1.4 % of total Belgian exports in 2013. As far as services are concerned, balance of payments statistics suggest that flows to and from Russia were even less significant, representing around 1 % of the total in 2012. That said, this analysis of direct trade may mask indirect economic relations, as a country can use value added created by a country that does not rank among its direct suppliers, for example if a third country acts as a broker. So Russia might well be more important to Belgium than would appear on the basis of direct export and import data.

In addition to the € 0.6 billion increase in the goods and services balance, the primary income surplus also rose in 2014, to € 11.3 billion from € 9.1 billion. This improvement can mostly be traced back to higher income from investment on the back of higher dividends received, coupled with a fall in dividends paid. Earned income, another key component of primary income, recorded a surplus of € 5.4 billion, comparable with 2013.

The secondary income deficit is reported to have narrowed a little in 2014. These transactions include Belgian contributions to the budgets of EU institutions linked to the VAT base and gross national income (GNI), international collaboration and transfers between resident and non-resident private individuals. The improvement in this item reflects the fact that, in 2014, the Belgian government paid significantly less to European institutions on balance than it had in 2013, in keeping with a lower rate of call of the GNI resource.

All in all, the balance of payments suggests that the current account continued its favourable course in 2014, with its surplus rising to € 3.6 billion in the year under review from € 0.6 billion in 2013. This is 0.9 % of GDP.

(1) To better interpret economic developments, this analysis has adjusted the NAI's national accounts data for 2013 and 2014. The adjustment mimics the effect of the new methodology for calculating income from investment in the balance of payments, which now reflects a macroeconomic approach. It applies to the accounts for corporations and for the rest of the world.

Financial developments in Belgium

3. Financial developments in Belgium

Belgium's net external position remains robust, at 35.4 % of GDP. In the persistently fragile economic climate and given the low returns on low-risk investment instruments, households have focused their investment on both liquid assets and – more than in previous years – investment funds. Net mortgage loan growth remained moderate, with the exception of refinancing transactions to take advantage of lower interest rates. The pace nevertheless picked up by the end of the year, partly in anticipation of the introduction of a less generous tax treatment of mortgage loans, particularly in Flanders. Generally speaking, household debt ratio rose further, but remained sustainable, although some categories – particularly young people – are more exposed than others. Company demand for bank loans also stayed subdued, despite lower interest rates and easier credit standards. The anaemic economy and protracted low interest rates are posing challenges to banks and insurance companies; they have to make a real effort to bolster their capital positions and make sustainable profits if they are to also meet the more rigorous solvency requirements imposed by regulators.

3.1 Overall financial position of the Belgian economy

Belgium's net external position : strong, but weakening

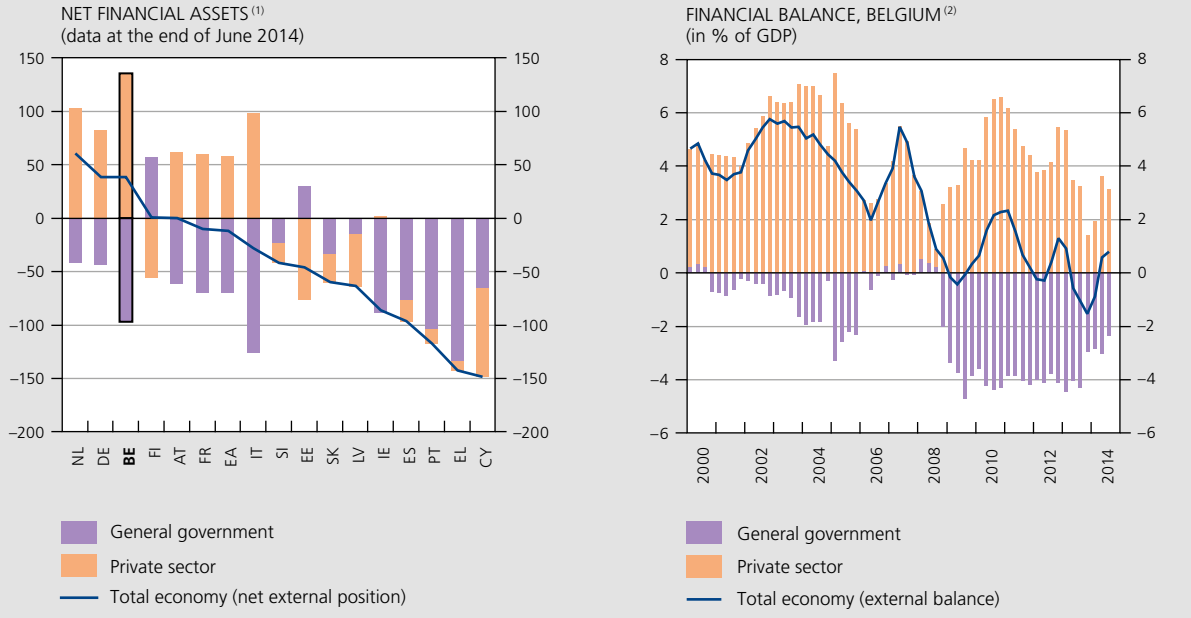
Belgium ranks among a small group of euro area countries – together with the Netherlands, Germany and Finland – reporting positive net financial wealth. Serving as a factor of financial stability, this net claim of all domestic sectors on the rest of the world amounted to € 142 billion or 35.4 % of GDP at the end of September 2014. This is largely down to the considerable net financial assets of Belgian individuals, the highest as a percentage of GDP (225 %) of the euro area Member States for which these data are available. Other sectors, with the exception of financial corporations, report net liabilities.

Belgium's external position may still be robust, but it has been falling since peaking at 57.6 % of GDP in 2011. This is attributable to the development of the economy's overall balance and to changes in the position primarily related to the revaluation of outstanding assets and liabilities. The downward trend persisted into the first nine months of 2014 and Belgium's net assets fell by € 25.7 billion, or 6.5 % of GDP.

Whereas Belgium had recorded major current account surpluses in the past and so built net claims on other countries, the situation has reversed since 2009. The country has from then on seen periods of current account deficits, during which it contracted net liabilities abroad. In the first nine months of 2014, the current account was positive and € 2.6 billion – i.e. 0.6 % of annual GDP – worth of net foreign assets were acquired. The positive financial balance was due to households and financial institutions, with the latter preferring to use a large part of their profits to shore up their balance sheets.

Other changes, including revaluations, amounted to a negative € 28.3 billion or –7.1 % of GDP in the first three quarters of 2014, more than wiping out the effect of the positive financial balance. Traditionally, the Belgian economy suffers negative revaluation effects when financial markets recover, primarily concentrated on non-financial corporations and the general government. Rising stock market prices in 2014 pushed up the value of non-financial corporations' outstanding liabilities, much more so than the increase in the value of their financial assets, in which equities represent a smaller share. In addition, declining yields in the secondary market for general government debt pushed up its market value, while private households as a net creditor sector enjoyed gains on their capital on the back of rising asset prices.

CHART 44 NET FINANCIAL ASSETS AND FINANCIAL BALANCE
(in % of GDP)



Sources: EC, ECB, NBB.
(1) Difference between the outstanding amount of financial assets and liabilities. Luxembourg and Malta are not included in view of the high volatility of their data.
(2) Difference between transactions in financial assets and liabilities, cumulative over four quarters.

Financial institutions also posted gains, as price effects were more significant for their assets than their liabilities.

Financial assets and liabilities turn back up, albeit moderately

For the first time since 2011, Belgium's domestic sectors taken together recorded an increase in financial assets of € 77 billion, although this was still lower than the average since 1999. The financial assets portfolio mainly grew in the financial sector (€ 67.6 billion), in stark contrast with the balance sheet contraction of the 2008-2013 period. As described in Box 7, the financial sector is defined more broadly than the sector of banks and insurance companies mentioned in section 3.4, although banks did account for three-quarters of its asset formation in the first three-quarters of 2014. Households grew their financial assets to much the same degree as in 2013, while those of non-financial corporations shrank for the second year running. The general government sector also saw financial assets come down, by € 4.5 billion.

At € 74.3 billion, growth in financial liabilities fell behind that in assets and remained below its historical average. And yet, the outstanding amount in financial liabilities reached new all-time highs in all sectors except financial services.

Gross debt ratio of non-financial private sector still inching up, but remains at sustainable levels

Against a backdrop of subdued bank lending and GDP growth, the consolidated gross debt ratio of the Belgian non-financial private sector still inched up, from 162.8 % of GDP at the end of 2013 to 163.2 % in September 2014. The debt ratio of Belgian households rose further, by 1.2 percentage points of GDP, to 57 % of GDP, while non-financial corporations reported a 0.7 percentage point fall to 106.3 % of GDP. This latter result is all down to positive GDP growth, as non-financial corporations are still actively incurring mainly non-bank debt.

In the euro area, the process of deleveraging, which had started in 2010, continued apace in the non-financial private sector, reducing the debt ratio from 139.8 % of GDP at the end of 2013 to 139 % of GDP at the end of June 2014. At that point, debt ratios of households and

TABLE 11 FINANCIAL ASSETS AND LIABILITIES BY SECTOR

(non-consolidated, in € billion, unless otherwise stated)

	Outstanding amounts at the end of September 2014			Change since December 2013			
	Assets	Liabilities	Net financial wealth	Total[1]	Transactions[2]		
				Net financial wealth	Assets	Liabilities	Financial balance
Households	1 146.6	245.6	901.0	22.1	18.7	8.0	10.7
Non-financial corporations	1 268.2	1 637.2	–369.0	–22.2	–4.8	–5.3	0.5
General government	161.2	559.2	–398.0	–42.3	–4.5	7.1	–11.7
Financial corporations[3]	2 372.2	2 364.6	7.6	16.7	67.6	64.6	3.0
p.m. Total of domestic sectors	*4 948.3*	*4 806.6*	*141.7*	*–25.7*	*77.0*	*74.3*	*2.6*
Idem, in % of GDP	*1 235.2*	*1 199.8*	*35.4*	*–6.5*	*19.2*	*18.6*	*0.6*

Source: NBB.

(1) Change over the first nine months of 2014.

(2) Cumulative flows over the first nine months of 2014.

(3) Financial corporations comprise mainly monetary financial institutions (NBB, credit institutions and monetary UCIs), non-monetary UCIs, other financial institutions (stockbroking firms, financial head offices and holding companies), in addition to insurance companies and pension funds.

non-financial corporations amounted to 62.1 % and 77 % of GDP respectively, i.e. 2.4 and 6.1 percentage points of GDP below their all-time highs of 2010. Deleveraging is mostly taking place in the periphery of the euro area, but is modest compared with previously accumulated debt. That said, most of these countries are engaged in active deleveraging and their debts are falling in nominal terms.

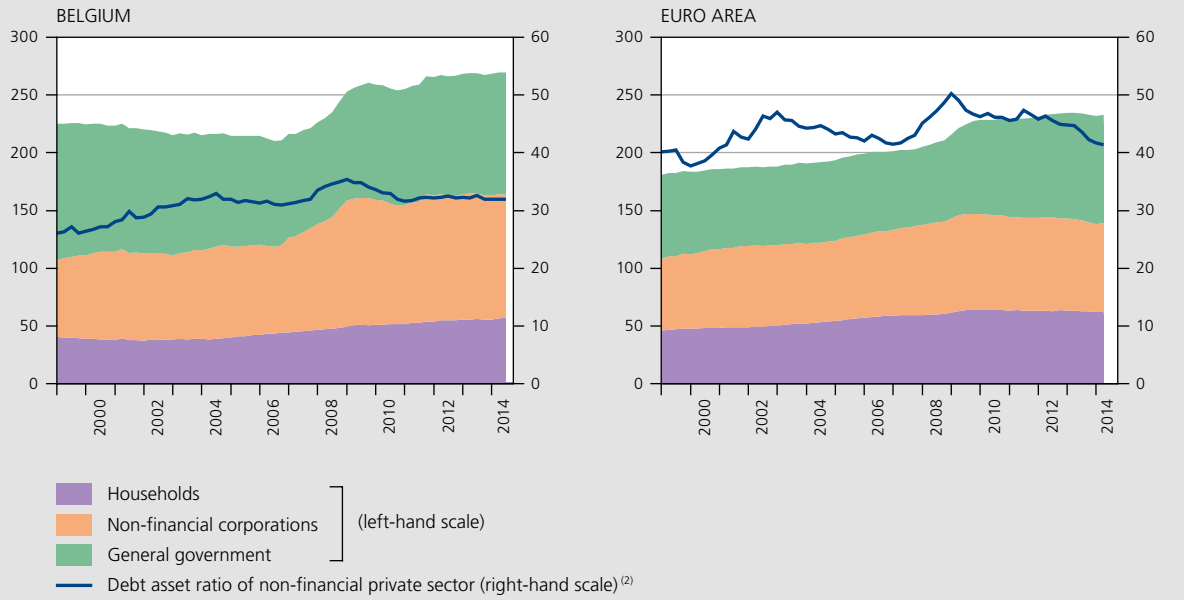
Factoring in public debt, the deleveraging process in the euro area becomes less clear-cut and the non-financial sector ends up close to its peak of 235 % of GDP, compared with 270 % in Belgium. Like net external positions, gross debt ratios, which include both the general government and the non-financial private sector, feature in the scoreboard that the European authorities use for the purpose of the macroeconomic imbalance procedure (MIP). The EC uses consolidated gross debt thresholds of 60 % of GDP for general government and 133 % of GDP for the non-financial private sector, and posits that any breach of these might suggest a macroeconomic imbalance. Belgium exceeds both threshold values: for its public and non-financial private sector debt.

However, the heavy debt level of the non-financial private sector in Belgium requires additional explanation. In reality, a large proportion of non-financial corporations' debt ratio (106.3 % of GDP) is made up of intra-company debt, even on a consolidated basis. Although funding received from other resident non-financial corporations is stripped out in line with the consolidated concept – as the counterpart assets are held by other entities in the same sector – these calculations do factor in loans by foreign affiliates, even if these frequently belong to the same group. Non-bank debt financing from abroad typically involves resources for head offices resident in Belgium and will typically also be transferred abroad, directly or indirectly. Financial flows between associated companies need to be monitored closely, of course, as significant amounts of money are involved, but these represent a much smaller risk of macroeconomic imbalances in Belgium – a fact recognised by the EC in its assessment of the Belgian economy's structural position. At the end of September 2014, foreign non-bank loans stood at € 90 billion or 22.4 % of GDP. With the implementation of new accounting rules for national accounts (ESA 2010), funding of non-financial corporations by "captive financial institutions and non-institutional money lenders" is also included in the consolidated debt ratio (see Box 7). Rather than meeting external borrowing requirements, these holding companies are incorporated in Belgium to redistribute financial resources within groups. Any funding from these holding companies will typically return to them or go to other group entities, without any net debt resulting. At the end of September 2014, loans by "other financial institutions" (OFIs), which comprise these holding companies, amounted to € 127 billion, or 31.6 % of GDP.

Setting aside these qualifications regarding non-financial corporations' debt level, various factors point to the

CHART 45 GROSS DEBT RATIO OF THE NON-FINANCIAL SECTOR (1)

(consolidated debt in % of GDP, unless otherwise stated)



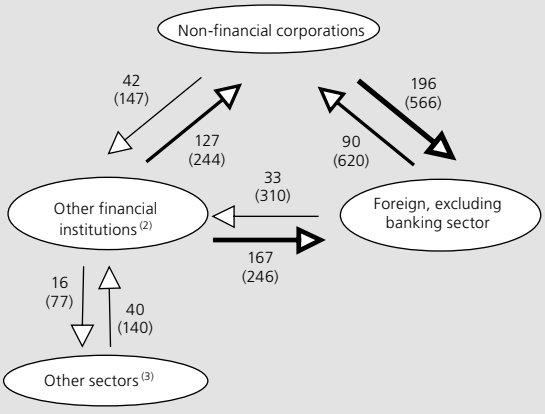
Sources: EC, ECB, NBB.

(1) Data up to the third quarter of 2014 for Belgium, up to the second quarter for the euro area. Quarterly data for the non-financial private sector debt ratio. Annual data for public debt (end of period, forecast for 2014), interpolated linearly on a quarterly basis. Euro area public debt before 2010 is defined in accordance with the ESA 95.

(2) Non-consolidated debt in %.

CHART 46 MUTUAL CLAIMS AND LIABILITIES BETWEEN NON-FINANCIAL CORPORATIONS AND (QUASI-) FINANCIAL CORPORATIONS (1)

(outstanding amount in September 2014, in € billion)



Source: NBB.

(1) The arrows indicate the amount involved in debt instruments or, in brackets, total assets held by the sectors relative to one another.

(2) Primarily "captive financial institutions and non-institutional money lenders".

(3) Households, general government, the (resident and non-resident) banking sector, non-monetary institutions for collective investment (UCIs), insurance companies and pension funds.

sustainability of private debt. At 56.5 % of GDP in mid-2014, the household debt ratio was below that for the euro area, although the gap has steadily narrowed. Looking at the relationship between the debt and the value of the financial assets held by households and companies – i.e. the debt-to-asset ratio – the non-financial private sector in Belgium has a much lower debt ratio than the euro area. And unlike debt expressed as a percentage of GDP, this ratio has remained relatively stable over the past decade. Lastly, it appears that debt service burdens – *ex ante* from the debt-service ratio and ex post from both the level and trend in arrears on loans as registered by the Central Individual Credit Register (CICR) – are manageable for most households. More generally, the financial position of households and companies in Belgium does not seem to point to any special debt sustainability issues.

Box 7 – Impact of ESA 2010 on Belgium's financial accounts

The new ESA 2010 methodology will bring numerous changes to the financial accounts. Providing a new delineation between institutional sectors, it also introduces a reclassification of and increase in the number of financial instruments. What is more, valuation effects and other volume changes in assets and liabilities will be separately recorded, alongside outstanding amounts and transactions[1].

The methodological changes have a significant effect on the financial assets and liabilities of the various sectors, as well as on various indicators of their financial position, such as the debt ratio, net assets and financial balance. With these indicators taking on a more central role in macroeconomic and prudential policies, this Box describes the changeover from the ESA 95 – the previous methodology – to ESA 2010, and the main effects of this on the key indicators.

Assets, liabilities and net financial assets of the various sectors

Assets and liabilities of the Belgian economy as a whole, as estimated according to the new methodology, were virtually unchanged compared to ESA 95. Data for the situation at end-2013 were revised by –1.1 % and –0.7 % respectively. However, the change in the definition of the institutional sectors has quite a significant impact on the size of the assets and liabilities of the different sectors. The financial sector, in particular, was expanded to include sub-sector S.127 "captive financial institutions and non-institutional money lenders" (mainly holding companies),

FINANCIAL ASSETS AND LIABILITIES PER SECTOR

(non-consolidated, in € billion, end 2013)

	ESA 2010			ESA 1995			ESA 2010 – ESA 1995 differences		
	Assets	Liabilities	Net financial assets	Assets	Liabilities	Net financial assets	Assets	Liabilities	Net financial assets
Households	1 114	235	879	1 090	220	870	24	15	9
Non-financial corporations	1 266	1 613	–347	1 936	2 295	–359	–670	–682	12
General government	162	518	–356	137	457	–321	25	60	–35
Financial corporations	2 267	2 276	–9	1 700	1 699	1	566	577	–10
of which:									
Monetary financial institutions (MFIs)	1 095	1 078	17	1 090	1 095	–5	5	–17	22
Other financial institutions (OFIs)[1]	869	908	–39	307	315	–8	562	593	–32
Insurance corporations and pension funds (ICPFs)	303	290	13	303	289	14	0	1	–1
p.m. Total of the domestic sectors	*4 809*	*4 641*	*167*	*4 863*	*4 672*	*191*	*–54*	*–31*	*–24*

Source: NBB.
(1) Including non-monetary UCIs.

(1) Please refer to the methodological note for an overview of the changes made to the national accounts.

which had previously mostly ranked in the non-financial corporations category. The change makes for a key shift in assets and liabilities from non-financial to financial corporations.

Compared with other countries, Belgium is facing a major impact from this sector shift, as many holding companies and treasury centres are incorporated in this country. Assets of OFIs, which now cover the new sub-sector S.127, were revised upwards by 140 % of GDP at the end of 2013, i.e. € 562 billion. This and other changes sparked an overall upward revision of the financial corporations sector's assets from 444 % to 573 % of GDP. By contrast, total financial assets of non-financial corporations came down to 320 % of GDP from 506 % at the end of 2013, due to this and a number of other smaller revisions.

The introduction of a new sub-sector "captive financial institutions and non-institutional money lenders" also widens the definition of the financial sector in the financial accounts, with a wider gap emerging between the credit institutions and insurance companies as discussed in section 3.4 of this Annual Report. The nine sub-sectors now making up the financial sector in the financial accounts can be broken down into monetary financial institutions (MFIs), other financial institutions (OFIs), and insurance corporations and pension funds (ICPFs). Under ESA 95, MFIs accounted for around 64 % of the entire financial sector, but their relative proportion fell to 48 %, with the share of OFIs and ICPFs now at 38 % and 13 % respectively.

Although the changes mainly affect outstanding amounts, in some cases they also provide a different take on developments. The balance sheet total of non-financial corporations, for one, edged down after touching record highs in 2011. The contraction of the financial sector's assets in the wake of the financial crisis – caused by the banking sector, in particular – looks a lot less significant, as it was not as visible in the non-banking financial sector. This also has repercussions on the EC scoreboard used for the macroeconomic imbalance procedure (MIP), one of the headline indicators being the year-on-year change in financial sector liabilities. The debt-to-asset ratio, which serves as an additional indicator, is also strongly affected.

Total assets and liabilities of the other sectors (households and general government) have been revised to a lesser extent. That said, for end-2013, the (non-consolidated) liabilities of the general government were revised upwards by 11.5 % of GDP to 130.9 % of GDP, to reflect the new boundary of general government. Differences with the Maastricht concept of debt used in the European excessive debt procedures (104.5 % of GDP) are that this debt only refers to deposits, debt securities and loans, excluding other liabilities such as tax refunds or pending invoices, and that liabilities on other entities of the general government sector are consolidated. In addition, general government debt will now be recognised in the financial accounts at market values, whereas the Maastricht definition prescribes nominal values for recognition. The slight increase in household assets and liabilities particularly reflects new basic information on non-profit institutions serving households (NPISHs).

In most cases, the impact on assets and liabilities is similar, and thus, overall the revision of the net financial assets of the various sectors is minor.

Debt ratio of non-financial corporations

The reclassification of "captive financial institutions and non-institutional money lenders" also has a major effect on the debt ratio of non-financial corporations. On a non-consolidated basis, the debt ratio was adjusted by around 58 % of GDP, which brought it back down to 136 % of GDP at the end of 2013, the direct effect of the shift of holding companies from the financial corporations to the non-financial corporations sector.

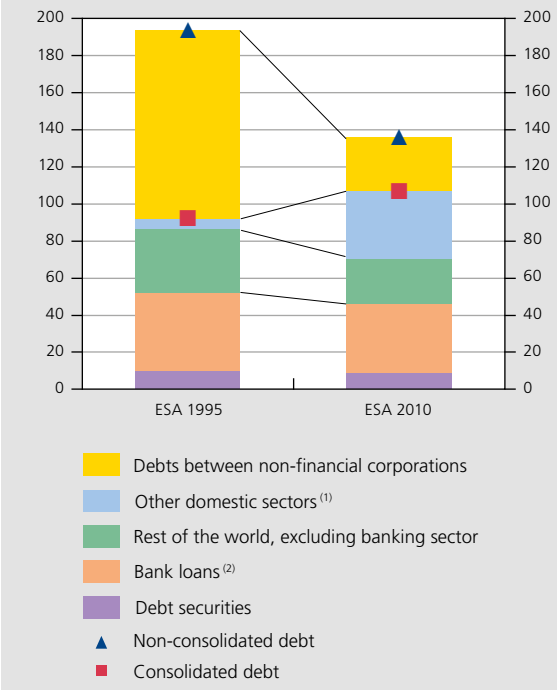
On a consolidated basis, the reclassification of the holding companies meant that the debt ratio was increased by around 15 % of GDP. This increase stems from two opposing factors. On the one hand, any debt contracted by holding companies in other sectors is no longer recognised in the non-financial corporations sector, but on

the other hand, the liabilities of non-financial corporations on holding companies are now recognised in their consolidated debt, as they relate to two different sectors, whereas these used to be consolidated.

At the end of 2013, the consolidated debt ratio stood at 107 % of GDP. Bank loans and debt securities only account for 46.2 % of this debt ratio.

IMPACT OF THE METHODOLOGICAL CHANGES ON THE DEBT RATIO OF NON-FINANCIAL CORPORATIONS

(at end-2013, in % of GDP)



Source : NBB.

(1) Households, general government, non-monetary UCIs, insurance corporations, pension funds and "other financial institutions". In ESA 2010 this latter category also includes "captive financial institutions and non-institutional money lenders".

(2) Loans granted by the resident and non-resident banking sector, including securitised loans.

3.2 Households

In 2014, the financial behaviour of households was primarily influenced by three factors. First, economic agents' confidence remained fragile and was eroded during a large part of the year, even though – unlike in the two previous years – both purchasing power and housing investment were up. Second, financial market developments have widened the gap between returns on low-risk and riskier investment instruments, which may have triggered a search for returns. Nominal interest rates on deposits and loans plunged to historic lows in the year under review, whereas returns on the equity markets held up well, even though they were volatile. Lastly, changes in a number of tax conditions – in particular the reforms of the tax treatment of mortgage loans – heavily influenced loan demand at the end of the year.

As confidence in the economy fell, the year started off with a lull in new loans taken out by households, a continuation of 2013 trends. By the second half of the year, activity picked up on the back of loan refinancing inspired

by lower interest rates or early implementation of planned transactions to lock in more favourable tax treatment. In view of the economic climate, households amassed fewer financial assets than the average in the first three quarters of the years 2006 to 2012, but about as much as that observed in 2013. In terms of categories, households kept their assets very liquid in the first nine months of the year, to face down prevailing uncertainty. At the same time, though, they moved quite a significant proportion of their savings to riskier assets, particularly investment funds, in search of higher returns.

Net household wealth continues to grow at a moderate rate

Total net wealth of households, representing the sum of their financial assets and real estate, amounted to € 2 077 billion at 30 September 2014, an increase on end-2013 by € 64 billion. Both real estate and household financial assets contributed to the increase.

The increase in real estate from € 1 135 billion at the end of 2013 to € 1 176 billion on 30 September 2014 reflects net housing investment as well as higher values of land and buildings in the first three quarters of 2014. Box 8 describes the development of property prices in Belgium and the valuation methods used for its residential property market.

Financial household wealth in Belgium continued to rise in 2014. Estimated at € 1 147 billion at the end of September, compared with € 1 114 billion on 31 December 2013, this exceeds the average increase between 2006 and 2013. Belgian households have also seen their financial wealth increase as a percentage of GDP, from 268.5 % at the end of 2010 and 281.9 % at the end of 2013 to 286.1 % in September 2014. This means that they remain among the wealthiest in the euro area, which as a whole recorded households' financial wealth at 207.2 % of GDP in June 2014.

Belgium's higher household wealth showing reflects both new financial asset accumulation and other flows, including revaluations of existing assets, reclassification and other one-off adjustments. These other flows, which between them amounted to € 13.5 billion, were driven by favourable financial market trends.

TABLE 12 HOUSEHOLD ASSETS AND LIABILITIES
(in € billion)

	Outstanding amount		Change from December 2013		
	End of 2013	End of September 2014	Total	Transactions	Other flows[1]
Real estate	1 134.7	1 176.3	41.6	25.4	16.1
Financial assets	1 114.4	1 146.6	32.2	18.7	13.5
of which:					
Notes, coins and deposits	347.4	353.5	6.2	8.9	–2.7
Debt securities	87.4	81.4	–6.0	–6.5	0.5
Equities	268.7	275.0	6.3	0.9	5.4
Investment fund units	125.9	144.7	18.7	10.7	8.0
Insurance products	269.1	275.7	6.5	4.4	2.1
Other	15.9	16.4	0.5	0.3	0.2
Financial liabilities	235.4	245.6	10.2	8.0	2.3
of which:					
Mortgage loans	181.8	185.5	3.8	3.8	0.0
Other loans	38.9	42.6	3.7	3.5	0.2
Other liabilities	14.7	17.4	2.7	0.7	2.0
Total net assets	2 013.7	2 077.3	63.6	36.2	27.3

Source: NBB.
(1) Other flows comprise both "valuation effects" and "other volume changes". Amongst those, one-off elements such as reclassification of transactions with regard to other sectors may be included.

Box 8 – Valuation of Belgium's residential property market

In Belgium, nominal residential property prices have practically doubled since the beginning of the century, and the drop seen during the great recession was very limited in both scale and duration compared with that in many other euro area member countries. However, the pace of the increases has slowed down markedly in the past two years, and the rise in property prices over the first three quarters of 2014 was only 0.4 % compared with the same period of the previous year. In real terms, prices have come down slightly.

Against this backdrop, the affordability of housing improved somewhat in 2014, as measured by the indicator developed by the NBB and presented in Box 4 of its 2012 Annual Report. After all, the debt service burden on mortgage loans as a part of household disposable income generally eased during the year under review, as both property prices and mortgage rates fell.

The empirical literature describes a range of methodologies for assessing property market valuations, which roughly break down into two categories. The first comprises traditional indicators, i.e. simple ratios of macroeconomic variables expressed as the deviation from their long-term average. Two of the most commonly used – price-to-income and price-to-rent – compared property price developments with household incomes and rents, and both ratios typically point up a strongly overvalued Belgian property market. OECD figures put this overvaluation in the third quarter of 2014 at 50.2 % and 55.3 % respectively.

These yardsticks, which are relatively easy to apply, have their limitations and their outcomes need to be interpreted with caution. The theoretical concept of equilibrium underlying this method of valuing the property market is approached on the basis of the indicators' long-term averages. This is a weighty hypothesis, as it presumes that the equilibrium value is constant over time, whereas it fluctuates in line with changes in the fundamental determinants of property prices, such as interest rate levels, demographics, the preferences of economic agents, mortgage contract features and applicable tax treatment.

VALUATION OF THE BELGIAN RESIDENTIAL PROPERTY MARKET

(percentage deviation from the long-term average, in the third quarter of 2014, unless otherwise stated)

Indicator	Value
Ratio price-to-rent	55.3
Ratio price-to-income	50.2
Interest-adjusted affordability index	28.0
Econometric regression (1)	3.6

Sources: OECD, NBB.
(1) Percentage deviation from the equilibrium value as estimated by the model.

In the case of the price-to-rent ratio, there is a key conceptual difference in that house prices (in the numerator) are based on new secondary market transactions and therefore reflect market conditions, while rents (in the denominator), which in Belgium correspond to the rent component of the consumer price index, usually reflect the rents under existing leases rather than new leases. In addition, as rents in Belgium are subject to various legal rules restricting increases over time, such as (non-obligatory) annual indexation on the basis of the health index,

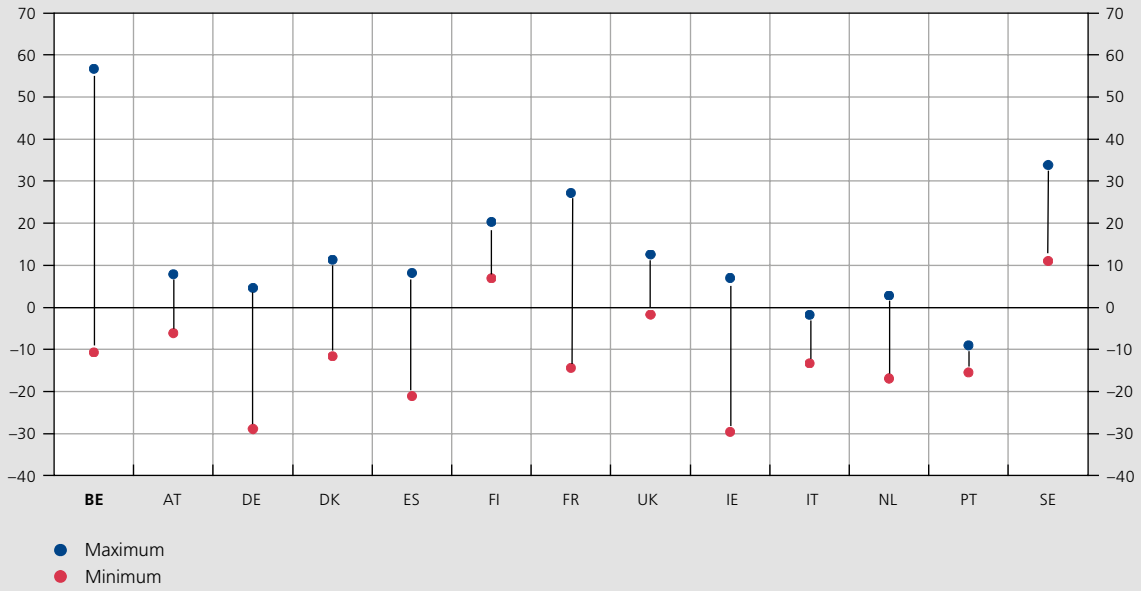
the results obtained essentially reflect those index movements. Lastly, Belgium's relatively small rental market also detracts from the relevance of the price-to-rent ratio.

The price-to-income ratio is then adjusted for movements in mortgage rates, a major influence on household borrowing capacity, giving "interest-adjusted affordability". This indicator – which is invariably expressed relative to a long-term average – suggests that the Belgian housing market was 28 % overvalued in the year under review.

The second approach for assessing property market valuation is based on econometric techniques, the aim being to use fundamental determinants to fix an equilibrium price which can then be taken as the benchmark for measuring deviations in recorded prices. More specifically, this indicator corresponds to the residuals from the regression of a series of fundamental determinants of residential property prices, i.e. average household income, mortgage interest rates, the number of households plus a binary variable to help take account of changes in 2005 to the tax treatment of mortgage loans. This approach would put the Belgian property market at near-equilibrium, a stark contrast with the outcome of the traditional approach.

RESIDENTIAL PROPERTY MARKET VALUATIONS IN A SELECTION OF EUROPEAN COUNTRIES[1]

(in %)



Source : ECB.

(1) Estimates reflecting four different approaches, i.e. price-to-rent, price-to-income and two indicators based on econometric regressions. Minimum and maximum points reflect the lowest and highest estimates of the four methods. For more information, refer to Box 3 of the June 2011 Financial Stability Review (ECB).

As in the case of financial assets, assessment of the fundamental value of property remains a perilous exercise, and the results must be viewed with caution. Despite its unmistakable advantages – factoring in fundamental market determinants and not establishing the market's equilibrium value on the basis of a long-term average – the econometric approach is not without its flaws. The gap between recorded prices and the equilibrium price might be down to the omission of one or more fundamental determinants, or to the explanatory variables deviating

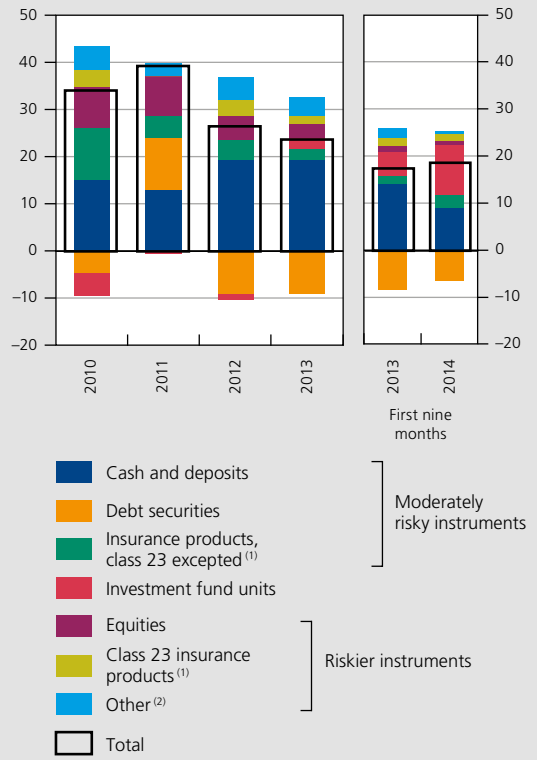
from their own long-term equilibrium values, as is the case with abnormally low mortgage rates. Another example would be the announcement – and in the case of the Flemish Region the early implementation – of measures reducing tax relief on mortgage loans, a decision that could significantly depress house prices in 2015.

The analysis for the euro area countries as reported by the European Systemic Risk Board reveals that major valuation gaps between methods are no typically Belgian phenomenon. However, price-to-rent and price-to-income are completely out of step in Belgium.

In the first three quarters of 2014, Belgian households accumulated new financial assets worth € 18.7 billion (compared with € 17.5 billion in the same period of 2013). That said, their new liabilities also exceeded those in the first nine months of 2013, at € 8 billion. Overall, the balance of households' financial transactions contributed € 10.7 billion to the increase in their net financial wealth between January and September – slightly down on the € 12.1 billion recorded in the same period of 2013.

CHART 47 FORMATION OF FINANCIAL ASSETS BY HOUSEHOLDS: BREAKDOWN BY ASSET CLASS

(in € billion)



Source: NBB.

(1) These items comprise the net claims of households on technical insurance reserves and on standardised guarantee schemes.

(2) This item comprises households' pension entitlements and, insofar as they have been recorded, export credit as well as miscellaneous claims on general government and financial institutions.

The financial liabilities of households comprise mainly mortgage loans. In net terms, refinancing of current loans are not included, as these do not affect total volumes of household liabilities. Like their assets, households' total net financial liabilities continued to rise in 2014 to reach € 245.6 billion at the end of September, compared with € 235.4 billion in the comparable nine-month period.

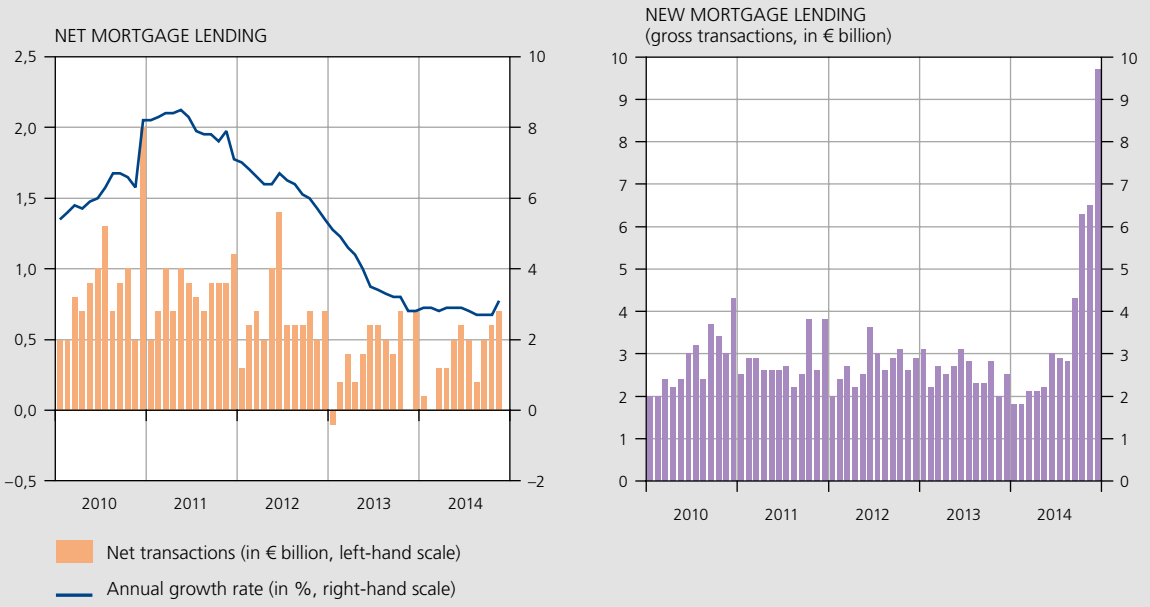
Households partially refocus new investment to riskier assets

In 2014, households redirected a greater proportion of their savings to investment products than in 2013. Falling consumer confidence and continued fragile economic prospects have led households to retain a significant amount of precautionary savings: short-term liquid assets accounted for a large proportion of savings in the first six months of the year.

The financial assets acquired by households can be divided into three categories of instruments, according to the nature of the associated risk: assets bearing a low risk, including cash, deposits, debt securities and insurance products (except class 23); higher risk products such as equities and class 23 insurance products; and finally, units in investment funds, which combine moderately risky products (bond UCIs) with other, riskier products (equity UCIs, mixed funds and funds of funds). According to data from the Belgian Asset Management Association, it was mainly the latter that attracted the interest of investors in 2014, which is why these are ranked among equities and class 23 insurance products in this Report.

According to this breakdown, riskier instruments would seem to account for a large proportion of new investment

CHART 48 MORTGAGE LENDING



Source: NBB.

in financial assets by Belgian households in the first nine months of 2014 (€ 13 billion, compared with € 8.2 billion in the comparable period of 2013). Although cash and deposits remain sought-after instruments, claiming € 8.9 billion of new investment, households have also invested in investment fund units and equities, for a total amount of € 11.6 billion.

As for moderately risky assets other than cash and deposits, € 2.8 billion of household savings went into insurance products, class 23 products excluded. This compares with € 1.6 billion in the first three quarters of 2013.

As in previous years, households completely ignored debt securities. Sales and redemptions of these instruments exceeded purchases and subscriptions by € 6.5 billion, compared with a € 8.4 billion negative flow in the first nine months of 2013.

Investment in investment fund units was sharply ahead of the 2013 figures: € 10.7 billion in the first three quarters of 2014, compared with € 5.2 billion in the same period of the previous year. Virtually all investment went into non-monetary investment funds.

Households invested a little less in equities than they had in 2013, with net equity investment amounting to € 0.9 billion in the first nine months of 2014, compared with € 1.3 billion from January to September 2013.

Class 23 insurance products, the other instruments in the riskier category largely linked to individual life insurance, attracted € 1.3 billion, one-third of total new insurance product transactions. These instruments had accounted for € 1.7 billion in the first three quarters of 2013.

Mortgage loans see moderate net growth despite intensive refinancing activity

Various factors influenced the growth of new household loans in the year under review, and more specifically the signing of new mortgage contracts, as the deteriorating economic climate of the spring of 2014 affected the formation of new financial liabilities by households. Specific developments such as the ongoing fall in mortgage rates and changes in the tax treatment of property loans (tax rebates on mortgage interest) sharply pushed up (gross) demand for loans. The demand spike was particularly noticeable in the second half of the year and took the shape of a significant increase in refinancing volumes – which did not affect net demand – and higher levels of new loans for the new construction, purchase and/or renovation of homes. As a result, annual growth rates of property loans

remained moderate – and relatively steady – in 2014, at around 2.8 %. This percentage shot up to 3.1 % by the end of the year, as households anticipated changes in the law on mortgage interest relief.

In the first nine months of 2014, net volumes of new loans contracted by households – both mortgage loans and consumer credit – rose from € 5.3 billion in the comparable period of 2013 to € 7.9 billion. On the one hand, new mortgage loans edged down from € 4.2 billion in 2013 to € 3.8 billion in the first nine months of 2014, reflecting households' wait-and-see attitude in the period. Taking account of reclassification and other adjustments, households' total mortgage debt came to € 185.5 billion by September 2014, compared with € 181.8 billion at the end of 2013. On the other hand, the total increase in new financial liabilities was partly attributable to new long-term non-mortgage loans, the net volume of which amounted to € 1.7 billion in the first nine months of 2014, compared with a slightly negative figure of € 0.1 billion in the same period of last year. Higher new financial liability volumes have further pushed up households' debt ratio, to 103.5 % of their disposable income in September 2014, as against 101.1 % at the end of 2013.

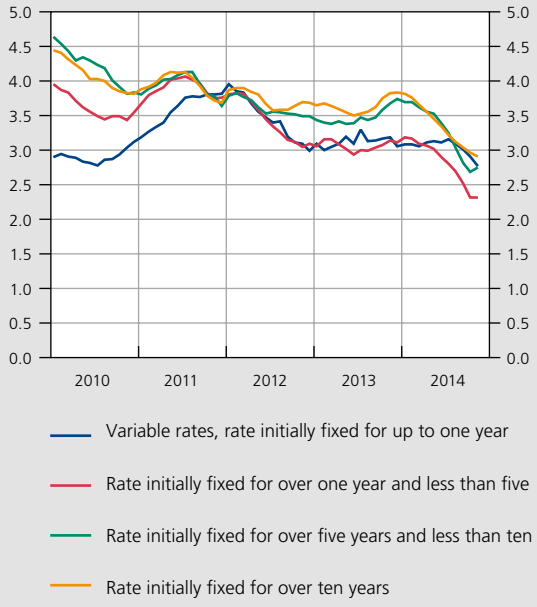
Housing investment and new mortgage contract growth remained subdued in the wake of restrictive bank lending conditions (disregarding interest rates) and the greater challenge for households to financially secure their new loans due to the rather limited rise in disposable incomes. The bank lending survey found that banks further tightened their mortgage lending criteria in the second and fourth quarters of the year in view of general economic conditions and housing market-related risk trends. Mortgage lending criteria remained fairly tough in 2014: banks have yet to ease mortgage loan conditions tightened up in 2012 during the sovereign debt crisis.

However, in the second half of the year, households were keen to lock in persistently falling mortgage rates, which have plumbed historic lows, particularly by refinancing. In keeping with benchmark rates, mortgage loans recorded uninterrupted falls in interest rates as the year progressed. Loans with original maturities of over ten years came down by 93 basis points to 2.9 % between December 2013 and November 2014.

From September 2014, the CICR recorded a significant increase in new mortgage loans: between September and December an average 67 300 mortgage contracts were agreed, compared with an average 22 000 a month between January and August. The amounts involved were also slightly higher. However, the overall number of loans has failed to keep up with this pace, suggesting that part

CHART 49 MORTGAGE LOAN COSTS

(in %)



Source: NBB.

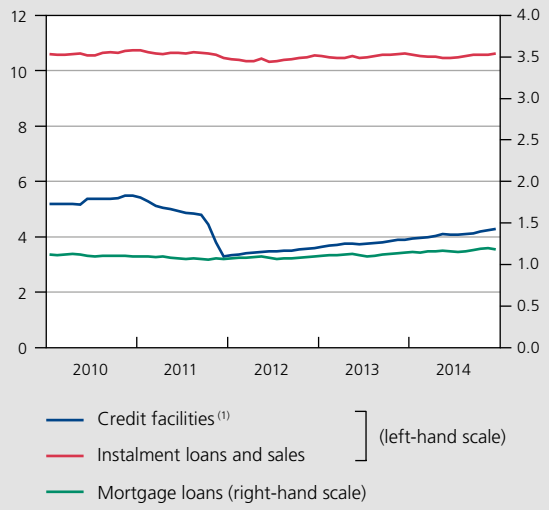
of the upturn was down to refinancing. But even ignoring any refinancing effect, the home loan market has become more dynamic since September. The situation may reflect some front-loading related to tax treatment reforms introduced by the Flemish government, which has decided to cut the maximum mortgage rate reduction for would-be buyers from 2015, from € 2 280 to € 1 520 (amounts increased by € 760 in the first ten years). Starting in 2015, the tax break will be reduced to 40 % in Flanders. The number of residential building permits, an indicator anticipating the start of construction work roughly three months before, reached record highs in March and April of 2014, exclusively due to figures from Flanders.

Risks related to private individuals' debt limited on balance, if a heavier burden on some categories

Statistics from the CICR reveal an upward trend in the number of non-regularised defaults on mortgage loans since mid-2012, amounting to 1.2 % of total loans outstanding at the end of November 2014, the highest level since 2007. Though this low percentage is no cause for concern, this indicator should be closely monitored, particularly in the event of economic stagnation. As Box 9 shows, some categories, including the young, those on the

CHART 50 NON-REGULARISED DEFAULTS

(in % of the number of current loans)



Source: NBB.

(1) Credit facilities showed a statistical break at the end of 2011, which was due to the Central Individual Credit Register's increased scope. Since the end of 2011, authorised current account overdrafts have needed to be recorded in the Register, whereas this did not previously apply if the facility was less than € 1 250 and was repayable within three months.

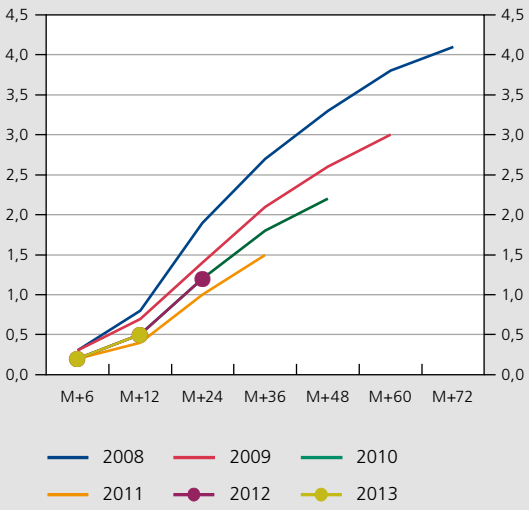
lowest incomes and highly leveraged households, are more at risk. Lastly, the average level of arrears and amounts due rose to € 38 400 at the end of November 2014 from € 36 400 at end-December 2013, a 5.5 % increase.

In the case of revolving credit facilities – which since end-2011 include current accounts allowing overdrafts – defaults continued to rise in 2014: defaults recorded on this type of loan amounted to 4.3 % of all contracts in November, an increase of 0.4 percentage point on the end-2013 figure. The amounts involved are smaller than in the case of mortgages: an average of € 1 700 per default. Default rates on instalment loans and sales held steady in the year under review, accounting for 10.7 % of the total number of loans outstanding at the end of 2014. Default amounts stood at nearly € 1 200 for instalment sales and at around € 7 800 on instalment loans.

An analysis of annual default ratios for a range of credit types might show up changes to credit conditions imposed by banks or any post-financial crisis intensification of repayment problems. Instalment sales excepted (an unusual category anyway, as contracts have slumped in the past years), no significant increase in default rates has been recorded since the economic and financial crisis first took hold. In fact, for mortgage loans successive cohort curves fundamentally declined in the 2008-2011 period, which points to an improved – and downward – trend in defaults between these two years. Default rates edged back up from these record lows in 2012 and 2013, but have remained low.

CHART 51 DEFAULTS ON MORTGAGE LOANS (1) BY YEAR OF GRANTING (2)

(in % of the number of loans)



Source: NBB.

(1) A default is recorded if the sum due remains fully or partly unpaid three months after due date, or if the sum due remains fully or partly unpaid after a demand by registered letter, or if the sum is fully or partly unpaid a month after formal notice has been served by registered letter.

(2) Loans are grouped according to the year of origination. For each year, the curves show defaulting loans as a percentage of the original total number of loans after a certain number of months from the date the facility is granted. Any loan regularisations are disregarded.

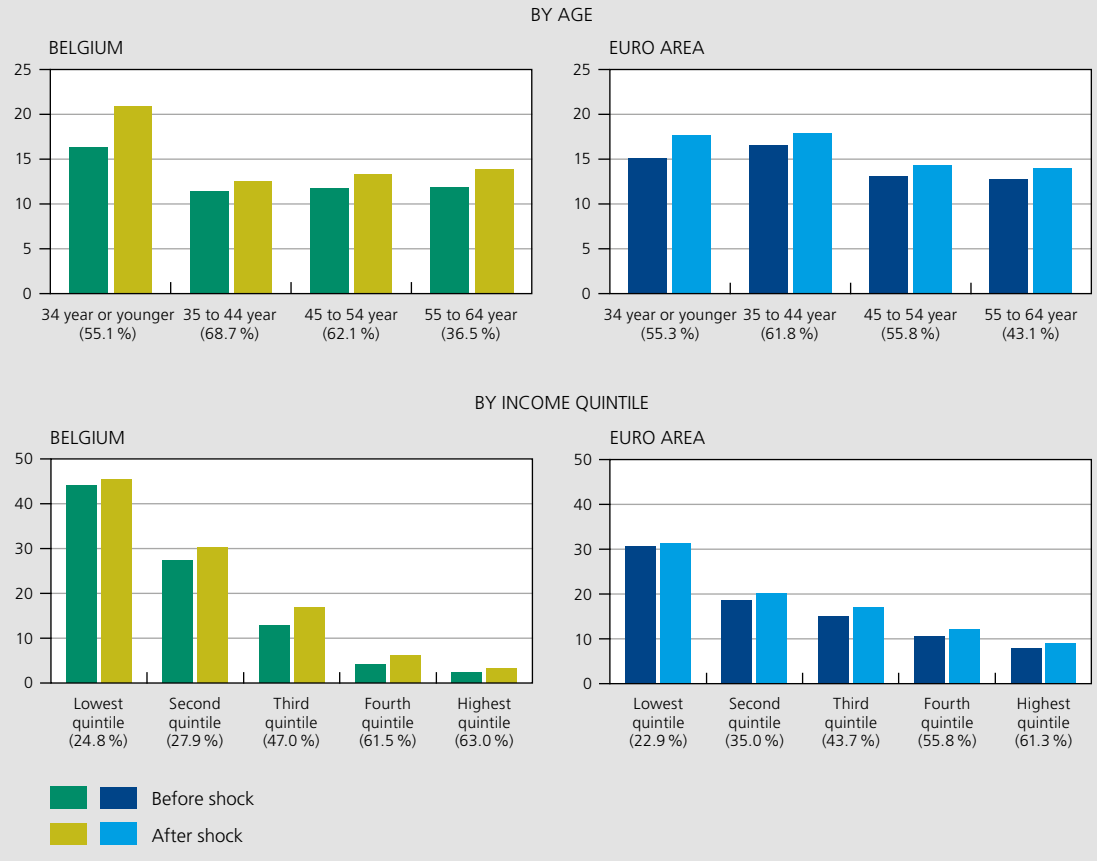
Box 9 – Household debt sustainability: effect of income shocks on the repayment capacity of Belgian households

The financial accounts data show total debt to be pretty favourable for Belgian households. However, these aggregate statistics provide a total debt overview for all households taken together, regardless of their levels of indebtedness, and do not enable deeper research into the borrowing capacity of specific groups or individual households. And so it is useful to estimate the effect of macroeconomic shocks on the debt sustainability of individual households based on microeconomic data. Using data derived from the Household Finance and Consumption Survey (HFCS) for 2010, this Box investigates the effects on household sustainability and, more specifically, on the repayment capacity of households.

HFCS data show that less than half of all Belgian households are indebted, by mortgage loans or otherwise. Participation in the credit market is 44.8 % in Belgium, compared with 43.7 % in the euro area. Belgian household

SENSITIVITY OF DEBT-SERVICE-TO-INCOME RATIO TO AN INCREASE IN UNEMPLOYMENT (1) (2)

(number of households with a debt-service-to-income ratio of over 0.3, in % of indebted households)



Sources: ECB, NBB (HFCS).

(1) In the simulated income shock, employees stand a 5 % chance of losing their jobs and income from employment (10 % for employees under 35 and over 55), after which they will have to draw unemployment benefit.

(2) In brackets: indebted households in % of total households of the comparable group.

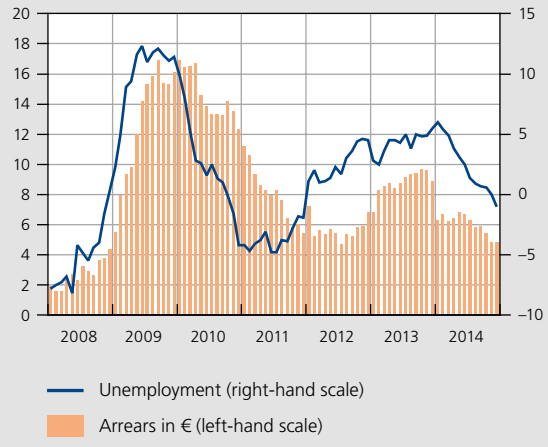
debt can be analysed more closely by breaking down households into age groups and income quintiles[1]. Credit market participation exhibits a hump-shaped age profile both in Belgium and in the euro area, with participation initially rising with age, from 55.1 % for the youngest households (in which the reference person is under 35) to a peak of 68.7 % for the 35-44 age group, and then coming down again. Credit market participation increases with income, from 24.8 % in the lowest income quintile to 63 % for the highest. Households with higher incomes find it easier to get and repay loans. Outstanding loans typically exhibit age and income profiles similar to the participation rate.

Total outstanding debt levels for households provide no information on the repayment capacity of individual households. A frequently used indicator in this context is the debt-service-to-income ratio, which measures the proportion of income that is needed to repay the debt and meet interest payments. Academic studies suggest that households which spend more than 30 % of their income on servicing debt potentially run higher liquidity risks. According to HFCS data, the proportion of households with a debt-service-to-income ratio of over 0.3 stood at 12.9 % of all indebted households in Belgium, compared with 14.1 % for the euro area.

Not all household categories run the same risk of too high a debt-service-to-income ratio. Indebted young families potentially run a slightly higher risk, and the share of households with problem debt ratios also falls with income levels. Belgium's age and income profiles related to potential debt service issues are both slightly more pronounced than in the euro area: although the proportion of households with problem debt-service-to-income ratios is smaller in Belgium on average, the share of youngest households (16.3 %) exceeds the figure for the euro area (15.2 %). In the lowest income quintile, 44.2 % of Belgian indebted households exhibit debt-service-to-income ratios of over 0.3, compared with 30.6 % for the euro area. The share of indebted households with problematic

UNEMPLOYMENT AND HOUSEHOLD DEFAULT

(annualised percentage changes)



Sources: NEO, NBB (CICR).

debt ratios is bigger for Belgium's lowest income quintiles than for the euro area. Belgium's more pronounced age and income profiles – accounting for a relatively higher risk than in the euro area for the youngest households and households in the lowest income group – reflect different patterns in property ownership and related mortgage

(1) Du Caju Ph. (2013), "Structure and distribution of household wealth: An analysis based on the HFCS", NBB, *Economic Review*, September, pp. 41-63.

loans. Unlike the euro area, Belgium typically has the highest loans in the youngest indebted households, reflecting faster and more general access to home ownership: 46 % of households with a reference person under the age of 35 own their own home, compared with only 31.9 % in the euro area.

Drawing on HFCS data, a simulation can be used to gauge the effects of an income shock on the debt sustainability of households and their capacity to keep repaying their debts. More specifically, it analyses the consequences of an upturn in unemployment that threatens to destroy the jobs of 10 % of employees under the age of 35 and over the age of 55, with 5 % of employees in the middle age brackets hit[1]. After all, youth unemployment tends to be more cyclical and corporate restructurings typically end in older employees being made redundant. All other things being equal, the shock would push up unemployment by nearly 4 percentage points. This static simulation does not factor in any behavioural adjustments, changes in the the labour force or feedback effects.

Loss of income from employment and its replacement by unemployment benefits can turn a family's debt position into a problem. The chances of this happening depend on their basic financial situation before the shock, the amount of outstanding debt and other sources of income. Under this simulated unemployment shock, the share of families with a debt-service-to-income ratio of over 0.3 would rise from 12.9 % to 14.9 % in Belgium and from 14.1 % to 15.5 % in the euro area, with the relatively stronger impact in Belgium affecting mostly young families. The share of indebted families in the under-35 bracket and with a debt-service-to-income ratio of over 0.3 would climb from 16.3 % to 20.9 % in Belgium and from 15.2 % to 17.7 % in the euro area. The unemployment shock's impact on household debt sustainability would be fairly evenly distributed across the income groups (quintiles). Belgian families in the lowest and middle income groups prove more vulnerable than those in the euro area. Middle incomes in Belgium have a lot of double-income, steeply mortgaged couples whose outstanding debt is generally higher than in the euro area.

The outcomes of these simulations are broadly confirmed by trends in arrears as registered with the CICR[2]. Between 2008 and 2014, changes in the number and size of arrears in Belgium closely mirrored unemployment trends, with CICR data confirming that younger people struggle more with arrears on their loans. A more pronounced correlation between repayment problems and unemployment rates is also noted, with most of the defaults concerning non-mortgage loans.

(1) Du Caju, Ph., F. Rycx and I. Tojerow. Unemployment risk and financial fragility: a microeconometric perspective. NBB Working Paper, forthcoming
(2) Du Caju, Ph., Th. Roelandt, Ch. Van Nieuwenhuyze and M.-D. Zachary (2014). "Household debt: Evolution and distribution", NBB, *Economic Review*, September, pp. 65-85.

3.3 Non-financial corporations

In the first three quarters of 2014, the financial transactions of non-financial corporations were heavily influenced by historically low interest rates coupled with a fragile and tentative economic climate. Despite better funding conditions, corporations took on fewer new financial liabilities, although the net fall was not as steep as in the comparable period of 2013 and was the outcome of trends pulling in many different directions. Bank lending to large companies fell further, as they increasingly tapped the capital markets by issuing bonds and equities. By contrast, bank lending to small and medium-sized enterprises (SMEs) picked up slightly in 2014. As loan conditions have eased, the overall drop in total external funding would appear to point to ongoing relatively weak investment demand, possibly caused by increased uncertainty, sluggish final demand and a deteriorating outlook for economic growth. These factors also partly explain why corporations piled up liquid assets in anticipation of future investment.

Companies see their net financial liabilities increase on the back of rising stock market prices

In the first nine months of 2014, the financial liabilities of non-financial corporations grew by € 24.5 billion in total, whereas their assets added only € 2.3 billion, taking their net financial liabilities € 22.2 billion higher to € 369 billion (or 92.1 % of GDP) by the end of September 2014. As in 2013, the balance of financial transactions was negative in

TABLE 13 FINANCIAL ASSETS AND LIABILITIES OF NON-FINANCIAL CORPORATIONS

(in € billion)

	Outstanding amount		Change from December 2013		
	End of 2013	End of September 2014	Total	Transactions	Other flows[1]
Financial assets	1 265.9	1 268.2	2.3	–4.8	7.1
of which:					
Cash and deposits	112.2	116.6	4.4	1.5	3.0
Debt securities	20.2	11.6	–8.6	–8.4	–0.2
Listed shares	89.9	90.5	0.5	0.5	0.0
Unlisted shares and other equity	405.1	417.8	12.7	11.5	1.2
Loans	363.4	371.0	7.6	5.2	2.4
Trade credit	146.2	135.2	–11.1	–11.3	0.3
Other assets[2]	128.7	125.5	–3.2	–3.7	0.4
Financial liabilities	1 612.6	1 637.2	24.5	–5.3	29.9
of which:					
Debt securities	37.9	40.8	2.9	2.3	0.6
Listed shares	199.1	229.0	29.9	3.3	26.7
Unlisted shares and other equity	717.3	717.5	0.2	–5.4	5.6
Loans	499.8	504.5	4.7	6.0	–1.3
Bank loans	147.1	146.5	–0.5	–0.3	–0.2
Non-bank loans	352.7	358.0	5.2	6.3	–1.0
Trade credit	134.3	120.7	–13.6	–12.2	–1.3
Other liabilities[3]	24.3	24.7	0.4	0.7	–0.3
Net financial assets	–346.8	–369.0	–22.2	0.5	–22.7

Source: NBB.
(1) Comprising both "valuation effects" and "other volume changes".
(2) Primarily statistical adjustments.
(3) Almost exclusively other debt, with the exception of trade credit.

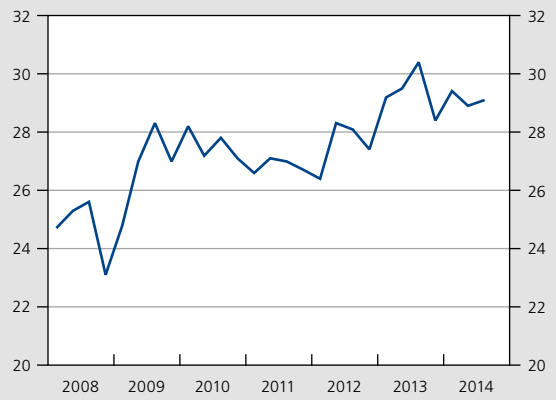
the first three quarters of 2014, both for liabilities and for assets. The shortfall was more than offset by positive changes in corporate financial positions on the back of rising stock market prices and a number of reclassifications.

Total financial assets and liabilities of non-financial corporations mainly reflect cross-balance-sheet positions: almost one-fourth of non-financial corporations' liabilities are held by other resident non-financial corporations, often in the shape of inter-company positions, and about half by foreign companies and holding companies, which will henceforth be recognised under the financial sector (see section 3.1). Around 30 % of total financial assets of non-financial corporations have resident non-financial corporations as their counterparty; foreign companies and holding companies account for 60 %. It is of course quite likely that not all transactions with foreign companies or holding companies are inter-company transactions, but these figures probably serve as a reasonable approximation of such transactions. Instruments used in cross-positions are primarily unlisted equities and other equity, as well as non-bank loans.

Total financial liabilities grew less robustly than in the comparable period of 2013, and mostly advanced as listed shares, non-bank loans and debt securities. The € 29.9 billion surge in listed shares mostly reflects rising stock market prices and only slightly the net issuance of new shares. Outstanding debt securities at the end of September 2014 recorded a total value nearly € 3 billion up on the end of 2013, on the back of positive net issuance. Outstanding loans also increased, by € 4.7 billion, but these were exclusively facilities furnished by sectors other than MFIs. All in all, corporations tapped the financial markets for their external funding and relied less on bank loans, while also using less trade credit.

CHART 52 CASH AND DEPOSITS HELD BY NON-FINANCIAL CORPORATIONS

(outstanding amount, in % of GDP)



Source: NBB.

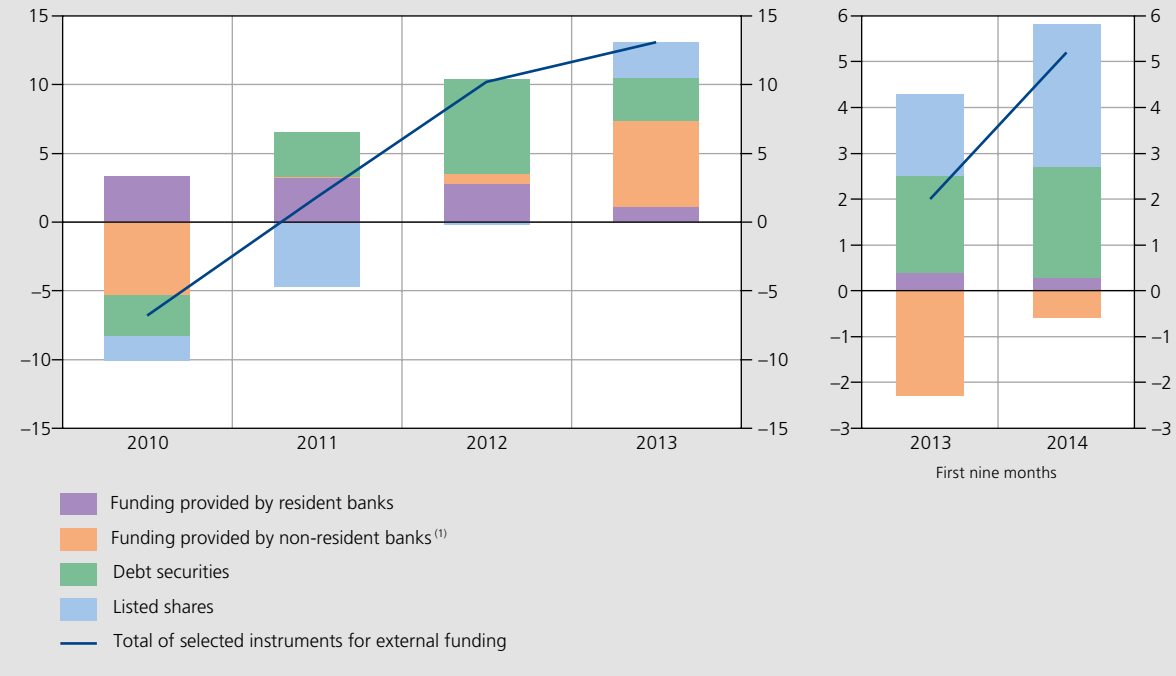
On the assets side, non-financial corporations' balance sheets recorded positive developments for unlisted shares and other equity, lending and cash & deposits. Conversely, they furnished fewer trade loans and held fewer debt securities.

Corporations continue to enjoy ample financial reserves

Recording a further increase of around € 4.4 billion in the first nine months of the year under review, cash and deposits outstanding at non-financial corporations amounted to € 116.6 billion by the end of September 2014, or 29.1 % of GDP – a hefty cash reserve when compared with the average since 1999 of 24 % of GDP. Non-financial corporations have been improving their profitability since 2013, but a dearth of attractive real and financial investment opportunities has kept them from dipping into their financial reserves. They will be able to draw on these reserves to complement external funding when implementing investment projects as soon as the economic recovery gathers momentum.

CHART 53 SELECTION OF NEW FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

(consolidated data, in € billion)



Source: NBB.

(1) Whereas net lending by non-resident banks was negative for the first nine months of 2013, the positive full-year figure reflected an exceptional transaction in the fourth quarter.

Companies used more long-term market instruments to finance their operations

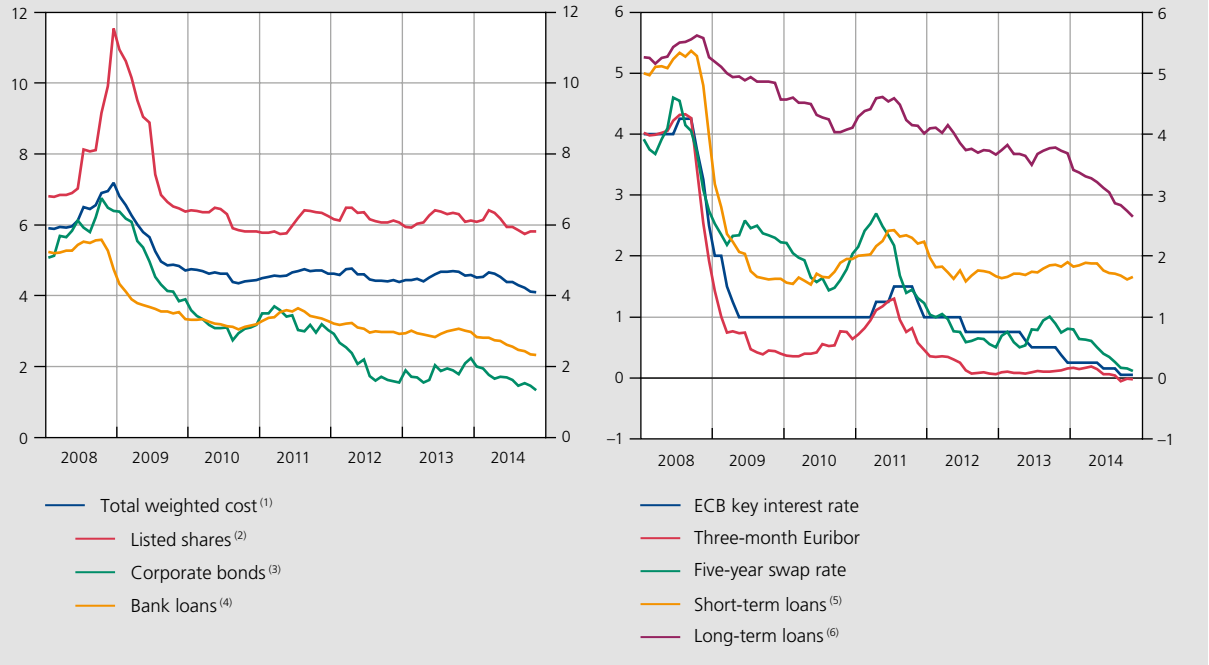
Funding transactions will now be reviewed on a consolidated basis and so ignore funding from other resident non-financial corporations. What results is still an unavoidably distorted view, however: the figures are not adjusted for any funding provided by holding companies and associated companies incorporated abroad, as sufficiently detailed information is lacking.

The consolidated data show corporations to have reduced their total financial liabilities by € 0.6 billion in the first three quarters of the year under review, compared with a net increase of € 5.1 billion in the comparable period of 2013. The figures primarily reflect a net € 7.1 billion fall in unlisted shares and other equity. A large proportion of this may well be down to cross-holdings within the same group, as holding companies and foreign companies together account for around 90 % of the fall. Non-financial corporations did tap the markets more in the first nine months of the year under review, using long-term market instruments in particular. They did not just increase the issuance of listed shares – the very embodiment of long-term financing – but also issued more debt securities, particularly long-term ones.

Corporations again borrowed less from banks in the first three quarters of 2014, but the net € 0.3 billion fall was wholly attributable to short-term credit trends. Resident banks granted as many short-term loans as there were repayments, but short-term lending by non-resident banks continued to decline. The same was true for their long-term loans, but this was offset by non-financial corporations drawing on more long-term credit from resident banks. Besides, non-financial corporations also issued new debt securities in the first nine months of the year under review. Consolidated net debt securities issuances totalled € 2.4 billion, compared with € 2.1 billion in the comparable period of 2013, breaking down into long-term debt securities at € 1.9 billion and short-term issuance worth only € 0.5 billion. For corporations able

CHART 54 EXTERNAL FUNDING COSTS OF NON-FINANCIAL CORPORATIONS

(monthly data, in %)



Sources: Barclays Capital, Thomson Reuters Datastream, NBB.

(1) Obtained by weighting the cost of funding by listed share issuance, bond issues and bank loans according to their respective share in the total outstanding amount of these financial liabilities.

(2) Estimated on the basis of a dividend discount model (see Box 19 in the 2005 Annual Report).

(3) Return on an index of euro-denominated bonds issued by Belgian non-financial corporations, with maturities of more than one year and with a rating in excess of Baa; the index is weighted according to the outstanding amounts.

(4) Weighted average rate applied by resident banks to business loans. The weighting is based on the outstanding amount of the various types of credit.

(5) Interest rate on new bank loans of more than € 1 million at variable rates, initially fixed for up to one year.

(6) Interest rate on loans of € 1 million or less, with a rate initially fixed for more than five years.

to issue bonds, this type of market funding was again relatively attractive when compared with bank loans, as interest charges on bank lending are invariably higher (see below). And although the issuance of listed shares comes at a steep cost, corporations increasingly draw on these instruments too: on a consolidated basis, they issued € 3.1 billion in listed shares, compared with € 1.8 billion in the comparable period of 2013.

Funding environment for corporations improved significantly

On the whole, non-financial corporations saw their funding environment improve massively from the end of 2013, which was reflected in lower costs of a range of external funding sources. A number of surveys of banks and entrepreneurs also found that general funding conditions – price and non-price – have improved both for large companies and to a lesser degree also for SMEs.

Corporations' total financing costs – calculated by weighting the nominal cost of each funding source according to its respective share in the total outstanding amount of its financial liabilities – fell further in the year under review, to historic lows. The average financing costs of all non-financial corporations taken together were estimated at 4.1 % in November 2014, compared with 4.6 % in December 2013. Note that this average masks sizeable differences between funding sources, with costs ranging between 1.3 % for corporate bonds and 5.8 % for listed shares. And although costs came down sharply in 2014 for all types of external funding, long-term bank loans and corporate bonds fell the hardest, by 105 and 90 basis points respectively.

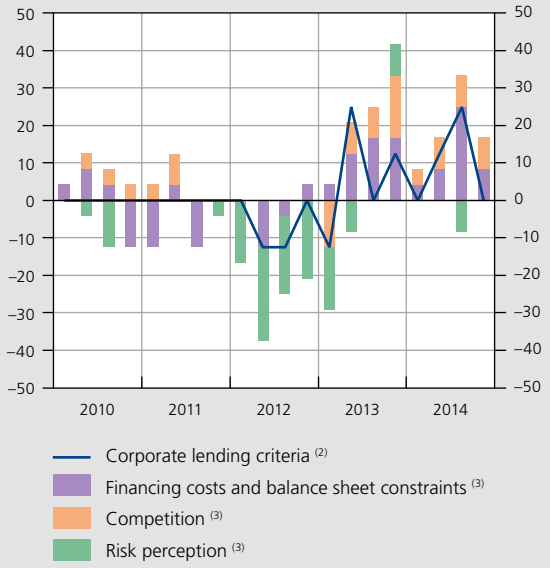
In part, these reduced costs reflect accommodating monetary policies set by the ECB, which cut its key interest rate further and confirmed its forward guidance, sparking an immediate further drop in money market rates – and especially the long-term ones. The three-month swap rate fell by 18 basis points compared with end-2013, to –0.02 % in November 2014, while five-year swap rates were 70 basis points lower at 0.1 %. Effective interest rates on new bank loans to corporations also followed the downward trend: interest rates on short-term loans for amounts in excess of € 1 million fell from 1.9 % at the end of 2013 to 1.7 % in November 2014, while long-term loans initially fixed for more than five years dropped 105 basis points to 2.6 %.

The improved funding environment for non-financial corporations did not just reflect external borrowing costs but also non-monetary conditions. In a range of qualitative surveys both banks and entrepreneurs agreed that the availability of external funding, and in particular of bank loans, had improved in the course of 2014. The Eurosystem's bank lending survey found that Belgium's four resident major banks had further eased their credit standards for corporate loans in the second and third quarters of 2014, as they had seen their own financing costs and balance sheet restrictions relax and competition pick up, although risk perceptions had heightened again and affected credit standards in the third quarter. This easing of borrowing conditions primarily showed up in improved monetary conditions – lower margins on corporate loans with average risk profiles – but banks also proved more relaxed about term to maturity, volumes and clauses in loans agreed. Better non-monetary conditions generally benefited large companies more than they did SMEs.

Another NBB survey revealed that business leaders also took a favourable view of general conditions for new bank loans in the second and third quarters of the year under review – for the first time since the second quarter of 2011. Positive sentiment primarily reflected a more favourable perception of bank lending rates, while views

CHART 55 CREDIT STANDARDS AND DETERMINANTS ACCORDING TO CREDIT INSTITUTIONS

(weighted net percentages of the responses by credit institutions (1))



Source: NBB (Eurosystem bank lending survey).

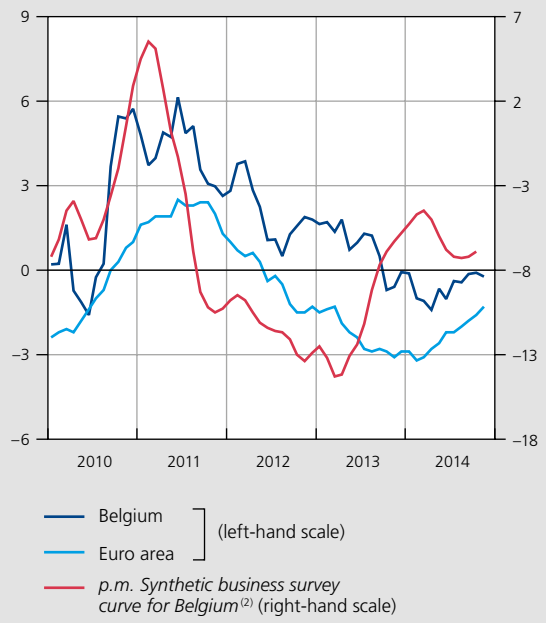
(1) The responses are weighted according to their distance from the "neutral" response: mention of a "considerable" change in the lending criteria is accorded double the weighting of a "slight" change.

(2) The degree to which lending criteria were eased (+) or tightened (–).

(3) A positive (negative) net percentage corresponds to a factor contributing to easing (tightening) the lending criteria. Average of net percentages for the various sub-questions.

CHART 56 LENDING BY RESIDENT BANKS TO RESIDENT NON-FINANCIAL CORPORATIONS[1]

(end-of-month data; annualised percentage changes, unless otherwise stated)



Sources: ECB, NBB.
(1) Including securitised loans.
(2) Smoothed indicator, balance of responses.

of non-monetary conditions continued to deteriorate, albeit to a lesser degree. The total net percentage score assigned to loan volumes came to –6 % in the third quarter of 2014 for all companies together, compared with –26 % in the first quarter of 2013, while the percentage had already turned positive for very large companies. Both surveys point to significant across-the-board improvements for large companies, while small and medium-sized enterprises mainly benefited from lower interest rates but not (yet) so much from easing of non-monetary criteria. These findings are corroborated by a third qualitative annual survey, the Survey on the Access to Finance of small and medium-sized enterprises in the euro area (SAFE), in which Belgian SME respondents reported easier access to bank loans between April and October 2014, for the first time since the survey was launched in 2009. SMEs with robust balance sheets, in particular, appeared to encounter fewer challenges in attracting outside funding, despite the subdued general economic climate. Lower interest rates were primarily cited, but far fewer SMEs reported that their loan applications were wholly or partly rejected by their banks.

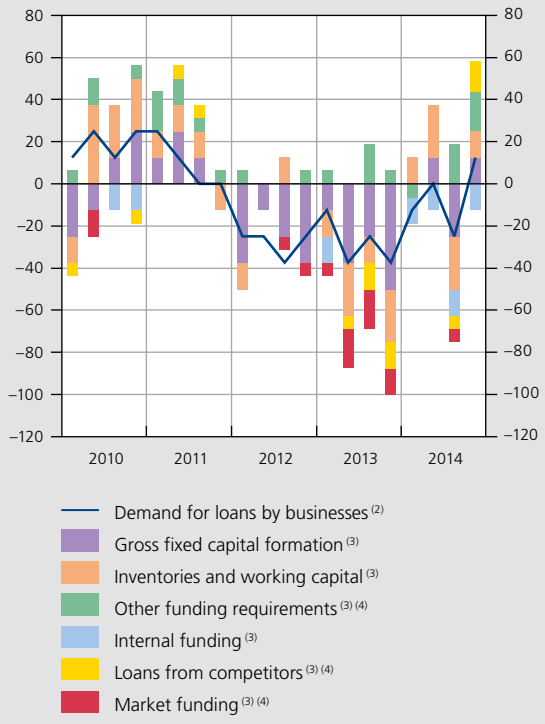
Weak bank loan growth mainly demand-related

Despite this robust improvement in the funding environment, bank lending to non-financial corporations continued to grow at a glacial pace in the first three quarters of 2014. With bank loans virtually the only source of debt financing for SMEs and given these companies' crucial role in Belgium's economy, the importance of stable bank lending cannot be underestimated.

According to resident banks' monthly statistics – still drawn up in keeping with the ESA 1995 definition of non-financial corporations – the annual percentage change in loans to corporations stayed negative in 2014. That said, the recent downtrend that started in May 2013 would now appear to have ended: by April 2014, the percentage change had plumbed an all-time low of –1.4 %. By November 2014, growth was at an annualised –0.2 %, comparable

CHART 57 LOAN DEMAND AND DETERMINANTS ACCORDING TO CREDIT INSTITUTIONS

(weighted net percentages of responses by credit institutions[1])



Source: NBB (Eurosystem bank lending survey).
(1) The responses are weighted according to their distance from the "neutral" response: mention of a "considerable" change in borrowing demand is accorded double the weighting of a "slight" change.
(2) The degree to which borrowing demand went up (+) or down (–).
(3) A positive (negative) net percentage corresponds to a factor contributing to borrowing demand going up (down).
(4) Average of net percentages for the various sub-questions.

to end-of-2013 levels. More relaxed loan criteria notwithstanding, loans provided by resident banks to non-financial corporations continued to exhibit very subdued growth, underlining the key influence of sluggish demand.

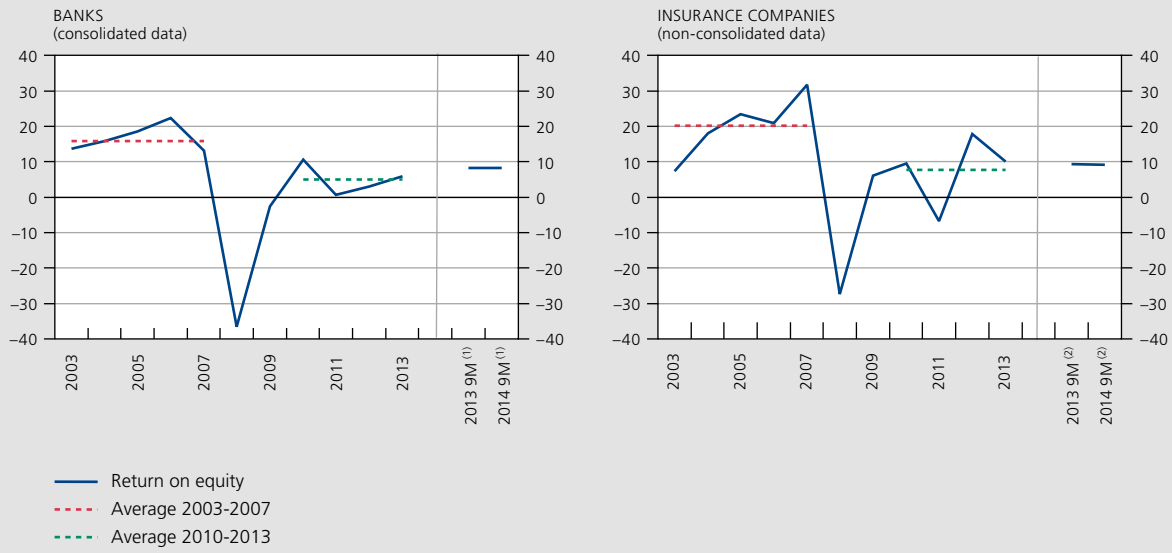
Two factors of a very different nature could explain the sluggishness: continued reticence on the part of corporations to launch investment projects and corporations increasingly tapping non-bank funding sources, such as corporate bonds or equities. In the latter case, subdued bank loan growth need not be regarded as acting as a brake on future investment, but rather as a positive trend towards a more diversified financing structure and a more robust financial base for non-financial corporations. What is more, this would give the banks more room to lend to SMEs, which are typically too small to tap resources in the equity or bond markets. It is important to establish whether subdued bank credit growth is down to substitution by large companies or to a dearth of suitable investment projects.

According to the Eurosystem bank lending survey, Belgium's four resident major banks did indeed report that the demand for loans remained very weak and that it has consistently fallen since the beginning of 2012, only starting to pick up again in the fourth quarter of the year under review. Initially, it was only loan demand by large companies that contracted, but SME demand has also been declining since the end of 2012. The situation for large companies improved in 2014, but for SMEs, the net percentage has again remained negative since the third quarter. The banks blame corporations' weak demand for loans in recent years both on reduced gross fixed capital formation, inventories and working capital, and on increased use of alternative funding. Both factors showed similar trends in 2014, but banks would appear to have attached more importance to alternative funding, primarily internal resources, as the year progressed. Unfortunately, the data do not enable a breakdown into large companies and SMEs.

However, the available figures do allow for a breakdown by company size, and Central Corporate Credit Register data – still drawn up in keeping with the ESA 95 definition of non-financial corporations – suggest that credit expansion contracted much more sharply for large companies than for SMEs. Large companies saw annual growth come down from 13 % in the 2005-2008 period to –4.4 % between 2009 and the third quarter of 2014. For SMEs, the trend was much less marked, with average growth figures of 9.7 % and 3 % respectively. All things considered, these data present a somewhat clearer picture of the negative loan growth at resident banks: the contraction is

CHART 58 RETURN ON EQUITY

(in %)



Source: NBB.

(1) Annualised.

(2) Annualised based on quarterly reporting. Quarterly figures do not completely coincide with the annual figures, as they do not take account of any dividend payments to shareholders and insurance policy-holders.

mainly attributable to large companies, which have mostly swapped bank loans for bond issuance. This is not to say that lacklustre borrowing requirements did not have a key part to play: both lending to SMEs and debt financing of large companies merely edged up compared to their long-term averages.

3.4 Financial institutions

Profitability vulnerable at financial institutions

In the first nine months of 2014, Belgium's banking and insurance sectors returned profits of € 3.6 billion and € 1 billion respectively, comparable to the same period of 2013. Return on equity at Belgian financial institutions remained significantly lower than before the financial crisis.

Economic conditions in Belgium and in the rest of the euro area – low interest rates coupled with weak economic activity – are squeezing the profitability of both banks and insurance companies. And although both have taken measures to combat their economic impact, continued poor conditions cannot be ruled out and financial institutions might feel compelled to adjust their business models and cost structures even further.

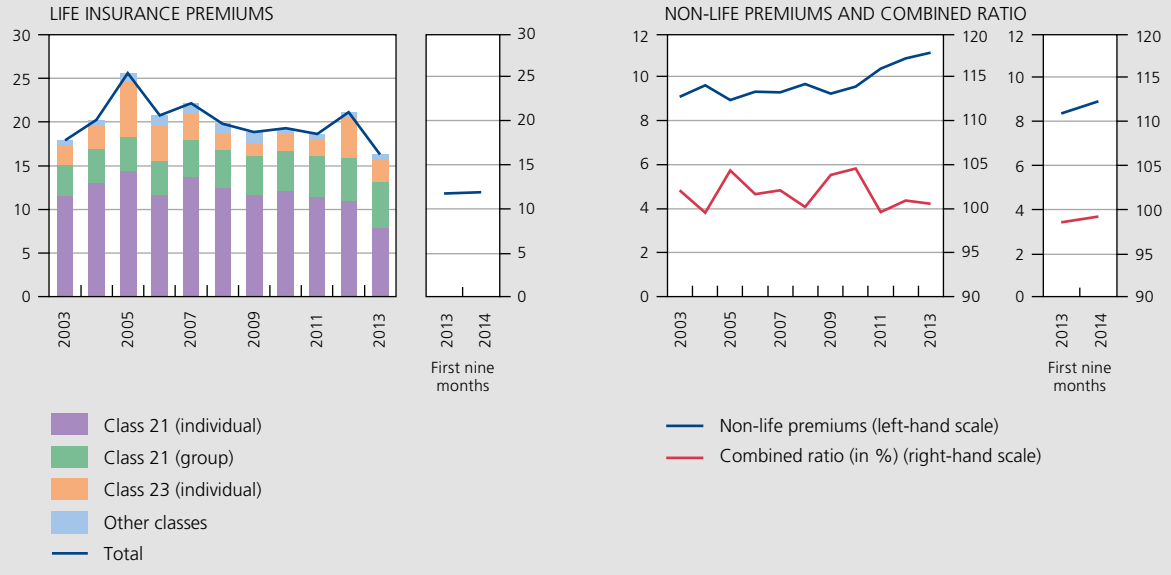
Weak economic growth curbs activity at banks and insurance companies

Recent sluggish economic trends have combined with the gloomy outlook to curb demand for core banking and insurance products. Weak loan demand has squeezed banks' net interest income, although some of them have been able to offset the shortfall with repo operations (loans collateralised by temporary transfer of securities), but repo-derived margins are typically much slimmer than those on traditional financial intermediation services. Against this backdrop, there was hardly any need for Belgium's banks to raise more funds via the Eurosystem in 2014, and their rather extensive call on the second targeted longer-term refinancing operation (TLTRO) was mostly prompted by the rollover of the three-year longer-term refinancing operations maturing at the beginning of 2015. Although banks tapped the two TLTROs to the tune of € 6.3 billion cumulative, total funding provided by the NBB as part of its monetary policy transactions fell from € 16 billion at the end of 2013 to € 11.7 billion at the end of 2014.

Flat macroeconomic conditions continued to hit demand for life insurance products from insurers, as households preferred to keep their assets liquid. The massive fall in 2013 premium income can largely be explained by the increase in the tax on premiums paid on life insurance

CHART 59 INSURANCE COMPANIES: PREMIUM INCOME AND COMBINED RATIO(1)

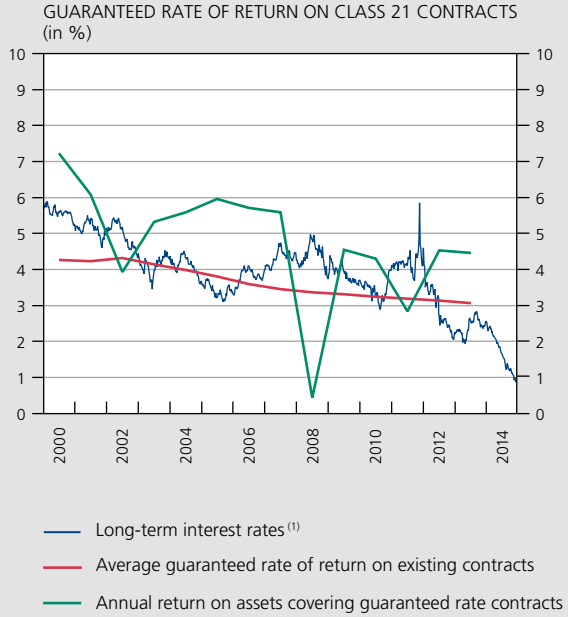
(non-consolidated data; in € billion, unless otherwise stated)

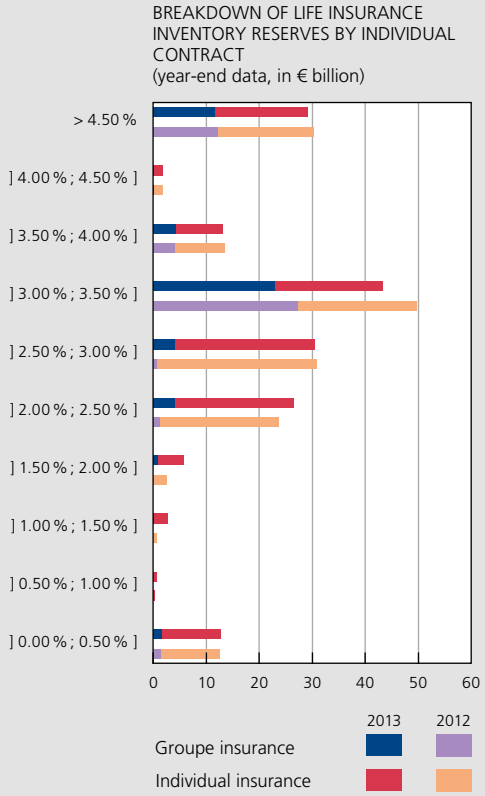


Source: NBB.

(1) The combined ratio is the ratio relating the sum of the cost of claims plus operating expenses to net premium income.

CHART 60 GUARANTEED RATES OF RETURN AND BREAKDOWN OF LIFE INSURANCE COMPANIES' INVENTORY RETURNS





Sources: Thomson Reuters Datastream, NBB.
(1) Secondary market yields on ten-year Belgian government loans (OLOs), weekly data.

products to 2 % at the beginning of that year, while anticipatory buying had caused a temporary spike in 2012. No one-off factors explain why 2014 premium income languished at the unusually low levels of the previous year, with this rather reflecting a fundamental downward trend that had got underway in 2008 and now appears to have accelerated. Given Belgium's *bancassurance* model, this general climate may have inspired banks to move household savings to more profitable investment instruments rather than to life insurance contracts.

Non-life insurance tends to be less sensitive to macroeconomic conditions than life insurance, with profitability generally satisfactory and some insurance companies preferring non-life operations anyway. In 2014, premium increases could not absorb the effects of higher storm-related claims in the first half of the year. Having recorded a steady upward trend since 2008, non-life results were slightly down in the year under review. The combined ratio, which reflects the sum of claims and operational costs as a ratio of net premium income, slid from 98.6 % in the first nine months of 2013 to 99.3 % in the same period of 2014.

Negative impact of low interest rate environment on profitability at banks and insurance companies offset by 2014 measures

Overall, the repercussions of the economic slowdown were cushioned by low interest rate levels – both short-term and long-term – thus supporting the activity of the financial sector and the broader economy. That said, low interest levels also affect the financial sector in a more specific way.

A long period of low interest rates does not benefit the insurance sector, particularly life insurance as its liabilities typically have longer maturities than its assets and it is also facing high interest rates guaranteed in the past. Annual returns on assets covering guaranteed-return contracts have dipped below guaranteed returns three times in the

past, in 2002, 2008 and 2011, i.e. the years of the financial crises and the sovereign debt crisis in the euro area. In 2013, the effective return on class 21 contracts (4.44 %) made it possible to cover interest rates guaranteed in the past. However, effective investment returns are showing a clear downward trend in line with financial markets and if current low interest rates are here to stay, significant amounts of high-rated securities (AAA or AA) will have to be replaced by lower-yielding investments. There is a real risk, then, that the effective return on assets will not be enough to cover the guaranteed interest rates on contracts entered into earlier.

The outstanding total of life insurance contracts with guaranteed return and the actual rates paid on them are therefore very important risk parameters for insurance companies in times of falling interest rates on risk-free investments.

Total inventory reserves related to guaranteed return contracts rose only slightly between end-2012 and end-2013, from € 165.6 billion to € 166.3 billion, on the back of group insurance growth at over 6 %. By contrast, individual insurance products contracted by nearly 2 % (€ –2.1 billion). This decrease only concerns guaranteed-return contracts of over 2 %. Inventory reserves of guaranteed-return contracts of up to 2 % added 33 %, albeit from a fairly low base.

Contracts agreed in the past whose guaranteed returns on future premium-based reserves exceeded 4.5 % accounted for € 29.2 billion – i.e. 17.5 % of inventory reserves, compared with € 30.2 billion in 2012 – € 26.1 billion of which related to contracts with guaranteed returns of 4.75 %, the legal maximum for this type of contract up to June 1999. This legacy of contracts with high guaranteed returns that cannot currently be funded profitably is the biggest risk currently facing the Belgian insurance sector.

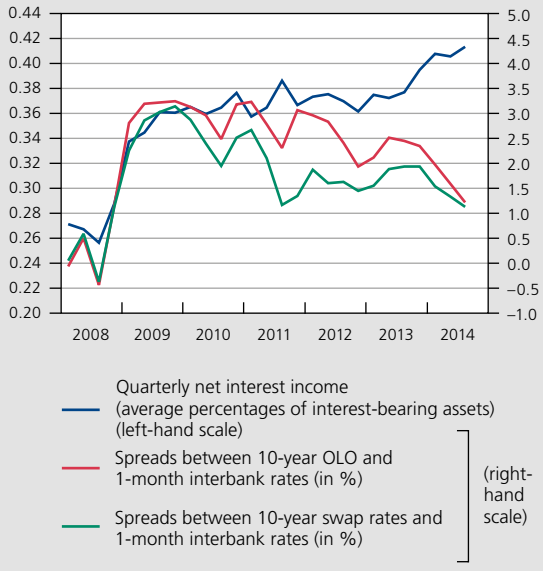
Persistently low interest rates are forcing insurance companies to offer contracts more in line with market conditions, taking the average guaranteed return of class 21 agreements down from 3.12 % in 2012 to 3.04 % in 2013 – which is the last year for which aggregate data are available – and also encouraging them to promote class 23 agreements that are linked to investment funds and offer no guaranteed return. What is more, some class 21 contracts impose time limits on guarantees and specify that the reserve built up will technically be considered a new premium after the agreed period, with guaranteed returns in line with market conditions that apply by that time. Meanwhile, insurance companies have also developed hybrid products to help reduce their risks, consisting of a guaranteed-return life insurance product (class 21) coupled with another life product in class 23, whose returns reflect the performance of an investment fund. Options to shift lower returns to those paid out to policy-holders are limited by intense competition between insurance companies and from other savings products. If returns stay too low, insurance companies run the risk of contracts getting taken over.

To support their net profits, insurance companies also made capital gains of € 1.3 billion in the first nine months of 2014. At times of low interest rates, prudential rules oblige insurance companies to include additional annual provisions in their accounts. These provisions, for which no exemptions were forthcoming in 2013 and which stood at a cumulative total of € 3.8 billion by the end of that year, made the sector less profitable and translated into the need to constitute a higher solvency margin.

Persistently low interest rates also depress total interest margins generated by Belgium's banks, against a backdrop of intensified competition as a result of banks refocusing their business on a highly saturated domestic market. Credit institutions have seen an erosion of the gains from very cheap resources, such as sight deposits, on which remuneration is only partly linked to market rates. At the same time, high-yield securities or loans reaching maturity had to be replaced with others offering

CHART 61 BELGIAN BANKS' NET INTEREST INCOME AND YIELD SPREADS

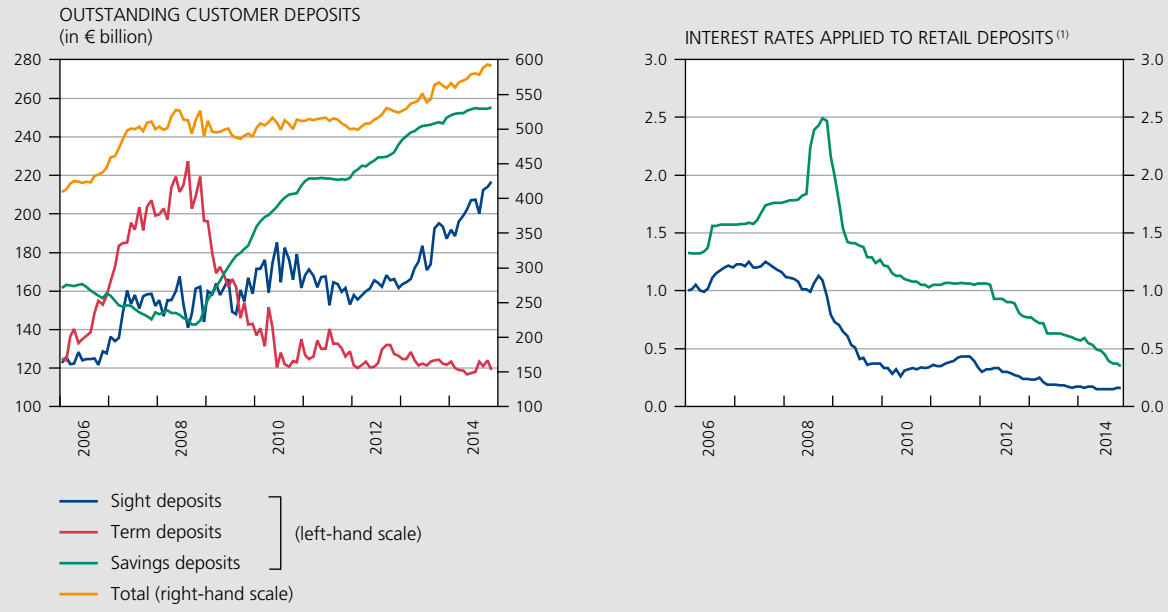
(quarterly data, on a consolidated basis)



Sources: Thomson Reuters Datastream, NBB.

CHART 62 BELGIAN BANKS' CUSTOMER DEPOSITS: OUTSTANDING AMOUNTS PLUS APPLIED INTEREST RATES

(non-consolidated data)



Source: NBB.

(1) New deposit data taken from monthly MIR survey.

lower yields, while lower interest rates also entice borrowers to refinance their mortgages.

Belgian banks were able to take temporary measures to offset the negative impact on their profitability and prepare for this impact to continue over the next few years.

On the other hand, Belgian banks in general kept their commercial margins on new loans at a high level, despite intensified competition in this market. Positive effects on total margins tend to be greater as the share of new business – which commands steeper commercial margins – in total outstanding loans increases. In the teeth of challenging conditions, Belgian banks still managed to increase their net interest income in 2014, both in absolute terms and as a percentage of interest-bearing assets.

Nevertheless, most of these effects are usually temporary. With balance sheets typically having more short-term liabilities relative to longer-term assets, banks benefit from falling interest rates, as the costs of their liabilities adjust more quickly to the new situation than do the returns on their assets. Although the intermediation interest rate structure continued to be favourable in 2014 – albeit it less so than in previous years – borrowing costs are not likely to come down any further, as interest rates offered on savings deposits have hit new lows while, conversely, returns on assets should gradually contract. A lengthy period of persistently low interest rates would pare down the interest income received by Belgian banks, which is precisely their most important source of net income. Return on equity, which averaged 8.2 % in the first nine months of 2014, might therefore come under pressure in the future.

Other factors also had positive or negative effects on bank profitability. In 2014, Belgian banks no longer notched up massive gains on financial instruments, unlike in 2013, when such gains were booked when selling securities. Loan loss provisions totalled € 1 billion in the first nine months of 2014, remaining below the figure for the same period of 2013. This was largely due to the slowing of the deterioration in the quality of certain foreign portfolios, such as Irish portfolios. Conversely, unexpected provisions were required in the Hungarian retail loans portfolios, in the wake of measures announced by the government in Budapest in the first half of 2014 which promised borrowers repayment of a proportion of amounts collected and in due course also the conversion of foreign currency-denominated loans into Hungarian forints.

Limited refocusing on investment policies

The current climate and pressures on their profitability might induce financial institutions to redirect their investment policies to higher-yielding asset classes. However, there were no clear signs of such a shift in Belgium by the end of September 2014, either at its banks or at its insurance companies.

Banks saw a minor rebalancing of their balance sheets in favour of foreign claims in the first nine months of 2014, but nowhere close to pre-crisis levels. More Italian and Spanish government bonds were taken on at the expense of Belgian ones, reducing the high concentration of government paper owned by Belgian banks that had been built up since the start in of the sovereign debt crisis in the euro area in 2011-2012.

Belgian insurance companies saw the outstanding amount in their government bond portfolios decline by 2.2 % in the course of 2014, as a result of the sale of bonds – creating capital gains – and because of the fact that they were compelled to change their investment strategies and focus on riskier asset classes to maintain return levels. Low-yielding fixed-income investments prompted some of them to redirect their assets to longer-term alternatives, such as corporate bonds or UCI units. Such alternatives promise higher yields but also imply greater credit and liquidity risks.

These changes in insurance companies' investment strategies are already partly dictated by the new prudential solvency rules due to come into force in January 2016. Class 23 products will be subject to more favourable capital requirements under the new rules. These products, which are less risky for insurance companies, have flourished since 2012.

Adjusting cost structures

To cope with the current flat economic climate – which is likely to last for a while longer – and with the repercussions for asset quality of any further deterioration of economic conditions or financial market corrections, financial institutions will have to bolster their profit-generating

TABLE 14 INCOME STATEMENT OF BELGIAN CREDIT INSTITUTIONS

(consolidated data; in € billion, unless otherwise stated)

					First nine months		In % of operating income
	2010	2011	2012	2013	2013	2014	
Net interest income	13.8	14.0	13.6	13.3	9.9	10.8	68.4
Non-interest income	5.6	4.8	4.5	7.0	5.9	5.0	31.6
Net fee and commission income (including commission paid to agents)	4.3	4.4	4.5	5.0	3.9	4.1	26.1
(Un)realised gains or losses on financial instruments (1)	0.0	–0.8	0.0	0.8	1.1	0.3	
Other non-interest income	1.3	1.2	0.0	1.3	0.9	0.6	
Operating income	19.3	18.7	18.1	20.3	15.8	15.8	100.0
Operating expenses	–12.5	–12.3	–13.0	–12.4	–9.4	–9.6	60.8 (2)
Gross operating result	6.9	6.4	5.0	8.0	6.4	6.2	
Impairments and provisions	–1.8	–5.0	–2.6	–3.0	–1.4	–1.0	
Impairments on loans and receivables	–1.8	–3.0	–2.0	–2.3	–1.2	–1.0	
Impairments on other financial assets	–0.1	–1.4	0.8	0.0	0.0	0.0	
Other impairments and provisions	–0.2	–0.6	–1.5	–0.6	–0.2	0.0	
Other components of the income statement	0.5	–1.0	–0.8	–1.8	–1.5	–1.6	
Net profit or loss	5.6	0.4	1.6	3.3	3.5	3.6	

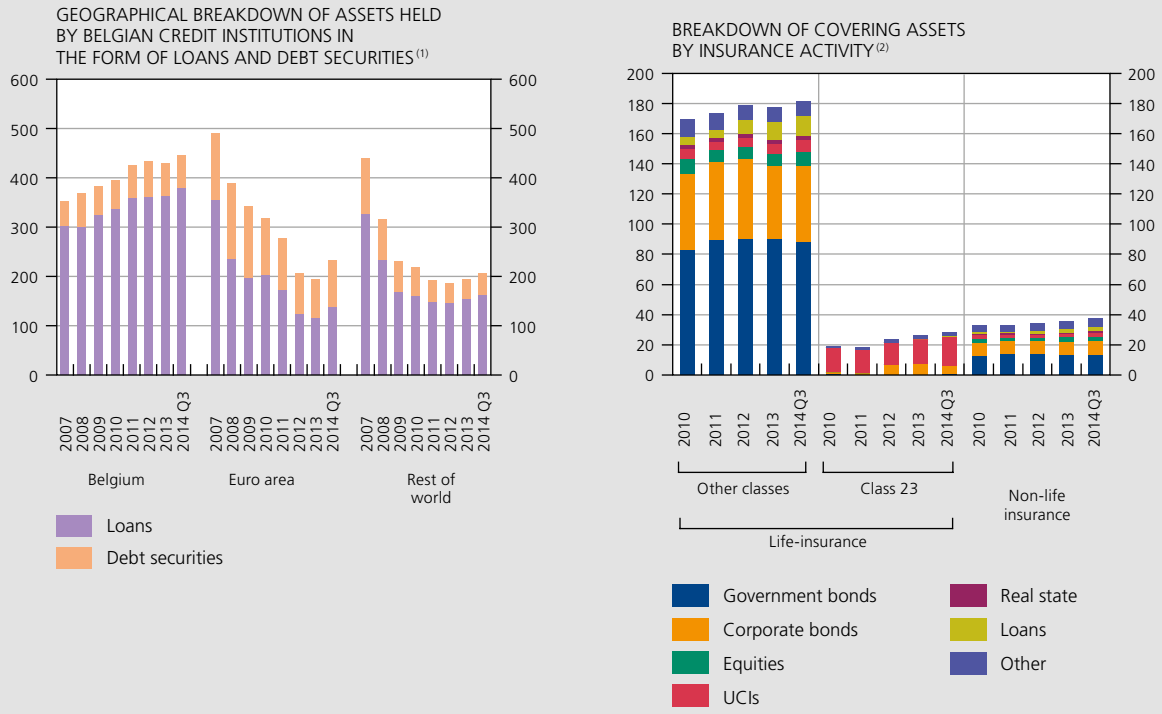
Source: NBB.

(1) This item also includes the net realised gains (losses) on financial assets and liabilities not measured at fair value through profit or loss, the net gains (losses) on financial assets and liabilities held for trading and designated at fair value through profit or loss, and the net gains (losses) from hedge accounting.

(2) Cost/income ratio of the Belgian banking sector.

CHART 63 LOANS AND DEBT SECURITIES HELD BY CREDIT INSTITUTIONS AND INSURANCE COMPANIES' COVERING ASSETS

(end-of-period data; in € billion)



Source: NBB.

(1) Data obtained from the consolidated financial reporting of Belgian credit institutions. Breakdown in line with FINREP prudential reporting.

(2) Non-consolidated data.

capacity. This will require a review of business models, cost structures and consolidations. As described in the "Prudential regulation and supervision" part of this Report, the review was one of the focal points of the NBB's macroprudential policies.

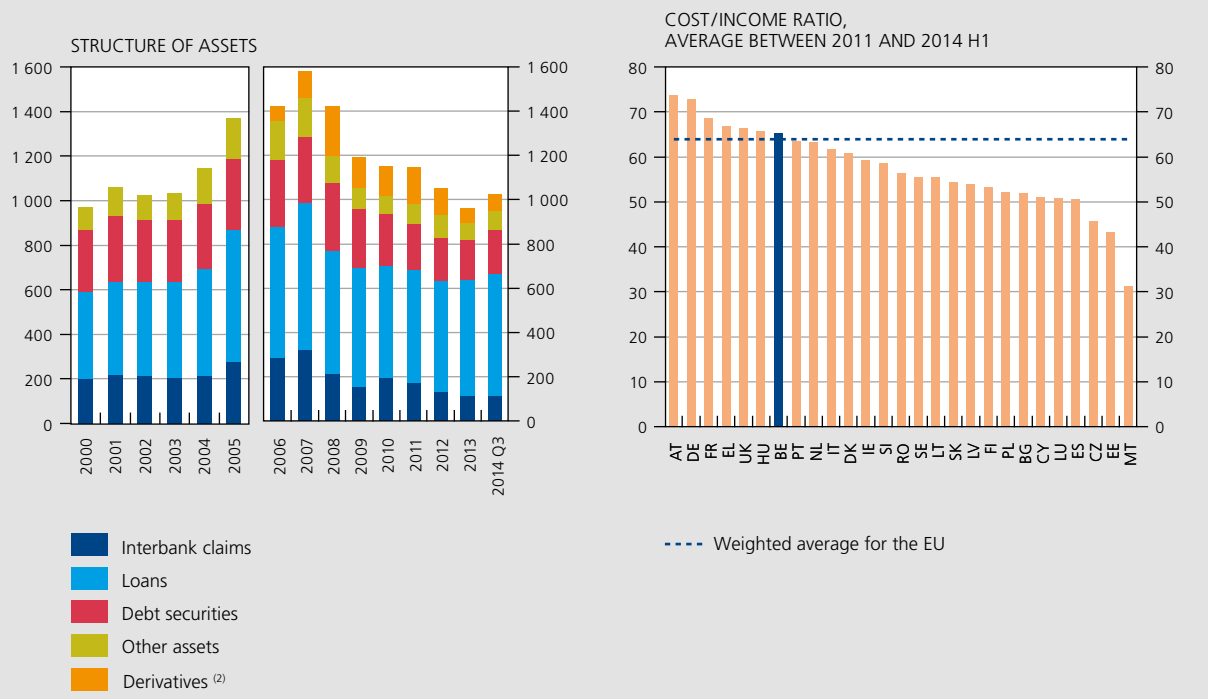
Between 2008 and 2013, Belgian banks significantly reduced the scope of their activities, particularly abroad, but they have yet to prune costs to the same degree. The country's major institutions have announced restructurings and have made a start on actually implementing them, but have so far failed to control operating costs: these added 2 % in the first nine months of 2014 compared with the same period of 2013. The increase largely reflects changes in the consolidation scope of a major bank and is thus also partly offset by the consolidation's positive effects on operating income. The cost/income ratio of the Belgian banking sector amounted to 61 % in the first nine months of 2014, dipping under the ratios observed in 2011 and in 2012. The average ratio between 2011 and the first half of 2014 puts Belgium among the highest in Europe, even though other banking sectors are facing similar challenges, in both big and smaller countries.

Insurance companies saw the ratio of operating expenses to technical result in non-life decline in 2014, continuing the steady downtrend since 2009. In life insurance, by contrast, the ratio increased in the wake of rising costs coupled with a weaker technical result.

Transition to new solvency framework

The new EU solvency regulations for insurance companies, known as Solvency II, which come into force on 1 January 2016, present a massive challenge for Belgium's insurance industry. Under Solvency I, solvency requirements are linked to insurance business as measured by premium income, claims numbers and technical reserves. By contrast, Solvency II imposes a calculation based on the risks of both the assets and the liabilities side of the balance sheet, at market values. The riskier the assets (equities, hedge funds, etc.), the bigger the required regulatory capital is likely to be. One of the first effects of the new rules is already visible: a shift from the most capital-intensive assets (equities) to assets that are much less capital-intensive (bonds) and a preference for liquid assets

CHART 64 BELGIAN BANKS' BALANCE SHEET[1] AND COST/INCOME RATIOS



Sources: ECB, NBB.
(1) Data compiled according to Belgian accounting rules until 2005 (Belgian GAAP) and in line with IAS/IFRS standards since 2006.
(2) Derivatives are recorded at their market values, including – from 2007 – income receivable and charges payable (which are not included in the data relating to 2006).

over long-term investments which are less favourable in terms of capital requirements. Capital requirements under Solvency II will be eased by a correlation matrix between different securities, measured by asset class, and insurance companies will do well to diversify their assets more. With assets no longer recognised at historical values, solvency margins will be much more sensitive to fluctuations in the interest rate and equity market movements, as well as to margin risks.

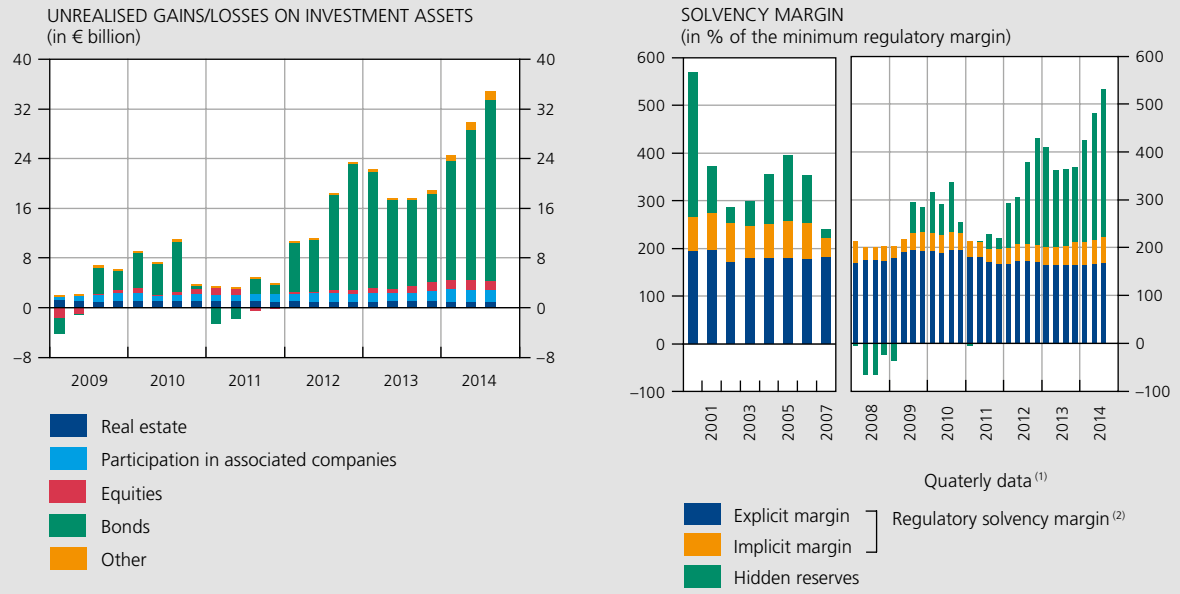
Interest rate falls pushed the solvency margin upwards in 2014 on the back of higher market values for the bond portfolio, and even more for much longer-dated bonds. The unrealised gains reached new highs in September 2014 at € 34.9 billion, 84 % of which derived from bond holdings. If approved by the NBB in its capacity as prudential regulator, these unrealised gains are recognised in the implicit component of the solvency margin, thus strengthening it. Factoring in the stability of the explicit component, which essentially includes own funds and subordinated debt, the regulatory solvency margin advanced by 4 % in the year.

In the life insurance business, slightly better solvency margins were attributable to the implicit margin, which has been stable since 2013. In non-life, which is better placed for the transition to Solvency II, the solvency margin is bolstered by the explicit margin, which has recorded an upward trend since June 2014.

Belgium's banks have also been subject to a new regulatory framework since 1 January 2014, known as Basel III. The transition to the new framework, of which the most recent developments are discussed in section A.1.4 of the "Prudential regulation and supervision" part of the Report, has led to an increase in risk-weighted assets. Credit-risk-related assets were up in the first nine months of 2014 as a result of the higher weighting assigned to exposures to credit institutions and because some banks were no longer able to apply a – more favourable – standard approach to sovereign debt exposures rather than an approach based on internal models. Basel III also introduces the Credit Valuation Adjustment (CVA), which aims to serve as a better hedge for the counterparty risk related to derivatives transactions, adding € 9 billion to risk-weighted assets. The decline in assets weighted for

CHART 65 UNREALISED GAINS/LOSSES AND SOLVENCY MARGIN OF BELGIAN INSURANCE COMPANIES

(non-consolidated data)



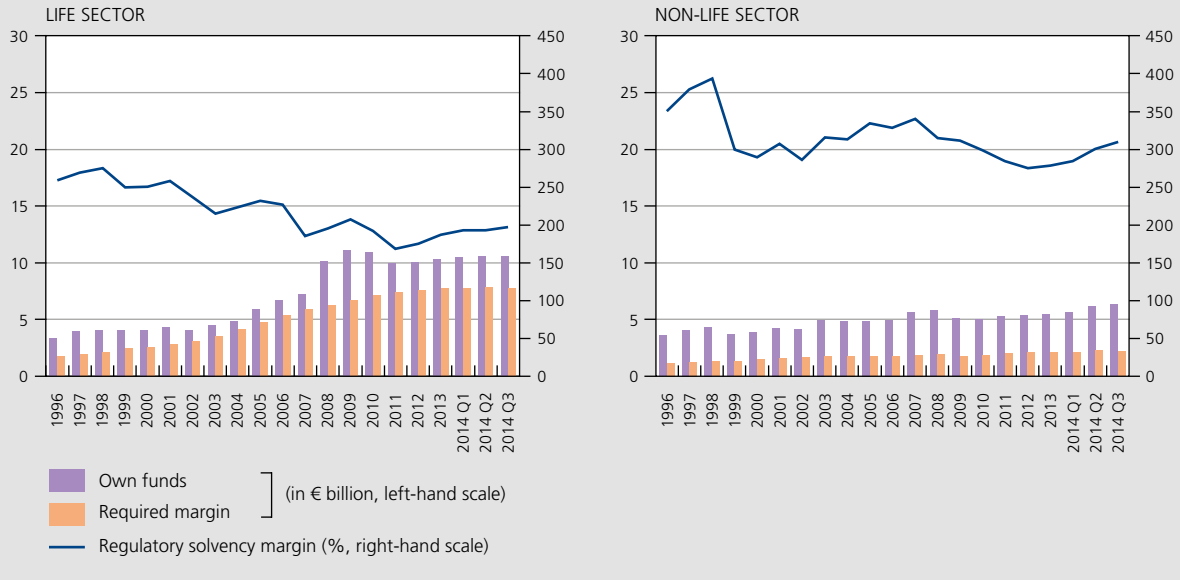
Source : NBB.

(1) The figures reported quarterly are not entirely comparable with the final annual figures. In particular, they take no account of any distribution of profits to shareholders and policy-holders.

(2) This margin is composed of an explicit margin including own funds, subordinated debt and selected other balance sheet items and an implicit margin which, subject to NBB's approval, comprises certain other specific elements, the principal one being a part of the unrealised gains on investment portfolios.

CHART 66 OWN FUNDS, REQUIRED MARGIN AND REGULATORY SOLVENCY MARGIN OF BELGIAN INSURANCE COMPANIES

(non-consolidated end-of-period data)



Source : NBB.

TABLE 15 BREAKDOWN OF TIER 1 CAPITAL AND RISK-WEIGHTED ASSETS

(end-of-period data, on a consolidated basis, in € billion, unless otherwise stated)

	2009	2010	2011	2012	2013	September 2014
Tier 1 capital	53.9	57.9	56.5	55.9	55.6	54.9
of which:						
common equity Tier 1	–	–	–	–	–	51.9
Risk-weighted assets	407.5	372.5	373.8	352.7	339.4	349.6
of which:						
Credit risk	352.3	322.8	312.9	301.0	287.7	289.4
Market risk	16.1	10.7	21.9	16.6	9.9	7.4
Operational risk	38.8	35.1	35.2	35.0	34.2	34.6
CVA	–	–	–	–	–	8.9
Other	0.2	3.9	3.8	0.1	7.6	9.3
Tier 1 ratio (in %)	13.2	15.5	15.1	15.9	16.4	15.7
Common equity Tier 1 ratio (in %)	–	–	–	–	–	14.9

Source: NBB.

market risk seen since the end of 2011 is primarily down to reduced securities trading by Belgian banks.

With capital relatively stable in 2014, the increase in risk-weighted assets caused the Belgian banking sector's solvency ratios to come down. Those ratios are much higher than the minimum requirements imposed by Basel III (4 % for common equity Tier 1 and 5.5 % for Tier 1 in 2014). These minimum requirements will gradually be raised and be linked to buffers, so that the new Basel III solvency standards will be in full force from 2019.

In the course of 2014, the ECB extensively tested banks' capacity to keep their solvency margins sufficiently high as part of its comprehensive assessment, consisting of an asset quality review and stress tests. This exercise is described in more detail in the "Prudential regulation and supervision" part.

The solvency position of Belgian banks is generally comfortable, but their average levels of return need to go up, particularly at institutions that have reported extremely weak returns on equity. This should enable them to achieve the best possible positions in a sector being restructured as part of regulatory framework changes, intensified competition and subdued profit generation.

Public finances

4. Public finances

The general government deficit ended 2014 at 3.2% of GDP, up from 2.9% in 2013. The modest consolidation that started in 2011 failed to keep going and the benefits of reduced interest charges were lost in a climate of low interest rates. So, the deficit moved into "excessive" territory by breaching the 3% ceiling. Government debt climbed 1.9 percentage points to 106.5% of GDP, its acceleration due to both the deteriorating primary balance and GDP's subdued nominal growth. The Belgian government's budget plan is focused on achieving structural balance by 2018, and the European Commission will investigate in March whether it meets the requirements of the Stability and Growth Pact prior to implementation of the budget and the proposed structural reforms. In this particular context, Belgium faces extremely high fiscal and parafiscal pressure on labour income, and a shift to other tax bases would benefit job creation as well as competitiveness.

4.1 Overview of fiscal policy

Deteriorating nominal and structural overall balances have put a stop to the modest improvement of the previous few years

The Belgian government ended the year 2014 in the red to the tune of 3.2% of GDP, a deepening of the deficit by 0.3 percentage point compared with 2013. A combination of lower revenues and a higher ratio of primary expenditure to GDP was to blame, while interest charges came down further.

It was the reversal of a recent trend: the fiscal consolidation that had got underway in 2011 was stopped in its tracks. Belgium's structural overall balance as measured by European Commission (EC) methods – which adjust the budget for the effects of cyclical and temporary factors – worsened by 0.1 percentage point of GDP, whereas it had improved by around 1 percentage point between 2011 and 2013. Non-recurrent factors had put a 0.3% positive shine on nominal deficit levels – tax regularisation revenues being the key factor – but their total effect was 0.3 percentage point less than in 2013. The business cycle proved a neutral force, as economic activity roughly kept pace with the economy's growth potential in 2014.

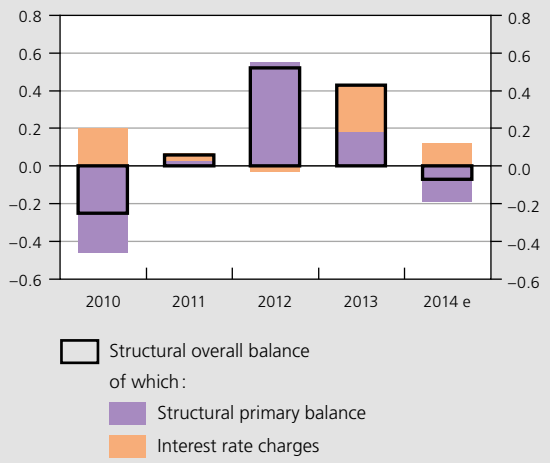
TABLE 16 GENERAL GOVERNMENT ACCOUNTS
(in % of GDP)

	2000	2011	2012	2013	2014 e
Revenue	48.6	49.3	50.7	51.5	51.2
Primary expenditure	42.2	49.8	51.4	51.2	51.4
Primary balance	6.4	–0.5	–0.7	0.3	–0.2
Interest charges	6.5	3.4	3.4	3.2	3.0
Budget balance	–0.1	–3.9	–4.1	–2.9	–3.2
p.m. Effect of non-recurrent factors	*–0.2*	*–0.2*	*–0.4*	*0.6*	*0.3*

Sources: EC, NAI, NBB.

CHART 67 DETERMINANTS OF THE CHANGE IN THE GOVERNMENT'S STRUCTURAL OVERALL BALANCE

(changes compared to the previous year, in percentage points of GDP)



Sources : EC, NAI, NBB.

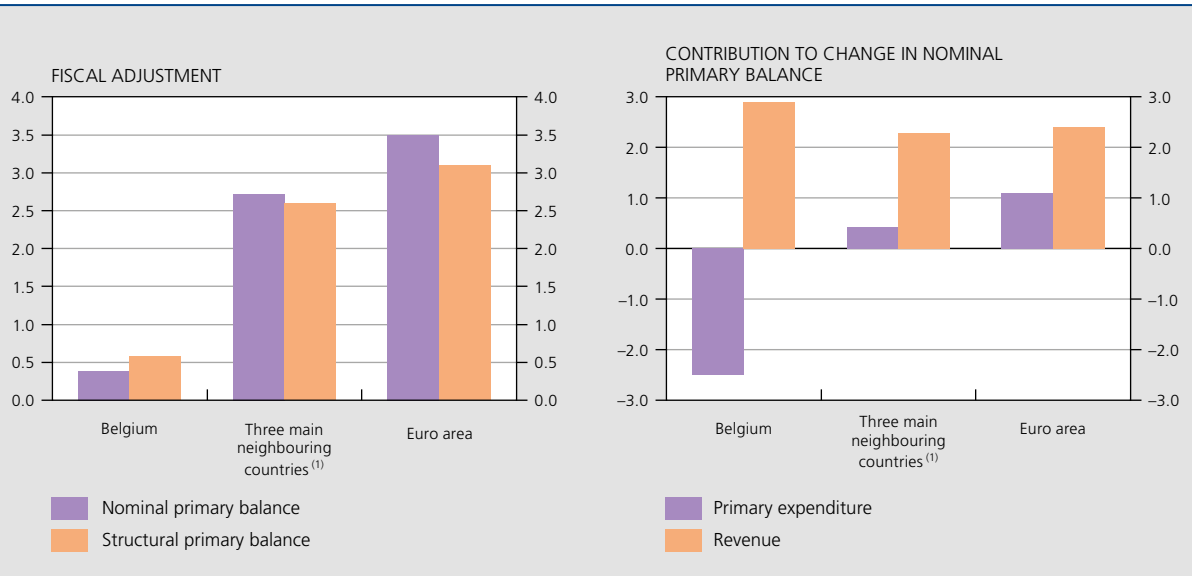
In addition to its interrupted consolidation, Belgium may also be observed to have trodden relatively lightly on austerity compared with measures taken in its three main neighbouring countries and elsewhere in Europe, particularly in the peripheral countries. Measured by the structural primary balance, which ignores interest charges, non-recurrent factors and cyclical effects, Belgium's fiscal consolidation worked out at 0.6 % of GDP between 2010 and 2014, as against 2.6 % of GDP for the three main neighbouring countries – with Germany notching up a 2.2 % improvement, France 2.6 % and the Netherlands 3 % – and compared with 3.1 % of GDP for the euro area at large. France, the Netherlands and Germany – if by a very small degree – had bigger deficits than Belgium in 2010, as did the euro area as a whole, but have managed to shrink them significantly in 2014, France excepted. Germany returned to a balanced budget in 2012.

The contrast with the approach to fiscal consolidation is also striking : throughout the euro area, both the expenditure and revenue levers were applied at the same time, but in Belgium expenditure has gone up as a percentage of GDP, which has not helped to make public finances any healthier as it required offsetting by significantly higher revenues.

The budgetary deterioration of 2014 prevented Belgium from meeting its target as set in its October 2013 draft budget, i.e. a structural balance improvement of 0.6 % of GDP. On the basis of calculations made at the time, this target was in line with a nominal deficit of 2.1 % of GDP, a norm also included in the April 2014 stability programme. Belgium's failure to achieve the structural

CHART 68 SIZE AND BREAKDOWN OF FISCAL CONSOLIDATION

(changes between 2010 and 2014, in percentage points of GDP)



Sources : EC, NAI, NBB.
(1) Unweighted averages.

TABLE 17 INTERNATIONAL COMPARISON OF OVERALL BALANCE AND PUBLIC DEBT
(in % of GDP)

	Overall balance					Consolidated gross debt
	2010	2011	2012	2013	2014 e	2014 e
Belgium	–4.0	–3.9	–4.1	–2.9	–3.2	106.5
Three main neighbouring countries[1]	–5.3	–3.4	–2.9	–2.1	–2.2	79.9
Germany	–4.1	–0.9	0.1	0.1	0.2	74.5
France	–6.8	–5.1	–4.9	–4.1	–4.4	95.5
Netherlands	–5.0	–4.3	–4.0	–2.3	–2.5	69.7
Euro area	–6.1	–4.1	–3.6	–2.9	–2.6	94.7

Sources: EC, NAI, NBB.
(1) Unweighted averages.

balance improvement as envisaged in its budget was the main reason for its non-compliance with its nominal target. Plus which, the review of the general government accounts in the wake of the transition to ESA 2010 caused a negative effect on the overall balance of nearly 0.3 % of GDP[1].

Belgium needs to bring its fiscal policy in line with the European governance framework

The April 2014 stability programme also set out a budget path based on the recommendations of Belgium's High Council of Finance in March 2014, which envisaged a structurally balanced budget by 2016. This was never a formal commitment, however, as it noted in the run-up to the general elections of 25 May 2014 that both these fiscal targets and their breakdown across the various entities were indications only and could well be changed by future federal, community and regional governments. As it turned out, such adjustments were indeed agreed during the coalition negotiations and the achievement of a structural balance was pushed back by two years, to 2018.

The federal government agreement also provides for new pension reforms, their main aspects being an increase in the statutory retirement age to 66 in 2025 and to 67 in 2030, tighter early retirement conditions, changes to civil

(1) See Methodological Note.

TABLE 18 TARGETS FOR THE OVERALL BALANCE OF BELGIAN GENERAL GOVERNMENT
(stability programme targets, unless otherwise stated; in % of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018
Nominal balance								
April 2011	**–3.6**	–2.8	–1.8	–0.8	0.2			
April 2012		**–2.8**	–2.15	–1.1	0.0			
April 2013			**–2.5**	–2.0	–0.5	0.4		
April 2014				**–2.1**	–1.4	–0.4	0.6	
October 2014 (draft budget)				–2.9	**–2.1**	–1.3	–0.4	0.0
Structural balance								
April 2014				–1.4	–0.7	0.0	0.75	
October 2014 (draft budget)				–2.0	–1.3	–0.6	–0.1	0.0

Sources: FPS Budget and Management Control, FPS Finance.

servants' pension calculations and an increase in the age at which people are eligible for survivor pensions. It is too early to say if these reforms will enable Belgium to ease its medium-term target – which is currently a structural surplus of 0.75 % of GDP – as it has not yet been possible to estimate accurately the extent to which these reforms will curb the budgetary cost of ageing in Belgium.

A revised budget path was included in the draft budget plan for 2015, as submitted to the EC and the Eurogroup on 22 October. On 28 November 2014, the EC found that the draft budget risks falling short of the requirements of the Stability and Growth Pact, in view of inadequate improvements to the structural balance in 2014 and 2015. It urged the Belgian authorities to take the necessary measures to bring the 2015 budget into line with the requirements of the Pact as part of its national budgetary process, while also encouraging Belgium to pursue its efforts in the structural arena of the EU Council's public finances recommendations. In early 2015, the EC will review the situation in light of the completion of Belgium's fiscal laws and the implementation of the structural reforms announced by the authorities.

Although the Ecofin Council decided on 20 June 2014 to end the excessive deficit procedure (EDP) against Belgium that it had opened in December 2009, the country's nominal overall balance worsened in 2014 and the latest estimates suggest that it again breached the reference threshold of 3 % of GDP. At the end of March 2015, the NAI will make its first submission to Eurostat of the official general government accounts for the year 2014.

Box 10 – European fiscal rules for Belgium

The fiscal policies of EU Member States are required to comply with all European fiscal rules, whose aim is to avoid flawed policies and undesirable outcomes. The Treaty on the Functioning of the European Union (TFEU) and the Stability and Growth Pact underpin these rules, whose application has been fleshed out by the European Commission [(1)]. It has put in place both preventive measures – to ward off any emergence and/or development of untenable budgetary situations – and corrective recovery action for Member States that run into particularly severe difficulties in terms of their public finances.

This Box provides an overview of the key rules that Belgium is expected to comply with. Following the Ecofin Council's decision on 20 June 2014 to lift the excessive deficit procedure embarked on in December 2009, Belgium is now subject to the preventive arm of the Stability and Growth Pact, while also needing to comply with the transitional arrangements relating to the corrective arm's debt criterion.

Preventive measures

The medium-term objective

Setting and achieving a medium-term objective (MTO) is the very essence of the preventive arm, this being a country-specific reference value of the overall balance as expressed in structural terms, i.e. adjusted for cyclical influences and excluding temporary factors. The Member States themselves choose their own medium-term objectives in their stability or convergence programmes, although their MTOs should meet a minimum standard taking into account public debt and the expected budgetary cost of ageing, as forecast by the EC's Ageing Working Group. In 2012, the EC put the required minimum for Belgium at 1.3 % of GDP. However, the minimum may not exceed an upper limit, which for Belgium is currently set at a maximum of 0.75 % of GDP. It is thus the highest of all the euro area countries, reflecting the high debt level and the significant budgetary cost of population ageing in Belgium.

(1) EC (2013), *Vade mecum on the Stability and Growth Pact*, EC Occasional Paper 151, May.

Convergence towards the medium-term objective

Countries that have yet to achieve their medium-term objective – like Belgium in this instance – are expected to converge on their MTOs at an appropriate pace along an adjustment path. Progress is assessed by analysing two indicators, namely the structural balance and real government expenditure. The required improvement in the structural balance is determined on the basis of the economic cycle and the public finances of the Member State. Based on the European Commission's guidance on the practical application of the Stability and Growth Pact rules for the 2014 European Semester, and given its 13 January 2015 Communication for the 2015 European Semester, these improvements can be summarised in the following table:

DETERMINING THE REQUIRED STRUCTURAL BALANCE IMPROVEMENT

(in percentage points of GDP)

Economic conditions	Gross debt < 60 % and no risk pertaining to the sustainability of public finances		Gross debt > 60 % of GDP or sustainability of public finances at risk	
	Semester 2014	Semester 2015	Semester 2014	Semester 2015
Exceptionally poor: real growth < 0 % ou output gap[1] < –4 %	No adjustment			
Very poor: –4 % ≤ output gap < –3 %	> 0.0	0.0	≥ 0.5	0.25
Poor: –3 % ≤ output gap < –1.5 %				
a) real growth < potential growth		0.0		0.25
b) real growth > potential growth		0.25		0.5
Normal: –1.5 % ≤ output gap < 1.5 %	0.5	0.5	> 0.5[2]	> 0.5[2]
Good: output gap ≥ 1.5 %	> 0.5[2]		> 0.5[2]	
a) real growth < potential growth		> 0.5[2]		≥ 0.75
b) real growth > potential growth		≥ 0.75		≥ 1.0

Source: EC.
(1) The output gap equals the difference between actual GDP and its potential level and is expressed as a percentage of the latter.
(2) An improvement in the structural balance by over 0.5 percentage point of GDP is conventionally considered as at least equal to 0.6 percentage point of GDP.

In July 2014, the Ecofin Council recommended an improvement in Belgium's structural balance by 0.5 percentage point of GDP in 2014, and by 0.6 percentage point of GDP in 2015, taking into consideration the EC's recommendations and the rules as set out in the above schedule. The required minimum improvement is higher for 2015 as the EC forecast a negative output gap of below 1.5 % of potential GDP and debt exceeding 60 % of GDP. The requirements do not change under the Commission's new interpretation for the 2015 European Semester.

To pinpoint the permitted annual change in real government expenditure[1] a benchmark was created for all Member States based on potential GDP growth in the medium term. Countries like Belgium, which have yet to

(1) Government expenditure does not include interest charges, cyclical unemployment benefit expenditure and all expenditure on EU programmes funded by the EU. Government expenditure is also adjusted for the budgetary impact of discretionary reveneu measures..

hit their medium-term objectives, have reference values below the benchmark, enabling them to converge to the objective. For Belgium, this implies a real annual change of 0.2 % in 2014 and 0 % in 2015.

Compliance monitoring

Every spring, the EC assesses countries' performances on the basis of data submitted, more specifically identifying any significant deviations from medium-term objectives or convergence paths. Deviations are found to exist if the two conditions below are met, or if one of them is met and a more general analysis establishes that the other is met to a limited degree:

- The deviation between structural balance developments and the pre-agreed path amounts to no less than 0.5 percentage point of GDP in any one year or an average 0.25 percentage point of GDP per annum in two successive years;
- Government expenditure deviates from the agreed objective, affecting the government balance by at least 0.5 percentage point of GDP in any one year or cumulative in two successive years.

Temporary deviations from the adjustment path to the medium-term objective are possible, for instance if there are unusual events outside the control of the Member State which have a major impact on its financial position, in periods of severe economic downturn for the euro area or in the EU as a whole, or to combat negative short-term effects of significant structural reforms which have a verifiable positive fiscal effect in the longer term, provided that this does not jeopardise the sustainability of public finances in the medium term.

If it identifies a significant deviation, the EC will notify the Member State, under Article 121 (4) of the Treaty on the Functioning of the European Union. A decision by the Ecofin Council on a significant deviation from the adjustment path to the medium-term objective will trigger the preventive arm procedure as laid down in the Stability and Growth Pact, and sanctions may be imposed.

The corrective arm

The general government overall balance

A country's general government deficit cannot be greater than 3 % of GDP in nominal terms.

Public debt

General government outstanding debt should not exceed 60 % of GDP or, failing that, it should be approaching the reference value at a satisfactory pace. The general rule is that Member States reduce their debt-to-GDP ratios each year, measured as an average over a period of three years, by one-twentieth of the difference between the initial debt ratio and the reference value.

Since the measure was only adopted fairly recently, several euro area countries – including Belgium – are nevertheless put under a transition regime after closure of the excessive deficit procedure against them. For Belgium, this transition period runs from 2014 to 2016, during which time sufficient progress needs to be made towards respecting the general rule. This progress is measured by the change in the structural balance, also called the 'minimum linear structural adjustment'. Based on the EC's autumn projections, Belgium currently needs to notch up a minimum improvement of 0.8 percentage point of GDP per year, whereas the spring projections were still pointing to 0.3 percentage point of GDP. This clear tightening directly ties in with the country's higher debt

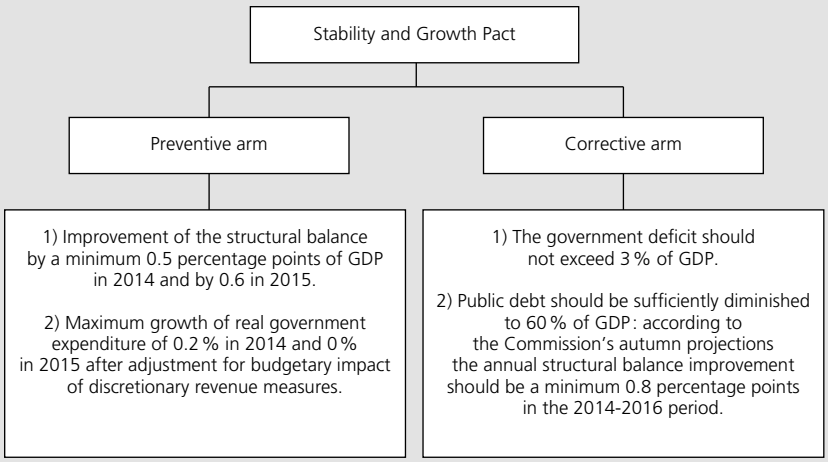
ratio and fiscal deficit in 2013, but primarily also with the downward revision of nominal GDP growth, which caused a deterioration in the debt-to-GDP ratio. On 8 December 2014, the Eurogroup nevertheless said it was aware that poor economic conditions and extremely low inflation have made it difficult to meet the debt reduction criterion and acknowledged that Belgium currently faces a real challenge meeting it.

In order to ensure continuous and realistic progress towards compliance with the debt rule by the end of the transition period, a Member State should respect two conditions: the annual adjustment of the structural balance should not deviate from the required improvement by more than 0.25 percentage point of GDP, and the remaining annual structural improvement should not exceed 0.75 percentage point of GDP at any time during the transition period. A larger annual effort put into meeting the first condition may mean that the second condition does not apply.

Breaching the criteria

If the figures show a Member State not to have met the criteria or if the forecasts suggest a risk of non-compliance, a Commission report under Article 126 (3) of the TFEU will consider all the relevant factors to see whether an EDP needs to be launched. If, on the basis of the Commission's opinion, the Ecofin Council decides that an excessive deficit exists, it sends a recommendation to the Member State to absorb the deficit within a set period and may even impose sanctions.

SUMMARY OF EUROPEAN FISCAL RULES THAT BELGIUM IS REQUIRED TO COMPLY WITH IN 2014 AND 2015



Source: EC.

4.2 General government revenue, expenditure and overall balance

Falling revenue after four years of consistent increases

In 2014, total government revenue declined to 51.2 % of GDP, mainly in the wake of lower non-fiscal revenue, while fiscal and parafiscal revenue stabilised. Belgium's revenue ratio remains high, both historically and compared with other European countries.

Levies on earned income dipped slightly under last year's levels, while the relationships between the various components remained unchanged.

Income tax held more or less steady as assessments developed favourably and offset lower payroll tax revenues, which were hit by the slighter share of wages in GDP as a result of meagre improvements in employment and the freezing of real negotiated wages. These effects were compounded by slower inflation, as indexation fed into wages much less than into tax brackets, which are index-linked to inflation in the previous year. These negative factors were only partly offset by higher social security benefits on which payroll tax is due, as the number of claimants increased. Lastly, the structural measures related to tax on income from employment had a slightly negative impact.

Social security contributions have barely come down from the previous year, despite wage restraint and the rather negative effect of the wider cuts in social contributions – and particularly the structural component granted to employers, as well as fresh tax reductions for the accommodation and food services sector, as long as employers register their employees on a daily basis.

TABLE 19 GENERAL GOVERNMENT REVENUE
(in % of GDP)

	2010	2011	2012	2013	2014 e
Fiscal and parafiscal revenue	42.3	43.0	44.1	44.8	44.8
Levies weighing chiefly on earned income	25.2	25.5	25.8	26.2	26.1
Personal income tax[2]	11.2	11.4	11.4	11.7	11.7
Social contributions[3]	14.0	14.1	14.4	14.4	14.4
Taxes on company profits[4]	2.5	2.8	3.0	3.1	3.1
Levies on other incomes and on assets[5]	3.6	3.7	4.0	4.4	4.4
Taxes on goods and services	11.0	10.9	11.3	11.1	11.2
of which :					
VAT	6.9	6.8	6.9	6.9	7.0
Excise duties	2.1	2.1	2.1	2.0	2.1
Non-fiscal and non-parafiscal revenue[6]	6.0	6.3	6.6	6.7	6.4
Total revenue	48.4	49.3	50.7	51.5	51.2

(1) In line with ESA 2010, total revenue of general government does not include the proceeds of customs duties transferred to the EU nor the revenues levied directly by the EU.
(2) Mainly payroll tax, advance payments, assessments and additional percentages on personal income tax.
(3) Including the special social security contribution and the contributions of people not in work.
(4) Mainly advance payments, assessments and withholding tax.
(5) Mainly withholding tax on income of individuals, withholding tax on income from immovable property (including the proceeds of additional percentages), inheritance taxes and registration fees.
(6) Income from assets, imputed social contributions, current transfers and capital transfers from other sectors, plus sales of goods and services produced, including revenues on guarantees granted by the State on interbank loans.

Box 11 – Fiscal and parafiscal levies on labour and tax shift options

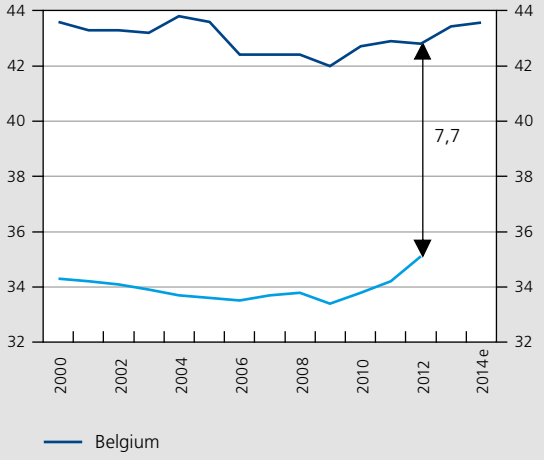
The general level of taxation in Belgium is high, with the tax burden on labour being among the highest in the euro area. The most recent EC statistics show that the implicit tax rate on labour is 7.7 percentage points higher than the euro area average in 2012, despite the strong rise there in 2010. And with the Belgian rate increasing further in recent years, the country's tax burden has again reached a level similar to that seen in 2000. On top of this, marginal rates have hit a record high: in Belgium, about two-thirds of pay rises go towards paying fiscal and parafiscal levies, irrespective of levels of income and family situations.

Although heavy taxation of labour income is used to fund a large proportion of social security costs and other public spending, it is clear that it has a discouraging effect on labour supply and demand. It might therefore be desirable to make the tax system more efficient, which would imply reducing the tax burden on labour and shifting it to less distorting tax bases. As the need for fiscal consolidation remains, a rebalancing of this kind would mean giving greater weight to consumption – in particular consumption with an adverse environmental footprint – and to capital as a basis for taxation. Corporation tax, on the other hand, is also generally felt to have an unfavourable impact on growth, so reforms to shift the tax burden onto corporations would not offer a good alternative to levies on labour.

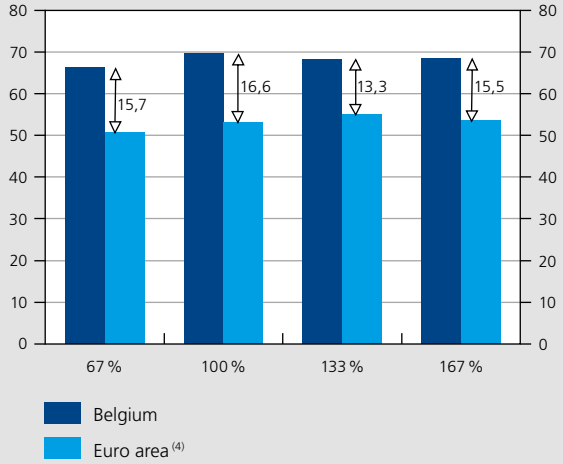
On 2 June 2014, the Ecofin Council recommended that Belgium should try to restore equilibrium in its tax system and improve its overall fairness in the 2014-2015 period, as well as preparing far-reaching tax reforms. This would, at the same time, pave the way for reducing the tax burden on labour income by shifting the tax base towards levies that would promote growth, simplify the tax system, put an end to tax abuse, improve VAT efficiency, broaden the tax base, lower tax expenditure and gradually abolish environmentally unfriendly subsidies.

LABOUR TAXATION

IMPLICIT RATE OF TAXATION ON LABOUR [1]
(as a % of labour costs)



MARGINAL FISCAL AND PARAFISCAL RATES ON LABOUR FOR A SINGLE EMPLOYEE WITHOUT DEPENDENT CHILDREN FOR VARIOUS INCOME LEVELS [2]
(as a % of labour costs, 2013)



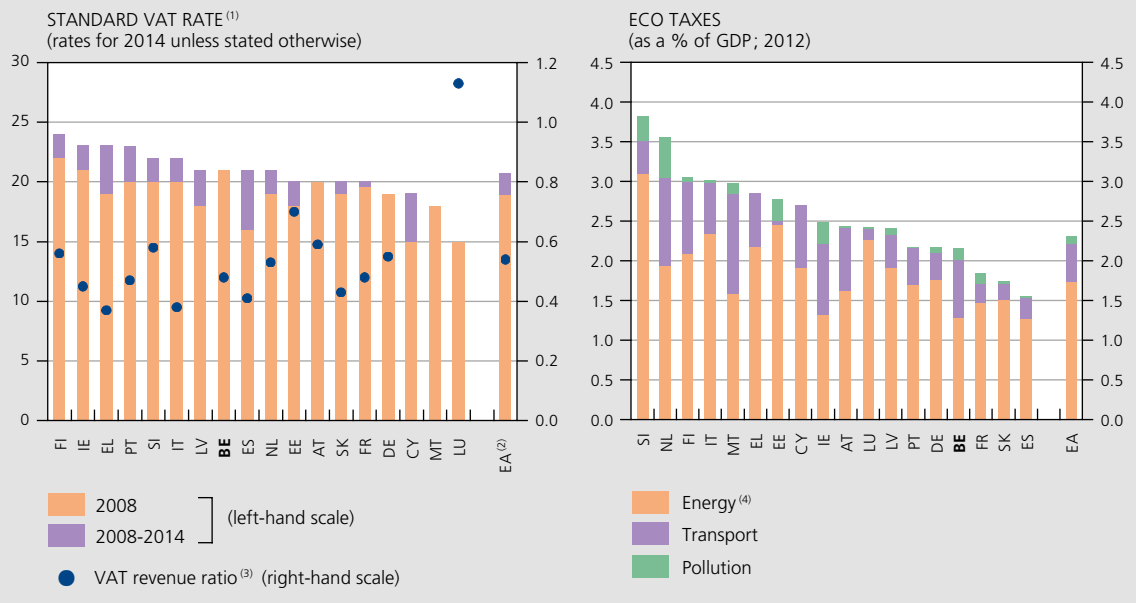
Sources: EC, OECD, NBB.
(1) Defined as total levies on labour income paid to the government, divided by the wage bill. Calculated on the basis of the national accounts.
(2) Expressed as a percentage of the average wage.
(3) Unweighted averages.
(4) Unweighted averages, except for Cyprus, Malta and Latvia.

The standard VAT rate in Belgium is close to the average for the euro area, particularly since most Member States recently raised their rates. However, the VAT revenue ratio, which measures the difference between effective revenues and the theoretical revenues that would have been collected if the standard VAT rate had applied to total consumption, shows that this difference is fairly large in Belgium. It has even risen in recent years, partly in response to the fact that the lowered rates were applied to accommodation and food service activities and to electricity consumption. Some thought should be given to using lowered rates for a significant proportion of the consumer basket.

At the same time, Belgium has a real opportunity to raise revenues from environmental levies. Expressed as a percentage of GDP, these levies are among the lowest in the euro area. Belgium's revenues from levies on energy are amongst the smallest, an average half a percentage point of GDP lower than the average for the other Member States. Excise duties in Belgium are also fairly low compared with most other countries in the euro area, for example on diesel and domestic heating oil. Moreover, the tax treatment of company cars and fuel cards is very generous.

Belgium could use additional levies in the form of indirect taxes and eco taxes to lower the tax burden on labour while at the same time encouraging more sustainable consumption patterns. Note in this regard that such a tax shift will have the best possible effect on Belgium's competitive position and employment if the impact on prices does not lead to wage increases.

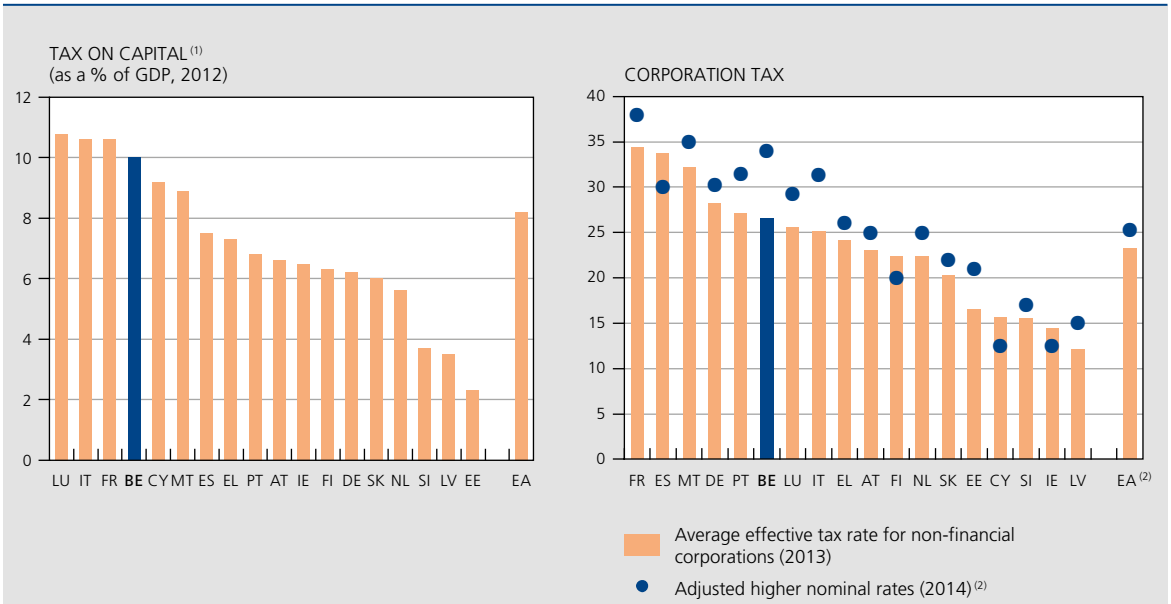
VAT AND ENVIRONMENTAL LEVIES



Sources: EC, OECD.
(1) If two rates apply in a given year, the rate that applied on 1 July is used.
(2) Unweighted averages.
(3) Calculated by the OECD, 2012 data.
(4) These taxes include excise duties on fuel.

Capital is more heavily taxed in Belgium – where tax on capital amounts to 10 % of GDP – than in the euro area, where the average amounts to 8.2 % of GDP. Corporation tax adds to the relatively high tax burden, giving Belgium one of the highest nominal tax rates in the euro area. Tax deductibles for companies – including tax allowances for venture capital – are very generous in Belgium, bringing the effective tax rate to 26.5 %. This tax rate is higher than in most European countries, but does not exceed the rate in France and Germany, for example. Capital transfer taxes, such as inheritance taxes and registration fees, are also substantial. Whereas annual capital income used to be only moderately taxed in Belgium, the situation changed as a result of withholding tax increases between 2012 and 2014. Capital gains realised by private individuals are barely taxed, however, whereas they are subject to taxation – in a variety of ways – in several European countries, including Belgium's neighbours. Note also that the effective tax rate is very unevenly distributed across the various types of assets. Some are heavily subsidised through personal income tax allowances, for example within the context of pension savings schemes. Other assets, such as interest income from savings, are exempt from the 25 % general withholding tax. This different tax treatment can lead to imbalances between types of savings. Besides the conversion of labour income into corporate revenues leads to distortions. Remedying these distortions could generate additional revenues, which could also be used to shift the tax burden.

TAX ON CAPITAL AND CORPORATION TAX



Sources : EC, ZEW.

(1) In Belgium, examples of capital taxation include, notably, corporation tax and tax paid by the self-employed, inheritance and gift taxes, tax paid on long-term savings, proceeds from tax regularisations, property tax, road tax paid by companies and rent payments by the nuclear power supply company.

(2) Unweighted averages.

(3) If different tax rates exist, only the highest base rate applies ; any additional levies and the average of local taxes are then added.

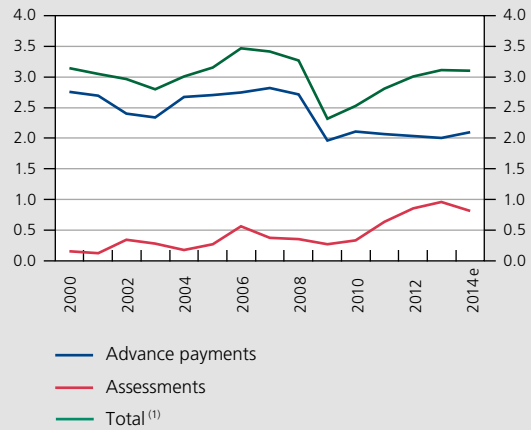
The tax burden on labour could also be relieved by improving tax administration procedures and combating tax fraud and tax evasion. This requires cross-border cooperation and the effective international exchange of tax information. In any case, recent decisions in this area are encouraging. In addition, various forms of fraud could be more efficiently tackled by making optimum use of the technical resources available to determine all incomes and the financial position of private individuals.

Tax revenues on company profits were virtually unchanged at 3.1 % of GDP in 2014. Assessments were negatively affected by a temporary factor, as last year's revenue had reflected a settlement with a company in the diamond sector involved in a massive international fraud. In addition, the 'fairness tax', a new measure that was supposed to bring in more tax revenue – applicable to certain companies whose distributed profits exceed the basis of assessment for corporation tax – did not yield as much as had been hoped, while the budgetary gains of other decisions were modest. Equally modest was the effect of measures reducing tax collection, such as higher tax allowances for investment – SMEs are granted tax exemptions for creating investment reserves and enjoy a 4 % allowance rate for their investment expenditure. However, the rise in advance tax payments almost made up for reduced assessment revenues, and 2014 would appear to have seen fewer companies shift to collection via assessments than in previous years. The tax surcharge due in the event of insufficient advance payments was unchanged, but a lot higher than market rates, so it may be cheaper to take out a loan to finance the advance payments than pay the penalty. That said, the increase was more modest than might be expected given the steady upward trend in gross operating surplus and the lower reference interest rate used to calculate the tax allowance for risk capital and the limited possibilities for transferring it.

Levies on other incomes and on assets held steady at 4.4 % of GDP, after having risen for four successive years – temporary factors being a key influence in recent fluctuations. For one thing, the increase in withholding tax on liquidation gains, raised from 10 % to 25 % in October 2014, had boosted revenues by around € 600 million in 2013 on the back of a transition measure, rising further to around € 660 million in the year under review. What is more, the third tax regularisation operation, heralded as people's last chance for tax forgiveness, was a resounding success. Files submitted in this third tax amnesty operation were dealt with in the course of 2014, and, together with the final stage of the second operation, generated around € 480 million more in tax revenues than in 2013, with the proportion related to inheritance tax falling to the Regions. Registration fees benefited from structural measures, primarily on long leases, to the tune of nearly € 100 million. Together, these favourable measures conspired to cushion the impact of lower inheritance taxes due to faster processing and the drop in withholding tax,

CHART 69 CORPORATION TAX

(in % of GDP)



Sources: NAI, NBB.

(1) Including other taxes, the main component of which is withholding tax.

TABLE 20 MAIN FISCAL AND PARAFISCAL MEASURES (1)

(in € million, differences compared to the previous year)

	2012	2013	2014
Structural fiscal measures	3 663	1 677	612
Federal government and social security	3 550	1 650	562
Personal income tax	1 330	461	–56
Corporation tax	1 087	552	327
Levies on other incomes and on assets	81	71	131
Taxes on goods and services	1 052	566	166
Communities and Regions and local authorities	113	27	44
Structural parafiscal measures	81	–121	–194
Non-recurrent measures	1 236	1 091	–140
of which:			
Liquidation gains	0	600	60
Tax regularisation	0	668	477
Late payment of the 2011 nuclear rent	500	–250	0
Inheritance taxes: filing deadline shortened by one month	80	40	–120
Early collection of the advance levy on life insurance	200	–200	0
Tax agreements and court decisions	300	–52	–248
Total	**4 980**	**2 647**	**278**
p.m. In % of GDP	*1.3*	*0.7*	*0.1*

Sources: Budget documents, NBB.

(1) This generally concerns the presumed influence of the measures according to the budget documents. The final impact may be different.

which reflected low interest rates and a shift of a proportion of savings to instruments taxed less heavily or later.

Taxes on goods and services rose by 0.1 percentage point of GDP, as the tax base remained robust. Private consumption virtually kept pace with GDP, but private investment – which is also subject to VAT – was relatively dynamic, while various indirect tax measures were also supportive. For instance, higher excise duties on tobacco and fuels (with a total impact of over € 330 million), the increase in annual taxes on credit institutions and a higher monopoly rent paid by the Loterie Nationale/Nationale Loterij (Belgium's national lottery) more than made up for the nearly € 400 million fall in VAT on electricity consumption and banks' lower contributions to the deposit guarantee scheme.

Non-fiscal and non-parafiscal revenues inched down in 2014, from 6.7 % to 6.4 % of GDP, in part because revenue-enhancing elements from 2013 had run their course, such as the Bank's record payments to the State or the refunds of excess customs duties levied by the EU. However, the main reason was the further erosion of interbank guarantee fees paid by financial institutions and the drop in dividends paid, totalling over € 600 million. After all, the Belgian State has fewer holdings in these institutions and the federal and Flemish governments also made fewer loans to some of them.

Continued high levels of primary expenditure

The government's primary expenditure, i.e. spending excluding interest charges, amounted to 51.4 % of GDP in 2014, a slight increase on the previous year, taking the increase in expenditure volumes, which is 1.3 %, a touch higher than the 1% real GDP growth rate.

To obtain a true picture of the fundamental trend in fiscal policy, the growth of expenditure should be adjusted for temporary factors as well as for cyclical factors and indexation effects. Non-recurrent factors, which include one-off refunds of unlawfully levied corporation tax, have fuelled expenditure in 2014 by 0.2 percentage point of GDP. Unemployment benefits show up the impact on primary expenditure of the economic cycle and stayed below their average pace of growth in 2014, with the cyclical component shaving a total 0.1 percentage point off primary expenditure in the year. Lastly, factors relating to indexation exerted more downward pressure on spending in 2014, estimated at 0.3 percentage point. After all, civil service pay and social benefits were not index-linked in the year – as the key index on which this mechanism is based has not been exceeded since the end of 2012 – while general price levels went up further.

At the end of the day, primary expenditure recorded adjusted growth of 1.5 % in 2014, and so exceeded GDP growth. This acceleration in real terms of general government's adjusted primary expenditure masks divergences between the various sub-sectors. The federal and local governments were expected to post a new drop in their

TABLE 21 GENERAL GOVERNMENT PRIMARY EXPENDITURE

(deflated by the GDP deflator, percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e	Average 2000-2013
Level recorded (1)	48.9	49.8	51.4	51.2	51.4	46.3
1. Real recorded growth	1.1	3.6	3.2	0.0	1.3	2.9
2. Influence of non-recurrent or fiscally neutral factors (2)	–1.3	0.6	0.8	–1.1	0.2	0.1
3. Influence of cyclical factors (2)	–0.1	–0.3	0.1	0.1	–0.1	0.0
4. Indexation effect (2) (3)	–0.9	0.3	0.3	0.4	–0.3	0.0
5. Adjusted real growth (1 – 2 – 3 – 4)	3.4	3.1	2.0	0.7	1.5	2.8

Sources: DGS, NAI, NBB.

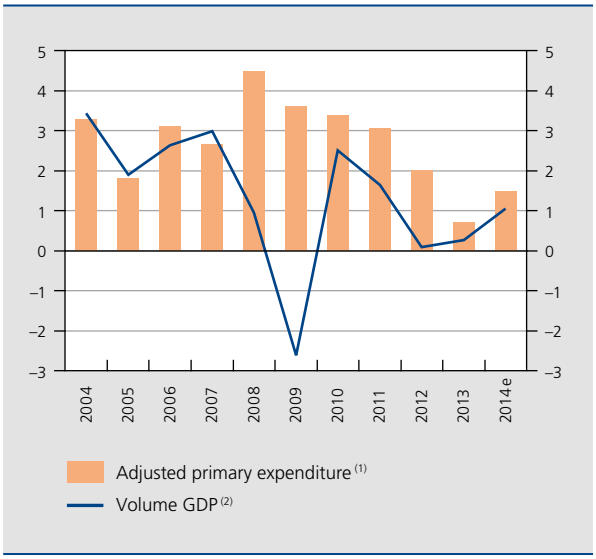
(1) In % of GDP.

(2) Contribution to real recorded growth of primary expenditure.

(3) Effect caused by the difference between, on the one hand,the actual indexation of public sector wages and social security benefits and, on the other hand, the rise in the GDP deflator. The other effects due to differences between inflation measured by the GDP deflator and the movement in price factors influencing other expenditure categories – whether these are attributable to the indexation mechanisms or to divergent patterns in the prices of certain expenditure categories – are not adjusted, owing notably to the absence of sufficient information.

CHART 70 PRIMARY EXPENDITURE OF GENERAL GOVERNMENT AND GDP

(percentage volume changes compared to the previous year)



Sources: NAI, NBB.

(1) Primary expenditure deflated by the GDP deflator and adjusted for cyclical and non-recurrent or fiscally neutral factors, and for the indexation effect. The latter is caused by the difference between, on the one hand, the actual indexation of public sector wages and social security benefits and, on the other hand, the rise in the GDP deflator.

(2) Calendar adjusted data.

adjusted expenditure, whereas spending on social security and spending by the Communities and Regions was estimated to have exceeded economic activity by 1 and 2 percentage points respectively.

Various budget items contributed to more moderate adjusted federal government expenditure in 2014. For instance, a further marked reduction in the number of public sector workers led to a fall in remuneration, while purchases of goods and services by the federal government held steady in real terms. Conversely, the volume of subsidies to businesses increased, mainly comprising lower payroll tax and subsidies to the national railway company (SNCB/NMBS), Infrabel and bpost.

In 2014, growth of adjusted social security expenditure stayed firmly below the average in the past decade, and this related to the main social security benefits categories. Health care spending, which represents just over a third of the social security budget, increased by 1.3 % in real terms, a fairly similar trend to the previous year, which itself had been considerably below trend growth in the past. The target for real growth of health care expenditure, set at 3 % for 2014, was amply met.

Pension expenditure increased by 2.6 % in real terms, which was below the average since 2000 and reflected slowdown in the growth of the number of pensioners in 2014. That said, the pensions bill continued to grow faster than average economic activity, while benefits paid under the sickness and disability scheme shot up to well above the long-term average in real terms. By contrast, cyclically adjusted unemployment benefits fell in real terms on the back of the labour market reforms introduced by the previous federal government, such as making unemployment benefits more degressive over time, and raising to 60 the age up to which unemployed people must be available for work.

TABLE 22 ADJUSTED PRIMARY EXPENDITURE BY GENERAL GOVERNMENT SUB-SECTOR (1) (2)

(deflated by the GDP deflator, percentage changes compared to the previous year)

	2010	2011	2012	2013	2014 e	Average 2000-2013
Entity I	4.6	3.5	2.1	0.6	1.4	2.8
Federal government	8.2	4.9	0.2	–1.4	–0.4	2.5
Social security	3.1	2.9	3.0	1.5	2.2	2.9
Entity II	1.4	2.3	1.7	0.9	1.6	2.7
Communities and Regions	2.2	1.8	0.5	2.0	2.9	2.9
Local authorities	0.1	3.3	4.0	–1.0	–0.8	2.3
Total	3.4	3.1	2.0	0.7	1.5	2.8

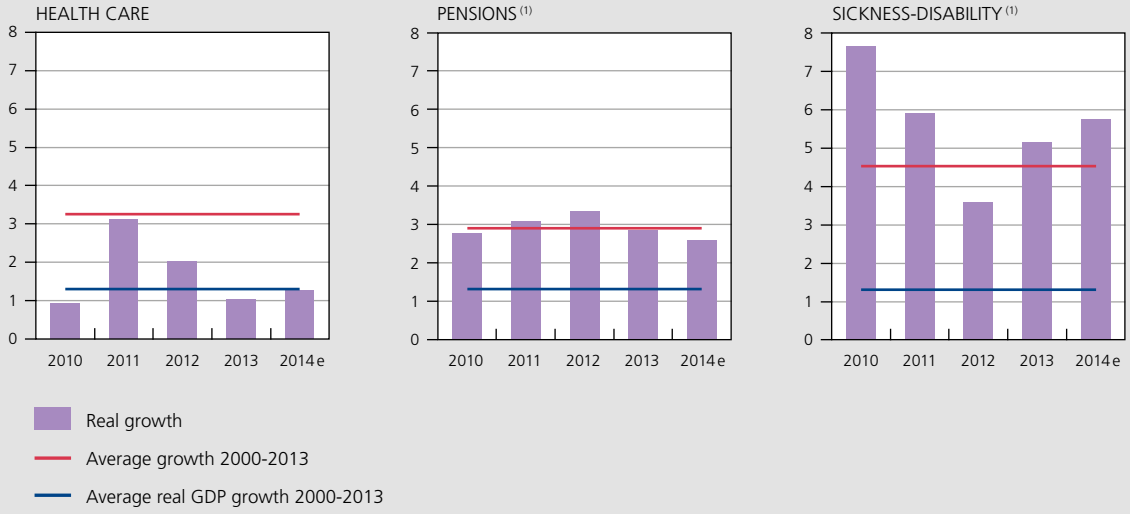
Sources: NAI, NBB.

(1) The expenditure of the general government sub-sectors does not include mutual transfers.

(2) Primary expenditure deflated by the GDP deflator and adjusted for cyclical and non-recurrent or fiscally neutral factors, and for the indexation effect. The latter is caused by the difference between, on the one hand, the actual indexation of public sector wages and social security benefits and, on the other hand, the rise in the GDP deflator.

CHART 71 PUBLIC EXPENDITURE ON HEALTH CARE, PENSIONS AND SICKNESS AND DISABILITY BENEFITS

(deflated by the GDP deflator, percentage changes compared to the previous year, unless otherwise stated)



Sources: Budget documents, NAI, NBB.

(1) Expenditure adjusted for the indexation effect, caused by the difference between, on the one hand, the actual indexation of public sector wages and, on the other hand, social security benefits and the rise in the GDP deflator.

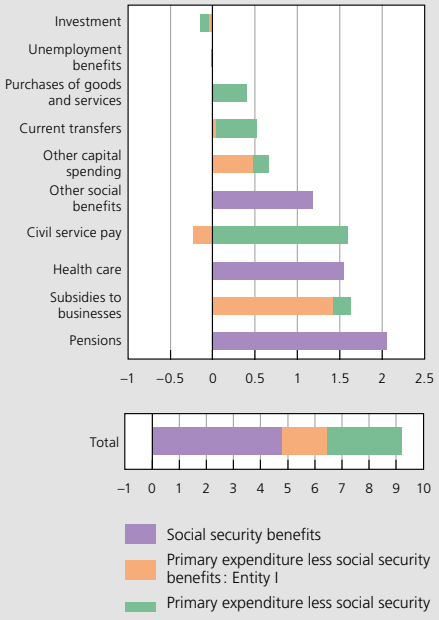
The Communities and Regions reported a 2.9 % increase in adjusted primary expenditure, the big-ticket items being subsidies to businesses, current transfers and investment. Lastly, adjusted expenditure by local government came in 0.8 % lower as a result of reduced government investment, which traditionally drops back in the two years that follow local and provincial elections.

Taking a long-term perspective, however, primary expenditure has staged a significant 9 percentage point average upturn since 2000, this being mostly down to three key expenditure categories: social security benefits, civil service pay and subsidies to businesses. First, social security benefits added 4.8 percentage points of GDP, climbing much faster than economic activity. The category saw pensions and health care spending add 2.1 and 1.5 percentage points between 2000 and 2014. Second, civil service pay was up 1.4 percentage points in the same period, all of this attributable to the Communities and Regions, and local government. The last contributor, subsidies to businesses, accounted for 1.6 percentage points of GDP in the period, which is attributable to the federal government (payroll tax reductions) and to social security (the service voucher scheme and employment activation programmes).

Investment, which is considered productive public spending as it bolsters the economy's growth potential, was

CHART 72 PRIMARY EXPENDITURE BY CATEGORY AND BY ENTITY

(changes between 2000 and 2014, in percentage points of GDP)



Sources: NAI, NBB.

the only category to decline relative to GDP, from 2.3 % in 2000 to 2.1 % in 2014. The election cycle's influence on local government spending offers only part of the explanation, and relative government expenditure levels are well below the average in the euro area.

Interest rate falls push interest charges down further

In 2014, interest charges fell by 0.2 percentage point to 3 % of GDP, in line with the ongoing downward movement in the interest charges-to-GDP ratio since the early 1990s. This steep fall was due mainly to the steady reduction in the implicit interest rate on the public debt, down from 10.1 % of GDP in 1990 to 3 % in 2014. Up to 2007, the fall in interest charges was also caused by the significant decline in the debt ratio, but the rise in the debt ratio has slowed the reduction in interest charges since the end of 2008.

The year under review was no different and the further decline in interest charges mirrored the exceedingly low interest rates on new securities and government loans, both short-dated and longer-dated paper. In fact, ten-year rates kept coming down throughout the year and even dipped below the 1 % threshold by the end. Most countries in the euro area saw similar movements. The spread on Belgian government paper against Bunds halved to around 30 basis points by the end of 2014, which is similar to the spread observed for French government loans.

Overall balance of the general government sub-sectors

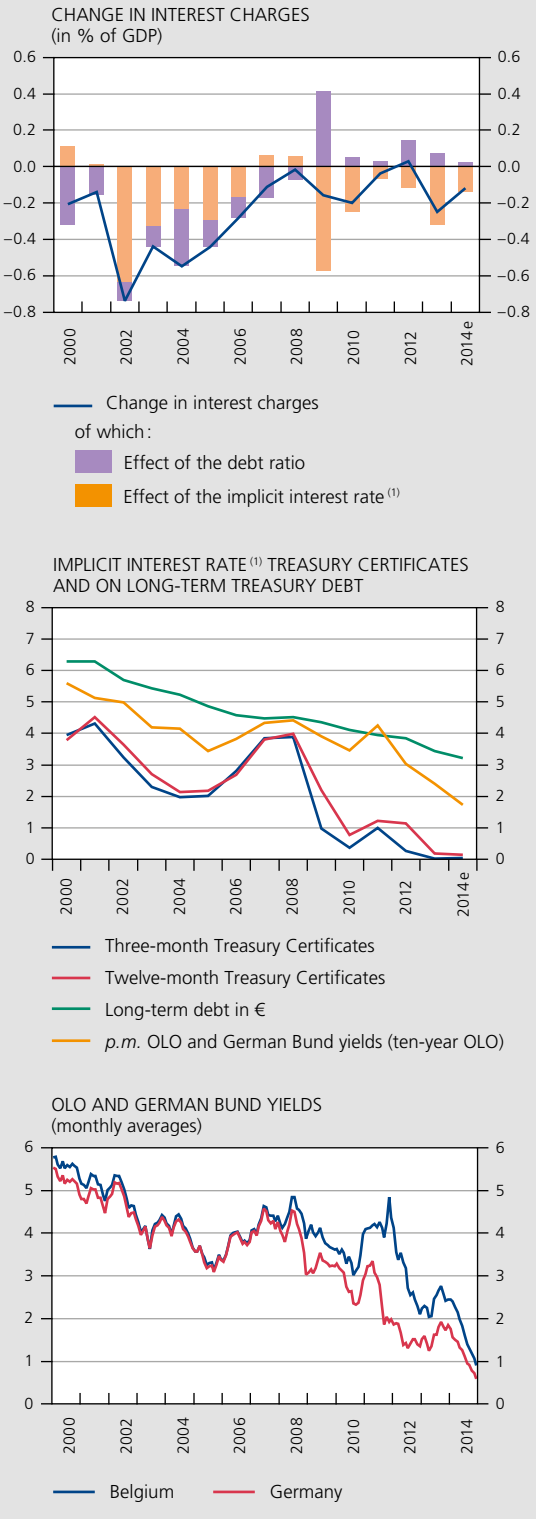
Despite a minor fall in interest charges, the federal government deficit climbed to 2.6 % from 2.4 % of GDP in 2013. This deterioration was caused by a fall in both non-fiscal and fiscal revenues that are retained at the federal level of power after transfers to all other sub-sectors. In this respect, transfers rose faster than the revenues collected by FPS Finance.

The additional revenue received from the federal government partly went towards social security; as in previous years, it helped to pay for the sudden increase in social security benefits. After a small deficit in 2013, social security spending was in balance again in 2014.

The Communities and Regions saw their deficit widen further, to 0.5 % of GDP. The Flemish Community, the Walloon Region and the French Community ended the 2014 fiscal year on significant funding shortfalls, while the Brussels-Capital Region was predicting a virtually balanced

CHART 73 TEN-YEAR GOVERNMENT BOND YIELDS AND BREAKDOWN OF CHANGES IN INTEREST CHARGES

(in %, unless otherwise stated)



Sources: FPS Finance, NAI, Thomson Reuters Datastream, NBB.

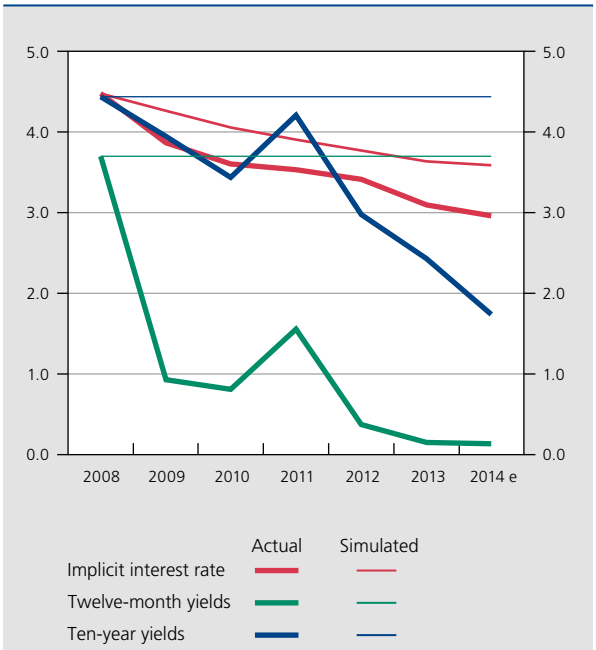
(1) Ratio between interest charges in the current year and debt at the end of the previous year.

Box 12 – Lower interest rates and their effect on government interest charges

The fall in interest rates over the past few years has sharply reduced the interest charges paid by the Belgian State. To get an idea of the amounts actually saved by the Treasury, this Box compares paid interest with the interest bill it would have had to pay if rates had stayed at their average market levels since the outbreak of the financial crisis in 2008. At the time, Treasury bills were looking at three-month rates of 3.7 % and ten-year linear bonds (OLOs) at 4.4 %. These theoretical levels can be tested against effective rates, which fell by 3.6 and 2.7 percentage points respectively between 2008 and 2014. These projections suggest that the implicit interest rate, i.e. total interest charges relative to outstanding debt, will continue to decline despite constant market rates, as previously taken out higher-rated loans mature and are refinanced with cheaper loans.

BELGIAN GOVERNMENT YIELDS, ACTUAL AND SIMULATED

(annual averages)



Source : NBB.

The simulation shows that the Treasury would have had to pay € 2.9 billion more in interest charges in 2014 if Belgian public debt securities had been issued at average conditions prevailing in 2008. Over one-third of this would be attributable to lower short-term yields, and nearly two-thirds to falling long-term yields. This saving, which gradually rises from 2008 onwards, would have implied a windfall gain for the budget in 2014 of 60 basis points in terms of the implicit interest rate on Belgian government debt, taking the saved amount, which rises steadily in the simulation period, to 0.7 % of GDP. All in all, lower interest rates would have saved a total € 11.2 billion over the projection period, with cumulative cost-cutting since 2008 taking 2.8 % off the debt ratio. And if market rates remain low, the positive effects would be even greater in future.

Falling interest rates, the result of the ECB's accommodating monetary policies among other things, have thus somewhat eased the fiscal restrictions faced by the government. But although low interest rates have in fact kept interest charges in check, they are caused by an economic climate not beneficial to public finances. These two effects, lower interest charges and pressure on the primary balance related to unfavourable economic conditions, are pulling in two different directions. By the same token, the burden carried by debt-laden entities – such as the government – in a low-inflation environment is lessened by the falling nominal interest rates resulting from this environment, albeit that the offset is only partially due to the inertia of the implicit interest rate.

Lower interest charges present an opportunity the government should jump at to reduce its deficit. It needs to preserve the sustainability of public finances, and not just because of the effect of rising implicit interest rates on public debt, but also because of the rapidly growing costs of ageing, a trend that has already got underway.

INTEREST-RATE REDUCTION AND ITS EFFECT ON GOVERNMENT INTEREST CHARGES

(data concerning 2014)

	Implicit interest rate (1)	Interest charges	
		(in % of GDP)	(in € billion)
1. Actual levels	3.0	3.0	12.2
Short-term debt	0.1	0.0	0.0
Long-term debt	3.2	3.0	12.2
2. Simulated levels (2)	3.6	3.8	15.1
Short-term debt	2.8	0.3	1.1
Long-term debt	3.7	3.5	14.0
3. Difference (1 – 2)	–0.6	–0.7	–2.9
Short-term debt	–2.7	–0.3	–1.1
Long-term debt	–0.5	–0.5	–1.8

Sources: NAI, NBB.

(1) Relationship between interest charges in the current year and debt at the end of the previous year.

(2) The simulation assumed unchanged figures for the government's funding structure and primary balance levels; only outstanding debt was influenced by the change in the interest charge amount.

budget. Primary expenditure caused the increased deficit in the Communities and Regions as a whole, which saw their own revenues fall in the wake of fewer tax receipts and an absence of a dividend payment to the Flemish Community by KBC (unlike the previous year). The overall fall exceeded the additional tax revenues allocated by the federal government under the old Finance Act, last applied before the sixth State reform – as announced on 6 January 2014 – came into force.

Local government saw its deficit come down to 0.1 % from 0.2 % of GDP. Revenues stagnated, while expenditure dropped on the back of investment cuts in keeping with its typical electoral cycle.

In its April 2014 stability programme, the federal government proposed a breakdown of the budget target across the sub-sectors, in addition to outlining the fiscal path for government as a whole, assuming a deficit of 2.1 % of GDP for 2014. The objectives for fiscal 2014 were in line with the July 2013 cooperation agreement, which had envisaged a surplus for local government reflecting its elections-related investment cycle. Between them, the Communities and Regions were supposed to strike a nominal balance, in

TABLE 23 OVERALL BALANCE OF GENERAL GOVERNMENT AND BY SUB-SECTOR
(in % of GDP)

	2010	2011	2012	2013	2014 e	Target in 2014[1]
Entity I	–3.1	–3.4	–3.6	–2.5	–2.6	–2.3
Federal government	–3.0	–3.5	–3.4	–2.4	–2.6	–2.3
Social security	–0.2	0.1	–0.1	–0.1	0.0	0.0
Entity II	–0.8	–0.5	–0.5	–0.4	–0.6	0.1
Communities and Regions	–0.7	–0.3	0.0	–0.2	–0.5	0.0
Local government	–0.1	–0.2	–0.5	–0.2	–0.1	0.1
Total	–4.0	–3.9	–4.1	–2.9	–3.2	–2.1

Sources: FPS Finance, NAI, NBB.
(1) Targets from the April 2014 stability programme, determined on accounts drawn up in accordance with ESA 95.

accordance with the recommendations of the High Council of Finance's Public Sector Borrowing Requirement section. Entity I, which comprises the federal government and social security, was to limit its deficit to 2.3 % of GDP, a figure in line with the objective imposed on the federal government, assuming that it would keep social security in balance.

On the basis of the most recent data under ESA 2010 – which entail an increase in the deficit of nearly 0.3 % of GDP compared with ESA 95, in use when the stability programme was drawn up (see Methodological Note) – the fiscal targets of the Stability Pact were not achieved for either Entity I or Entity II, with both the Communities and Regions and local government responsible for the latter.

4.3 Public debt and government guarantees

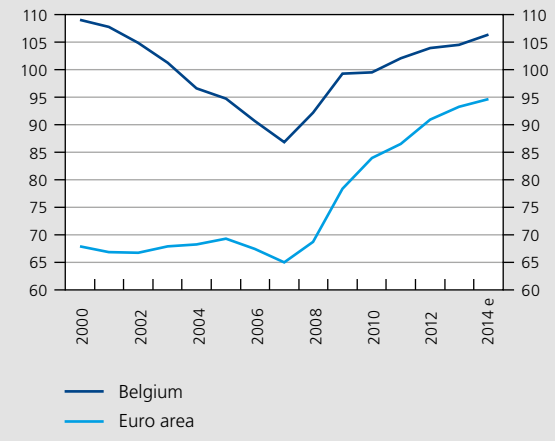
Debt ratio back up

The Belgian government's debt ratio came to 106.5 % of GDP at the end 2014, compared with 104.5 % a year earlier. A range of methodological changes introduced by the NAI in the course of 2014 – partly due to the transition to the ESA 2010 methodology – led to a total upward revision of the ratio by 4.5 percentage points of GDP. The revision was mainly the result of the inclusion of institutional entities in the public sector and the rearrangement of transactions that used to be recognised differently in the accounts (see Methodological Note).

There was no change, then, in the upward debt ratio trend that started in 2008, when the government first injected capital into various ailing financial institutions. Belgium has seen its debt ratio add nearly 20 percentage points of GDP since 2007, while public debt in the euro area rose by close to 30 percentage points of GDP. In contrast with the previous two decades, however, the debt ratio gap between Belgium and the euro area widened in the year under review.

Endogenous factors underlay much of the 2014 rise in the Belgian debt ratio, accounting for 1.6 percentage points of GDP. Their impact is determined partly by the gap between the implicit interest rate on the public debt and nominal

CHART 74 CONSOLIDATED GROSS GOVERNMENT DEBT IN BELGIUM AND IN THE EURO AREA
(in % of GDP)



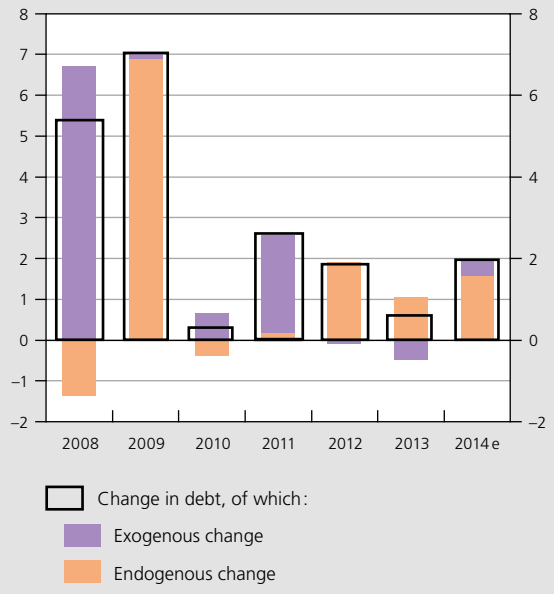
Sources: EC, NAI, NBB.

GDP growth, and partly by the level of the primary balance. With both real GDP and the GDP deflator barely moving, nominal GDP growth was relatively subdued and stayed well below the implicit interest rate on public debt. The primary balance, which reversed into a deficit of 0.2 % of GDP in 2014, was unable to stop the domino effect.

Exogenous factors, so named because they have an impact on the public debt but not on the overall balance, had an unfavourable influence of 0.3 % of GDP on the debt in 2014. Once again, Belgium's federal debt was directly affected by Europe's sovereign debt crisis, as aid to Greece, Ireland and Portugal via the European Financial Stability Facility (EFSF) and the capital contributions to the ESM increased the debt by nearly 0.2 % of GDP. The cumulative effect of the aid to European countries in difficulty, granted by Belgium since 2010 in the form of bilateral loans and via the EFSF and the ESM, comes to 3 % of GDP. In 2014, the debt ratio also added nearly 0.1 % of GDP as a result of the integration of Dexia NV, the holding company of the Dexia group, within the general government boundary, following the sale of Dexia Asset Management at the beginning 2014. Two temporary factors also weighed on the debt ratio. First, the Flemish municipalities acquired Electrabel's stake in the Flemish mixed (public and private) distribution system operators for gas and electricity, after receiving a bridging loan from Eandis for this purpose, pending an equally large sum from a planned capital reduction. And second, corporation tax receipts lagged behind assessments in the year under review. By contrast, other factors helped relieve debt, one being the repayment by KBC of the capital injection received from the Flemish Community, worth 0.1 % of GDP. Moreover, actual debt management also pushed GDP down by 0.5 %, owing to hefty issue premiums. With coupons on general government debt exceeding market rates, issue values were higher than their nominal values – the benchmark for what is known as the Maastricht debt. This effect will peter out as higher coupons are paid.

CHART 75 DETERMINANTS OF THE CHANGE IN THE CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT

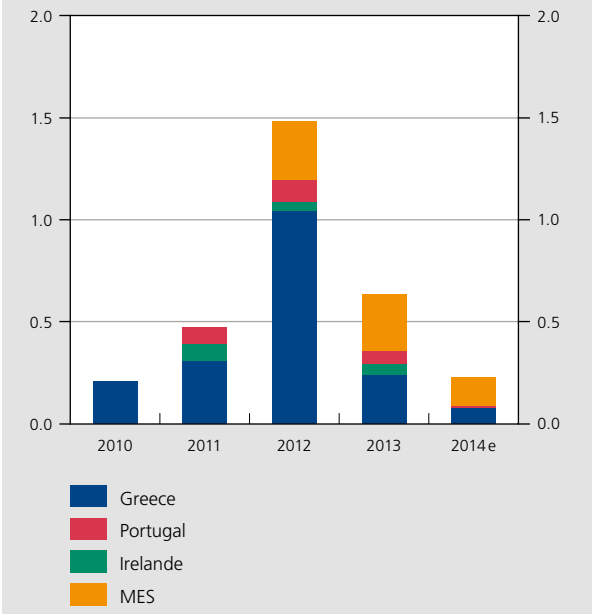
(in % of GDP)



Sources: NAI, NBB.

CHART 76 DIRECT IMPACT OF THE SOVEREIGN DEBT CRISIS ON BELGIAN PUBLIC DEBT [1]

(in % of GDP, end-of-year data)



Sources: EFSF, ECB, NBB.

(1) Direct impact of the loans to other euro area countries (bilateral loans to Greece and loans via the EFSF) and capital injections into the ESM.

Treasury debt management again benefited from favourable conditions

In 2014, the gross balance to be financed by the Treasury stood at € 38.2 billion, which is below the € 40.4 billion figure recorded in 2013. The federal government's growing fiscal deficit was amply offset by steep falls in medium- and long-term loans maturing – the outcome of the steady increase in maturities in the past few years – and by the smaller amount of outstanding loans bought back compared with the previous year.

Unlike in the 2011-2013 period, the Treasury increased short-term financing by issuing Treasury bills in 2014, in order to boost the instrument's liquidity. Combined with a lower gross borrowing requirement, this resulted in a sharp reduction in medium- and long-term refinancing, particularly by way of OLOs. And yet, the Treasury issued more loans than it had planned towards pre-funding expected 2015 requirements, which were adjusted upwards as the year progressed. Solid debt management kept the average maturity of the Treasury's debt portfolio virtually unchanged at 7.8 years, whereas it had continuously risen in the previous few years. A longer average maturity typically reduces refinancing risks.

2014 confirmed the upturn in foreign demand for Belgian government securities, first observed in 2013, and the share of debt held outside Belgium rose to 50 % by the end of the third quarter. This was solely due to renewed investor interest from outside the euro area. In the context of investors' search for yields in the financial markets, robust foreign demand and shrinking spreads between Belgian interest rates and core euro area countries also reflect confidence in the Belgian markets.

Further reduction in guarantees granted to financial institutions

Against the backdrop of the financial crisis, the Belgian government, principally the federal State, granted guarantees to financial institutions, which do not affect the budget balance or the debt unless they are called on. At the end of 2014, the only remaining guarantee was the Dexia interbank funding that had been agreed in December 2011. Federal government guarantees for KBC ended, as in 2014 the bank wound down the CDOs they underpinned. Remaining guarantees for Fortis were also lifted at the start of 2014, and the total amount of guarantees – ignoring the deposit protection scheme – declined by € 7.8 billion to € 37.6 billion at the end of 2014. Despite this, guarantees granted to the financial sector still constitute a major potential commitment, accounting for 9.4 % of GDP, and comprise the vast majority of all general government guarantees. Recent NAI figures put other guarantees at nearly 1.8 % of GDP. These were granted by the federal government as well as the Communities, Regions and the local government.

TABLE 24 FINANCING REQUIREMENTS AND RESOURCES OF THE FEDERAL GOVERNMENT

(in € billion)

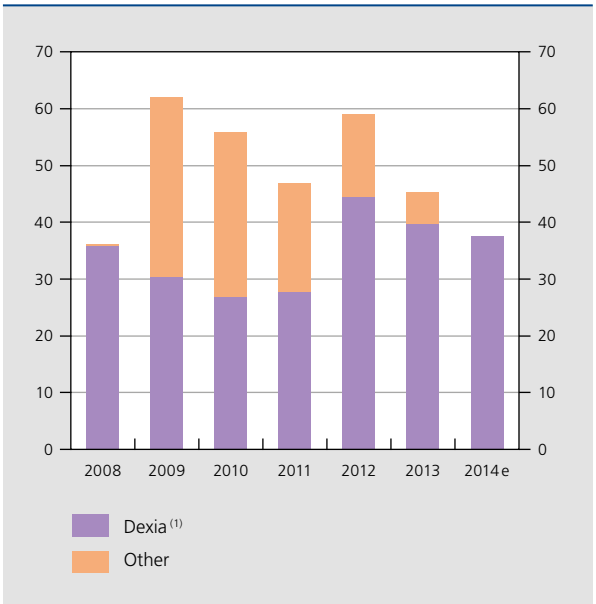
	2012	2013	2014 e
Gross balance to be financed	40.5	40.4	38.2
Gross financing requirements	33.5	33.0	32.8
Budget deficit (–) or surplus (+)[1]	8.0	5.7	10.5
Medium- and long-term debt maturing during the year	25.6	27.3	22.4
In euro	25.6	27.3	22.4
In foreign currencies	0.0	0.0	0.0
Buy-backs (securities maturing the next year or beyond)	7.0	7.4	5.3
Other financing requirements	0.0	0.0	0.0
Funding resources	48.0	46.7	35.7
Linear bonds (OLOs)	43.0	42.3	31.8
State notes and others	5.1	4.4	3.8
Net change in the short-term debt in foreign currencies	0.0	0.6	–0.6
Change in the outstanding amount of Treasury Certificates	–3.4	–7.1	1.8
Net change in other short-term debts in € and in financial assets	–4.1	0.1	1.4

Source: FPS Finance.

(1) The overall balance is calculated on a cash basis and takes account of financial transactions which are not included in the overall balance of general government which, in accordance with ESA 2010, is calculated on a transaction basis.

CHART 77 GUARANTEES GRANTED TO FINANCIAL INSTITUTIONS

(in € billion)



Sources: NAI, FPS Finance, NBB.

(1) Guarantees relating to the 2008 and 2011 schemes. For 2014, only the 2011-related guarantees apply.

Placing the economy on a broader footing

5. Placing the economy on a broader footing

Like many other European countries, Belgium is facing significant challenges, specifically related to its steep government debt levels, the budgetary costs of population ageing, its low employment rate and the marked slowdown of productivity gains. Key measures have been implemented since 2011 and the newly elected government announced further steps after the May 2014 elections, with pension reform again claiming a central position. More generally, job creation in the market sector and productivity enhancements should help assure a sustainable consolidation of public finances. Eight out of ten jobs created between 2000 and 2013 are mainly paid from government resources and labour costs in Belgium are higher than in neighbouring countries, particularly due to very high fiscal pressure. These costs affect the demand for low-skilled labour and hamper the transition to paid work. To improve this transition, the country needs to introduce appropriate financial incentives, coupled with education and activation policies to help reduce labour market mismatches. Smoothly functioning product and labour markets should also encourage a reallocation of production factors to the most efficient companies, and serve as an important source of productivity gains in the economy, notably in the services sector. However, Belgium is struggling with thin business creation. Meanwhile, long-life-cycle investment is required to prevent looming shortages in electricity supplies, for which a stable and predictable regulatory framework is a prerequisite.

5.1 Major challenges

In 2014, the Belgian economy again performed less well than expected, as was generally the case elsewhere in Europe. Yet the rate of fiscal consolidation slowed, monetary policy remained accommodating and financial conditions were favourable. This underlines the need to reinforce the economy's ability to boost economic activity and employment on a long-term basis. There is a need to strengthen the economy's resilience to strong cyclical fluctuations and, at the same time, in combination with Belgium's fiscal policy, to safeguard prosperity and consolidate support for the social protection of today's and future generations.

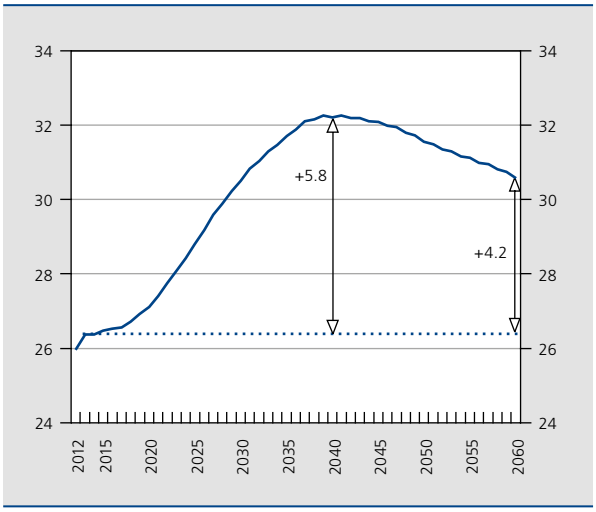
In this respect, Belgium faces the same challenges as most other European countries. It should therefore follow the shared European strategies and comply with the recommendations that have been drawn up. In doing so, it will contribute to the proper functioning of the Economic and Monetary Union (EMU), which brings major benefits for the country. That said, Belgium has specific characteristics that require special treatment and priorities in order for the economy to be able to perform optimally.

Characteristics that are specific to Belgium are the high (and still rising in 2014) level of public debt, the budgetary costs of ageing, the low employment rate and the sharp downturn in productivity gains.

High public debt reduces the scope of budgetary policy to help cushion cyclical downturns and makes the economy more vulnerable to increases in financing costs, especially if these continue to rise. What is more, the budgetary costs of ageing are very high in Belgium, and accelerating fast. According to the most recent forecasts from the Belgian Study Group on Ageing (July 2014), the weight of benefits as a percentage of GDP will add 5.8 % between 2013 and 2040 if policies are left unchanged; and the European Commission is predicting an even stronger increase on the basis of other macroeconomic hypotheses and different expenditure parameters.

CHART 78 BUDGETARY COSTS OF AGEING

(in % of GDP)



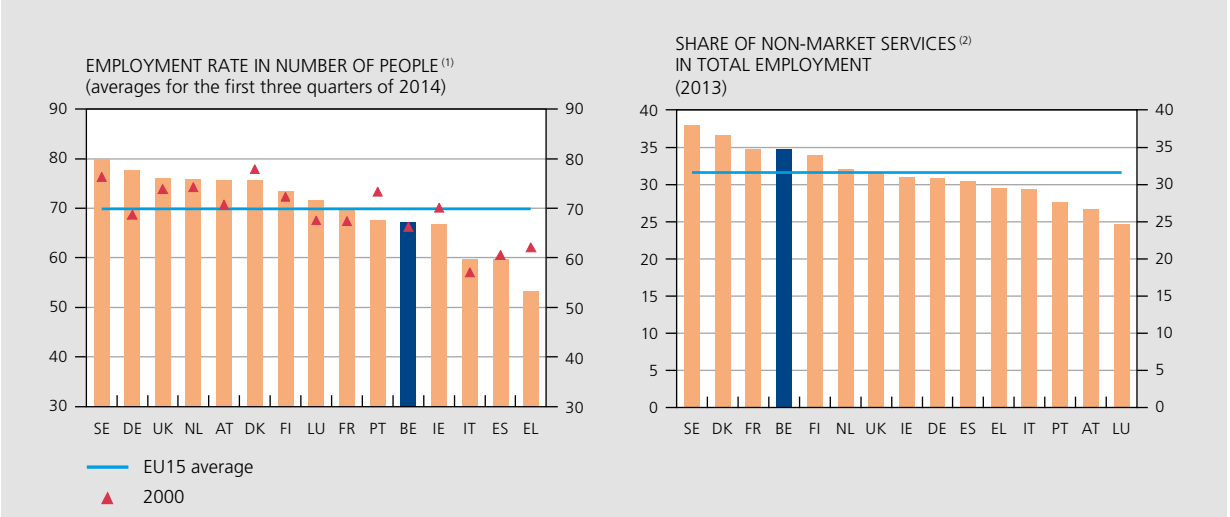
Source: Study Group on Ageing.

Since the previous government had launched an initial range of measures – whose effects were factored into the Study Group on Ageing forecasts – the newly elected federal government has announced it will tighten up the age and minimum career length conditions for early retirement, raise the statutory pension age to 66 in 2025 and 67 in 2030, and review the parameters for calculating civil servants' pensions. With no precise implementing details available at this stage, it is not yet possible to estimate the effects of these reforms on the cost of an ageing population. It will take a more detailed assessment to work out to what extent these new measures might reduce these costs, especially in the early stages when they will grow the fastest.

The employment rate amongst people aged 20-64 years averaged 67.2 % in the first three quarters of 2014. Not only is this 2.6 percentage points below the EU15 average and nearly 13 percentage points lower than in Sweden, it is well below Belgium's own objective of 73.2 % set in the context of the Europe 2020 strategy. The economic crisis has undoubtedly squeezed the employment rate, but does not entirely explain why Belgium is falling behind, as demonstrated by the modest difference between the unemployment rate of 8.6 % on average in 2014 and the structural unemployment rate of 7.8 % according to EC estimates.

The employment rate for the 55-64 age bracket is clearly too low (42.3 % compared with an average 53.8 % for the EU15), although it has risen significantly since 2000. The same applies to low-skilled workers (46.5 % of those who have not obtained a certificate of higher secondary education or the equivalent are in employment, against 52.8 % for the EU15). Employment is particularly low among nationals from outside the EU, only 41 % of

CHART 79 INTERNATIONAL EMPLOYMENT COMPARISON



Source: EC.

(1) As a % of the population aged 20-64 years.

(2) As a percentage in line with the national accounts. The non-market services comprise public administration, national defence, education, health care, social services and other services.

TABLE 25 EMPLOYMENT TRENDS BY MAIN BRANCH OF ACTIVITY

(in thousands of people)

	Change	Level
	2000-2013	2013
Domestic employment	429	4 543
Market activities[1]	159	2 966
Non-market services	270	1 577
p.m. Service vouchers	*118*	*118*
p.m. Jobs largely funded by the government[2]	*352*	*1 659*

Sources: NAI, NSSO.

(1) Agriculture, industry, construction, trade, transport, hotels and restaurants, information and communication, financial and insurance activities, real estate activities and business services.

(2) Jobs in non-market services and estimated share of service-vouchers based employment in market activities.

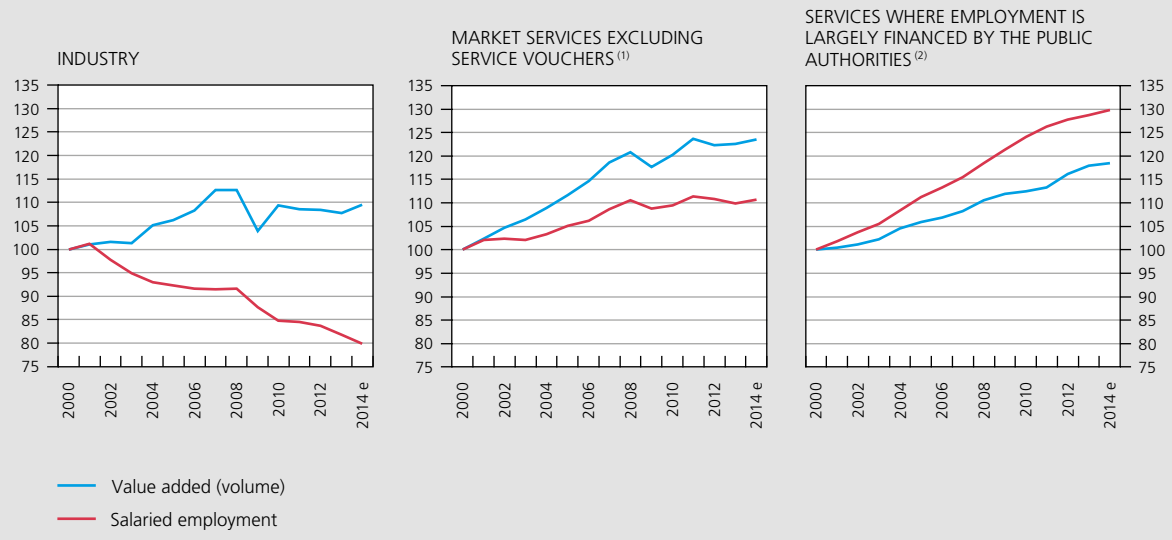
whom are in work – i.e. almost 30 percentage points less than Belgian nationals. Other categories, such as women and the under 30s, also have a lower probability of being employed, while regional differences are also very marked, with the employment rate in Flanders over 10 percentage points higher than in Wallonia (71.8 % as against 61.7 %) and Brussels (58.4 %).

What is more, the percentage of jobs in the non-market sector is relatively high in Belgium, standing at 34.7 % in 2013 compared with an average 31.6 % in the EU15. In fact, employment growth in Belgium since the early 2000s has been mostly on the back of the net creation of jobs that are partly or wholly funded by the government. And this does not just concern additional people in public administration and education, who saw their numbers swell by 100 000, but primarily around 170 000 extra workers in health care and social services and people who work for private sector employers under the service voucher scheme. In all, an estimated eight out of ten jobs created between 2000 and 2013 primarily rely on government funding.

Value added and employment trends vary widely from one sector to the next. In industry, growth in economic activity was rudely interrupted by the great recession, the lingering effects of which had still not disappeared by the end of 2014. The sector's value added increase is in stark contrast with its falling employee numbers, and reflects an accumulation of significant productivity gains. These are much more modest in market services, where value added growth more closely reflected employment,

CHART 80 EMPLOYMENT AND VALUE ADDED IN THE MAIN BRANCHES OF ACTIVITY

(data adjusted for seasonal and calendar effects, indices 2000 = 100)



Sources: NAI, NBB.

(1) Trade, transport, hotels and restaurants, information and communication, financial and insurance activities, real estate activities and business services, disregarding service-voucher jobs from market activities.

(2) Non-market services, including service-voucher-related employment in market services.

while the crisis had much less of an impact and proved more temporary than in industry. By contrast, non-market services hardly felt the recession at all : employment was up sharply and staged the highest growth in the economy, with economic activity trailing slightly behind.

Public services and personal service activities undoubtedly contribute to community well-being, and respond to the needs of a society whose socio-demographic make-up and lifestyles are changing. By providing education and health care, in particular, these services also support growth potential. But these trends also imply risks – to the sustainability of public finances in particular – if they do not coincide with sufficient job creation in the market sector. Sustainable public finances can only be secured if the economy has a sufficiently wide range of income-generating activities, as non-market services that weigh on the primary balance are not neutral for government budgets.

While the Belgian economy was changing in structure, its trade balance also deteriorated, from a surplus of 2.9 % of GDP in 2000 to a deficit of 0.2 % in 2013 according to the balance of payments. Broadly speaking, a decline in the relative weight of market activities – and industry in particular – erodes an economy's ability to export goods and services. The 2002-2013 period witnessed net annual destruction of jobs in the manufacturing industry, which lost a total of no less than 117 000 jobs.

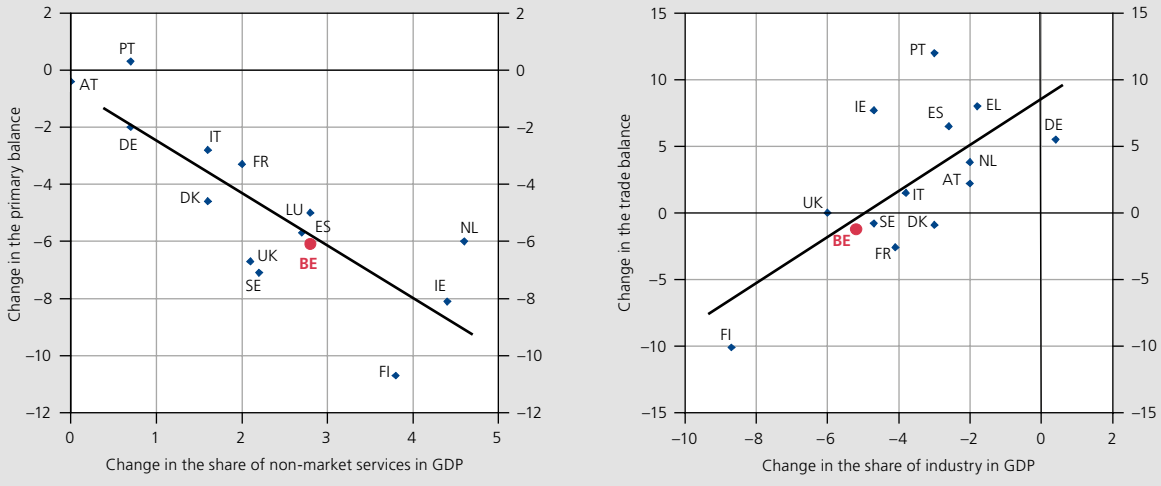
To a degree, the decline ties in with restructuring of production processes in industry itself : jobs that were previously done within the sector have been transferred to service suppliers to create greater flexibility and improve cost control, and research into the production process underlying exported goods has shown that part of their value lies in services sectors providing intermediary services to the manufacturing industry, such as legal and accounting services, management, services from architects and engineers, supervision, technical analysis and so on. Service suppliers increasingly also operate as commercial go-betweens, taking care of re-exported goods, or acting as an intermediary in the export of Belgian-made goods. That said, de-industrialisation has also brought a discontinuation of certain product lines that have only partly been replaced by new chains. With industry remaining the gateway to the global economy and the first to flag up new demand, a declining industrial sector weighs down on the trade balance.

More so than services, industry is a key source of productivity gains in the economy. Estimates show potential growth – and more specifically total factor productivity (TFP) – to have slowed in Belgium since the 2008-2009 economic recession. An international comparison flags up barriers that curb TFP growth, both in industry and in services – the latter typically known for weaker TFP figures.

Companies typically develop on their own merits and qualities, conquer positions in global value chains and

CHART 81 PUBLIC FINANCE AND TRADE BALANCE CHALLENGES

(changes between 2000 and 2013, in percentage points of GDP)



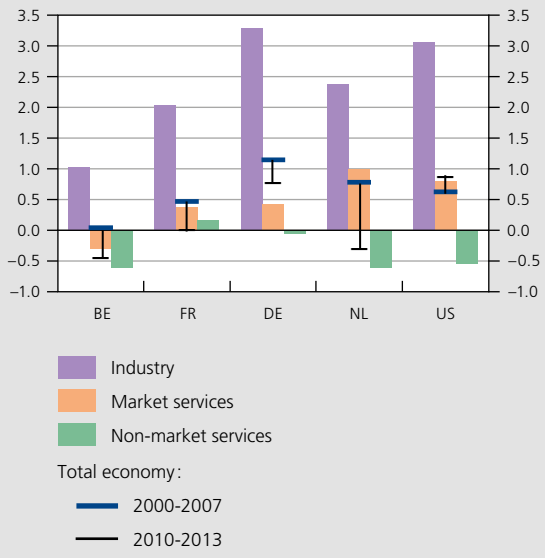
Source : EC.

so support productivity and employment, and some companies in Belgium are outstanding at doing just that. However, an analysis of the makings of a successful process reveals that the government also has a role to play, by taking measures to enhance intangible capital, channel resources to the most productive companies, encourage the implementation and spread of innovation, provide effective infrastructure and facilitate appropriate funding. More broadly, the government should create the conditions that help the economy create more jobs. All other things being equal, costs will be a decisive factor for where the different stages of the value chains will be based, both industrial production and its related services. And incidentally, this also applies to activities that focus on domestic demand, such as construction.

At the end of 2011, Belgium launched a series of key measures to address the structural problems vexing the domestic economy. New federal, community and regional governments took office in October 2014 and are planning their next moves in this direction. In view of the challenges and the feedback loops between them, these measures and their effects will demand close and constant scrutiny, as it would appear essential to operate the levers of employment creation and productivity development that will help achieve a sustainable consolidation of public finances.

CHART 82 TOTAL FACTOR PRODUCTIVITY (TFP)

(average annual growth between 2000 and 2007, in %, unless otherwise stated)



Sources: Conference Board, EU KLEMS.

5.2 Boosting job creation in the market sector

Creating more employment by encouraging job growth in the market sector means striking a better balance between supply and demand in the labour market. To that end, the labour market must operate flexibly in order to allow more robust demand from employers to match an appropriate supply of labour of the right quality. The World Economic Forum puts Belgium in 18th position among the 144 countries it compares in its Global Competitiveness Index (7th among EU15 countries). However, it performs worst on labour market efficiency, where it ranks 60th (10th among EU15 countries). This indicator draws on actual data (participation of women, redundancy costs) and on the annual WEF Executive Opinion Survey. There are five factors executives identify as hampering the labour market in Belgium: the effect of taxation on incentives to work (141st out of 144 countries), its strict hiring and firing practices (139th), its centralised wage negotiations (129th), the weak link between wages and productivity (100th) and, lastly, the lack of cooperation between social partners (78th).

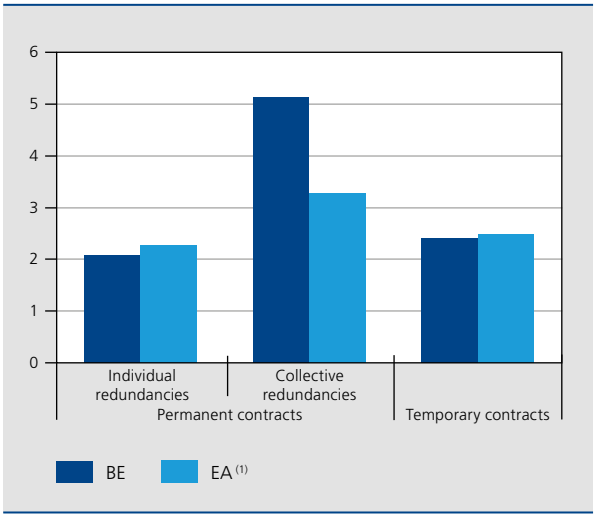
This perception of Belgium's executives matches earlier empirical findings, such as the importance of fiscal and parafiscal pressure on income from employment and the rather loose correlation between productivity and labour costs.

OECD data suggest that employment protection rules governing temporary contracts and individual redundancies of people on permanent contracts in Belgium are not really any more rigorous than in other euro area countries. By contrast, collective redundancies are subject to much stricter rules. Available indicators for an international comparison relate to the situation as at 1 January 2013. Two important developments have taken place since then. The first is the harmonisation of the status of blue-collar and white-collar workers; some points still have to be firmed up but blue-collar workers will be offered wider protection. And the second is the simplification of company closure and collective redundancies procedures (Renault Law), planned by the government, particularly by shortening them.

Many European countries have taken a range of measures concerning the functioning of the labour market, more particularly countries that were faced with dramatic increases in unemployment in the wake of the 2008 economic and financial crisis and the social repercussions of greater joblessness. Their implementation is in many cases so recent as to make it impossible to gauge their outcomes. A common trend would appear to be greater flexibility in terms of working hours (easier

CHART 83 EMPLOYMENT PROTECTION LEGISLATION

(indices, scale of 0 to 6, from less to more restrictive, situation in 2013)



Source : OECD.
(1) Data not available for Cyprus, Latvia and Malta.

to work overtime or change hours to fit demand on companies' output) and tighter early retirement access rules. In the case of temporary contracts or fixed-term contracts, opposing measures have been taken – and sometimes even in the same country – to prevent a two-tier labour market and at the same time encourage labour market participation.

Demand for labour

Of all the factors influencing the demand for labour, the most challenging are linked to wage-setting mechanisms and, more specifically, to wage levels. Belgium is among the countries with the highest hourly wage costs, which is very detrimental to employees whose productivity does not reflect or no longer reflects the labour costs for their employer, as may be the case for the lower-skilled – including younger people – or for some older employees.

Labour costs higher in Belgium than in neighbouring countries

Despite recent favourable labour cost trends compared to Belgium's three neighbouring countries – as described in section 2 – a comparison of wage levels reveals that significant differences remain. In 2013, hourly labour costs in the broader business sector amounted to over € 40 in Belgium, compared with € 35 for France and around € 32 for the Netherlands and Germany – and the differences are even more marked when compared with the average for the euro area. Of course, this average is heavily influenced by the countries of Southern Europe, whose standard of living, productivity and costs are clearly below average. Some of them however, are true competitors in the export markets.

Belgium's steep wage levels are the result of a combination of high net wages and an exceptionally heavy tax charge on labour (including employer and employee social security contributions and personal income tax). Average net hourly wages in Belgium – excluding levies – are estimated at € 24, which is about the same as in Luxembourg but exceeds the nearly € 20 in Belgium's three main neighbouring countries.

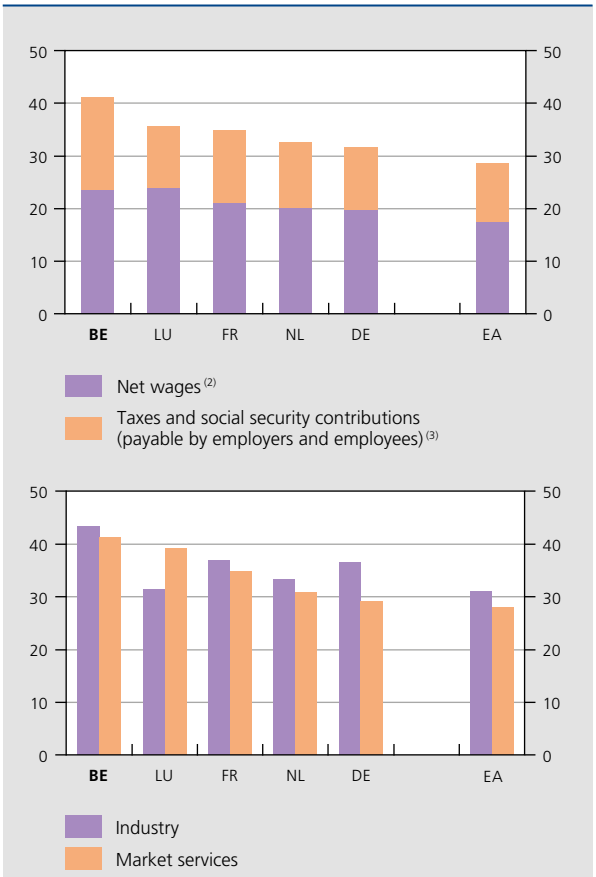
The € 960 million measures announced by the government to help reduce labour costs in 2016, particularly by reducing employer contributions, should help narrow the gap in hourly labour costs with neighbouring countries. These fresh measures will come on top of similar but less far-reaching ones in 2013 and 2014. What is more, any shift of the fiscal pressure on labour to other tax bases could also help improve companies' competitiveness, depending on how it is applied (see Box 11).

Both in industry and in market services, Belgium has the second heaviest hourly labour costs in the EU, hard on the heels of Sweden. And this continues to be the case at a less aggregated level, for instance when wage subsidies are taken into account, so the difference for all Belgian companies as a whole cannot be solely attributed to the structure of the economy.

High labour costs can get in the way of preserving and improving an economy's competitiveness. In Belgium, these are at least partly offset by equally high productivity levels at the aggregate level, but broken down by sector the offset may be stronger or less strong, in some sector even reversing into a drag on productivity. Analyses in 2013 of data drawn up in line with ESA 95 found that, in Belgium, unit labour costs were below those in its three main neighbouring countries in ten of the sectors surveyed while they were higher in the other eleven. However, this does not lead to an unambiguous conclusion as to whether higher productivity levels are a cause or an effect of higher labour costs. Where there are substitution options, high labour costs typically require companies to find capital or tap external resources, but they will translate into fewer jobs if there are financial restraints.

CHART 84 HOURLY LABOUR COSTS IN THE BUSINESS SECTOR[1] IN 2013

(in €)



Source: EC.

(1) Companies with ten or more employees.

(2) Labour costs less estimated fiscal and parafiscal levies.

(3) Estimated by applying the implicit rate of tax on labour (employers' and employees' social security contributions and personal income tax) in 2012 to hourly labour costs in 2013.

Labour costs affect demand for low-skilled labour

For economic reasons, employers will only take on more employees if the value generated by these exceeds their costs. Low-skilled young people, who lack experience to make up for any gaps in their initial training, will be the first to suffer from an unfavourable cost-to-productivity ratio. Other factors may also come into play, of course, but there appears to be a negative correlation between wage levels for young employees and the age group's employment rate. To prevent any distortions from differences in general wage levels between countries, the analysis uses the Kaitz Index, i.e. the lowest gross wages for unskilled youngsters as a ratio of median gross wages in the economy.

High minimum wages may help to reduce the likelihood of poverty for employees and – given relative benefit levels for people out of work – avoid any curbs on labour supply, but they do raise labour costs for low-skilled employees, who risk being pushed out of the labour market altogether. People with real or perceived extra productivity constraints, such as young people, older people or low-skilled workers of foreign origin, are likely to be hit hardest.

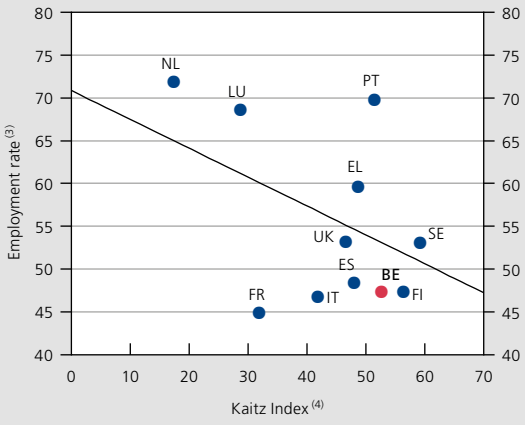
Only a few European countries impose a minimum wage that applies to the entire economy, and Belgium's is on the high side in an international perspective, while sector-wide agreements typically go higher still. What is more, Belgium has phased out lower minimum wages for young people, which often serve to mitigate the dangers of labour market exclusion and which have been implemented in nearly half of the OECD countries concerned. Sectoral agreements will still be able to set lower minimum wages for young people, but they will not be allowed to dip below the national statutory minimum wage.

Wages and seniority

Just like in other countries, wages in Belgium typically rise with age. In theory, pay-scale increases should reflect the declining effect of experience acquired in a specific position, that is, starting off high, then levelling off and

CHART 85 WAGES AND EMPLOYMENT OF LOW-SKILLED YOUNG PEOPLE[1] IN EU15[2] IN 2010

(in %)



Source: EC.

(1) Non-student 15-29 age group without secondary level qualifications.

(2) No data available for Austria, Denmark, Germany and Ireland.

(3) In % of the corresponding population.

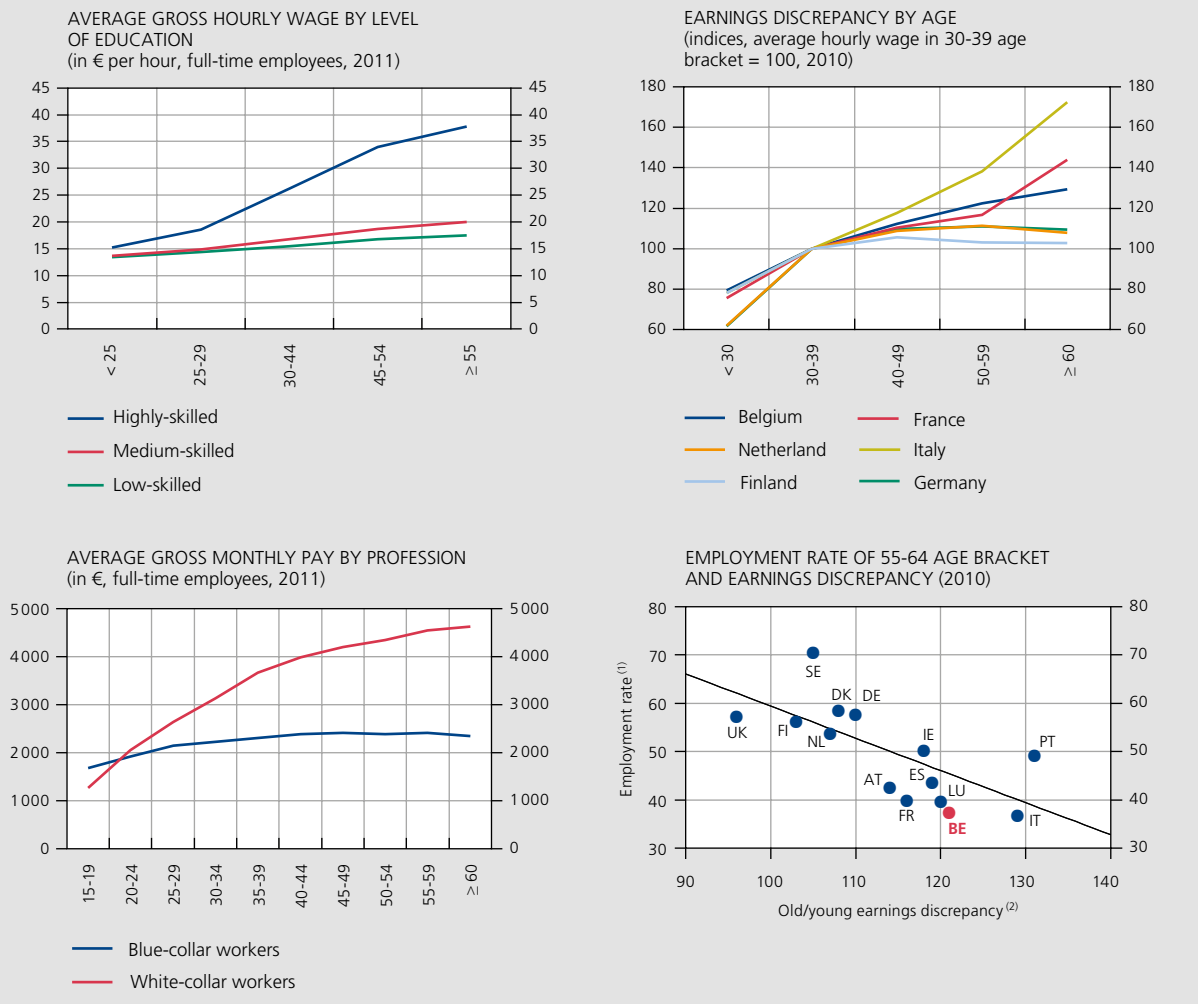
(4) Ratio for each of the countries between the fifth percentile of the distribution of gross wages of low-skilled young people and the total median gross wage, in %.

eventually ceasing altogether. It is typic ally Belgian that these pay-scale increases – at least for white-collar workers – do not slow down towards the end of people's careers. This causes the differences between wages and productivity to widen, and the resultant higher relative cost of older employees erodes their position in the labour market.

International comparisons based on such aggregate data should nevertheless be interpreted with caution, as these are prone to composition effects. For example, in terms of education levels, the composition of employees changes in the oldest age groups in Italy, Belgium and France – the number of highly-skilled workers increases; the low-skilled (who often earn below-average wages) more often drop out of the labour market via early retirement schemes. And Belgium's age-related wage profile is largely explained by early retirement – at the initiative of either the employees and/or the employers – and not just by seniority-related differentials. By contrast, countries working with apprenticeships typically have lower average wage levels for young people.

Although the low-skilled tend to leave the labour market prematurely more often than other groups, there is still a notable employment rate difference between the over-(55s) and the middle-aged group in Belgium. Generally speaking, there is a clearly negative correlation between seniority-related wages and the employment rate of older workers.

CHART 86 WAGES BY AGE (1)



Sources: EC, DGS.
(1) Ratio of workers aged between 55 and 64 to the total population in this age bracket, in %.
(2) Ratio of average monthly pay of employees between 50 and 59 to monthly pay of employees between 30 and 39, with wage levels of this latter group set at 100.

Incidentally, technology-related changes and longer working lives than currently will also require changes to the way labour is organised and human resources are managed. Lifelong learning typically contributes to professional development and so preserves productivity that matches wage development.

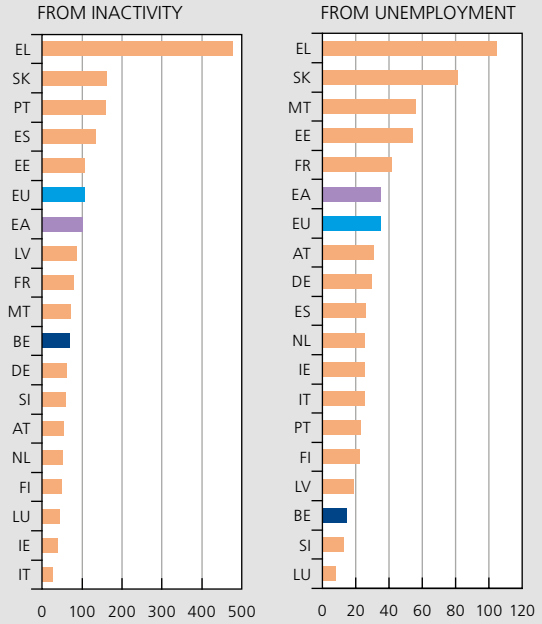
Labour supply

Appropriate financial incentives for transition to employment

To promote the supply of labour, work should be more appealing – not least financially – than unemployment or inactivity. The gap between net wages and social security benefits should be sufficiently large to make up for the expenses of having a job, such as the cost of transport, clothes and child care, but also the loss of the financial advantages of being a benefit claimant (income taxes, child allowances, access to certain government services). Most potential employees do not face this problem, as their expected earned income is significantly higher than social benefits. However, for the low-skilled, the difference between the two is sometimes too small to serve as a real incentive to accept a job that matches their skills and therefore will be low-paid.

CHART 87 FINANCIAL INCENTIVE TO ACCEPT A LOW-PAID JOB (1)

(net increase in disposable income, in %, situation in 2013)



Source: EC.

(1) Job remunerated at 67 % of the average wage for employees. Average situation for six types of households.

The financial incentive in Belgium appears to be on the low side when compared with the other euro area countries and the European average. From an inactivity baseline, a job earning 67 % of the average wage makes for a net income increase of around 70 % in Belgium, as against a European average of 100 %. Yet the advantage is still substantial and subsistence benefit does not appear to serve as a financial employment trap. Things are different for low-skilled job-seekers, though. In the euro area, they can look forward to an improvement in

TABLE 26 EXPENDITURE ON ACTIVE LABOUR MARKET POLICIES IN 2012

(in € per unemployed job-seeker in the relevant Region, unless otherwise stated)

	Brussels	Flanders	Wallonia	German-speaking Community	Federal	Belgium
Total (in €)	1 594	4 472	1 030	1 938	3 032	5 430
In % of the total per Region						
Labour market services	44.9	21.0	14.2	43.0	29.1	26.4
Training	31.2	24.4	28.0	13.1	13.3	18.9
Employment incentives	0.0	3.1	5.0	7.7	48.3	28.3
Supported employment and rehabilitation	14.5	41.9	46.0	35.8	0.2	17.4
Direct job creation	9.2	9.6	6.8	0.4	8.6	8.8
Start-up incentives	0.2	0.0	0.1	0.0	0.5	0.3

Source: FPS ELSD.

their net incomes by 35 %, but in Belgium this is a mere 15 %. Only in Slovenia and particularly Luxembourg can an even smaller difference be found. In November 2012, this state of affairs in Belgium prompted the implementation of degressive benefits over time, in a move to gradually step up the financial incentive while at the same time offer job-seekers an income that gives them enough time to find a position that matches their expectations and skills.

Job-seekers in Belgium do not receive unemployment benefit unconditionally, and have to prove they are doing whatever is necessary to find a job, in which they are supported by regional employment services. Following the sixth State reform, these organisations are now also responsible for checking job-seeker availability. A large number of other competences – like economic migration, target group policies, service vouchers and outplacement – were also decentralised on 1 July 2014. The federal government remains in charge of labour and social security legislation, including rules on unemployment.

Active labour market policies to support job-seekers

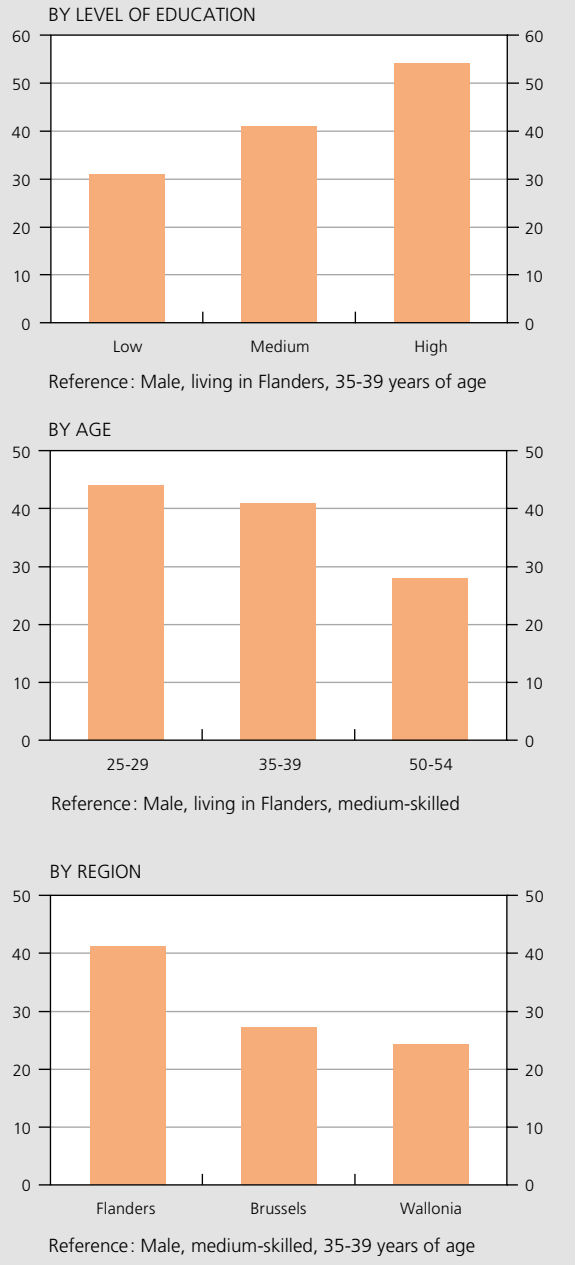
Drawing on a set of measures to activate job-seekers, the authorities can tailor their actions to the characteristics of the unemployed population and labour demand in their own Regions. The most recent data refer to 2012 and thus do not reflect the new division of competences. At the time, an average of € 5 400 per year was spent per unemployed job-seeker. Employment incentives were a largely federal matter, while supported employment and rehabilitation measures for the disabled were mainly drawn up by the Regions and the Communities. Ignoring the federal level, a comparison of the regional authorities gives some idea of the resources used and the choice of the specific measures selected at the time. Flanders spent nearly € 4 500 per job-seeker, significantly more than the other two Regions and the German-speaking Community. The latter's average budget was around € 1 900, compared with nearly € 1 600 in Brussels and just over € 1 000 in Wallonia. Relative to total resources used, Brussels and the German-speaking Community focused more on job-seeker guidance, while Flanders and Wallonia devoted more resources to work for the disabled, mainly in sheltered environments. Training expenses take second place in employment activation policies.

Slower transition from unemployment to work for some categories of job-seekers

An analysis of survey data, which factors in residence, gender, level of education and age, reveals major differences in the chances of finding employment in Belgium. In the bracket 'male, 35 to 39 years old and living in

CHART 88 TRANSITION FROM UNEMPLOYMENT TO WORK (1)

(transitions within a year, in %, situation in 2013)



Sources: DGS, NBB.

(1) Results based on a multivariate analysis, from which the effect of a variable can be measured while controlling for the effects of other available covariates.

Flanders', a little more than 30 % of the low-skilled will find a job within the year, compared with nearly 55 % of highly-skilled workers. Comparable gaps are found in other sections of the population. In other words, unemployment spells among the low-skilled are significantly longer.

Age is another key determinant in finding work. The reference group's job-seekers between 50 and 54 have only a one in four chance of finding a job within the space of one year, while the percentage is 41 % in the 35-39 age bracket. One possible explanation of this lower return-to-work rate from the age of 50 could be the notion of the reservation wage, which posits that job-seekers turn down jobs commanding lower wages than what they think they should earn. Job-seekers might be pegging their reservation wage too high because they compare their current situation with what they used to be paid, without allowing for the fact that a proportion of this former wage paid them for specific skills at their former employer that are not necessarily useful in a new position. And employers might have various reasons – for some of which there are no objective grounds – not to hire older job-seekers, perhaps because they fear older workers will have a harder time adjusting to a new workplace or will be absent more frequently for health reasons.

Region also has a part to play : irrespective of level of education, gender or age, job-seekers in Flanders move more quickly out of joblessness and into work than those living in Brussels or in Wallonia, with the transition percentage for medium-skilled men between 35 and 39 at 41 % in Flanders, 27 % in Brussels and barely 24 % in Wallonia. This regional variable is down to a range of factors, the most important of which is more plentiful employment opportunities in Flanders than in the other Regions. Of course, it might also reflect other differences ignored in the model, such as perhaps Flemish job-seekers doing better on average in terms of characteristics such as experience or language skills, or perhaps also the resources Flanders uses to get people back into work.

Skills mismatch

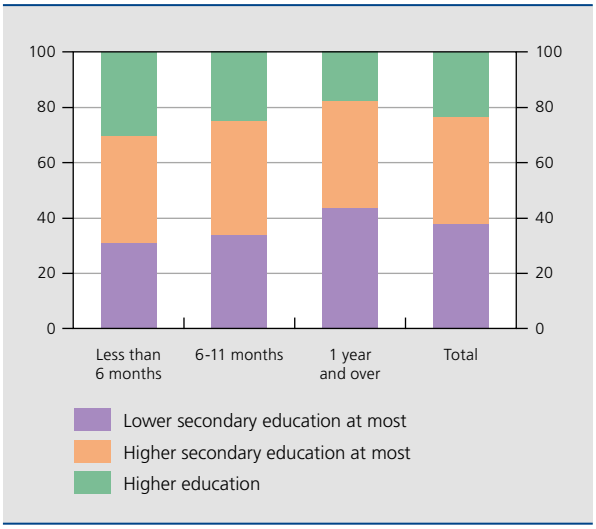
A low level of education reduces employment opportunities, as elementary occupations that do not require high skill-sets account for barely 10 % of total employment, a proportion that has been fairly stable since early 2000. By contrast, highly-skilled jobs such as managers and professionals have risen to 45 % of the total, and now claim as large a share of employment as medium-skilled jobs such as administrative personnel, salespeople or skilled blue-collar workers, a group that has proportionately been on the decline.

These are the hallmarks of a labour market transitioning to a knowledge economy – a trend visible to a greater or lesser extent depending on the sector. In industry, low- and medium-skilled jobs have been lost, partly because they have been outsourced, while highly-skilled jobs have been created. That said, this is still a sector with mainly medium-skilled, typically technical jobs. In services – and particularly in market services – elementary jobs have increased both in numbers and in their relative share of total employment, although this is still no more than 12 %. This is partly explained by the transfer of low-skilled jobs from industrial companies to the services sector, as well as by the development of the service voucher scheme, which primarily employs low-skilled workers. Non-market services, by contrast, have a high concentration – i.e. six out of ten – of highly-skilled jobs, such as intellectual and scientific professions.

This qualification-based employment structure does not match the skill-sets of job-seekers, three-quarters of whom were low-skilled or medium-skilled in 2013, which is to say that they had a certificate of secondary education at most. What is more, early school-leavers are over-represented among the long-term unemployed. Nearly one in four job-seekers does have a certificate of higher education – university degree or equivalent. This goes to show that some tertiary education courses are less well rewarded and their graduates run into problems when entering the labour market – which is obviously not the case for engineers and graduates from scientific disciplines.

CHART 89 BREAKDOWN OF UNEMPLOYMENT BY DURATION AND LEVEL OF EDUCATION

(in % of the total, situation in 2013)



Source : DGS.

In the 18-24 age group, a total of 11 % had not completed secondary education in 2013 and were not enrolled in a training course of any kind. This breaks down into 7.5 % in Flanders, 14.7 % in Wallonia and 17.7 % in Brussels, taking Belgium's proportion of early school-leavers to just below the European average. The Belgian government has made a commitment to reduce this percentage to 9.5 % by 2020.

In this context, there has been too little focus on technical and vocational training, and in particular on apprenticeships and internships. The number of apprentices between the ages of 15 and 29 is reported to be below 1 % in Belgium, compared with an average of 3.7 % in the EU (boosted in particular by Germany's large proportion). The new transition internship scheme for young job-seekers in Belgium has seen limited succes : it has brought only 3 000 contracts since its launch in 2013. Nevertheless, such schemes offer real employment opportunities for young people who are put off by the idea of excessively formal training. More generally, specific attention needs to be focused on the situation of young people of foreign origin, both in terms of their school careers and their entry into the labour market.

Greater need for lifelong learning as careers last longer

The recurrence of numerous jobs in the lists of critical occupations released each year by the public employment services proves the structural problem of filling specific profiles – technical in Flanders and Wallonia, and administrative in Brussels. Although few new occupations have emerged in recent years, many jobs have become more complex, and employers increasingly insist on people complementing their formal training and professional skill-sets with "transversal" competences.

Lifelong learning makes it easier to match labour supply and demand, and supports economic growth by enabling a better allocation of resources. As the population ages and measures are taken to lengthen careers, and as the work environment keeps changing and shifting, skills will need to be developed and updated throughout people's working lives, to bolster both the productivity and employability of workers and the competitiveness of companies.

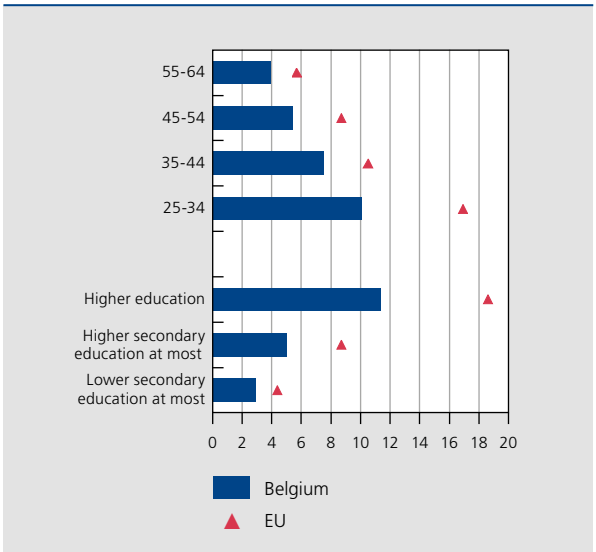
However, access to lifelong learning remains fairly limited in Belgium, and barely 6.7 % of the population between the ages of 25 and 64 were enrolled in some kind of course or training in 2013 – nearly four percentage points below the European average. Comparatively more job-seekers were taking courses, principally under the guidance of the regional public employment services.

Also, the proportion of training participants increases in step with the initial level of education : 11 % of highly-skilled adults received education or training, compared with 3 % of people who never finished their secondary education. And this is a phenomenon noted in all European countries. In terms of age, too, access to education is unevenly distributed : In Belgium, only 4 % of the 55-64 age group had followed a training course, compared with 10 % of the 25-34-year-olds – a negative average correlation found across the EU, including the Nordic countries which are generally considered as role models in vocational training. Investment in further training was long considered unnecessary, as these people were known to drop out of the labour market well before reaching the statutory retirement age.

With all the measures taken to make people work longer, this 'end-of-career' effect should become a lot less significant, and those in work should start to think differently about the value of further training. However, there is a risk that they will not, if they consider themselves sufficiently capable of handling their daily duties, if the training courses on offer do not help improve the quality of their daily work or their career opportunities, or if these courses do not match their learning skills and capabilities.

CHART 90 ACCESS TO LIFELONG LEARNING

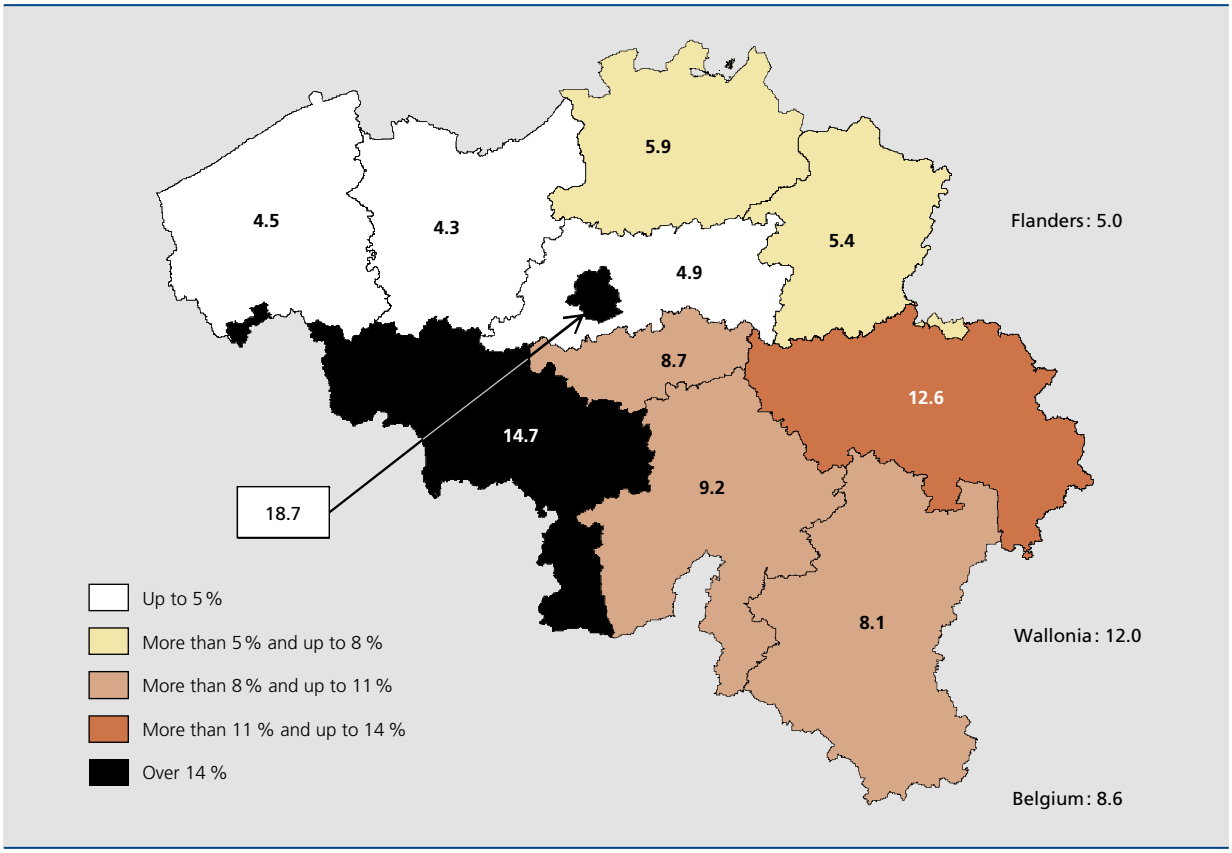
(percentage of the 25-64-year-olds, in %, who report having received education or training in the four weeks prior to the survey, situation in 2013)



Source : EC.

CHART 91 UNEMPLOYMENT IN GEOGRAPHIC PERSPECTIVE

(in % of the labour force aged 15 to 64, average of the first three quarters of 2014)



Source : DGS.

Persistent geographic mismatches

Divergent transition opportunities from unemployment to employment as broken down by Region (place of residence) are inevitably visible in the unemployment figures as well. On average, 8.6 % of the Belgian labour force was looking for work in the first three quarters of 2014. There were major differences between the Regions and even between neighbouring provinces: in Flanders, 5 % of the labour force was out of work, compared with 12 % in Wallonia and even 19 % in Brussels, which is facing specific big-city issues in terms of matching labour supply and demand. At the provincial level, the unemployment rate stood at 4.3 % in East Flanders and at 14.7 % in the Hainaut. Antwerp was the Flemish province returning the highest unemployment figure, at 5.9 %, and was still ahead of the province in Wallonia that registered the lowest joblessness figure: Luxembourg, at 8.1 %. The intra-regional differences are also markedly bigger in Wallonia: the unemployment rate spanned a range of nearly 7 percentage points, as against less than 2 percentage points in Flanders.

A proportion of vacancies in low unemployment provinces might be filled by job-seekers from other Regions. Increased job mobility could therefore help boost economic growth – a process in which the government has significant leverage, as it sets the rules for suitable work for job-seekers. Given the ongoing regionalisation of labour market powers, regional public employment services should work closely together, as in fact they already do when exchanging job offers, or organising language training.

5.3 Towards a more dynamic and flexible economy

Shifts in activities and jobs to support growth

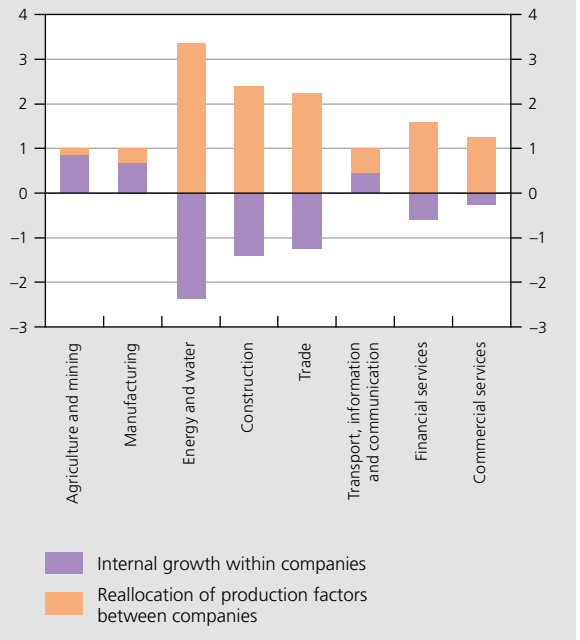
Although efficient labour markets are a necessary condition for more employment in the market sector, sustainable numbers of new jobs can only emerge in an environment based on solid activities. Entrepreneurial dynamism

acts as a catalyst for total factor productivity, or TFP. As highlighted at the October 2014 international conference held by the Bank, and further illustrated in the introduction to this section, TFP growth in advanced economies has seen a major slowdown over the past two decades. With the services branches of activity known for their relatively modest TFP gains, the shift to services in the economy has been an important contributory factor. Moreover, industry and the services sector have their own dynamics when it comes to productivity gains. In manufacturing, these are achieved by existing companies through R&D investment among other things, while the services sector records generally low – or even negative – productivity gains in its companies, the ICT sector being the only notable exception. The same is true for non-market services, which are traditionally characterised by very low productivity gains. By contrast, reallocation of production factors to the most efficiently operating service companies has proved a key source of aggregated growth, achieved by creating new companies or by growing the most productive ones at the expense of the most outdated.

The economic dynamics, with some activities or companies rising and growing while others are falling, of course make for a constant flow of job creation and destruction.

CHART 92 SOURCES OF INTERNAL AND EXTERNAL TFP GROWTH

(contributors to TFP growth of 1 % between 1998 and 2009, in percentage points)



Source: Van Beveren and Vanormellingen (2014).

Between 2006 and 2013, the Belgian economy saw an average of 209 000 new jobs created per annum, nearly 6 % of the existing total. At the same time, no less than 185 000 jobs have disappeared, an average 5 % of the number of people in work. One-fifth of new jobs were created in new companies, underlining the importance of a dynamic business environment. In a labour market characterised by high adjustment costs and asymmetric information, the extent of these workforce movements shows how big the challenges are and how essential a properly functioning market is to economic growth, by ensuring a smooth reallocation of workers between different jobs, both within the same sector and between different sectors.

The trade, transport, accommodation and food service activities accounted for a little over 30 % of all jobs created and destroyed in the Belgian economy. The accommodation and food service activities branch is particularly notable for its high churning rate, due to both its high numbers of start-ups and closures and to its wide use of temporary contracts and less favourable labour and wage conditions. The biggest number of jobs created by new companies is found in trade. Job creation and destruction were roughly balanced in commercial services, in industry and energy and in construction, while health care and social services saw many more jobs created than there were lost, as evidenced by the high share of this sector in net job creations in the economy as a whole.

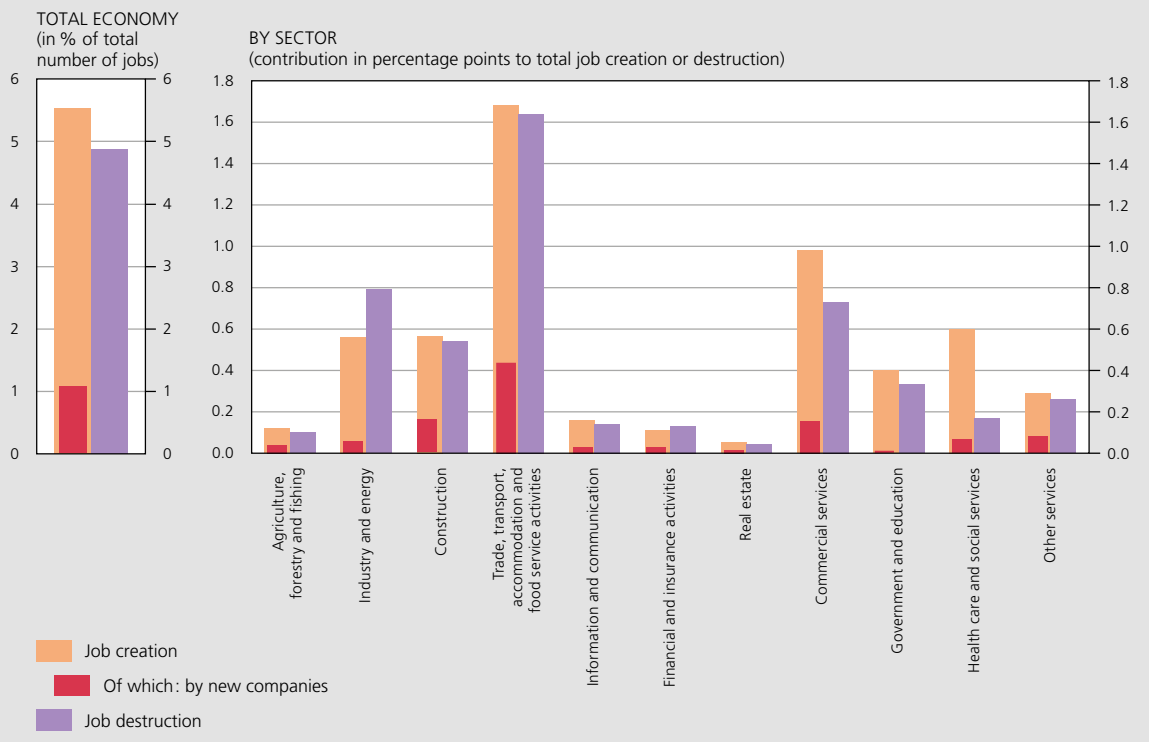
Low start-up ratio depresses economic dynamism

European Commission data show that there are fewer newly established companies in Belgium than in the other European countries, both in industry and in market services. This trend is unlikely to reverse any time soon, as fewer people have recently started a business or are planning to do so in the next three years.

There are likely to be a plethora of reasons behind this reluctance on the part of potential entrepreneurs to start a business. OECD indicators of Product Market Regulation (PMR) and the World Bank's Doing Business indicators suggest that entrepreneurship in Belgium is hampered by administrative, legal and tax constraints. The formalities and costs linked to registering ownership, tax charges, the cost of setting up a business and minimum capital requirements are all greater in Belgium than on average in the EU.

Not all indicators are flashing red for Belgium, though. The time required for setting up a business is comparatively

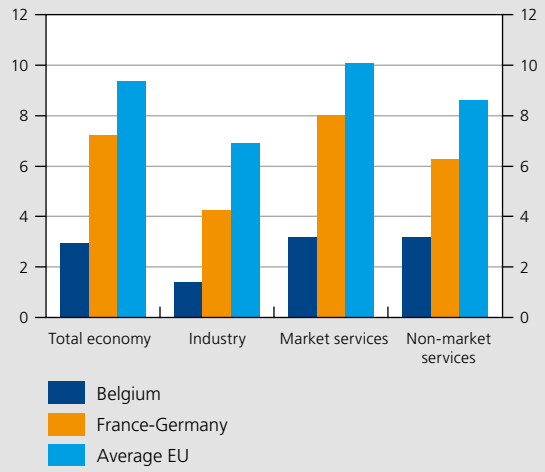
CHART 93 JOB CREATION AND DESTRUCTION IN THE 2006-2013 PERIOD



Source : DynaM-Belgium.

CHART 94 BUSINESS START-UPS[1]

(in % of the number of companies active in 2012)



Source: EC.

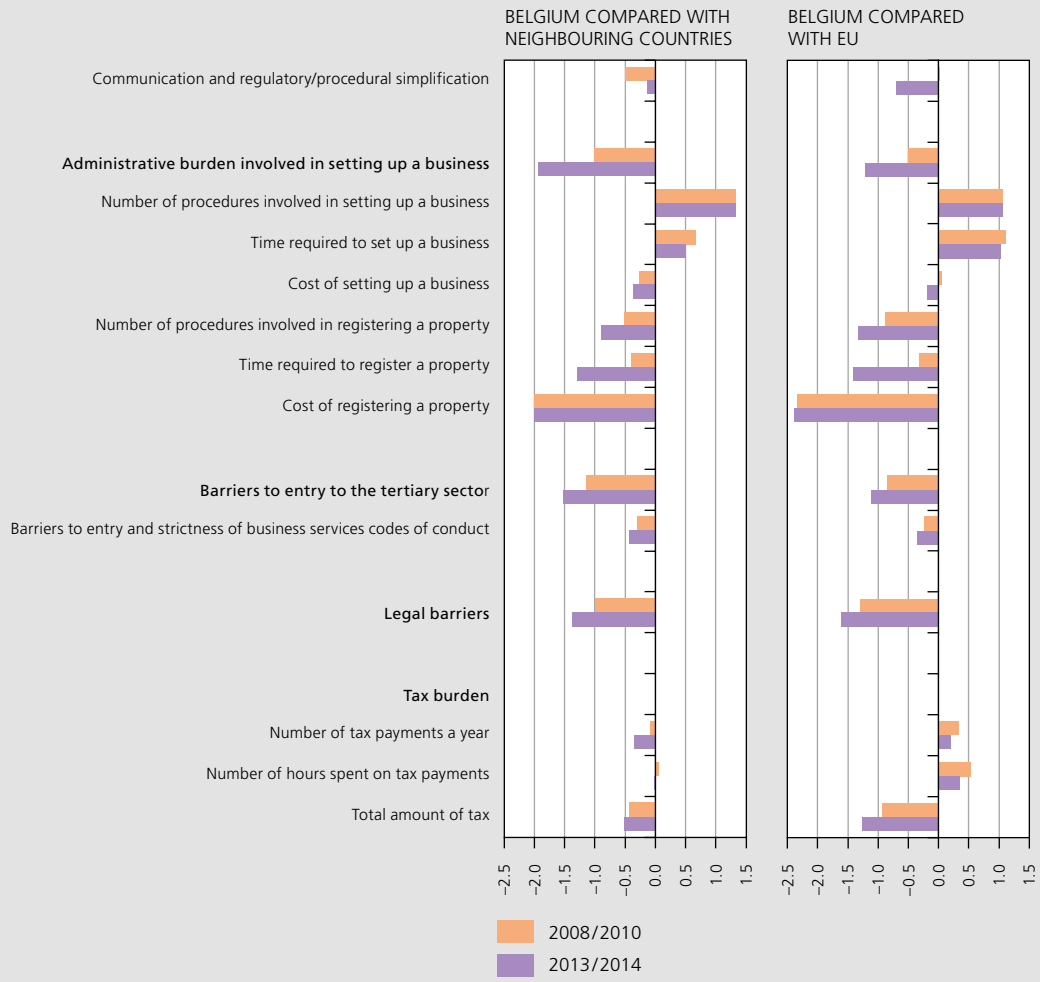
(1) Start-ups are defined as new companies that have used new production factors, particularly new jobs. Start-ups do not include mergers or company restructurings, nor dormant companies that resume their activities within two years.

short, tax is collected fairly efficiently and the execution of contracts is less expensive and less subject to disputes. However, on a very large number of indicators, Belgium saw its relative position deteriorate compared with the EU and its neighbouring countries, between the 2008-2010 period and the more recent 2013-2014 period. In this regard, efforts in other countries have been more extensive or have produced better results than they have in Belgium.

Ignoring all these barriers, it is generally entrepreneurial spirit that needs strengthening in Belgium. Paradoxically, the Community Innovation Survey (CIS) considers the opportunities for starting a business in the current general economic climate more favourable in Belgium than elsewhere. It would seem that psychological barriers, such as relative risk aversion, play a part, as Belgians report a greater fear of bankruptcies than do other nationalities and potential entrepreneurs feel their knowledge and competences are inadequate for starting a business. Media images of entrepreneurs are less favourable than in neighbouring countries and in the EU as well, with company success stories enjoying less media exposure.

CHART 95 ADMINISTRATIVE BARRIERS

(standardised differences between Belgium and the reference area)



Sources: World Bank (Doing Business indicators, 2010 and 2014), OECD (PMR indicators, 2008 and 2013).
Note: A negative value indicates a more difficult situation in Belgium than the average in the reference area.

When looking at the alternatives, aspiring entrepreneurs might also feel their potential income is too low and end up preferring other professions.

Diverging outcomes on innovation

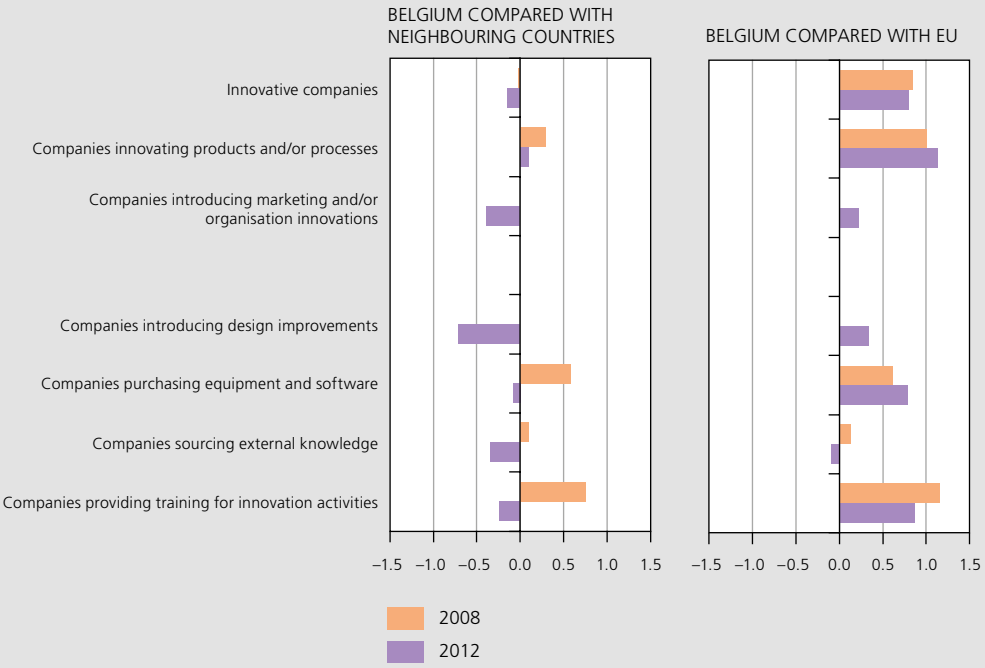
To foster the positive dynamics of new start-ups, conditions need to be in place to help them develop and flourish, with innovation one of the key ways to achieve this in a highly competitive world. Innovation can take many shapes and forms, ranging from fundamental research into the adoption of new management techniques to adjusting production or sales processes.

Despite all government efforts to encourage innovation, the R&D spending that is so seminal to the expansion of industry in Belgium lags below the average in advanced countries and is mainly limited to industrial multinationals. According to the OECD, Belgium's relative R&D weakness is attributable to the structure of its economy, which is more services-focused. Service companies typically spend less on R&D and acquire new technologies from external sources.

To encourage more R&D, different policy echelons have put in place measures and practical recommendations to help SMEs innovate. Specifically, regional government offers hands-on support by funding projects in areas of

CHART 96 INNOVATION

(standardised differences between Belgium and the reference area)



Source: EC (Community Innovation Survey).

growth. The federal government chips in by alleviating the cost of R&D investment, by offering tax relief to researchers and tax deduction on patent income.

Economic growth does not depend exclusively on R&D expenditure, especially in an economy focused on providing services. The OECD's Oslo Manual, which proposes guidelines for collecting and interpreting technological innovation data, describes innovation as a much wider concept that also includes later stages of development and testing, as well as new production processes, marketing new products, training employees, design, etc.

Belgium has about as many innovative companies as its main neighbouring countries, but their results on innovation in its broadest sense show moderate progress on design, marketing or organisational aspects. This is a general observation that applies to both industry and market services, and specifically to small companies, which tend to have a harder time innovating.

The main reason Belgian companies cited for innovation weaknesses – in a survey conducted by the OECD – was difficulties in freeing up funds. In 2013, only 2.3 % of GDP was invested in venture capital in Belgium, only 30 % of which was earmarked for financing the later development stages of the companies, compared with an EU15 average of 2.9 %. This is not just a Belgian phenomenon, it is an EU-wide problem: even the three EU15 countries scoring highest – i.e. Ireland, Finland and Sweden – are trailing over 11 percentage points behind the United States, where this type of financing accounts for 17.5 % of GDP.

In addition to funding, companies mentioned a shortage of capable employees. Although Belgium has a large number of people taking long higher education courses, the number of students in scientific or technical fields is low compared with the rest of the EU and neighbouring countries. And this is precisely the employee profile companies are looking for when trying to encourage innovation.

Business environment curbs services activities

Service activities deserve a special mention, in view of their importance in the functioning of advanced economies, as well as the characteristics of the production and trade methods in this area. What is more, in Belgium, these activities are marked by higher and more persistent

increases in consumer prices than in the main neighbouring countries, and by relatively unfavourable productivity trends, as demonstrated in the discussion on prices and labour costs in section 2.3.

The heavy regulatory framework that characterises the services sector can act as a brake on growth. And although a majority of the European countries face similar problems, Belgium has a specific set on its own. For one thing, its liberal professions are more rigorously regulated than in the neighbouring countries or on average in the EU. Except for engineers, Belgium's other liberal professions accountants, lawyers and architects are bound by strict rules governing their entry to the market and the way they carry out their profession. There is undoubtedly a need for a framework addressing market imperfections – e.g. the problems clients may experience in evaluating the quality of proposed services ex ante – but this should be set up in such a way that it does not impede the development of these activities. Retail trade is also more highly regulated in Belgium than in the rest of the European Union,

Box 13 – Regulating service activities at European level

Market services are a dominant economic sector in Europe, accounting for 50.7 % of total value added and 43.2 % of employment in the economy as a whole. Moreover, other economic sectors that use services in their production processes benefit from productivity gains in market services. Services are particularly important for global value chains, as exporting industries typically outsource many of the services relating to their activities – such as transport, marketing, accountancy, financial, technical and other specialist services – either to businesses in their own countries or to companies in other European countries.

In general, however, productivity gains in the European services sector are limited. The OECD attributes this to a number of factors, including the rigidity of market regulations. Indicators of Product Market Regulation (PMR), for example, show that professional services tend to be most highly regulated in the countries of Europe, with the exception of the United Kingdom and the Nordic countries of Sweden, Finland and Denmark.

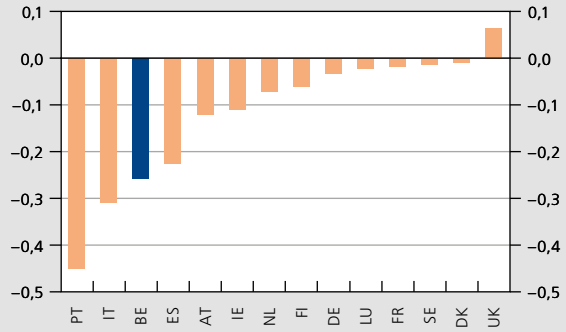
Although stringent regulations may be introduced with a specific goal, such as defending the public interest, protecting consumers or monopoly control, they may also shelter companies from international competition. It will hardly come as a surprise, then, that the services sector is among the least efficient of all sectors in terms of the allocation of means of production. An analysis of the indicator for 'allocative efficiency', which sheds light on the relationship between productivity and market share, shows that – unlike production in the manufacturing industry – production in the services sector is not necessarily generated by the most productive groups of companies.

However, relaxing regulations governing services activities could generate growth potential and productivity gains. This would, moreover, offer the best guarantee that the labour market reforms in most European countries will produce optimum results. As competition may erode any benefits gained, it would raise the chance of these reforms resulting in a fall in prices, productivity gains and the creation of employment rather than in higher profits for the companies protected. EC estimates show that a decline in the PMR indicator in the professional services sector would facilitate business start-ups and lead to an improved allocation of the means of production.

It is against this background that the EC sought to relax the regulatory framework in its economic policy. It urged Member States to transpose the Services Directive into national law by 2009. The purpose of this Directive was to remove legal and administrative barriers. Despite the efforts made by many countries, a large number of barriers are currently still in place, five years after the Directive entered into force. Most progress made in this area to date has resulted only in the partial removal of these barriers.

In accordance with another aspect of its economic policy under the European Semester, the EC also draws up specific recommendations for Member States, including recommendations for market regulation. In 2014, for

MEASURING THE EFFICIENCY OF THE ALLOCATION OF PRODUCTIVE RESOURCES[1] IN PROFESSIONAL SERVICES[2]



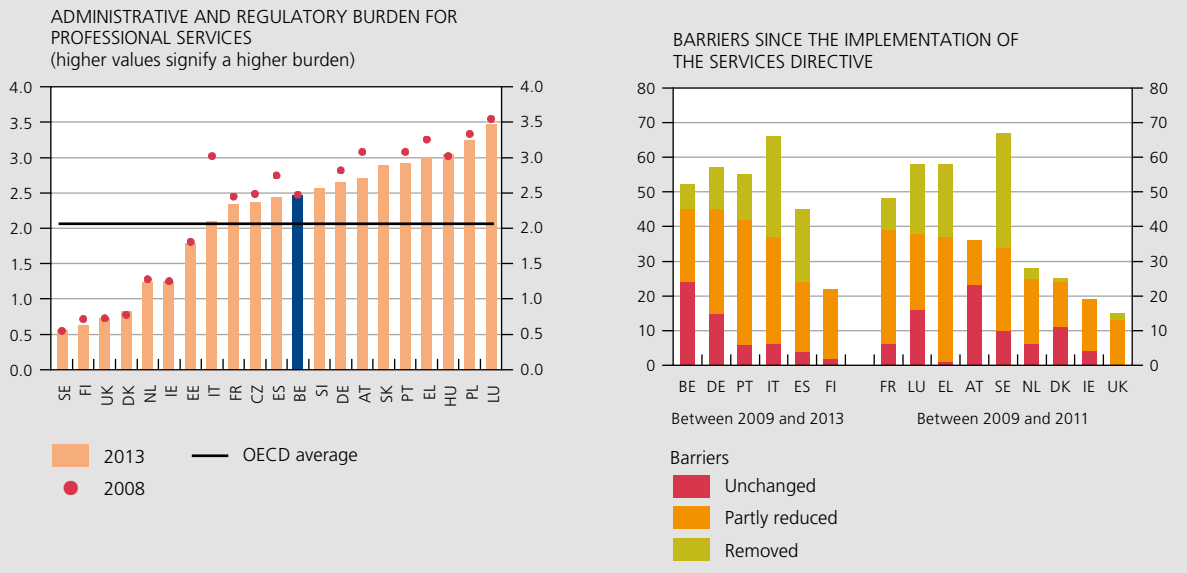
Source : EC.

(1) A value of the indicator of -0.2, for example, indicates that actual labour productivity is 20 % lower than the calculation based on a baseline scenario in which means of production are randomly allocated to the various company size categories using a uniform distribution. A positive value means that actual productivity is higher than in the base scenario.

(2) Professional, scientific and technical activities.

example, Belgium, Denmark, Germany, Estonia, Finland, France, Hungary, Ireland, Italy, Austria, Poland, Portugal, Slovenia, Spain and the Czech Republic were urged to simplify the procedures in their services sectors or to remove access barriers in an effort to strengthen competition. These recommendations applied not only to professional services but also to network industries and to the construction industry.

CHART 97 REGULATORY FRAMEWORK FOR SERVICES ACTIVITIES



Sources: EC, OECD.

including standards governing seasonal sales, market impediments to protect existing companies and licences required to start a trading company.

The OECD's PMR indicators suggest that Belgium has made little progress on simplifying its administrative procedures since 2008. And it also happens to be among the countries that have made the least headway on implementing the Services Directive.

In view of the fact that a large number of services, principally network industries, professional services and distribution, have remained overprotected, the EC, OECD and IMF have recommended that Belgium encourage competition by removing legal and administrative barriers. After all, for professional service providers, sheer cost and excessive regulation prevent innovative business models from emerging and curb investment. The retail trade sector has also come in for closer scrutiny as prices have remained higher than in neighbouring countries. More specifically, the rules on seasonal sales and opening hours need some easing.

Moving beyond services, international institutions have repeatedly urged Belgium to do something about the risk of additional increases in energy distribution costs. Its power distribution rates are still among the highest in Europe and the regionalisation of these powers has only served to increase uncertainty over future price trends. Regionalisation of a set of economic powers is typically a cause for concern anyway: though facilitating greater flexibility, it increases the risk of uncoordinated action and could affect economic activity. Close cooperation at all policy levels and with the social partners is advisable in these circumstances.

These same institutions have suggested other measures as well, such as simplifying the complex regulatory framework of the network infrastructure industries by putting into place one regulator per sector across the country. They have also urged Belgium to restructure public service obligations, for public procurement for example. In 2013, Belgian legislation in this area was changed: the ceiling was raised on negotiated procedures without prior notice and electronic procedures were simplified, while the scope of public procurement legislation was expanded to include private social institutions such as hospitals, colleges of higher education and universities, etc.

Infrastructure

In addition to the intangible assets, the actual quality of network infrastructure improves an economy's production capabilities, particularly when it comes to information and communication technologies, transport and energy. Even ignoring the short-term effect on economic activity, investment in network infrastructure supports economic production in the longer term by enabling the economy to work efficiently.

Optimum use of extensive, high-grade and low-cost information and communication networks boosts an economy's potential and facilitates connectivity between people and companies. Remarkably, whereas the economic and financial crisis has only exacerbated the TFP slowdown in Europe, the United States has been notching up TFP gains since 2010 similar to those at the start of the millennium, mainly thanks to its investment in ICT. The European economies, on the other hand, have found it much more difficult to benefit from the digital revolution. And this is not about the contribution of the telecommunications sector to total TFP growth – which is significant – but about the lack of productivity gains that ICT has brought to other sectors of the economy.

In the 2010-2013 period, nearly 92 % of Belgian companies on average had broadband internet access, but a mere 38 % of companies employing ten people or more had access to a mobile broadband network (3G or 4G), compared with an average 45 % in the EU and 69 % for the three most advanced European countries in this respect. In terms of economic activity, Belgian companies generated only 15 % of their sales through e-commerce, compared with 21 % in the three best performing European countries. Belgium has principally fallen behind them in sectors of specialist, scientific and technical services, in addition to administrative and support services.

Quality of transport is also a key contributor to growth, as efficient transport networks ensure productivity gains by bringing down logistics costs and enabling better market integration. Between 1995 and 2011, State-held net capital stock in transport infrastructure has declined and capital investment has been insufficient to address wear in the existing network. The current situation is a worrying, as Belgium is the most congested country in Europe, and INRIX puts Brussels, Antwerp and Ghent in the Top 20 of most traffic-jam-prone cities. Research by the Belgian Federal Planning Bureau shows that congestion would be even worse by 2030 in the event of no policy changes, and that average driving speeds would fall even further, by 29 % during rush hour and by 16 % at other times.

However, the OECD noted that any expansion of the already dense road network would be expensive and an additional source of pollution, without necessarily solving the problem of traffic jams. The efficiency and planning

of investment needs to be improved by better use of cost-benefit analyses and coordination between the various policy remits. To influence use of different modes of transport, Belgium should ensure their externalities are more appropriately reflected in their costs, net of subsidies or tax relief.

Security of power supply and risk of shortages

Energy is another key to a smoothly functioning economy. In 2014, the issue of having adequate infrastructure to guarantee energy provision, and electricity in particular, became a genuine concern.

Fear of power shortages …

Adverse events have dragged down the performance of the Belgian electricity generation capacity (fleet) in the past two years and fuelled fears of power shortages – a tricky situation both for residential users, for whom this is considered as a public service, and for professional users, who need power as an essential input in their production processes, with cost and security of supply being key influences on competitiveness.

In the absence of major storage facilities to help manage temporary imbalances, the security of power supply issue should also be assessed in the light of available production capacity and its flexibility to respond to peaks and troughs in demand, as well as the capability of transmission and distribution networks to ensure stability. In this context, the increasing integration of decentralised and intermittent power generation from renewable energy sources (RES) requires even more flexible means. In this respect, demand-side measures are equally relevant, both to adjust demand profiles and to reduce demand levels, but their implementation turns out to be a more delicate business, as power consumption is spread out over time and space.

In the event of a failure in the power grid, the production-consumption adjustment should be immediate. In this case, any room for manoeuvre is at the consumption end, in the form of power outages, as measures to recover production would be too slow to restore the grid immediately.

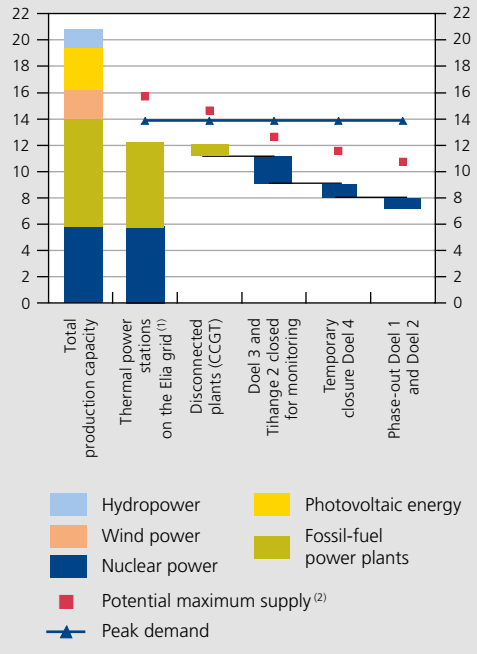
… when markets take an unexpected turn

Boasting a total capacity of almost 21 GW in 2014, Belgium's power generation fleet has nevertheless quickly evolved into a situation where the available capacity became insufficient to meet the peak demand traditionally seen at the end of a winter's day. 3 GW worth of photovoltaic solar power capacity is obviously not effective at that moment, and the risk of under-capacity increases if the dangers of the loss of 1.7 GW in wind power capacity under harsh weather conditions are likewise factored in. In these circumstances, the production capacity from fossil-fuel-fired and nuclear power plants that grid operator Elia can call on amounts to 12 GW, compared with a total generation capacity of 15.3 GW connected to the grid.

Power shortage concerns emerged in the course of 2014, when the owners of two combined cycle gas turbines (CCGT) power plants decided to switch them off, as recent relative price trends compared with gas and coal and carbon prices did not move in their favour; these shutdowns were temporary in the case of one plant and until further notice for the other, involving 485 MW and 385 MW respectively. This was exacerbated by the unexpected unavailability – for an indefinite period – of two nuclear units (Doel 3 and Tihange 2 – 2 014 MW), as these had failed technical tests. At the start of the winter

CHART 98 POTENTIAL ELECTRICITY SUPPLY DEPENDING ON THE UNAVAILABILITY OF PRODUCTION PLANTS

(capacity in GW, in 2014)



Sources: DG Energy, Elia.

(1) Thermal power stations running on fossil fuels and nuclear fuels, excluding producers on the distribution grid.

(2) Remaining domestic production capacity after unavailability, plus maximum import capacity.

of 2014-2015, Belgium was facing a significant 25 % fall in the available minimum capacity to meet peak consumption, estimated at 13.9 MW. And the situation even got worse when another unit (Doel 4 – 1 039 MW) had to be shut down temporarily due to deliberate damage.

Belgium has interconnected transmission infrastructure in place (maximum capacity : 3.5 GW) to import power to make up for the shortfall, provided neighbouring countries' production capacity and connection capabilities allow them to supply the power, which depends on their own domestic demand. Yet, operational margins for running the Belgian power grid are growing increasingly thin, and without any guarantees regarding the availability of electrical energy to import.

The immediate challenge is to prevent any power outages, for the benefit and convenience of the general public and smooth operation of economic activities. In addition to the cost of interruptions in terms of activity adjustments, a perceived deterioration in the quality of the electricity supply damages a country's reputation and appeal as a location to develop new business activities. To date, Belgium's power system is considered very reliable in terms of power cuts and voltage stability – the country scores 6.4 on scale of 1 to 7, claiming 16th position among 144 countries. However, the World Economic Forum's executive opinion survey has pushed it down three places when compared with the 2009-2010 league table.

A European agenda …

Long-life-cycle investment will have to go into any solutions considered and/or agreed to address the stability issues currently hitting the electricity system, but swift and timely investment must also be tailored to future energy needs. All these decisions need to be grounded in a stable and predictable regulatory framework, involving numerous policy-makers and various pieces of legislation, from the EU down to the Regions and local governments.

At the European level, cross-border interconnection of network infrastructure is an essential component of a liberalised Single Market, facilitating transactions and competition between operators and contributing to secure supplies. In the past, security of supply was the responsibility of one national actor, which planned and developed the relevant infrastructure accordingly, but market liberalisation has changed all that and security of supply is no longer the sole domain of a single operator. Unbundling of production-transmission-sales activities, together with restructuring of the sector and its expected development into an integrated European market open to new entrants, have spread this role across a set of actors, where necessary requiring a joint approach headed up by national authorities. After all, the interests of the various operators do not necessarily go hand in hand with a country's security of supply, but rather depend on their main generation options and on making their investment pay, also at European level.

The approval of a European low-carbon economy strategy in 2008 has had implications for the way electricity systems work and are developed, at the level of both production and transmission. Of the renewable energy sources on offer to power vehicles and produce electricity and heating, wind and photovoltaic power have proved most popular, with their respective capacity in the EU having increased by as much as half and by a factor of four between 2009 and the end of 2013 while their share in total output went up to 6.2 % and 2 % respectively in 2012. This has affected how electricity systems work in three distinct ways. First, the RES-related intermittent production pattern implies alternate and flexible production units that can step in and take over when one of them goes down, requiring greater flexibility of the system, at the international level too. Second, this flexibility structure also concerns transmission, as national grids – historically designed and established on the basis of centralised production units – need to be adapted to cope with decentralised production flows. Finally, given the steep start-up capital costs involved, renewable energy has been supported through subsidy mechanisms varying from one Member State to another, depending on the energy mix and political choices about allocating the cost of subsidisation. This massive growth in – subsidised – RES, which have virtually no marginal cost of production and to which the system gives priority access, has eroded the profitability of fossil-fuel-fired power plants, and these are used less as a result.

… and Belgian political choices …

In view of this European agenda, margins are limited for a small, densely populated country with few fossil fuel resources. Moreover, regarding its energy mix, Belgium has made the sovereign choice to stop using nuclear power plants by 2025, while it has become effectively impossible to operate coal-fired power plants as local authorities refuse to grant environmental licences. Obviously, the transition to an electricity system guaranteeing power at an affordable price and under environmentally sustainable circumstances is not an easy one, and will have to take on board all these decisions.

… plus a range of challenges in terms of long-term solutions

If there is no policy change, the power production fleet will have to undergo significant adjustments to meet the aims of a low-carbon economy and low-carbon electricity generation, with only a limited possible choice of production systems in view of decisions made by the authorities. On Federal Planning Bureau projections, capacity needs to be boosted to 27 GW by 2030, from 20 GW today, once all these decisions have fully played out, while ensuring continued investment in replacing obsolete and dismantled production plants and in adjusting the grid. In financial terms, investment in production capacity has been estimated at around € 31 billion between now and 2030.

Finally, recent developments have thrown into sharp relief a number of shortcomings in the way the market currently functions. The current framework does not guarantee the continued operation of gas-fired plants, which might cause supplies to fall short in the event of peak demand. This market, which is subject to frequent changes in the regulatory climate, looks poorly suited to properly address the problem of security of supply and to provide encouraging and timely signals to generate the necessary investment. Other Member States have run into similar difficulties, albeit over different issues, and this has required the authorities to step in by launching tendering procedures to install capacity.

Prudential regulation and supervision

A. Further development of the new supervision framework

Introduction

In the wake of the crisis, the framework for supervision of the financial system underwent a thorough overhaul in order to strengthen the sector, improve governance, and thus provide better safeguards for financial stability. During the year under review, the transposition and gradual implementation of the measures resulting from that overhaul continued at both European and Belgian levels.

With the entry into force of the single supervisory mechanism (SSM) in November 2014, the first pillar of the banking union has become a reality. Before that, the banking sector had been subjected to a comprehensive assessment (CA). The adoption of European legislation on recovery and resolution, the intergovernmental agreement and the establishment of a single resolution fund opened the way to the second pillar of the banking union, namely the single resolution mechanism (SRM). During the same year, some of the provisions of this European legislation were transposed into Belgian law by the Banking Law, and the Bank was designated as a resolution authority. As for the third pillar, i.e. the common deposit guarantee system, the EU Directive on the subject is to be transposed into Belgian law by the summer of 2015.

The various Banking Law provisions on such matters as structural reforms, governance, and remuneration policy were also implemented. In addition, the Bank continued to implement the provisions on liquidity and capital laid down by the Basel Committee on Banking Supervision and those of the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR). The various items on the agenda for reform of the banking sector are described in section 1 of this chapter.

Turning to the insurance sector, preparations for the transition to Solvency II continued, as described in section 2 of this chapter. In that connection, the European Insurance and Occupational Pensions Authority (EIOPA) arranged stress tests to assess the sector's resilience in view of the introduction of the new solvency requirements in a context of persistently low interest rates.

The Regulation on central securities depositories (CSD Regulation) brought in common prudential rules for CSDs. During the course of 2014, international guidelines were also adopted on the preparation of recovery plans for financial market infrastructures. These measures designed to strengthen the sector's resilience are explained in more detail in section 3 of this chapter.

At the various meetings held in 2014 by the Bank's Board of Directors in its capacity as macroprudential authority, the emphasis was on monitoring systemic developments and analysing the possible use of macroprudential instruments (see section 4 of this chapter).

Finally, during the year under review, special attention focused on the assessment by the Financial Action Task Force (FATF) of the Belgian regulatory and prudential provisions for combating money-laundering (section 5.1) and on the auditor approval programme (section 5.2).

1. Banks : progress with the banking union and implementation of Basel III and the Banking Law

1.1 The single supervisory mechanism

1.1.1 Entry into force of the single supervisory mechanism

During the year under review, the ECB and the national competent authorities (NCAs), including the Bank, were engaged in preparing the single supervisory mechanism. Under the SSM Regulation[1], the ECB took on the tasks entrusted to it on 4 November 2014. The entry into force of the SSM meant the transfer to the ECB of a substantial part of the Bank's responsibilities, notably in regard to banks considered significant.

On 4 September 2014, the ECB published two lists, one comprising significant banks and the other comprising less significant banks. Seven Belgian banking groups were included in the list of significant banks. Six of them are significant because of their size : AXA Bank Europe, Bank of New York Mellon (BNY Mellon), Belfius, Dexia, Investar BVG (Argenta) and KBC. Banque Degroof was designated as significant on account of the significance of its cross-border activities. The Belgian subsidiaries and branches of banking groups established in other countries participating in the SSM have the same classification as the banking group to which they belong. For instance, BNP Paribas Fortis Bank and ING Belgium are among those considered significant.

During its first year of operation, the ECB Supervisory Board, created in January 2014, concentrated on preparations for its task, namely establishing a legal framework, drawing up the supervisory manual, classifying banks as significant or less significant, conducting the comprehensive assessment and preparing for the first set of decisions on capital under the SSM.

Following a public consultation, the ECB adopted the Framework Regulation on the SSM[2]. This Framework Regulation defines the methodology for classifying institutions as significant or less significant, and forms the legal basis for organising the joint supervisory teams (JSTs) in charge of microprudential supervision, and the inspection teams. It specifies the cases in which institutions subject to supervision can apply to the Bank or the ECB. It also establishes the general principles which are to form the basis of the supervision procedures, paying particular attention to respect for the right to be heard, the right of access to the files, and the ECB's obligation to state the reasons for its decisions, as well as the general principles to be taken into account in organising the sanction procedures. In addition, the SSM Framework Regulation reiterates the basic principles underlying the cooperation between the ECB and the national competent authorities, namely the duty to cooperate in good faith and the general obligation to exchange information. Finally, the Framework Regulation notes that the ECB can request the national authorities to make use of their powers.

The ECB's powers in respect of significant banks are determined by the list of tasks set out in the SSM Regulation. In addition, the ECB only has competence to apply the European legislation or the rules derived from it. That is

(1) Regulation (EU) No. 1024/2013 of the Council of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.
(2) Regulation (EU) No. 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (ECB/2014/17).

the case, in particular, for the single rulebook defined by the CRD IV and the CRR[1], including its implementation at national level. In that respect, the gradual harmonisation of the national discretion permitted by the CRD IV and the CRR for supervisory authorities will be a major challenge for the SSM. The ECB is bound by the European implementing legislation, prepared by the European Banking Authority (EBA). The national authorities remain responsible for checking compliance with various rules in certain areas, notably the rules on consumer protection, prevention of money-laundering, covered bond issuance and structural reforms.

The ECB gave significant banks the option of using English for communicating with it. Six Belgian banking groups chose to do so, which does not imply renunciation of their right to revert to their national language subsequently.

The ECB's Regulation on supervisory fees[2] determines the arrangements for covering its costs incurred in supervising significant and less significant institutions. The expenditure of the national competent authorities in connection with the SSM remains subject to a national fee regime.

In accordance with its accountability obligation, the ECB reported back every three months to the European Parliament, the Council and the Commission on the progress made in the operational implementation of the SSM Regulation. This preparatory stage will also be covered in the first annual report of the SSM, to be published in the spring of 2015.

1.1.2 Organisational structure and supervisory practices of the SSM and implications for the Bank

Organisational structure of the ECB

In order to fulfil its prudential supervision tasks, the ECB has defined its organisational structure by segregating the departments responsible for supervising institutions from the departments providing supervision support. It thus set up three departments for the supervision of institutions. They share responsibility for overseeing the banks under the SSM according to the significance and risk profile of the institutions.

While the Directorates General (DG) Microprudential Supervision I and Microprudential Supervision II deal with the day-to-day prudential supervision of institutions considered significant (around 30 and 90 respectively), DG Microprudential Supervision III is responsible for the indirect prudential supervision of institutions considered less significant. The work of these three Directorates General is supported by DG Microprudential Supervision IV, which carries out specialised, horizontal tasks relating to all credit institutions subject to SSM supervision, and supplies expertise on specific aspects of supervision. One of the tasks of DG IV is to ensure consistency between the various approaches of the JSTs. It comprises various services, such as the Risk Analysis Division, responsible for the horizontal analysis of risks in the euro area banking system, the Supervision Policy Division which helps to draw up regulatory prudential standards for all banks on the basis of the Basel agreements and the EU Directives, the Methodology and Standards Development Division, responsible for devising and regularly updating the supervision methodologies, and the Internal Models and Centralised On-Site Inspections Divisions which will be separated from the supervision units and will be responsible respectively for validating the internal models that institutions use to calculate their capital requirements, and for conducting and coordinating on-site inspections.

In order to ensure good coordination in these matters between the ECB and the national competent authorities (NCAs), it was decided to form networks of experts for each of the DG IV Divisions. The aim of these networks is to exchange information and pool experience in order to establish good practices to be applied for each subject within the SSM.

A new approach to supervision

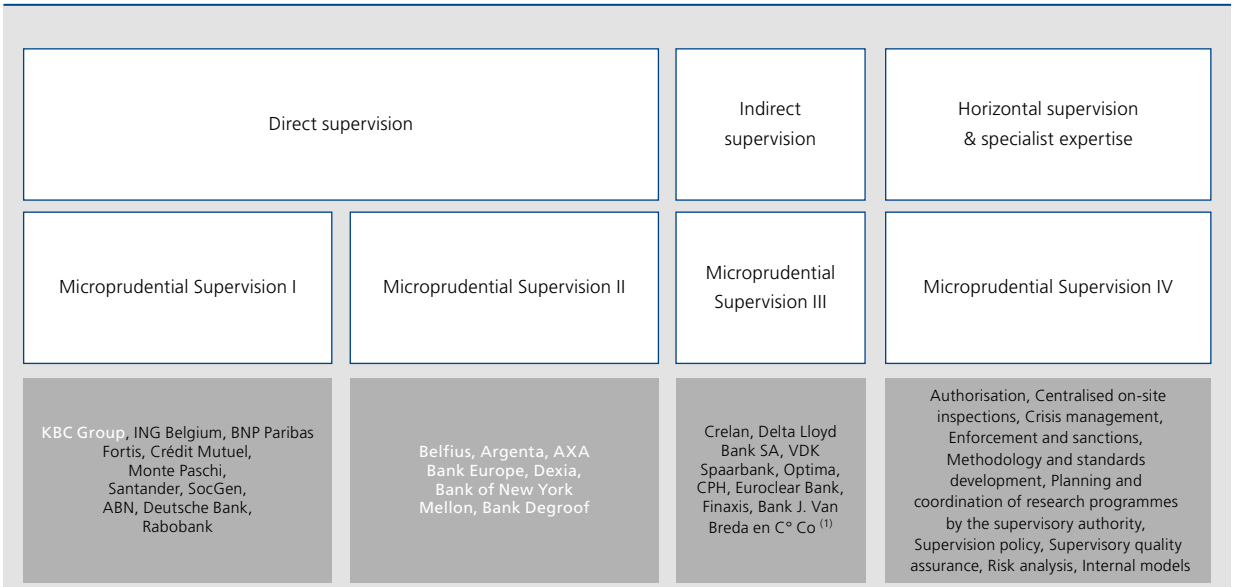
One JST was formed for each significant banking group. The JST is responsible for carrying out the prudential supervision of the designated institution, and coordinates the supervision activities with the national competent authorities concerned. Each JST is managed by an ECB coordinator[3] and comprises members appointed by the NCAs of the countries where the credit institutions, their subsidiaries and branches are established. The size, overall composition and organisation of the JST is geared to the size, complexity, business model and geographical distribution of the credit institution concerned. The national supervisory authorities which are members of the JSTs work under the direction of the ECB coordinators and

(1) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC and repealing Directives 2006/48/EC and 2006/49/EC and Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

(2) Regulation (EU) No. 1163/2014 of the European Central Bank of 22 October 2014 on supervisory fees (ECB/2014/41).

(3) Generally speaking, the JST coordinator does not come from the country where the supervised institution is established.

CHART 1 ORGANISATION OF THE SSM SUPERVISION UNITS AT THE ECB AND IMPLICATIONS FOR BELGIAN BANKS



Sources: NBB, ECB.

(1) ABK Bank CVBA, Banque Delen & de Schaetzen, Banque Eni SA, Byblos Bank Europe, Centrale Kredietverlening, Citibank International plc, Datex, Dierickx, Leys & Cie Effectenbank, Euroclear SA, Europabank, FCE Bank plc, Hoist Finance, HSBC Bank plc, ICICI Bank UK plc, J.P. Morgan Europe Limited, J.P. Morgan International Bank Limited, Keytrade Bank SA, Shizuoka Bank (Europe) SA, The Royal Bank of Scotland plc, United Taiwan Bank SA, van de Put & C°, Effectenbank – Banque de titres.

Note: The banks listed in white are those which had been supervised by the Bank at the highest level of consolidation before implementation of the SSM (home supervision). The banks mentioned in black concern branches or subsidiaries of foreign banks which were subject to supervision by the Bank at sub-consolidated level (host supervision).

on the basis of the methodologies and work programme adopted at ECB level. The sub-coordinators appointed by the NCAs assist the JST's ECB coordinator in the day-to-day supervision of credit institutions considered significant, and also pass on the views of the NCAs concerned.

Close collaboration between the ECB and the NCAs is crucial to ensure the success of the SSM, particularly in view of the NCAs' supervisory expertise and the need to continue improving supervision practices and rules.

For some assignments and for more specific tasks, the JSTs can call on the assistance and expertise of the horizontal and specialist divisions of DG Microprudential Supervision IV, e.g. in regard to the validation of internal models, appraisal of recovery plans, and on-site bank inspections.

Progress made in supervisory practices

Much of the work concerning the harmonisation of supervisory practices related to the methodologies that the JSTs are to use for risk assessment and for evaluating the adequacy of the solvency and liquidity position. The cornerstone here is the Supervisory Review and Evaluation Process (SREP).

The SSM SREP encompasses the processes, procedures and methods for supervising significant and less significant institutions, and conforms to the EBA's guidelines on the SREP[1]. The SREP assists the supervisory authority in taking decisions on capital and liquidity requirements or on any other prudential measure in relation to individual institutions, and makes a useful contribution towards determining the minimum level of supervision and the Supervisory Examination Programme (SEP).

From 2015, the SSM SREP will replace the analyses and methods of the national SREP. Nonetheless, pillar 2 decisions for 2014/2015 will still be based on national SREP applications. However, banks which have proved short of capital in the stress tests conducted as part of the comprehensive assessment are required to take the practical measures necessary in regard to capital in order to eliminate any shortage (see in this connection part A, section 1.4.1, which also describes the national SREP policy). The switch to the SSM SREP in 2015 could mean changes to the pillar 2 requirements for credit institutions.

For each significant credit institution, the SREP comprises three dimensions. The first is the Risk Assessment

(1) Final Guidelines on SREP methodologies and processes, 19 December 2014.

System (RAS), namely the methods of risk assessment applied by the supervisory authority and the latter's continuous analysis of the institution's performance and risks. The RAS generates a general risk score for the institution and consists mainly of analyses concerning (i) the business model (evaluation of the institution's viability and permanence), (ii) internal governance and risk management (quality and effectiveness of these two elements and the institution's data processing and reporting infrastructure), (iii) quantitative and qualitative aspects of capital risks (including credit risk, market risk, interest rate risk and operational risk) and (iv) quantitative and qualitative aspects of liquidity risk within the institution.

The second dimension covers the periodic quantification of the capital and liquidity requirements. The minimum prudential requirements for the capital and liquidity of each institution are established on the basis of the RAS observations and the benchmarks defined by quantifying the risks and making comparisons between institutions in the euro area, and by analysing the internal capital adequacy assessment process (ICAAP) and the Internal liquidity adequacy assessment process (ILAAP) established by each institution.

Finally, decisions on capital and liquidity and on any supplementary prudential measures are taken and communicated at least once a year on the basis of the supervisory findings, the quantification of the capital and liquidity, and the economic context.

For the calibration of the indicators used in the RAS and for the definition of the benchmarks and risk quantification, the ECB has already organised various data-gathering exercises in the euro area, in addition to the standard reporting. It has also conducted field tests to stabilise and refine the SREP methods and their calibration, and to examine the general outcomes before finalising the SREP instrument.

Implications for organisation at the Bank

In view of the scale of the ECB's tasks, it is important to ensure that the Bank has the optimum organisational structure and takes account of ECB practices. In that context, the Bank made various changes to its internal organisation during the year under review, while endeavouring to make use of the existing structures wherever possible, as described in the Report 2012. Those adjustments are thus intended to ensure a degree of organisational consistency with the ECB's chosen policy and, more fundamentally, to guarantee the efficiency of the structures so that the meetings at SSM level can be properly monitored and prepared.

Within the SSM, a distinction was made between continuous supervision and on-site inspections. As explained in the Corporate Report 2014, that distinction led the Bank to modify the organisational structure of its supervision teams. Thus, the teams of inspectors were grouped in the horizontal Service for Operational Functions, which also includes the team in charge of model validation and monitoring, and the team responsible for IT-related risks. The supervisors at the Bank who are members of the JSTs, including the JST sub-coordinators, were grouped in the Prudential Supervision of Banks and Stockbroking Firms Service. This Service was also divided into sub-entities, distinguishing between significant and less significant institutions, while taking account of the risk profile and business model of the various institutions (for more details, see chapter B, section 2.2).

In addition, to optimise the preparation of the meetings of the ECB Supervisory Board and Governing Council in prudential matters, and to provide for appropriate transversale monitoring of the cases taken up by the ECB, the SSM policy group unit was set up within the Prudential Policy and Financial Stability Service. That unit also receives the support of the International and Eurosystem Coordination Service, which coordinates the preparation of the Supervisory Board meetings and the monitoring of written procedures and cases relating to institutional aspects of the SSM. In addition, the SSM Risk Committee was established to ensure consistency between the activities of the JSTs and those of the various DG IV networks. This Committee assists the Bank's Board of Directors in matters relating to the SSM.

1.2 Comprehensive assessment

1.2.1 Objectives and components of the comprehensive assessment

General framework

During the final quarter of last year, the ECB and the national supervisory authorities (including the Bank) completed a vast exercise – the comprehensive assessment (CA). This exercise, conducted before the entry into force of the SSM, involved a full appraisal of the strengths and weaknesses of the large euro area banks. The CA was essential to ensure the credibility of the new single supervisory mechanism.

The CA had three aims: to increase transparency by improving the quality of the available information on the situation of the banks, to strengthen the banking system

by identifying and implementing the measures necessary to guarantee solvency, and finally, to boost confidence in Europe's credit institutions. These conditions will enable the sector to provide more effective support for economic growth.

The assessment was based on two complementary pillars: an asset quality review (AQR) and stress tests. These two main elements were supplemented by a join-up exercise to incorporate the AQR results in those of the stress tests and thus ensure the CA's overall consistency.

The exercise was coordinated by the ECB and based on a harmonised methodology designed to promote convergence in the definition of concepts and prudential rules, and in supervisory practices. Despite that harmonisation, comparisons of results between countries must be treated with caution since the CA permitted the maintenance of certain regulatory options which are allowed for the time being under the European Directives, particularly in regard to the definition of the capital.

As the national supervisory authority, the Bank was closely involved in this exercise, as described in chapter B, section 2.2. The stress tests required close interaction between the banks – which had to carry out this exercise themselves – and the national supervisory authorities, such as the Bank, responsible for the initial quality control in direct contact with the credit institutions and the ECB. The ECB was also responsible for confirming the final outcome of the tests and determining whether corrective measures were needed in the event of inadequate capital. Altogether, around 400 people took part in conducting the CA in Belgium, excluding the resources that the financial institutions themselves had to use in order to carry out this exercise, which was very demanding in terms of data and documentation.

The 130 groups taking part in the CA included six Belgian institutions, namely AXA Bank Europe, Argenta, Belfius, Dexia, KBC Group and Bank of New York Mellon[1]. Although Dexia is an entity that is currently in orderly resolution, it was subjected to the full exercise. However, the CA did not cast doubt on the restructuring plan approved by the European Commission in 2012. It should also be noted that a number of banks operating in Belgium, including BNP Paribas Fortis and ING Belgium, were subjected to the CA via their parent company.

(1) Banque Degroof did not take part in the CA as the institution was not designated as significant until after the ECB had published the list of institutions subject to the CA.

Asset quality review

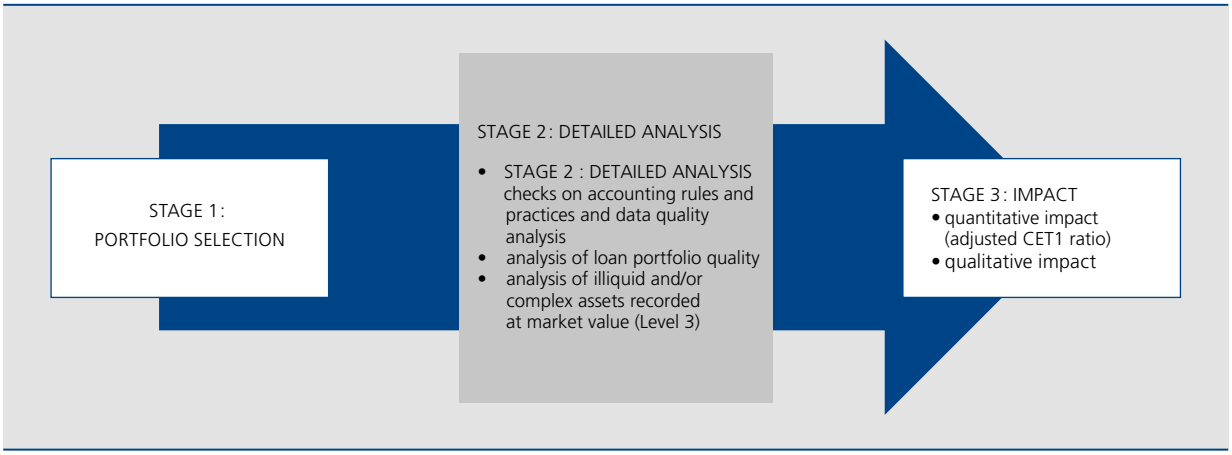
The AQR mainly centred on verifying the valuation of the assets in the institutions' accounts as at 31 December 2013. The aim was to assess to what extent the institutions were correctly applying the current accounting standards, and to check whether the asset valuations in the accounts were prudent. In order to ensure equivalent treatment between institutions, the ECB proposed a conservative, uniform interpretation of the rules for applying the International Financial Reporting Standards (IFRS). That implied the use of fairly strict parameters or specific limits and indicators, notably for the definition of non-performing loans.

The AQR was not confined to the detailed analysis of balance sheet exposures but also covered off-balance-sheet items. In addition, it covered both domestic and foreign exposures, whether they concerned governments, financial institutions, firms or individuals. The AQR comprised three main stages.

The first stage involved selecting the portfolios, which was necessary in view of the level of detail in the analysis. The aim was to include the riskiest portfolios and to cover at least 50 % of the credit-risk-weighted assets for each institution subject to the exercise. For the banks with the greatest exposure to illiquid securities, which were recorded in particular at fair value by using models (Level 3), some additional portfolios were also selected.

The second stage involved credit quality analyses and the valuation of the illiquid assets in a number of successive steps. First, the institutions' accounting rules and practices were thoroughly analysed with due regard for international standards and certain conservative parameters imposed by the methodology. That examination was accompanied by analysis of the banks' data quality. Next, a line-by-line analysis of the sample of selected portfolios was used to determine whether the level of individual provisions was sufficient in view of the revaluation of the collateral and the harmonised definition of non-performing loans, while the level of collective provisions was estimated on the basis of a model developed by the ECB. Finally, for banks which had significant exposures in their portfolios available for sale or held for trading, a detailed analysis was conducted on the recording at fair value of complex or less liquid assets (Level 3). This examination concerned both securities and derivatives recorded at fair value. Specific attention also focused on calculating the credit valuation adjustment (CVA), which corresponds to the adjustment of the derivatives' value to incorporate the change in the counterparty's credit quality. The CVA aims to take account of the counterparty's probability of

CHART 2 COMPONENTS OF THE ASSET QUALITY REVIEW



Source : ECB.

default, and hence the non-recovery of cash flows from derivatives.

In the final stage, the quantitative impact of the adjustments to provisions and to the valuation of complex assets led to a correction of the common equity Tier 1 (CET 1) ratio to be used as the basis for the stress test. The more qualitative shortcomings detected by the AQR also led to detailed and specific recommendations which the credit institutions must implement in the coming months.

Stress test

The second major component of the ECB's comprehensive assessment of the leading euro area banks comprised stress tests to determine the ability of credit institutions to withstand macroeconomic and financial shocks over a three-year period. For these tests, two main scenarios were considered. The first, known as the baseline scenario, was based on economic forecasts produced by the European Commission at the end of 2013 ; that already corresponds to a relatively difficult situation for the banks, in view of the predicted weak economic growth. The second, called the adverse scenario, simulates a severe deterioration in the economic situation. The volume of GDP declines slightly at first in 2014, but then very sharply in 2015 before stagnating in 2016 ; this leads to a steady rise in the unemployment rate amounting to 2 % over the period as a whole, both in Belgium and in the euro area. The increase in consumer prices initially slows and then ceases in 2016. The adverse scenario assumes a rise in both short-term and long-term interest rates, accompanied by widening spreads over the period of the exercise. The main difference in parameters between the Belgian economy and that of other countries concerns housing market prices, which decline by a cumulative total of 25 % over three years in Belgium, compared to 15 % in the euro area. Such extreme assumptions show that the stress tests must be seen as a prudential exercise, and are in no way a prediction of future events.

In order to determine whether the financial institutions subject to the CA need to adopt corrective measures, a minimum solvency ratio in terms of CET1 was fixed at 8 %, both for the asset quality review and for the stress test baseline scenario, and at 5.5 % for the adverse scenario ; this was 1 % higher than the minimum set by the Basel III rules, in order to take account of the systemic risk.

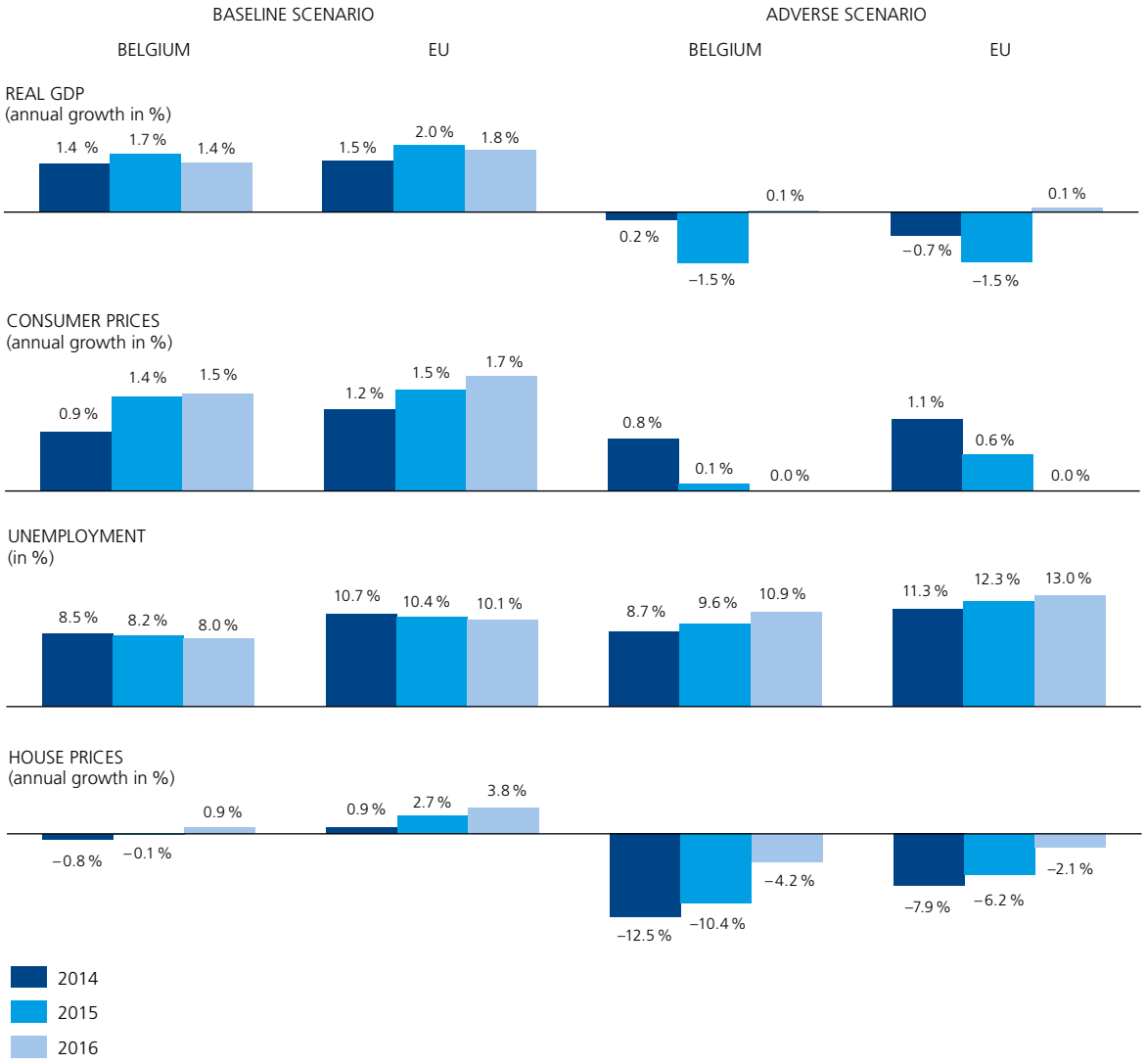
1.2.2 Results of the comprehensive assessment

Asset quality review

The detailed asset quality review covered 38 portfolios representing 51 % of the risk-weighted assets of Belgian credit institutions subjected to the exercise. In each portfolio, a representative sample of the riskiest credit files was examined, making a total of more than 4 200 credit files and almost 3 150 collateral items. In addition, 13 complex valuation models were analysed along with the valuation of 96 illiquid securities held at fair value and amounting to € 3.5 billion.

The asset quality review revealed that the Belgian banks' accounting practices were generally prudent and in line with the international accounting standards ; that was reflected in an adequate level of individual and collective provisions for the loan portfolios. The adjustments

CHART 3 COMPARISON OF THE MACROECONOMIC SCENARIOS FOR BELGIUM AND THE EU



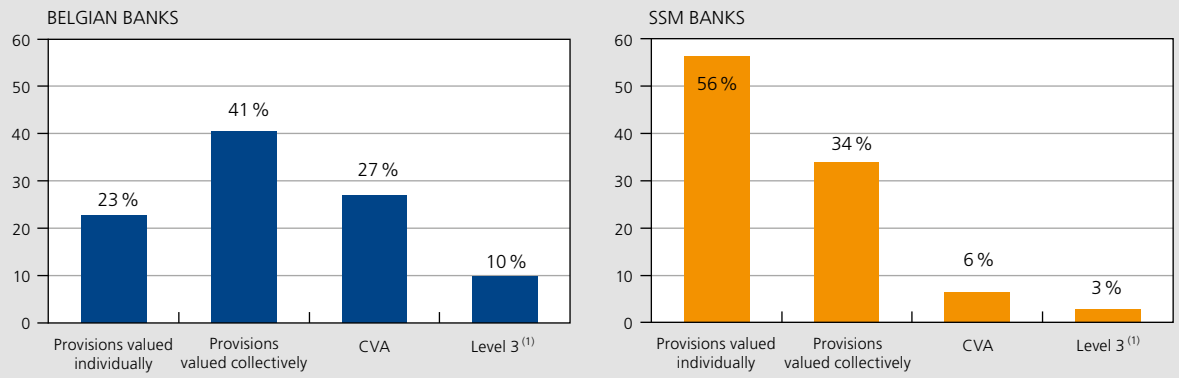
Source: ECB.

required by the AQR were therefore minor, averaging 0.5 % of the CET 1 ratio in Belgium. Those adjustments were due mainly to the conservative rules imposed for the exercise, and do not raise doubts about the annual accounts of credit institutions.

As for the quantitative impact, these results are broadly similar to those seen on average for the euro area, although there are fairly marked differences between individual countries. However, the components of the adjustments made do differ. For instance, the corrections for the CVA are proportionately larger in Belgium, whereas in the euro area the revision of credit provisions valued individually predominates. This relative under-estimate of the CVA of Belgian banks may be attributable in particular to the hedging modalities of the interest rate risk used by some of them, and to the relatively long maturity of their derivatives, due to their business model. The fact that, in comparison with the euro area, there was no marked adjustment to the provisions valued individually is most likely due to a more favourable economic environment than in some Member States, as well as to the conservative practices adopted by Belgian banks in that respect. The same applies to the provisions valued collectively, leaving aside the adjustments resulting from the foreign portfolios of certain Belgian banks.

CHART 4 CONTRIBUTION OF THE VARIOUS FACTORS TO THE QUANTITATIVE RESULTS OF THE AQR IN BELGIUM AND IN THE EURO AREA

(in %)



Sources: ECB, NBB.
(1) Recording of assets at fair value by means of models.

Apart from the quantitative adjustments, the AQR highlighted a number of shortcomings in data quality and in the methodologies used to value the assets and the real estate collateral. The Bank expects the Belgian institutions to make sure that, in the coming months, they deal with the points for attention that the AQR identified and which gave rise to the recommendations described in Box 1.

Box 1 – Qualitative recommendations resulting from the AQR

One of the aims of the AQR was to increase the transparency of credit institutions' balance sheets, more particularly by improving the quality of the information and data in order to enable risks to be detected at an early stage. Various weaknesses were apparent in the Belgian banking sector in general, leading to the following recommendations.

Quality of the data and the information

Since the data forming the basis of the credit quality assessment are not always reliable and complete, the quality of the information used to value the assets and assess the risks has to be improved. In addition, the banks must ensure that the data in their various information systems are consistent. Thus, institutions must respect the "Principles for effective risk aggregation data and risk reporting" (1) defined by the Basel Committee on Banking Supervision. Similarly, the parameters used to value derivatives and to calculate the collective provisions on the loan portfolio must be better documented and explained in order to ensure that these valuations and provisions are appropriate.

(1) Basel Committee on Banking Supervision, "Principles for effective risk data aggregation and risk reporting", January 2013.

Policy for the valuation of real estate collateral, both residential and commercial

The rules and practices concerning the periodic revaluation of collateral need to be applied more consistently and based on complete and reliable data. The criteria for determining whether independent valuers can be brought in and the standards that they must respect need to be defined more strictly.

Rules on classification of non-performing exposures and forbearance policy

These rules had to be revised and redefined by the end of 2014 on the basis of the EBA's recommendations concerning the classification of these exposures. The AQR revealed the need to reclassify some exposures in the non-performing category, and the inability of some institutions to identify systematically the exposures for which the banks have granted loan restructuring or concessions on account of the deterioration in the counterparty's quality (forbearance). In that context, the banks will have to establish a new process and ensure that their data systems are geared to detecting cases of forbearance at an early stage.

Governance of the procedures for periodic checks on market prices and validation of recording of assets at fair value

In view of the risk that market activities may entail, it is vital for banks to have appropriate governance for valuation in accordance with the principles defined by the Basel Committee. Thus, all institutions must conduct regular, independent checks on valuations at market prices and on models for the valuation of complex assets.

Stress tests

For the 130 European banks subjected to the exercise, the average CET 1 increased from 11.4 to 11.6 % in the baseline scenario, and fell from 11.4 to 8.4 % in the adverse scenario. The latter scenario detected an overall capital deficit of € 25 billion among 25 banks. That total, which must be viewed in the context of the capital increases amounting to € 57 billion effected by the participating banks in the first three quarters of 2014, was regarded as credible by the markets. They responded positively, thus endorsing the opinion of the ECB and the national supervisory authorities that such an exercise was justified prior to the launch of the SSM.

In Belgium, all credit institutions withstood the baseline scenario. With the exception of Dexia, which is in orderly resolution, the CET 1 ratio for the five other Belgian banks

TABLE 1 CHANGE IN THE CET 1 RATIO IN THE BASELINE SCENARIO AND THE ADVERSE SCENARIO
(in %)

	01-01-2014		31-12-2016	
	Before the AQR	After the AQR	Baseline scenario	Adverse scenario
SSM	11.8	11.4	11.6	8.4
Belgium	14.6	14.1	12.1	7.4
Belgium (excluding Dexia)	14.0	13.5	12.5	8.2

Source : NBB.
Note : The CET 1 ratios as at 01-01-2014 (before and after the AQR) are the figures as at 31-12-2013 adjusted to take account of the first phase of the introduction of the Basel III rules.

involved in the exercise would decline on average from 13.5 % in 2013 to 12.5 % at the end of 2016. That is well above the 8 % minimum set by the harmonised methodology, but indicates a less favourable picture than in the rest of the euro area. The cause must lie mainly in the repayment of state aid by one bank, whose capital position deteriorated accordingly[1]. Without that factor, the average CET 1 would have been stable at its 2013 level.

In the case of the five Belgian banks, in the adverse scenario, the extremely depressed macroeconomic climate would mean an average reduction of 4.3 % compared to the baseline scenario. However, the solvency position of the Belgian banks would still be well above the 5.5 % minimum at 8.2 % in 2016, and would be comparable to the average of 8.4 % for the euro area.

Two Belgian banks, namely AXA Bank Europe and Dexia, were particularly affected by the shocks in the adverse scenario, and their capital position dropped below the 5.5 % limit. However, from the end of December 2013, AXA Bank Europe continued to sell off assets relating to non-strategic activities in order to reduce its risk profile, and it increased its capital so that it now meets the ECB's requirements. In the case of Dexia, its specific characteristics were taken into account by considering the restructuring plan, the State guarantee and the sale of assets since the end of 2013. The conclusion was that the stress test did not cast doubt on the plan approved by the European Commission in 2012, and the group was not required to take any supplementary measures.

The comparisons between the overall results for Belgium and for the euro area need to be interpreted with caution because, on the one hand, the aggregate averages cover fairly diverse profiles, while the results for two large banks with a strong presence in Belgium, namely BNP Paribas Fortis and ING Belgium, are not included in the Belgian data since they are consolidated at their parent company level. Nonetheless, the stress tests highlighted certain characteristics of the Belgian banks.

Credit risks, traditionally the most sensitive to a deterioration in the economic climate, are mainly apparent for the foreign activities of Belgian banks which entail large positions on riskier market segments. However, the stress tests also simulated the outbreak of a property crisis in Belgium, similar to the crises facing certain European countries in recent years, and not at all comparable to past developments in Belgium. The Belgian banks demonstrated good resilience to this scenario component.

The legacy of past business also influenced the results, especially as one of the main assumptions implied leaving the banks' balance sheet unchanged at the end-2013 level, in order to prevent credit institutions from using expansion plans or the disposal of certain activities as a means of passing the test. While the exercise did allow the effect of restructuring plans approved by the EU to be taken into account, it disregarded other consolidation efforts taking place in 2014 and continuing in the coming years.

The rather low level of profitability also had an impact on the stress test results. In recent years, the Belgian banks have refocused on their traditional intermediation activities, where profitability is fairly modest. This mainly concerns lending to the Belgian economy and investment in government bonds, funded essentially by means of savings collected in Belgium, notably in the form of regulated savings deposits. The stress tests introduced very strict assumptions concerning future interest margins and the value of government bonds. In particular, it was assumed that the cost of financing would increase considerably owing to a general rise in interest rates, while the scope for passing on those increases in the interest rates on assets was severely restricted by the exercise parameters.

1.3 Bank resolution : towards a single resolution mechanism

The single resolution mechanism is the second pillar of the banking union. At European level, three pieces of legislation were adopted in 2014 defining the mechanism's contours. The first, Directive 2014/59/EU, known as the BRRD (Bank Recovery and Resolution Directive)[2], defines the general resolution framework. The second, Regulation 806/2014, known as the SRM Regulation[3], establishes the single resolution mechanism and the single resolution fund. The third, the intergovernmental agreement, deals with the transfer of contributions to the single resolution fund and the mutualisation of the national compartments within the single resolution fund.

The BRRD establishes the general framework for the recovery and resolution of bank crises and applies to all EU Member States. It lays down the preparation requirements, defines obligations concerning capital write-downs, introduces four resolution tools and the associated powers,

(1) Since it is regarded as core capital according to the Basel II rules, the state aid granted to KBC during the crisis fulfils the conditions for qualifying as CET 1 capital until 31 December 2017.

(2) Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council.

(3) Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010.

and deals with the financing of resolution via resolution fund contributions paid in by the banking sector in advance. It also requires the designation of a national resolution authority responsible for drawing up resolution plans and for using the resolution tools and powers.

The resolution procedure has to be seen as an alternative to bankruptcy. During the resolution process, the ailing banking institution or group is restructured or placed in orderly liquidation. This procedure has five objectives: (i) to ensure continuity of the credit institution's critical functions, (ii) to avoid the materialisation of risks to financial stability, (iii) to protect public funds, (iv) to safeguard protected deposits and protected investors, and (v) to protect customers' funds and assets.

The BRRD defines the conditions triggering resolution. Three conditions must be met simultaneously. First, the credit institution must be failing or likely to fail. Second, there must be no private or prudential alternative solution which could avert that failure within a reasonable timeframe. Third, the resolution process must be justified in the public interest.

If these three conditions are satisfied simultaneously, an institution enters a resolution procedure. Since the BRRD aims to limit the use of public funds, the resolution tools ensure that the shareholders are the first to absorb the losses, followed by the institution's creditors. Before resolution begins, the resolution authority is thus obliged to write down or convert the institution's capital instruments (common equity Tier 1, additional Tier 1 instruments, and tier 2 instruments). Next, it applies one of the four resolution tools, namely the option of selling a credit institution's assets or liabilities to a private partner, sheltering them in a bridge institution, transferring them to an asset management vehicle or arranging a bail-in.

The SRM Regulation establishes the SRM, composed of the Single Resolution Board (SRB), the EU Council of Ministers, the European Commission and the resolution authorities of the Member States participating in the SSM. The SRB is responsible for preparing and adopting the resolution plans and resolution schemes relating to institutions and groups that the ECB considers significant under the SSM or for which the ECB has decided to exercise its supervisory powers directly.

The SRB comprises a chair, a vice-chair, four other permanent members and a representative of each national resolution authority of Member States participating in the SSM. The European Commission and the ECB both have an observer on the SRB. The SRB meets in plenary or executive sessions. It generally meets in executive session to adopt a resolution plan or scheme for a particular group or institution, with the proviso that if, under a resolution scheme, use of the single resolution fund exceeds certain limits, the decisions are taken in plenary session. In executive sessions, only the permanent members of the SRB and the representatives of the national resolution authorities concerned are invited to join in the deliberations. Decisions should normally be based on a consensus. Failing that, they are passed by a simple majority of the permanent members of the SRB. The national resolution authorities have to ensure that SRB decisions are actually implemented.

The SRM Regulation also states that the SRM is based on a single resolution fund comprising contributions payable by each credit institution present in one of the participating Member States (see box 2 on the process of financing the single resolution fund and the principle of mutualisation of the national compartments). For the participating Member States, this single resolution fund replaces the national resolution funds established by the BRRD.

The Regulation provides an exhaustive definition of the single resolution fund's mission. The fund can guarantee the assets or liabilities of an institution subject to a resolution procedure, its subsidiaries, a bridge institution or an asset management vehicle. It can grant them loans or purchase some of its assets. The fund can also make contributions to a bridge institution or asset management vehicle. It can likewise pay compensation to shareholders or creditors if they have incurred greater losses than would have been the case under liquidation in accordance with a normal insolvency procedure. Finally, the fund can make a contribution to an institution under a resolution procedure in lieu of the write-down or conversion of the liabilities of certain creditors when the bail-in tool is applied and the decision is made to exclude certain creditors from the scope of the bail-in.

The BRRD was partially transposed into Belgian law by the Banking Law. That transposition is incomplete since the BRRD was still at the negotiation stage when the Banking Law was drawn up. It was therefore only possible to complete early transposition of the most stable elements of the Directive.

Thus, in accordance with the BRRD, the Banking Law stipulates that every Belgian credit institution must draw up recovery and resolution plans, though – in line with the principle of proportionality – there is provision for simplified obligations and the option of granting various waivers. If the plan does not meet certain criteria, and in particular if the resolution authority considers that resolution is not feasible, it has a range of powers intended to

remove the impediments to resolution. It can only use those powers after offering the credit institution the option of itself proposing corrective measures and in so far as it considers that those measures do not do enough to make resolution feasible. For example, it can require the negotiation of service contracts, it can impose limits on the individual and aggregate amount of certain risk exposures, dispose of assets, or modify the institution's legal or operational structures.

In addition, the Banking Law introduces into Belgian law the requirements concerning the write-down and conversion of capital instruments and three of the four resolution tools. The last tool, the bail-in, was not included in the Law but the King may introduce a bail-in scheme by a Decree deliberated in the Council of Ministers. However, such a bail-in scheme cannot enter into effect before 1 January 2016.

The elements still to be incorporated in Belgian law in order to complete the transposition of the BRRD mainly concern (i) the problem of groups, particularly cross-border groups (e.g. intra-group financial support agreements, resolution colleges, joint decision-making processes, etc.), (ii) the bail-in tool, (iii) the financing of the resolution of banking crises (and in particular the role of the resolution fund and the deposit guarantee fund), and finally (iv) the question of investment firms.

The Banking Law imposes dual checks on the resolution measures adopted by the resolution authority. First, the Finance Minister has 48 hours in which to oppose any disposition decision if he considers that the decision has an impact on the budget or systemic implications. Also, the resolution authority has to submit an application to the Brussels commercial court to obtain confirmation that the decisions which it is taking conform to the law and that the amounts of compensation are fair.

To supplement these arrangements, the Organic Law[1] confers the role of national resolution authority on the Bank. In accordance with the BRRD and to ensure that the prudential tasks are kept separate from the resolution activities, the Organic Law establishes a new body within the Bank, namely the Resolution College, chaired by the Governor of the Bank. Apart from the Governor, the Resolution College comprises the Vice-Governor, the Directors responsible for the Department in charge of the prudential supervision of banks and stock-broking firms, the Department in charge of prudential policy and financial stability, and the department in charge of the resolution of credit institutions, the Chairman of the Financial Services and Markets Authority (FSMA), the Chairman of the Board of the Federal Public Service Finance, the official in charge of the resolution fund, four members appointed by the King by a Decree deliberated in the Council of Ministers, and a magistrate appointed by the King.

The organisation and functioning of the Resolution College and the services responsible for preparing its work, and the conditions under which the College exchanges information with third parties (including the Bank's other organs and services) and the measures to prevent any conflict of interests between the Resolution College and the Bank's other organs and services have yet to be determined or defined by Royal Decree deliberated in the Council of Ministers.

(1) Law of 22 February 1998 establishing the Organic Statute of the National Bank of Belgium.

Box 2 – Financing of the single resolution fund

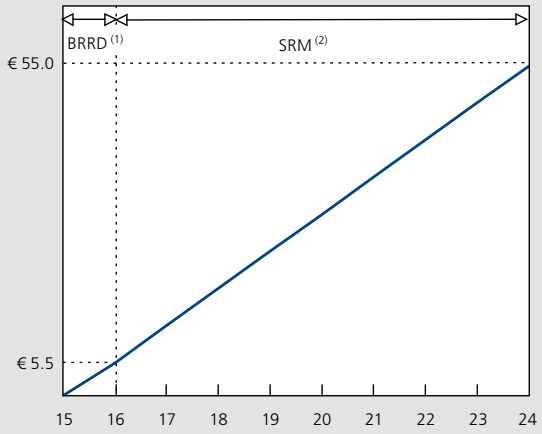
The BRRD stipulates that, from 2015, each EU Member State shall establish a national resolution fund financed by the banks and investment firms. Those institutions shall contribute to the fund of the Member State in which they are established. After ten years, the fund's resources will amount to 1 % of the covered deposits of the institutions authorised in the Member State concerned.

For euro area countries and the other Member States participating in the banking union, the single resolution fund will replace the national resolution funds from 2016. The contributions levied at national level in 2015 will then be paid into the single resolution fund. This fund will be established gradually from 1 January 2016 over an eight-year period, and will be financed by credit institutions and by investment firms belonging to a group subject to the consolidated supervision of the ECB. At the end of that period, the fund's resources will amount to 1 % of the guaranteed deposits of all authorised credit institutions in the banking union. According to the 2011 data

on deposits, the target will be € 55 billion, taking account of the contributions to be collected in 2015 under the BRRD.

AVAILABLE RESOURCES IN THE SINGLE RESOLUTION FUND

(in € billion)



Source : NBB

(1) Bank Recovery and Resolution Directive.

(2) Single resolution mechanism.

An intergovernmental agreement concluded between all EU Member States except the United Kingdom and Sweden [1] provides that, in a transitional phase, the fund will consist of national compartments. The contributions from Belgian institutions will be paid into the Belgian compartment. If the single resolution fund has to contribute to the financing of an institution's resolution, the amounts will be taken first from the national compartments. The proportion to be taken first from the national compartment concerned is limited to a percentage of the total resources in that compartment. That percentage will gradually decline from 100 % in 2016 to 6.66 % in 2023. The proportion to be taken from all compartments if the national compartment is insufficient will increase gradually from 40 % in 2016 to 100 % in 2023. This means that use of the fund resources will be "mutualised". If these two steps are still insufficient, the residual amounts can be taken from the national compartments. At the end of the eight-year transitional period, the national compartments will disappear and it will no longer be necessary to follow this complex sequence.

Calculation of the contributions

The size of each institution's annual contribution depends on the size of the bank and its risk profile. The BRRD amounts are defined by a delegated act of the Commission, and the SRM amounts are defined by an implementing act of the Council.

For each bank in a participating Member State, the levy basis is determined by deducting the deposits covered by the deposit guarantee system from the total liabilities excluding own funds. This levy basis is then multiplied

(1) The intergovernmental agreement does not apply to all 26 co-signatories. It only applies to euro area countries and, in the future, to non-euro area countries which join the SSM and the SRM.

by a risk weighting, which is based on four risk categories, including the financing structure and the institution's importance for financial stability. Since this levy basis is calculated for all banks, each bank's share in the total is known. The individual contributions of each bank can then be calculated as the bank's share in the target national amount specified by the BRRD for 2015. Since an abrupt switch from a national target figure in 2015 to a European target figure in the following year would lead to large divergences in contribution obligations between some Member States, the transition is being staggered. The proportion of the contributions payable by each bank according to the BRRD formula declines from 60 % in 2016 to 0 % in 2023. The SRM-formula proportion increases in inverse proportion to the reduction in the BRRD-formula proportion.

On the basis of the principle of proportionality, there are exceptions to this calculation method, particularly for small banks with a non risk-weighted levy basis of less than € 300 million and total assets of less than € 1 billion. These small banks will pay a flat-rate contribution of between € 1 000 and € 50 000, depending on the size of their levy basis. Similarly, other institutions with specific characteristics will qualify for waivers in the calculation of their contributions. Thus, the amounts which can be levied on market infrastructures approved with a credit institution licence are calculated solely on the basis of the liabilities derived from their banking activities.

1.4 Continued implementation of Basel III and the Banking Law

1.4.1 Developments concerning liquidity and capital

Liquidity

The CRR provides for the introduction, in October 2015, of a harmonised liquidity standard for all European credit institutions, namely the Basel III liquidity coverage ratio (LCR). The LCR will be phased in (60 % in 2015, rising by 10 % in 2016 and in 2017, and reaching 100 % from 2018), both at the level of the individual legal entity and at the highest consolidation level in Europe. The details of the final European LCR were determined in October 2014 by a delegated act of the European Commission[1].

Consequently, liquidity regulations and reporting in Belgium have to be adapted to the new European framework. The Bank decided in principle to use the scope that the CRR offers Member States during the transitional phase in regard to the supervision of liquidity and not to apply the said phased introduction. With effect from October 2015, the Belgian liquidity ratios will therefore be replaced by a 100 % LCR for all credit institutions.

In October 2014, the Basel Committee on Banking Supervision published a revised version of the second liquidity ratio specified by the Basel rules, namely the net stable funding ratio (NSFR), and a proposal for requirements concerning the transparency of that ratio. This structural liquidity ratio obliges the banks to finance illiquid assets by stable funding sources such as equity capital, deposits made by households and SMEs, and long-term liabilities. The NSFR therefore complements the LCR which requires the banks to hold liquidity reserves sufficient to cope with a short-term liquidity crisis. The recalibrating of the NSFR includes a revision of the treatment of transactions in derivatives and short-term loans to entities in the financial sector. The NSFR is to be introduced in Europe from 2018. During the year under review, the EBA embarked on an impact analysis of the implementation of the NSFR for European credit institutions, which will form the basis for the European Commission to initiate legislation in order to introduce the NSFR in Europe.

In addition, CRD IV stipulates that risk-based supervision – namely pillar 2 of the prudential supervision – must also consider an institution's liquidity position and its liquidity management, and that additional specific requirements concerning liquidity may be imposed on the basis of that analysis. This means that a similar decision on liquidity was introduced in 2014 alongside the pillar 2 decision on capital. That liquidity decision must be taken at least once a year, and may concern both quantitative and qualitative supervisory measures. In this context, a key point is that the decision in principle to introduce the LCR at 100 % from October 2015 already implies significant additional quantitative pillar 1 requirements for all the Belgian credit institutions concerned.

(1) Delegated Regulation of 10 October 2014 supplementing Regulation No. 575/2013 on the liquidity coverage requirement for credit institutions.

Under the SSM, it was agreed that, from 2014, the pillar 2 decision would be taken immediately by the SSM for institutions considered significant which are subject to its direct supervision. However, it was still up to the national supervisory authorities to conduct the necessary analyses for those institutions and to formulate proposals for supervisory measures based on a national methodology. In the case of institutions considered less significant, the Bank was responsible for both the assessment and the decision. In the year under review, the Bank therefore devised a pillar 2 methodology for liquidity risk based on the EBA's harmonised guidelines on the subject, proposing a level of liquidity that takes account of both quantitative and qualitative aspects.

Capital

The CRD IV and the CRR came into force on 1 January 2014. The EU Regulation offers a number of options enabling the national competent authorities to impose their own rules, notably on the application of certain transitional measures. The Bank's regulation dated 4 March 2014 [1] therefore supplements the new European regulatory framework and specifies the implementation in Belgium of the various options and transitional measures under the CRR. That regulation was approved by the Royal Decree of 10 April 2014 [2].

In regard to the existing CRD III options [3], the NBB regulation of 4 March 2014 adopted most of the options selected in the capital regulation of 15 November 2011 [4], in order to maintain regulatory continuity. However, one option in that regulation was amended, namely the provision for exemption from the internal ratings-based approach (IRB) for the exposures of central governments and central banks of Member States if those exposures are eligible for a 0 % weighting under the standard approach.

The regulation of 4 March 2014 stipulates that institutions qualifying for exemption for those exposures up to 31 December 2013 must apply the IRB approach to them from 1 January 2014. However, that measure is being phased in between 2014 and 2018, so that the institutions only have to apply 20 % of the capital requirements in 2014, 40 % in 2015, 60 % in 2016 and 80 % in 2017. It is only in 2018 that the institutions must apply 100 % of the capital requirement to those exposures according to the IRB approach.

The new options introduced in the CRR also permit holdings in financial sector entities to be exempted in some cases from deduction from the capital. In the case of holdings in insurance companies, the Bank follows the "Danish compromise" method of the CRD/CRR in order to harmonise the treatment of those holdings with that in most Member States. If certain conditions are met, notably if the solvency test for conglomerates is applied, that treatment allows those holdings to be weighted rather than deducted from the capital. The NBB regulation also specifies that, in regard to supervision on an individual and sub-consolidated basis, capital instruments issued by entities in the financial sector must be deducted from the capital in certain cases, notably if those holdings are not included in the scope of the consolidated supervision of the institution.

In regard to the new national options providing for transitional measures to enable the new, more stringent prudential standards to be phased in, the regulation only incorporated a few of the options in order to ensure that these new standards are implemented in full as soon as possible. For instance, goodwill and negative results for the current year must be deducted immediately from the capital.

The regulation nevertheless provides for transitional measures for the deduction from the capital of minority interests and instruments that no longer meet the conditions laid down by the CRR for qualifying capital. There are also transitional measures for the recognition as capital of deferred tax liabilities based on future profits and not resulting from time differences, and for inclusion in the capital of unrealised gains and losses on fixed-income securities and loans recorded at fair value on the balance sheet, with the exception of available-for-sale (AFS) reserves in the sovereign debt portfolio. For these measures, the regulation makes use of all the flexibility that the CRR permits to determine transitional percentages, and therefore does not provide for early implementation of these requirements.

In regard to the AFS reserve in the sovereign debt portfolio, the NBB regulation stipulates that this revaluation reserve will not be included in the capital unless the unrealised losses exceed 5 % of the book value of that portfolio.

Finally, pending harmonisation of the leverage ratios in 2018, the regulation stipulates that the National Bank is to maintain the requirements concerning the general solvency ratio specified in the regulation of 15 November 2011.

(1) Regulation of 4 March 2014 of the National Bank of Belgium on the implementation of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013.
(2) Royal Decree approving the regulation of 4 March 2014 of the National Bank of Belgium on the implementation of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013.
(3) Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).
(4) Regulation of 15 November 2011 of the National Bank of Belgium on the capital of credit institutions and investment firms.

In the same connection, during the year under review, the Basel Committee on Banking Supervision continued the solvency requirement reform programme launched as a result of the financial crisis. To that end, in January the Basel Committee finalised the definition of the new leverage ratio. That ratio determines the minimum amount of capital in relation to the total volume of assets, in order to ensure that a rapid expansion in lending to counterparties with a low risk weighting does not lead to an excessive rise in the overall debt ratio or in the leverage effect. The European Commission adopted this final Basel Committee definition in a delegated act so that this version of the leverage ratio is being introduced as an observation ratio and must be published by institutions from 2015. At a later stage, the European Commission may also initiate legislation to make this ratio binding for European credit institutions and investment firms. The Basel Committee text provides for a compulsory leverage ratio from 2018.

In addition, during the year under review, as part of its programme of reforms, the Basel Committee published norms concerning risk concentration, a new simplified and uniform standard approach to counterparty risk in derivatives and guaranteed financing transactions, and a new calculation of stricter solvency requirements concerning securitisation. The risk concentration rules limit the exposure of banks to individual counterparties or groups of linked counterparties. These rules are comparable to the European rules on the subject, which have already been applicable to European institutions for some time.

Other Basel Committee priorities on these subjects concerned ensuring consistency and comparability in the implementation of the solvency and liquidity requirements in order to enhance public confidence in the capital and liquidity ratios and to avoid distortions of competition between institutions. In that regard, the Basel Committee continued to work on the implementation of a vast programme of measures during the year under review.

The Regulatory Consistency Assessment Programme set up in this context by the Basel Committee includes provision for monitoring the implementation of the standards, notably with the aid of a comprehensive assessment by the Committee of the introduction of the Basel standards by the various supervisory authorities. The European legislation on the capital requirements for credit institutions resulting from the CRD IV and the CRR was analysed during the year under review. The findings revealed a number of areas in which the European legislation deviates from international standards.

In addition, like the EBA, the Basel Committee conducted other impact assessments to identify differences between the capital requirements calculated by the institutions unconnected with differences in the underlying risks. These impact assessments point to a considerable variation in the solvency requirements, notably in banks using internal models to calculate their capital requirements for credit risks, market risks and operational risks. During the course of 2014, the Basel Committee examined the feasibility of establishing measures to limit variations not attributable to differences in the underlying risks. First, the Committee aims to improve and enhance the risk sensitivity of the non-model-based standard approach used to calculate the capital requirements for credit risks, market risks and operational risks, in order to introduce a minimum percentage for these capital requirements as a minimum standard for the capital requirements calculated by internal models. Second, the Committee is undertaking a fundamental revision of the modelling practices used by banks, and has formulated proposals to clarify and simplify the use of internal models for the calculation of capital requirements.

Adaptation of the SREP capital assessment to the CRR framework

In accordance with the CRD IV, the Bank constantly assesses the risks to which credit institutions are exposed, and in so doing determines whether the strategies, processes and mechanisms used by those institutions are appropriate and whether their capital and liquidity are adequate.

In that connection, the Bank imposes a minimum capital ratio each year on the credit institutions under its supervision on the basis of a methodology that takes account of both the internal assessment of capital needs determined by the institution (ICAAP) and the results of the stress tests and the SREP conducted by the Bank. During the period under review, the Bank revised its methodology to take account both of the changes made by the CRR, notably in regard to the definition of the capital and of the weighted volume of risks, and of the results of the comprehensive assessment (see section 1.2 of this chapter).

As the ECB has been responsible for the prudential supervision of the Belgian banking groups since 4 November 2014, it was agreed that decisions on the minimum capital ratio would be formally taken by the ECB on the basis of a proposal from the Bank and the methodologies that it uses for the banks concerned.

On the subject of capital quality, the Bank has reinforced its policy of only taking account of capital instruments capable of covering the losses in a "going concern"

situation as the main basis for assessing the adequacy of an institution's solvency, since that assessment indicates the degree to which the institution can continue in business. Up to the end of 2013, the Bank set an institution's minimum solvency ratio by reference to the Tier 1 equity capital. However, the CRR made fundamental changes to the definition of Tier 1 capital by distinguishing between core elements of common equity Tier 1 (CET 1) – consisting mainly of capital and reserves – and hybrid Tier 1 instruments which only bear losses in the second rank or if the bank's solvency ratio has already been seriously affected by losses. Taking account of this change in the regulatory definition of the capital, the Bank decided to set the minimum solvency ratio by reference to the amount of CET 1, until such time as the ECB defines its own policy on the subject.

As for quantification of the institution's risk exposure, the Bank noted that the CRR had already raised the volume of the minimum capital requirement by taking better account of the counterparty risk, and that some of the assumptions behind the determination of needs additional to the minimum requirements ought to be revised, particularly in view of the assumptions applied in the stress tests conducted by the EBA and the ECB in 2014. It thus revised the methodologies used for its SREP, notably by adapting the assumptions concerning changes in interest rates used to assess the level of the interest rate risk on the banking book.

The Bank also took account of the results of the comprehensive assessment for the purpose of determining the minimum solvency ratio applicable in 2014 and 2015. It adjusted the CA findings where necessary to take account of risks not fully covered by that exercise, notably the risks relating to disputes or the business model of the institution concerned if they were considered sufficiently significant. By means of this approach, the Bank aimed to make sure that the banks subject to the CA were assigned a minimum solvency requirement which, taking account of the results of the asset quality review and the stress tests, enables them to respect at all times the minimum levels of 8 % of the CET 1 capital in the baseline scenario and 5.5 % of the CET 1 capital in the adverse scenario.

(1) Regulation of 1 April 2014 of the National Bank of Belgium on proprietary trading.

(2) Report of the European Commission High-Level Group on structural reform of the EU banking sector, 2012.

1.4.2 Structural reforms

Regulation of proprietary trading activities

The Banking Law and the Bank's regulation of 1 April 2014[1] form the framework for the structural reforms of the rules on the trading activities of financial institutions. These two tests adopt two lines of defence based on the recommendations of the Liikanen Report, namely the 2012 report by a European Commission high-level group of experts chaired by Erkki Liikanen[2], and on some elements of the Volcker Rule applicable in the United States.

First, some trading activities are totally prohibited. Other specific trading activities are permitted, but are subject to both quantitative and qualitative conformity requirements. In addition, a capital surcharge is imposed on financial institutions as a disincentive if the permitted trading activities exceed one of the quantitative limits set by the regulation. That capital surcharge was converted to a pillar 2 measure (see chapter 4 of this part).

The ban on proprietary trading activities concerns positions in financial instruments intended to make short-term profits from market price fluctuations. Similarly, high-risk trading activities which may lead to substantial losses, such as correlation trading and exposures linked to certain securitisation tranches, are covered by this ban. Also prohibited are transactions lacking adequate collateral, effected for own account with certain undertakings for collective investment which present exposures on other institutions with leverage in excess of a particular threshold, and proprietary trading by financial institutions directly involving leverage vehicles (hedge funds), without adequate collateral.

This ban is dictated by the principle that a financial institution cannot use deposits which it holds, and which are covered by a guarantee fund, for speculative purposes that make little contribution to the real economy. The role of such speculative activities in the recent financial crisis is one of the reasons for this measure.

Five categories of trading activities are permitted. The first two types of permissible trading activity concern providing customers with investment services and ancillary services, including the associated hedging, and the maintenance of a liquid market on the basis of a contractual obligation, by continuously quoting bid and offer prices for a particular type of security or financial instrument. Trading activities that constitute the effective economic hedging of the various risks inherent in a financial institution's own balance sheet, or those relating to sound liquidity management

or resulting from strategic decisions connected with the management of a permanent, liquid investment portfolio held by the institution concerned are also excluded from the ban so long as all these trading activities meet clearly defined criteria and standards.

The institutions have to submit a qualitative conformity report to the supervisory authority each year, showing that the framework established for the permitted trading activities meets the various requirements, notably in regard to internal control, good governance, organisation of the trading room, independent risk management, remuneration policy and exposure limits. Each individual trading unit must also have a clearly specified mandate defining the strategy and the range of permitted financial products, the authorised risk limits and the hedging strategies.

In addition, a detailed quantitative report on the permitted trading activities must be submitted quarterly for each trading unit and must enable the supervisory authority to check whether the requirements concerning quantitative limits or thresholds are being respected. That report includes an analysis of the daily results, the risks incurred by each trading unit, and the degree to which hedging transactions have effectively reduced the risks for specific risk factors.

If it should emerge that certain permitted trading activities do not fulfil these quantitative and qualitative conditions or exceed a particular risk-sensitive limit, and if the capital requirements for the trading activities concerned exceed 1 % of the regulatory capital, the institution will be requested to cut back these activities within thirty days or, if appropriate, to transfer them to a separate legal trading entity.

Developments at European level

In January 2014, the European Commission published a proposal for a Regulation on structural banking reforms [1]. That draft Regulation aims to reduce the risk of systemic banks and to harmonise the structural reform measures between the various Member States. Some Member States have already proposed a set of structural reforms. The proposal for a Regulation is currently under negotiation by the Member States in the Council, in which the Bank is taking part at technical level. For the moment, it is uncertain when the Regulation will be finalised.

Although it is too early to say what changes are likely to be made to the draft European Regulation, it should be noted that this text differs from the Belgian structural reform measures in a number of areas, which are described in the table. First, the European Regulation only applies to certain large banks, whereas the Belgian structural reforms concern all deposit banks eligible for the deposit guarantee scheme.

Next, the draft EU Regulation, like the Liikanen report, provides for some of the banks' trading activities to be transferred to separate trading entities within the group if specific indicator thresholds are exceeded and if the authorities establish that the bank's trading activities are a threat to financial stability. The specific activities that have to be separated and the full list of indicators to be used to trigger a prudential review and a possible separation decision have yet to be specified in secondary legislation. The Belgian legislation only prescribes the separation of own account trading activities or trading activities equivalent to own-account trading. At the same time, the Belgian legislation applies a capital surcharge to trading activities in excess of a given volume or certain risk limits.

Third, the draft EU Regulation prohibits banks and banking groups from engaging in proprietary trading. The proposal in fact uses a particularly narrow definition of proprietary trading that covers only the trading entities or staff specifically dedicated to own-account trading. This narrow definition of proprietary trading will only prohibit "open" own-account trading. It will have no impact on trading activities that a bank "conceals" among other types of trading activities, such as market-making or hedging transactions. However, most banks have terminated their open proprietary trading activities since the outbreak of the crisis.

Unlike the EU Regulation, and as explained above, the Belgian legislation also aims to detect proprietary trading activities conducted by banks under cover of another activity. That requires a broader definition of proprietary trading than the one used in the European Regulation, and entails establishing an appropriate reporting and monitoring framework for trading activities.

Another difference between the draft EU Regulation and the Belgian structural reform measures is that the former excludes trading in EU public debt from the definition of proprietary trading and from the calculation of the value of the indicators linked to the separation decision. The Belgian legislation does not allow any such exclusion, considering that proprietary trading in EU public debt may still entail substantial risks.

(1) Regulation on structural measures improving the resilience of EU credit institutions, 2014/0020, 29 January 2014.

TABLE 2 COMPARISON OF BELGIAN AND EUROPEAN STRUCTURAL REFORMS

	Europe (proposal for a Regulation)	Belgium
Scope	Banks considered of global systemic importance and banks reaching the following thresholds in three consecutive years: (1) total assets > € 30 billion and (2) assets and liabilities held for trading purposes > € 70 billion or > 10 % of the bank's total assets.	All banks accepting deposits eligible for the deposit guarantee.
	EU banks, their EU parent companies, their subsidiaries and branches including those in third countries, and EU branches and subsidiaries of banks established in third countries.	Belgian financial institutions (i.e. not branches of foreign institutions).
Trading activities	Broad definition, excluding purchase and sale of EU government bonds.	Narrower definition. Trade in EU government bonds is not excluded.
Proprietary trading	Prohibited, but very narrow definition since only the activities of desks, entities or operators dedicated to proprietary trading are prohibited.	Broader definition and in particular a "negative definition" stipulating that activities not falling within five authorised trading categories are treated as equivalent to proprietary trading.
	Banks must not invest in or hold shares in hedge funds, or hold certain alternative investment funds, nor may they invest in derivatives linked to that type of fund.	Banks must not invest in or hold shares in hedge funds, or hold certain alternative investment funds, nor may they invest in derivatives linked to that type of fund.
		Ban on all activities prohibited by the EU Regulation.
		Ban on certain risky activities.
	Trading in EU government bonds is exempt from the ban.	Proprietary trading in EU government bonds is not permitted.
Separation of trading activities	If certain thresholds are exceeded, the bank has to separate all the trading activities except trading in EU government bonds, unless it can demonstrate to the supervisory authority that those activities do not threaten financial stability.	Banks must separate all trading activities which do not clearly fall within the permitted trading categories.
	Certain derivatives used for hedging are excluded from the definition of trading activities and the bank may therefore retain them.	Banks have to separate trading activities which do not fulfil all the quantitative and qualitative limits for permitted categories of activities for which the capital requirements exceed 1 % of the capital.
	The supervisory authority must demand separation if certain criteria exceed a set of thresholds to be defined by the EBA.	A capital surcharge is applied to all permitted trading activities in excess of a specified volume or risk limit.

Source: NBB.

1.4.3 Governance: classification as a significant institution and Bank policy on restrictions on cumulating directorships

One of the key principles of the Banking Law lies in the concept of a "significant credit institution". In accordance with Article 3, 30°, of that Law, the concept covers both systemically relevant credit institutions and credit institutions which have a balance sheet total of over € 3 billion and which the supervisory authority does not consider to be non-significant on account of (i) their size, (ii) their internal organisation, and (iii) the nature, scale, complexity and cross-border character of their business. That definition is based on a presumption of significance that can be refuted. That presumption was included in the Banking Law to take account of the current diversity in the Belgian banking landscape. It should be noted that, in the Banking Law, the concept of "significance" differs in scope from the classification as a "significant/less significant" institution under the SSM.

Classification as a "significant" institution is particularly relevant for a range of legal provisions concerning the good governance of credit institutions, especially those relating to the formation of specialist committees within the board of directors (Article 33, § 1 of the Banking Law), the function of Chief Risk Officer (Article 37, § 3, first indent,

second sentence of the Banking Law) and the quantitative restrictions on cumulating directorships (Article 62, § 5, second sentence, and Article 62, § 6, second sentence of the Banking Law). The Bank wrote to significant institutions urging them to take the necessary measures in good time with a view to the entry into force of the rules on committees at the end of 2014.

Following the entry into force on 1 July 2014 of new restrictions on cumulating directorships, as provided for in Article 62 of the Banking Law, the Bank conducted an initial classification exercise.

For each credit institution concerned, it reviewed the said criteria specified by the new Law. These legal criteria were refined by definition of a range of circumstances making it less likely that the presumption of significance would be refuted:

- the presence of substantial foreign activities: branches, subsidiaries or other foreign connections;
- the coexistence of multiple business lines;
- the coexistence of widely varying customer profiles or product groups;
- heavy use of funding sources other than retail deposits;
- existence of a complex risk profile and/or excessive risk appetite;
- lack of sufficiently integrated group risk management;
- finding of points for attention in regard to shareholdership stability;
- membership of a group in which another institution was classed as significant.

Following analysis, the Bank decided to consider that a number of institutions did not qualify as institutions of significant relevance. Of course, that classification can be reviewed as time goes by, or if the institutions change their risk profile.

During the month of June 2014, the Bank informed the banking sector of the outcome of the classification exercise. At the same time, as the prudential supervision authority, it gave the significant credit institutions more detailed information on how it would interpret, in its supervisory practice, the new legal rules on cumulating directorships referred to in Article 62 of the Banking Law. Those institutions were also requested: (i) to check whether the legal rules on cumulating directorships were being respected for all members of their statutory management body, and (ii) to supply the Bank with a phased plan detailing how their institution intended to respect the legal rules on cumulation with effect from the next general meeting of shareholders. The institutions concerned were to submit that information by no later than 31 July 2014.

In its letter, the Bank first defined the scope of the new quantitative restrictions. This concerns more particularly the external mandates exercised in commercial companies by all directors of credit institutions and executive directors of holding companies. Directorships exercised in estate planning companies are excluded from the scope if those companies confine themselves to the routine management of family assets.

The Bank also stressed that the ceilings set by the Banking Law (a single directorship plus two non-executive directorships, or four non-executive directorships) are not an entitlement. On the basis of the criterion concerning the time commitment, the Bank may at any time require a reduction in the number of directorships exercised. In regard to management companies, the Bank will take account of all directorships whereby an individual acts as the permanent representative of a management company. Conversely, the position held within the management company itself need not count, provided the sole purpose of the management company is to exercise other directorships; the intention here is to avoid any double counting of directorships.

The Bank also clarified the counting of various directorships exercised within the same group. In accordance with Article 62, § 9, first paragraph, of the Banking Law, directorships exercised in firms belonging to the group of which the credit institution is a member, or to a group in which a firm maintains close links with the credit institution or its parent company, must be regarded as a single mandate (group counting). External directorships exercised in groups totally separate from the credit institution are disregarded for the purpose of group counting under the current legislation, which means that each mandate has to be taken into account separately.

1.4.4 Prudential requirements for cooperative societies

During the year under review, the Bank attended to the prudential measures needed to take account of the specific characteristics of the capital of credit institutions in the form of cooperative societies. The Bank also examined the provisions necessary to ensure the soundness of a cooperative entity holding shares in a credit institution, while taking care to prevent inappropriate use of such a shareholding structure .

Credit institutions established in the form of a cooperative society

The capital of a cooperative society is variable: members of the cooperative can ask the society to redeem the shares that they hold at the issue price. This characteristic is at odds with the fundamental principle of capital permanence defined by the CRR. Capital instruments recognised as CET 1 can in fact only be redeemed in the event of liquidation of the credit institution or if they are replaced with capital instruments of equivalent quality. The CRR, supplemented on this point by the EC Delegated Regulation No. 241/2014 of 7 January 2014, lays down specific provisions to take account of this peculiarity of cooperative capital and to allow it to be recognised as CET 1.

These provisions are intended to give credit institutions in the form of cooperatives the right to refuse to redeem their members' shares or to limit their redemption for an indefinite period, taking account of the prudential situation and in particular the institution's general position as regards finance, liquidity and solvency, and the amount of the capital in regard to all the requirements applicable[1]. This restriction option has to be assessed by the supervisory authority.

From a prudential perspective, however, a credit institution that has to block the redemption of members' shares incurs a reputational risk which may materialise, for instance, at the level of its deposits: since the members are usually also depositors, blocking or limiting the redemption of members' shares is also likely to lead to a withdrawal of deposits.

In this context, provision was made for various measures so that a credit institution in the form of a cooperative would have a financial buffer enabling it to meet requests for the redemption of members' shares and pay a dividend, and would also be able to withstand crisis situations, taking account of possible withdrawals by depositors[2]:

– Formation and maintenance of a prudential reserve equal to 30 % of the paid-up capital, funded by allocating part of the profits.
– The articles of association of the credit institution provide for the blocking of redemption of members' shares if redemption requests exceed 10 % of the paid-up cooperative capital over a 12-month period.
– Reinforcement of the future LCR, by reclassification of deposits belonging to cooperative members in the category of less stable retail deposits and by specifying a higher outflow rate for those deposits[3].

New credit institutions established in cooperative society form

Special attention focuses on the situation of a new credit institution established as a cooperative society, because new credit institutions must have sufficient resources from the start to cover the operating losses inherent in the initial years and the increased risks associated with the development of the business. As is the case for any new credit institution, this situation is handled by means of a specific capital requirement calculated on the basis of the total amount of the risk exposure of the institution concerned. In addition to the measures governing the launch of the activities of any new credit institution, whatever its legal form, the articles of association of a new credit institution established in the form of a cooperative society must – unless the institution is supported by an institutional investor – specify a category of members' shares which are subject to a minimum non-redemption period equivalent to the estimated period of the business launch. That requirement is intended to ensure that the new credit institution keeps holding an adequate part of its initial capital at all times during the start-up period.

At the end of the start-up period, in principle marked by the generation of profits, a prudential reserve must be formed in the same way as for any credit institution established in the form of a cooperative society (see above). In the case of a new credit institution, the blocking measures in the event of a crisis will not concern members' shares subject to a minimum non-redemption period until that non-redemption period ends.

Cooperative entity holding shares in a credit institution

The measures concern the situation of a cooperative society that owns shares in a credit institution established in a different form, where the holding of those shares is the cooperative's sole or principal activity.

The first point to note is that the recognition of the capital financed by the cooperative entity as CET 1 in the

(1) These rules go very much farther than Article 55 of the Banking Law of 25 April 2014, which specifies that no capital can be repaid, including in the form of the redemption of members' shares, if that causes the institution to fail to respect the capital requirements applicable.

(2) These various measures were based on Articles 150, 151 and 154 of the Banking Law and Article 11 of Commission Regulation No. 241/2014 of 7 January 2014 supplementing the CRR. Note that the specific capital requirement (pillar 2) to take account of the characteristics of cooperative capital is calculated on the basis of the paid-up amount of that capital (and not the total amount of the institution's risk exposure, which is not relevant in this case) and that it cannot be covered by issuing new members' shares (since the risk referred to here is specifically linked to the characteristics of cooperative capital).

(3) The liquid asset categories are defined by Commission Regulation No. 2015/61 of 10 October 2014 supplementing the CRR concerning the introduction of the LCR.

credit institution concerned is subject to appraisal of the independence of the shareholding cooperative entity in relation to the credit institution. That appraisal is conducted case by case on the basis of various independence criteria concerning governance, financial autonomy, and the operation of the shareholding cooperative entity. If the credit institution has control or a dominant influence over the cooperative entity, then the latter will be regarded as an *ad hoc* entity belonging to the credit institution (special purpose vehicle/special purpose entity, SPV/SPE); as a result, the shares in the capital of the credit institution subscribed and/or held by the shareholding cooperative entity cannot qualify as CET 1 capital[1].

In its general supervision of the shareholdership of credit institutions, the supervisory authority has to convince itself of the financial soundness of the cooperative entity and the ability of the credit institution concerned to fulfil and continue fulfilling the prudential obligations[2]. In a situation where the sole or principal activity of the cooperative entity consists in holding shares in the credit institution, the cooperative entity's income depends heavily on the dividend paid by the credit institution. The solvency of the shareholding cooperative entity can be seriously impaired if the credit institution gets into difficulty and the value of the shares has to be reduced.

To attenuate the impact of such risks, the shareholder in the form of a cooperative society is asked to have a shareholder's reserve calculated on the basis of the amount of the cooperative capital, in accordance with the same parameters as those that credit institutions established in the form of a cooperative society use to form their prudential reserve[3]. This solvency buffer is thus funded by the allocation of part of the result of the cooperative entity. The cooperative entity should also have a cash cushion in the form of assets that can be easily mobilised[4] other than securities issued by the credit institution concerned, in order to ensure that it is actually possible to redeem members' shares and/or pay a dividend to members out of the capital. That implies that part of the shareholder's reserve calculated on the basis of the paid-up cooperative capital of the said shareholding entity is not invested in securities of the credit institution owned. The amount of the cash cushion required takes account of situations where the shares of the credit institution in question are listed, enabling the shareholding cooperative entity to sell the securities of the credit institution owned in order to acquire the necessary liquidity.

In addition, the shareholding cooperative entity should provide for a block on members' share redemption applications which exceed 10 % of the paid up cooperative capital in a 12-month period. Such a measure may lead to the withdrawal of deposits by members of the cooperative entity who also hold deposits in the credit institution owned. There is therefore provision for reinforcing the LCR of the credit institution owned via reclassification of deposits held by members of the shareholding entity, placing them in the less stable retail deposits category and specifying a higher outflow rate for those deposits.

There are transitional measures to take account of existing situations and to enable credit institutions in the form of a cooperative society and cooperative entities holding shares in a credit institution to take the necessary steps to comply with the planned measures.

1.4.5 Recovery plans

Before the Banking Law came into force, a number of banks which were considered significant at national level had already drawn up recovery plans under the direction of the Bank. The Banking Law now requires all Belgian credit institutions to prepare such a plan.

In the plan, the institution is required to specify crisis scenarios which could threaten its viability, and to analyse the recovery options available to restore its financial health. The bank also has to include in its recovery plan a description of the monitoring arrangements that it has set up to detect any stress at an early stage. Those arrangements must include appropriate indicators so that decisions on activating the plan can be taken in time.

The EBA has produced a set of regulatory technical standards defining the content of the recovery plan. Those standards are in line with the NBB's policy on the subject, and should be read in conjunction with the EBA guidelines on the range of scenarios to be considered in the recovery plans. The EBA is currently also working on a set of guidelines establishing a minimum list of qualitative and quantitative indicators to be specified in the plans.

In addition, the Banking Law requires all banks to include in the monitoring arrangements in their recovery plan two indicators concerning asset encumbrance. Those indicators must ensure that the banks retain sufficient unencumbered assets so that, in the event of failure, they can cover the obligations stemming from the depositor preference rule stipulated by the Banking Law.

(1) Article 24 of Regulation No. 241/2014.
(2) Article 18, paragraph 2, c) and d) of the Banking Law of 25 April 2014.
(3) To prevent a cooperative entity from resorting to excessive debts to fund the investment in the credit institution, the amount of the shareholders' reserve must equal 25 % of the book value of the investment in the credit institution if that amount exceeds 30 % of the paid-up capital of the shareholding cooperative entity.
(4) The liquid asset categories are defined by Commission Regulation No. 2015/61 of 10 October 2014.

With regard to the principle of proportionality, the BRRD and the Banking Law provide that certain banks qualify for simplified obligations concerning their recovery plan. The legal criterion that banks must meet in order to be eligible for a simplified recovery plan is that the failure and liquidation of the institution in accordance with normal solvency procedures would have no significant negative impact on the financial markets, on other institutions or on the rest of the economy. In that context, the EBA has drawn up guidelines on the methodology to be used to determine which banks could qualify for a simplified regime. It should be noted that banks eligible for such a regime will still be obliged to monitor the indicators mentioned above concerning asset encumbrance. Apart from this simplified regime, the Banking Law offers credit institutions forming part of a federation of credit institutions the option of applying for exemption from the obligation to draw up a recovery plan.

Finally, the articles of the BRRD concerning recovery plans for consolidated groups have yet to be transposed into the Banking Act. In accordance with those provisions, group recovery plans must make provision for adopting measures to be implemented at both group and individual level. The Bank has already taken part in the preparation of plans in Crisis Management Groups (CMGs). Apart from the group recovery plan, a subsidiary may also be required to have a separate plan, normally on the basis of a joint decision between the consolidating supervisory authority and the subsidiary's supervisory authority. For banking groups considered to be significant, this joint decision-making process will be equivalent to a decision by the SSM alone, since the latter functions as the supervisory authority of both the parent company and its subsidiaries.

1.4.6 Remuneration policy

When the CRD IV was being transposed into national law, the requirements concerning remuneration policy were incorporated in full in the Banking Law, mainly in Annex II. The chief innovation concerns the introduction of a maximum ratio between variable and fixed remuneration from the 2014 performance year onwards. In particular, the Banking Law stipulates that, for each person, the variable remuneration must in all cases be limited to the higher of the following two amounts, namely 50 % of the fixed remuneration or € 50 000, but without exceeding the amount of the fixed remuneration. This makes the Banking Law stricter than the CRD IV, which specifies a maximum ratio of 1 to 1 between variable and fixed remuneration, with the option for the general meeting to authorise a deviation up to a ratio of 2 to 1. In that connection, on 15 October 2014, the EBA published a report and an opinion on the use of allowances to circumvent the (variable) remuneration rules, i.e. the said maximum ratio.

The Banking Law specifies that the remuneration policy must cover all categories of staff whose professional activities have a material impact on the institution's risk profile. From now on, these so-called Identified Staff must be selected on the basis of the criteria set out in the regulatory technical standards adopted by the European Commission [(1)]. According to the 4th recital and the introductory sentence of Article 2 of the Regulation based on these regulatory technical standards, institutions must also take account of the results of their own risk assessments so that all staff whose professional activities may have a material influence on the institution's risk profile are actually identified. The Bank's guideline, which states that at least 1 % of the total number of staff must be included in this group, has to be seen as a threshold, or in other words as a minimum figure to be applied following the risk analysis.

The 14th recital in this Regulation also specifies that this identification process must be adequately documented, including in respect of staff identified solely on the basis of the level of their remuneration, but who were not ultimately included because their professional activities were considered to have no material impact on the institution's risk profile. This should enable the Bank to see that the identification process operates correctly.

If appropriate, the next stage will be to examine in accordance with the Bank's guideline whether the group of Identified Staff includes employees whose variable remuneration is less than € 75 000. If so, then in view of their low variable remuneration such staff may be exempt from the specific requirements concerning deferral and financial instruments. Obviously, the Bank can always decide to adjust this policy later.

In 2014, the Bank again conducted a detailed horizontal analysis of compliance by large institutions with the rules on remuneration policy. By comparing the institutions with one another according to the same method, the Bank intends to promote a level playing field within the Belgian financial sector. In the event, six large institutions had been included in the analysis, which concerned performance in 2013 for which variable remuneration had been paid at the beginning of 2014. In this connection, the Bank paid particular attention to the use of

(1) Commission Delegated Regulation (EU) n° 604/2014 of 4 March 2014.

mechanisms to help ensure that the remuneration policy is linked to the institutions' risk management.

This fourth horizontal analysis showed that the principles concerning the linking of risk and remuneration policy are generally applied. In this context, the Bank stresses the importance of transparency, not only in relation to itself but also vis-à-vis the various stakeholders. In particular, each institution's remuneration policy must meet the following requirements: (i) exact description of the various components of fixed and variable remuneration; (ii) use of clear definitions and criteria to measure performance and adjust risks; (iii) clear description of the decision-making process on remuneration for Identified Staff, particularly the method of deciding on performance assessment and risk adjustment; (iv) clear description of the interaction with the group's remuneration policy in the determination of bonus pools for the various activities.

In addition, the specific decision-making process concerning performance assessment and risk adjustment must be adequately documented, particularly as regards the interaction between the use of risk-sensitive parameters and discretionary adjustments. Although the Bank understands that decisions are rarely automatic and often require a qualitative judgment, it calls for additional efforts to ensure transparent documenting of the decisions adopted. That enhanced transparency should enable all stakeholders to understand how the (abstract) remuneration policy results in the actual remuneration packages.

In regard to deferral and retention periods, the Bank finds that, overall, these measures are generally limited to the legal minimum and that, in any case, they hardly vary according to differences between staff. The Bank calls for additional efforts in this respect, and refers to the EBA guidelines on remuneration policies and practices, which will incidentally be updated during 2015 to take account of the experience gained since they were first applied in 2011 and the changes made following the CRD IV.

The Bank also expects every credit institution to examine how it will comply with the requirement whereby at least 50 % of all variable remuneration must comprise an appropriate balance between shares or equivalent instruments and, if possible, other capital instruments mentioned in the law. The conditions under which the said capital instruments can be used for variable remuneration are listed in the regulatory technical standards adopted by the European Commission [1].

Finally, on 13 June 2014, the EBA published a report on remuneration practices in the European Union covering the performance years 2010 to 2012. That report is based on remuneration data gathered from a representative number of institutions by the national supervisory authorities, including the Bank. The report reveals a general upward trend in the remuneration of Identified Staff, and a significant degree of switching to fixed rather than variable remuneration. It also highlights a number of other trends at EU level, notably in regard to the number of Identified Staff and the composition of the remuneration.

The EBA has updated the two guidelines relating to this data-gathering. These EBA guidelines, which were implemented in two Bank circulars [2], take the form of harmonised templates to be used by all European supervisory authorities. The first round of data-gathering was completed on 30 November 2014 and concerned performance in 2013. From now on, institutions will have to supply data by no later than the end of June each year.

(1) Commission Delegated Regulation (EU) No. 527/2014 of 12 March 2014.
(2) Circulars NBB_2014_08 and NBB_2014_09.

2. Insurance : preparation for the transition to Solvency II

2.1 International developments : amendments to Solvency II by Omnibus II

The Omnibus II Directive

In 2014, following a lengthy gestation period, the Omnibus II Directive[1] was adopted. Among other things, it amends the Solvency II Directive[2] in two key areas. The first aim is to introduce various measures concerning the technical provisions to compensate for the high volatility of the liabilities due to the calculation methods imposed by the Solvency II Directive. The second aspect concerns adapting the respective powers of the EC and EIOPA and the procedures relating to the Directive's implementing regulations in line with the new hierarchy of European legal rules introduced in the Treaty establishing the European Union (the Level 2 rules).

The Omnibus II Directive also made other changes, notably in regard to determination of the scope of groups subject to the provisions of the Solvency II Directive and the supervision of certain forms of reinsurance and securitisation vehicles.

Measures concerning long-term liabilities

The Solvency II Directive requires the technical provisions to be calculated by discounting outgoing flows (compensation payouts in respect of claims, redemptions, etc.) and incoming flows (premiums, investment income, etc.) so as to arrive at the best estimate of the technical provisions. This discounting is based on the relevant risk-free interest rate curve, each of those rates differing according to the discounting period. Use of this method causes volatility in the technical provisions in proportion to the volatility of the interest rates used to calculate the said curve. Since such volatility is not very compatible with the long-term liabilities of insurers and reinsurers, particularly in regard to life business, the Omnibus II Directive aims to rectify this undesirable effect via various measures.

The first measure concerns the extrapolation of the relevant risk-free interest rate curve, applicable once the bond markets are no longer considered deep, liquid and transparent, i.e. generally for terms longer than 20 years. The curve thus extrapolated tends towards a single interest rate, known as the ultimate forward rate for terms of more than 40 years.

A second measure is the option of applying a matching adjustment to the relevant risk-free interest rate curve. That matching adjustment is equivalent to the difference between the single rate that would have to be applied to liabilities to obtain the best estimate, and the single rate that would have to be applied to those same liabilities to find the value of the assets allocated to cover them. However, the matching adjustment must exclude the fundamental spread that takes account of the probability of default or depreciation of the assets. The application of the matching adjustment is subject to strict conditions, the main ones being that the undertaking must have a ring-fenced fund for the business concerned and must confine itself to single-premium life insurance contracts.

(1) Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No. 1060/2009, (EU) No. 1094/2010 and (EU) No. 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority).

(2) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking up and pursuit of the business of insurance and reinsurance.

The third measure is the option of applying a volatility adjustment to the relevant risk-free interest rate curve. That adjustment is equal to the difference between the interest rates of a reference asset portfolio that may be used to cover the technical provisions, and the rates of the relevant risk-free interest rate curve. That difference is calculated for each currency, and the reference asset portfolio is representative of the insurance and reinsurance products sold on each national market.

The measures on long-term liabilities also include extension of the recovery period applicable to undertakings in the event of a breach of the solvency capital requirement (SCR). While a recovery plan must not normally take longer than nine months, the supervisory authorities may extend that period to a maximum of seven years in the event of the three exceptional circumstances specified by the Directive, namely a sudden, steep fall in financial markets, a persistent low interest rate environment, or a high-impact catastrophic event. The exceptional circumstance must also affect a large part of the market or lines of business concerned, and must have been declared by EIOPA. Of course, the seven-year period is a maximum and the supervisory authorities may specify a shorter period depending on the particular case.

In addition to the four measures described above, there are two transitional provisions. The first, which applies to risk-free interest rates, authorises insurers and reinsurers to replace the rate derived from the relevant risk-free interest rate curve with the rate applicable to the contracts, in accordance with the current legal rules, less the difference between a rate representing the average interest rate on the undertaking's liabilities and the single interest rate which, if it were applied to outgoing financial flows, would permit calculation of the best estimate of the technical provisions. The reduction on account of this difference ranges linearly over 16 years. The measure only concerns contracts concluded before 1 January 2016, excluding renewals of such contracts after that date.

The second transitional measure applies to the technical provisions and concerns all the activities of insurance and reinsurance companies. It enables those companies to switch gradually from the amount of the technical provisions calculated according to the current standards to the amount calculated according to the Solvency II Directive. That is a linear process spread over 16 years.

It should be added that the companies cannot apply all the measures described above simultaneously. Thus, the matching adjustment excludes the volatility adjustment and the transitional measure on risk-free interest rates, and the two transitional measures are mutually exclusive.

The Level 2 rules

In its original version, the Solvency II Directive stipulated that – depending on the case – the EC could or must take measures to implement various technical aspects. Article 301(1) of the Solvency II Directive specified only that the EC "shall be assisted by the European Insurance and Occupational Pensions Committee".

In the new hierarchy of implementing rules under the Directive, the Level 2 rules are divided into three groups according to their initiator, their aim and whether or not the European Parliament and the Council have a right of objection. On the basis of these three criteria, a distinction is made between delegated acts, regulatory technical standards and implementing technical standards.

In all cases, the Level 2 rules require express provision for the delegation of power under the Solvency II Directive. The rules are adopted by the EC in the form of a European Regulation.

TABLE 3 LEVEL 2 RULES

Type of act	Initiative	Adoption	Right of the Parliament and the Council to object
Delegated act	European Commission	European Commission	Yes
Regulatory technical standard	EIOPA	European Commission	Yes
Implementing technical standard	EIOPA	European Commission	No

Source: NBB.

Phasing-in of the Solvency II Directive

The date for entry into force of the Solvency II Directive is set at 1 January 2016. However, the national supervisory authorities must be able to take certain decisions in 2015 in order to ensure a phased introduction.

Thus, from 1 April 2015, the supervisory authorities will be able to approve the use by insurance and reinsurance companies of ancillary own funds, specific parameters in the standard formula for calculating the required solvency capital, internal models for calculating that capital, and the use of various measures relating to long-term liabilities such as those described above. From that same date, the supervisory authorities must be able to determine the scope of groups of companies, identify the group supervisor and establish the college of supervisors for each such group.

From 1 July 2015, the supervisory authorities will be able to take a range of decisions concerning group supervision (deduction of participations, choice of method of calculating the required solvency capital, equivalence of third-country regimes, etc.) or concerning the various transitional measures.

Options introduced by the Omnibus II Directive

During the year under review, the Bank gave its opinion on the two new options offered to the Member States by the Omnibus II Directive. The first option concerns whether to make use of the volatility adjustment for the relevant risk-free interest rate term structure subject to prior authorisation by the supervisory authorities. The Bank decided in favour of a simple notification, since there is only limited scope for refusing use of the volatility adjustment in advance. The notification will enable the Bank to identify and monitor the companies using this technique. The second option is a transitional measure permitting some, but not all, group companies to use the group's internal model up to 31 March 2022. Although the situation concerned does not appear to arise in practice in Belgium, the Bank decided to remove the option for cases where it did arise.

2.2 National developments

Annual accounts of insurance and reinsurance companies

The statutory annual accounts of Belgian insurance companies are currently governed by a specific Royal Decree on accounting[1]. As in other economic sectors, the primary purpose of these annual accounts is to provide information for the public (policy-holders, investors, creditors, staff, etc.), to determine the companies' tax base and to apply certain rules to the companies' activities (dividend payable, minimum capital, bankruptcy, employment law, subsidies, etc.). For the insurance and reinsurance sector, the statutory annual accounts also form the basis of prudential reporting.

This link between the statutory accounts and the prudential provisions will be severed in 2016 on entry into force of the Law transposing the Solvency II Directive, partly because the Directive does not contain a section on statutory accounts and partly because the valuation rules are not comparable in the two reference systems. While the statutory accounts are based mainly on valuation at amortised cost which expresses a realised result, Solvency II adopts a transfer value approach which is quite similar to fair value, expressing the current value of future profits and losses from the point of view of an immediate transfer.

The alternative of basing the statutory accounts on the International Financial Reporting Standards, many of which refer to fair value, cannot be used because of the link between the annual accounts and taxation.

The Bank therefore proposes to maintain the current approach to the statutory accounts but with specific adjustments for insurance and reinsurance companies. The assets will therefore continue to be valued at amortised cost. The profit and loss account will only record income actually realised. Conversely, for the sake of prudence, permanent unrealised losses will be expressed as downward valuations. For consistency with the asset valuation, the current approach will also be maintained for the liabilities, and especially for the technical provisions. However, some of the rules from the current prudential framework will be incorporated, notably in regard to the flashing-light provision[2].

Profit-sharing

The approach adopted in regard to the statutory accounts also makes it possible to continue calculating profit shares on the basis of those same accounts. Nonetheless, the Bank proposes to introduce changes to take account not only of the profits realised by the

(1) Royal Decree of 17 November 1994 on the annual accounts of insurance and reinsurance companies.

(2) Insurance companies whose portfolios comprise contracts with a guaranteed interest rate well above the yields currently obtainable on the financial markets are required to form an additional technical provision, known as the flashing-light provision.

insurance company but also its solvency position and future profitability prospects.

The first concern is to prevent an insurance company from distributing profit shares when its profit is due to exceptional circumstances. To that end, the distribution of profit shares will be subject to a solvency ratio calculated on the basis of the new prudential standards, taking account of the transitional provisions (see section 2.1 of this chapter) that the company implements in order to meet the capital requirements.

The second concern is to prohibit any distribution of profit shares if that is not compatible with the profits that the company is most likely to make in future years while also limiting the amount that can be allocated to the contracts in any one year.

Management committee

For many years now, the prudential supervision authority has recommended all insurance and reinsurance undertakings to set up a management committee in accordance with Article 524*bis* of the Company Code, so as to cope as effectively as possible with the challenges presented by the increasing complexity of conducting the business of financial institutions and the ever more stringent prudential supervision requirements.

The establishment of a management committee, which in principle consists solely of directors, has the advantage of legal certainty, since the Company Code offers a complete framework for the extensive powers delegated to the committee to conduct the effective management of the company, including powers of external representation. The committee also permits clear separation between the management functions devolved to the management committee and the supervisory functions reserved for the board of directors. From that perspective, the management committee has an important advantage over delegation confined to day-to-day operations in that the latter involves the intervention of the board of directors in all acts not covered by that concept. As a result, the board is unable to perform its supervisory function to the full. The formation of a management committee also has the advantage of collegial operation, implying equality, mutual supervision and equal access to information for its members.

In the absence of any legal obligation, the Bank could only recommend the establishment of a management committee, notably via circulars addressed to undertakings subject to supervision. That is why, without waiting for the legislation transposing the Solvency II Directive, a law of 25 April 2014[1] amended the Law on insurance supervision[2] in order to oblige insurance and reinsurance companies to set up a management committee.

The Law on insurance supervision now includes the obligation on insurance undertakings established in the form of a public company to set up a management committee in accordance with Article 524*bis* of the Company Code. This obligation is extended to insurance companies established in another legal form, notably mutual insurance associations. However, with due regard for the size and risk profile of the undertakings concerned, the Bank may grant waivers in respect of the composition or even the formation of a management committee. The said Law of 25 April 2014 made the same changes to the Law on reinsurance supervision.

Recovery and resolution

A number of initiatives have been taken at international level concerning the recovery and resolution of insurance and reinsurance undertakings. For instance, in 2013, the International Association of Insurance Supervisors (IAIS) formally recommended that all global systemically important insurers (G-SIIs) should draw up and finalise recovery and resolution plans before 2015.

At European level, the European Commission opened a consultation in October 2012 concerning the framework for the recovery and resolution of financial institutions other than banks, in which it found that the recovery plans devised by systemic insurers could help to stabilise those institutions if they were confronted by a financial or operational shock. Once the consultation was over, the European Commission announced its intention to initiate legislation on the resolution framework applicable to financial institutions other than banks.

The legislation currently in force in Belgium stipulates various "plans" for insurers or reinsurers encountering severe financial problems and, more particularly, for those which no longer have the level of capital required by the supervision legislation. The major difference between these plans and the ones envisaged by the international recommendations is that they are drawn up *ex post*, i.e. only after it emerges that there are problems. In contrast, the international recommendations advocate the obligation to draw up this type of plan *ex ante*, namely before the institutions get into difficulties.

(1) Law of 25 April 2014 containing miscellaneous provisions.
(2) Law of 9 July 1975 on the supervision of insurance undertakings.

In the light of the above, the Bank launched a pilot project with an insurance company, even though the preparation of a recovery plan had initially concerned credit institutions. This pilot project was conducted and evaluated in 2014.

Supervision of occupational pension providers

At the end of 2013, the Bank and the FSMA had each submitted a report to the Minister for Economic Affairs concerning the organisation of the supervision of occupational pension providers. The lawmakers opted for the status quo, namely maintenance of FSMA supervision of institutions providing occupational and supplementary pensions[1].

2.3 EIOPA stress tests

On 30 April 2014, EIOPA launched its second stress test for the European insurance sector. That exercise was based on the latest known technical specifications of the future Solvency II regime. Part of the Belgian insurance sector participated in this stress test under the supervision of the Bank. The test comprised two quantitative modules, each supplemented by a number of qualitative questions:

– A core – or basic – module testing the financial resilience of the insurance sector via two consistent scenarios relating to market risks (core 1 and core 2) and via a range of sensitivity tests relating to insurance techniques. In the two market scenarios, insurers were subject to a range of stresses relating mainly to market risks, namely interest rate risk, credit risk (resulting from widening credit spreads), equity risk and real estate risk. The main feature of the core 1 scenario comprised increased levels of stress for government bonds, equities and property, while the core 2 scenario consisted primarily of higher stress levels for corporate bonds. The specific sensitivity tests chiefly concerned the risks relating to insurance techniques, namely mortality risk, the risk of longer life expectancy, the risk of natural disasters, the risk of rising inflation weighing on the amount of the claims provisions, and the surrender risk.

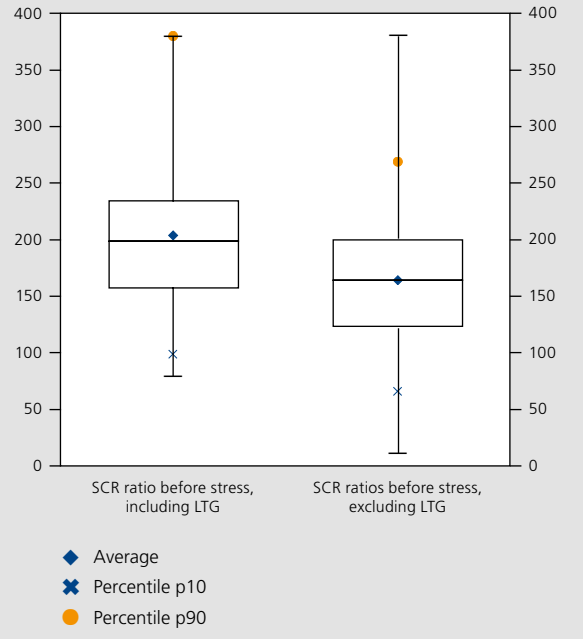
– A low-yield satellite module which specifically concerns the low interest rate environment. In this module, two possible risk-free interest rate curves are tested, namely a curve reflecting a Japanese-style scenario, with low interest rates throughout all terms, and an "inverted" curve with an increase in short-term rates and a fall in long-term rates.

At Belgian level, a total of 19 undertakings took part in the stress tests, 9 of them for the core module and 17 for the low interest rate module. On a solo basis in Belgium, the participation rate thus came to 62.6 % for the core module (in premium volume) and 96.35 % for the low interest rate module (in the volume of the technical provisions)[2]. The results for the Belgian market are aggregated and discussed below.

For all 19 stress test participants, the chart shows a box plot[3] of the distribution of the SCR ratio[4] before application of the test. The average SCR ratio calculated on the basis of the standard Solvency II formula came to 204.39 % before the test, indicating a comfortable starting position. In that regard, however, it should be noted that the companies were free to apply long-term guarantee measures (LTG). Once the Solvency II regime enters into

CHART 5 SCR RATIOS – SITUATION BEFORE THE STRESS TEST

(box plot[1], in %)



Sources: NBB.

(1) A box plot is a simplified presentation of the data distribution; read from the bottom to the top, it shows the minimum values, the first quartile, the median, the third quartile and the maximum.

(1) Article 53, 7°, of the Law of 19 April 2014 inserting book VII "Payment and credit services" in the Economic Code, and inserting definitions specific to book VII and penalties for infringements of book VII, in books I and XV of the Economic Code, and containing various other provisions.

(2) EIOPA was only given the results for some of these firms, enough to satisfy the minimum participation required by EIOPA, namely a market share of at least 50 %. This part of the stress test concerned 3 insurance groups/companies for the core module and 5 insurance companies for the low interest rate module.

(3) A box plot is a simplified presentation of the data distribution; read from the bottom to the top, it shows the minimum values, the first quartile, the median, the third quartile and the maximum.

(4) The SCR ratio is calculated as the ratio between the own funds and the capital requirements.

force, most of those LTG measures will have to be approved by the supervisory authority. However, no restrictions were imposed for the stress test, which makes it difficult to compare the results and interpret them unequivocally. That is why the chart makes a distinction between the results with and without the LTG measures. Of the 19 companies, 5 opted not to apply LTG measures. On the basis of the pre-test results, these LTG measures had an average impact of 40.8 % on the SCR ratio (average SCR ratio without LTG = 163.6 %).

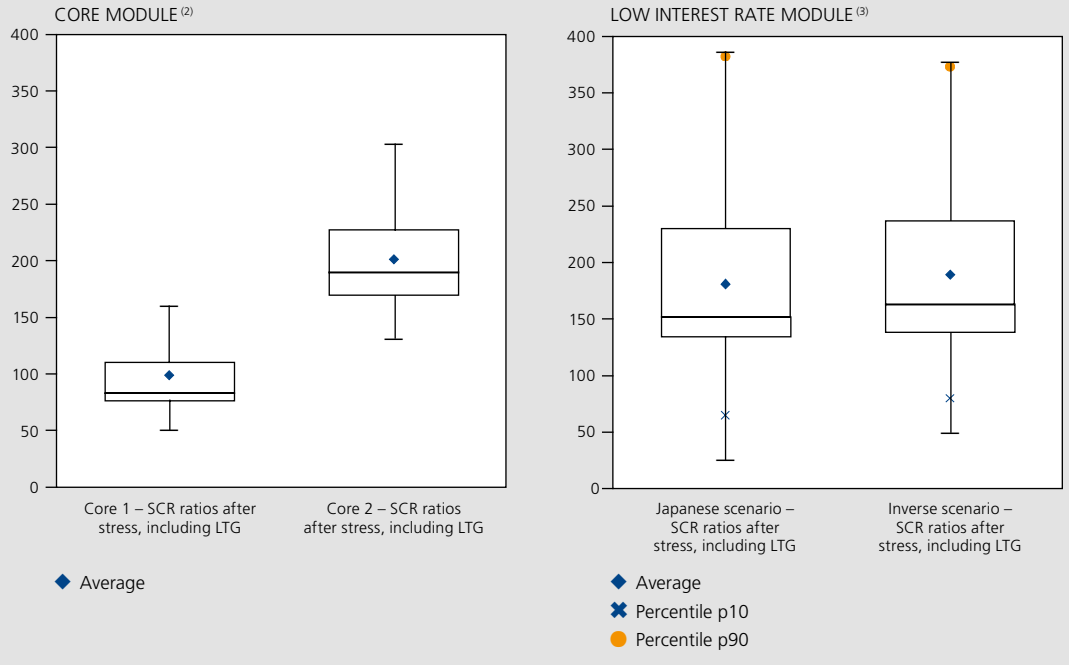
Next, the box plot on the left-hand side of the chart shows the distribution of SCR ratios following application of the two market scenarios. The chart shows that, for the 9 participants in the core module, it is mainly the first core scenario that has a marked impact on the Belgian participants. The average SCR ratio including LTG measures came to 99.1 % after core 1 and 201.3 % after core 2. As expected, the sudden shock to spreads on certain government bonds combined with the sudden shock affecting equities (41 %) and property (49 % for commercial property) and the lack of any compensatory downward effect from the decline in swap rates on the bond portfolio (see the double-hit principle[1]) had a significant impact at sectoral level.

Finally, the box plot on the right-hand side of the chart presents the distribution of the SCR ratios for the 17 participants in the low interest rate module. This shows that the impact of the two changes in the yield curve was generally similar. The Japanese-style scenario proved to be the most severe; that was predictable, given the still high guaranteed rates on certain products prevailing on the Belgian market. The average SCR ratio including LTG measures came to 181.3 % for the Japanese scenario and 189.1 % for the inverse scenario. Depending on the scenario, the proportion of firms failing to meet a 100 % SCR ratio came to 24 and 18 % respectively. Obviously, the results of this EIOPA stress test will be a significant input in the definition of the priorities and tasks for operational supervision in the context of the preparations for the future Solvency II regime.

(1) The double-hit principle meant that the decline in risk-free swap rates was offset by a widening spread on bonds in the interest rate module, which implied that bond values remained unchanged in this module. On top of this effect, one should add the increase of the spread following the spread module.

CHART 6 SCR RATIOS – SITUATION AFTER THE STRESS TEST

(box plot[1], in %)



Source: NBB.

(1) A box plot is a simplified presentation of the data distribution; read from the bottom to the top, it shows the minimum values, the first quartile, the median, the third quartile and the maximum.

(2) The data concern 9 participants.

(3) The data concern 17 participants.

3. Central Securities Depositories Regulation and recovery plans for financial market infrastructures

3.1 Central Securities Depositories Regulation

Central securities depositories (CSDs) are transaction-processing infrastructures that ensure the smooth functioning of the financial markets and guarantee that securities transactions will be executed properly and on time, including in periods of extreme stress. Owing to their key position in the settlement process, CSDs are of systemic importance for the functioning of the securities markets. CSDs are also vital intermediaries in the provision of collateral.

The lack of common prudential rules in the EU implies additional costs and risks for cross-border transactions and is detrimental to security, efficiency and competition on cross-border markets. The CSD Regulation[(1)] which came into force on 17 September 2014, introduces uniform prudential rules applicable to the authorisation, supervision and organisation of CSDs and introduces a harmonised settlement cycle for transactions on regulated markets. This European Regulation generally reflects the international principles for financial market infrastructures laid down by the Committee on Payments and Settlement Systems and the International Organisation of Securities Commissions (CPSS-IOSCO). One of the CPSS-IOSCO principles requires CSDs to settle the "cash" leg of securities transactions wherever possible by means of accounts held with a central bank, in order to avoid credit risk and liquidity risk. If that is not practicable, the CSD may, under certain conditions, effect settlement via accounts with a credit institution or by offering cash accounts itself. The CSD Regulation specifies that any CSD authorised as a credit institution and any credit institution designated to settle the cash leg of transactions must confine their activities solely to the ancillary banking activities listed in the Regulation.

The CSD Regulation also stipulates that, in the EU, all securities admitted to trading or traded on regulated platforms must be recorded in book-entry form, in order to increase the efficiency of settlement and ensure the integrity of securities issues. The CSD Regulation allows issuers to choose any CSD established in the European Union for recording their securities and providing the CSD services that they deem appropriate; this enables issuers to choose the best offer for the administration of their securities.

In addition to the CPSS-IOSCO principles, the CSD Regulation also provides for a penalty regime and buy-ins – aiming to penalise failure to settle transactions on the intended settlement date.

3.2 Recovery plans for financial market infrastructures

In accordance with the CPSS-IOSCO principles for financial market infrastructures, the latter must draw up recovery plans to ensure the continuity of their critical services in the event of financial stress. In that connection,

(1) Regulation (EU) No. 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No. 236/2012.

the Committee on Payments and Market Infrastructures (CPMI[1]) and IOSCO published guidance in October 2014 on the drafting of these recovery plans. That will be incorporated in EU legislation in the near future.

According to that guidance, the recovery plan must comprise the following main elements : the list of critical services that the infrastructure provides, the extreme scenarios considered, the triggers for implementation of the plan, and the recovery tools.

In Belgium, this international guidance applies in particular to the various Euroclear entities. The Bank is currently examining the conformity of the recovery plans of these CSDs.

The evaluations are coordinated with the supervisory and oversight authorities of the other CSDs belonging to the group. This coordination is vital to ensure that the various plans are consistent.

(1) The Committee on Payment and Settlement Systems (CPSS) was renamed the Committee on Payments and Market Infrastructures (CPMI) on 1 September 2014. The old name is used for reports prior to that date.

4. Macroprudential policy

4.1 The Bank's new powers

The Law of 25 April 2014[1] designated the Bank as the macroprudential authority. This new mandate was incorporated in the Bank's Organic Law as an element of its mission of contributing to financial stability. Belgium has thus complied with a recommendation by the European Systemic Risk Board (ESRB) asking each EU Member State to officially designate such an authority.

However, the recent allocation of that function to the Bank does not imply that it had not already been involved for a long time in supervising the stability of the financial system as a whole. Thus, its Organic Law already stated that the Bank was to contribute to financial stability. In that context, the Bank conducts analyses, and since 2002 has published a Financial Stability Review (FSR), to identify and assess the various factors that may impair the resilience of the financial sector. However, the new mandate introduces formal arrangements for performing that mission and gives the Bank specific means of action.

For instance, the Bank now has the power to ask for relevant information and statistical data necessary for performing its mission, not only from institutions under its supervision but also from any other entity that could create systemic risks, such as financial institutions not directly subject to regulation (e.g. entities in the shadow banking system). The Bank can also make recommendations if it considers that certain authorities or entities need to implement measures to prevent the occurrence of systemic risks.

(1) Law of 25 April 2014 establishing mechanisms for a macroprudential policy and defining the specific tasks delegated to the National Bank of Belgium as part of its mission to contribute to the stability of the financial system.

More fundamentally, the new Law offers the Bank a wide range of instruments for use in the event of a potential risk to financial stability. Some of those instruments had been initially intended solely for microprudential purposes, but they may also be used from a macroprudential perspective. For example, the Bank can impose additional capital requirements – such as the leverage ratio – or liquidity requirements, either in general or more specifically targeting certain risk exposures. Furthermore, limits can be set for certain types of counterparties or categories of business. Other instruments are more macroprudential in character. They include measures concerning mortgage debt in relation to the value of the property, or the level of debt repayments in relation to income. These last measures can be implemented by the government, notably on the recommendation of the Bank.

Breaches of the legal provisions may attract penalties in the form of fines. In view of the importance of these new tasks, the law also stipulates that the Bank must report to Parliament on the performance of its mandate, in particular by publishing an annual report. To meet that requirement, the Bank decided that the FSR would be replaced from 2015 by a special report which will also include a description of the risks to financial stability, an overview of any recommendations made by the Bank as the macroprudential authority, and an activity report.

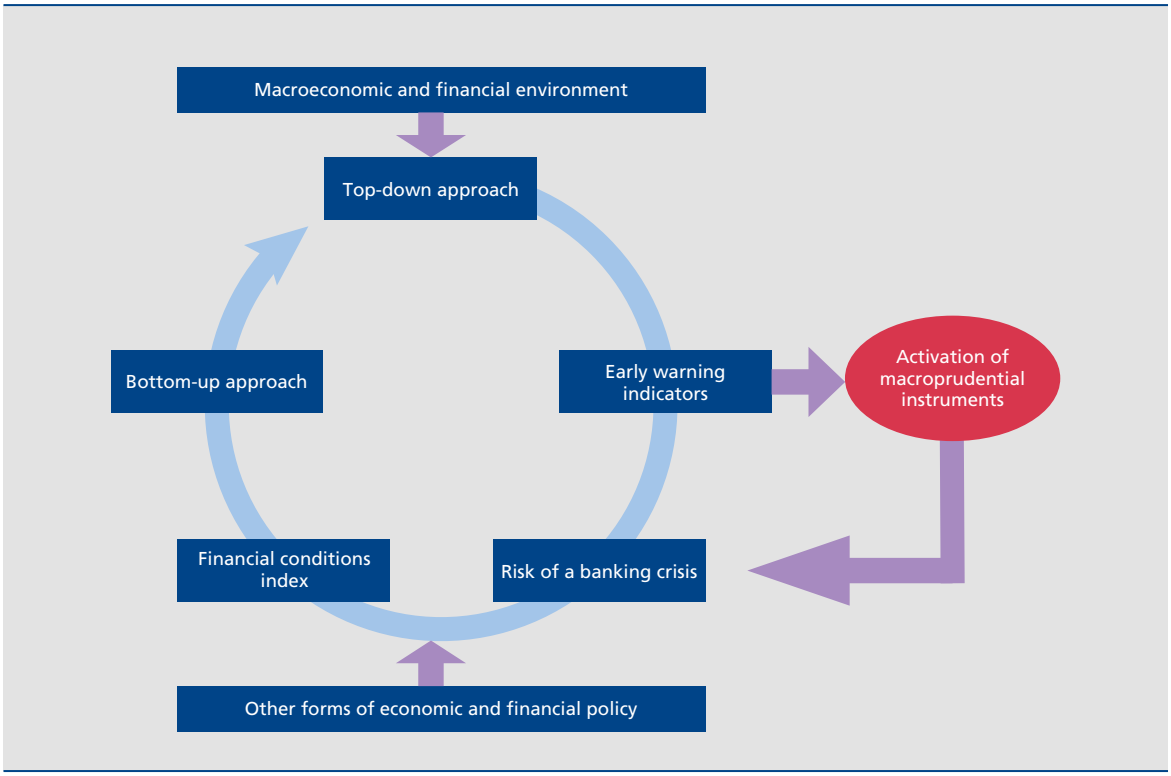
4.2 Exercise of macroprudential powers by the EU and the ECB

In so far as the macroprudential policy can be activated to avert financial instability risks resulting from cyclical or structural developments, that policy clearly has a national dimension. However, the European financial markets have now become closely integrated following the completion of the Single Market in the EU, the introduction

Box 3 – Analysis of macroprudential risks

The maintenance of financial stability implies two main aims for macroprudential policy. The first, which concerns the cyclical dimension, is to restrain the development of systemic vulnerabilities in certain periods by forming financial buffers to absorb the effects of aggregate systemic shocks and help to maintain lending to the economy in a recession. The second aim is to control the structural systemic risks resulting from vulnerabilities such as the interactions between financial intermediaries, the concentration of institutions' exposures and the crucial role that they play on significant markets, all factors which may make them too big to fail.

ANALYSIS OF MACROPRUDENTIAL RISKS AT THE BANK



Source: NBB.

An effective macroprudential policy is not possible without regular, detailed analysis of the risks that may threaten financial system stability and the resulting vulnerabilities for systemic financial institutions or for the sector as a whole. The macroprudential risk analyses that were conducted and debated at the Bank by various committees during the year under review were based on three different pillars which were examined side by side to arrive at an overall view. Those three pillars can be described respectively as a top-down approach, a bottom-up approach and a modelled identification of the potential threats to the financial stability of the Belgian financial sector.

– The top-down approach is based on analysis of general economic and financial developments backed by the assessment of the relevance of a whole range of economic parameters such as economic growth, macroeconomic imbalances, interest rate levels, the sustainability of public finances, the trend in lending, the financial situation of households and businesses, the trend in house prices, etc. This approach consists in determining the potential risks to the profit and loss account and balance sheet of Belgian banks, insurers and financial market infrastructures, and the associated consequences for financial stability.

– The bottom-up approach aims to establish the main points for attention in the ongoing risk analyses in the departments of the Bank responsible for the microprudential supervision of Belgian banks, insurers and financial market infrastructures. Those points emerge in particular from the analysis of developments specific to the various institutions viewed individually, and the sector-specific challenges, and may or may not be connected with changes in the macrofinancial parameters.
– The third pillar is an approach based more on models and intended to detect potential threats to the stability of the Belgian financial sector. It consists in first determining thresholds for a broad range of indicators concerning a number of sectors in the economy. Each threshold determines the intensity of the risk signal given by the indicator for a specific prediction horizon. Various methods are used to specify these thresholds, including a statistical methodology for devising early warning indicators to prevent bank crises. Next, the information supplied by the many indicators is collated in aggregate systemic risk readings. These aggregate values give the estimated probability of a banking crisis over a specified prediction horizon on the basis of a logistical function that links the indicators to past banking crises, and using a financial conditions index (FCI) calculated on the basis of a series of indicators relating to credit trends, the banking sector, the level of debt in the economy, the property market and current developments on the financial markets. Sub-indices are calculated for each aspect and are then aggregated into an FCI, taking account of their weightings and any endogeneity in the risks.

This macroprudential risk analysis forms the basis for defining areas of potential risk that require more detailed analysis, and for deciding on potential policy measures to be taken, including the activation of macroprudential instruments. The expected or actual effects of such measures taken previously are then incorporated in subsequent risk analyses.

of a common currency in the euro area, and the recent establishment of the SSM. As a result of these changes, Member States can no longer take action in isolation. The use of the macroprudential instruments is therefore circumscribed by European legislation to prevent uncontrolled use for the purpose of circumventing the harmonised banking and financial regulations (single rule book).

Within the limits set by the European legislation, the conduct of macroprudential policy is a competence shared by the euro area countries and the ECB. The SSM Regulation provides that, so long as they inform one another in advance, both the national competent authorities and the ECB may impose macroprudential requirements for systemic purposes. It follows that these respective powers will reinforce and supplement one another. However, the SSM Regulation allows the ECB to tighten up the regulatory requirements for macroprudential reasons by using instruments provided for by European legislation, but it cannot relax those requirements.

To maintain some cohesion in the respective powers and thus ensure that a coordinated macroprudential policy is implemented at the level of the SSM, internal structures were set up in the ECB bringing together all the national central banks or national supervisory authorities and the ECB. These arrangements are consistent with those set up at SSM level in order to ensure a degree of harmonisation and to optimise the development of macroprudential policy in Belgium[1].

4.3 Implementation of macroprudential policy in Belgium

In 2014, the Bank's Board of Directors met on two occasions, on 14 May and 7 October, in connection with its new macroprudential tasks. Each of these meetings at which the Bank acts officially as the macroprudential authority is preceded by preparation and coordination meetings between the Bank's services closely involved in monitoring developments on the markets and in financial institutions. During these consultations, attention focuses first on the major risks which could damage financial stability. The Bank also proceeded to phase in a conceptual framework for the selection, calibration and assessment of the macroprudential policy instruments. Box 3 presents a general outline of this new reference framework.

(1) Collin M., M. Druant and S. Ferrari (2014), "Macroprudential policy in the banking sector: framework and instruments", Financial Stability Review, National Bank of Belgium, 85-97.

At its first meeting on 14 May, the Bank confirmed two macroprudential measures. Taking account of the recent property price rises and the economic uncertainty that could hamper borrowers' future repayment capability, the Bank decided to increase by 5 percentage points the risk weighting ratios applied to mortgage loans, as those ratios were significantly lower than the ones in force in most neighbouring countries, reflecting the absence of any serious property crisis in Belgium in recent decades[1]. For that purpose, the Bank made use of Article 458 of the CRR[2] and obtained authorisation from the European authorities to do so. Also, in the context of discussions on the need for structural reforms in the banking sector, the Bank decided to impose a capital surcharge on trading activities above a certain threshold. This capital surcharge will be applied under pillar 2 as a macroprudential measure, in accordance with Articles 103 and 104 of the European CRD IV Directive transposed into Article 154 of the Banking Law.

Apart from these measures, the Bank maintained a close watch on risks to financial stability in Belgium. As explained in chapter 3, section 3.4 of the part of the Report on "Economic and financial developments", the Bank was alert to the impact of the economic gloom on the financial situation of banks and insurance companies. Taking account of the constant pressure on the profitability of financial institutions, in its press release at the end of the second meeting on 7 October 2014, the Bank urged financial institutions to continue their restructuring process and their rationalisation programme. Banks and insurers must further improve their solvency position and, to that end, they must if necessary limit the distribution of profit shares to their customers and the payment of dividends to their shareholders in order to safeguard their business in the long term. For the same reason, the Bank also urged insurers to be cautious when considering the realisation of profits. Moreover, the Bank takes the view that the maximum guaranteed interest rates for new group and individual insurance contracts must be reduced to offer a more accurate reflection of market conditions.

Finally, particular attention also focused on commercial property market developments and the growing importance of commercial property in the portfolio of Belgian financial institutions in recent years. In that context, banks and insurers were asked to improve the exhaustiveness and accuracy of the data on the commercial property market and to arrange regular appraisal of their collateral by outsiders, in order to ensure that those assets are correctly and prudently valued in their balance sheet.

(1) "The Belgian mortgage market: recent developments and prudential measures", Financial Stability Review, National Bank of Belgium, 113-122.

(2) Article 458 of the CRR offers the national competent authorities increased flexibility in the event of the emergence of systemic risks in cases where the macroprudential instruments explicitly provided for by the CRD would be inappropriate or insufficient. However, that additional flexibility is strictly regulated by the various international institutions which, in this regard, apply relatively onerous mandatory procedures for the notification of the competent European institutions (EBA, EC, ESRB).

5. Supervision framework applicable to all sectors

5.1 Measures to combat money-laundering

Mutual evaluation of Belgium by the Financial Action Task Force

In the initial months of 2014, the Belgian authorities responsible for combating money-laundering and the financing of terrorism and the proliferation of weapons of mass destruction (AML/CFT) continued the preparations for the fourth mutual evaluation of Belgium by the Financial Action Task Force (FATF) that had begun in 2013 [1]. As the supervisory authority, the Bank contributed to this important effort. This work was carried out in accordance with the new mutual evaluation methodology [2], which is an extension of the 40 new recommendations adopted by the FATF in February 2012 [3].

At the end of 2013, the information necessary for assessing the technical compliance of the current provisions with all the requirements of the FATF standards had been forwarded to the evaluation team. Next, in January 2014, the Belgian authorities compiled the information dossier and passed it to the assessors for the evaluation of the effectiveness of the AML/CFT mechanisms applied. Those authorities also had to answer a very large number of additional questions that the assessors raised in order to complete their understanding of those mechanisms.

After acquainting themselves with this large volume of information, the FATF assessors spent more than two weeks on a visit to Belgium. The detailed talks with the various Belgian authorities concerned and with the representatives of the financial institutions and non-financial undertakings and professions subject to the AML/CFT obligations enabled the assessors to enhance and clarify their analyses. These meetings were held on the basis of a "scoping note" identifying the main risks facing the country and the main questions arising from the information supplied in advance.

Following this site visit, there was continuing close contact between the assessors and the Belgian authorities throughout the second half of 2014, in a dialogue aimed at refining the draft mutual evaluation report on Belgium. That report will be mainly concerned with determining the effectiveness of AML/CFT in Belgium on the basis of the evaluation of the technical compliance of the legal and regulatory framework which is an essential precondition.

In this connection, it must be stressed that, in order to avoid a rapid succession of changes to the legal and regulatory framework, the Belgian authorities decided not to adapt that framework in line with the new 2012 FATF standards immediately, but to make the necessary changes for that purpose via the transposition of the 4th EU Money-Laundering Directive [4], which is currently in preparation. Since Belgium is among the first four countries to be assessed on the basis of the new international standards, that decision meant that, on the date of the evaluation, the Belgian legal and regulatory framework did not yet take full account of the innovations in those standards. Logically, that decision will mean a lower level of technical compliance than at the time of Belgium's previous evaluation in 2005. However, most of the comments that the 4th evaluation report will make in that connection will apply only temporarily, until the 4th Directive is transposed into Belgian law.

(1) See NBB, Box 3 of the part of the 2013 Report on "Prudential regulation and supervision".
(2) FATF, "Methodology for assessing technical compliance with the FATF recommendations and the Effectiveness of AML/CFT systems", February 2013.
(3) FATF, "International standards on combating money laundering and the financing of terrorism and proliferation – the FATF Recommendations", February 2012.
(4) Proposal for a Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money-laundering COM(2013)0045 – C7-0032/2013 – 2013/0025(COD).

The assessment of the effectiveness of the AML/CFT mechanisms actually implemented in Belgium will distinguish between their various components, including the application of preventive measures by financial institutions and non-financial professions subject to the AML/CFT obligations, and supervision of those measures by the competent authorities. It will also contain specific, detailed recommendations that the FATF will address to Belgium to provide even more effective protection against these harmful phenomena. As regards the supervision of financial institutions for which the Bank has competence, the FATF is likely to recommend deepening of the Bank's risk-based approach and a stronger focus on risks specific to money-laundering and terrorist financing, reinforcement of on-site inspections, and greater use of administrative penalties where serious shortcomings are found. To achieve these objectives, it will probably be recommended that the resources allocated to all these tasks should be considerably stepped up.

The evaluation report will be discussed at the FATF's plenary meeting in February 2015. It will then be made public and published on the FATF's website; after that, the FATF will ensure appropriate monitoring of the actual implementation of the specific recommendations addressed to Belgium.

The periodic questionnaire for financial institutions supervised by the Bank

During January and February 2014, the financial institutions which come under the Bank's supervisory powers responded for the first time to the periodic questionnaire on the prevention of money-laundering and the financing of terrorism drawn up by the Bank. The aim of the questionnaire is to provide systematic, uniform information on each financial institution's compliance with the legal and regulatory prevention obligations. The Bank uses that information as the basis for its assessment of the vulnerabilities of each financial institution to the risks of money-laundering and terrorist financing, that assessment being a vital element of the risk-based approach to the exercise of supervision.

In order to obtain the same quality information on payment institutions and electronic money institutions authorised in other Member States of the European Economic Area and pursuing their activities in Belgium via agents or distributors, the scope of the periodic questionnaire was also extended at the beginning of 2014 to include the ALM/CFT "central contact points" that those institutions have to designate in Belgium. Institutions with large networks of agents or distributors in Belgium, or those which engage in activities on a significant scale are now requested to answer the full questionnaire in the same way as Belgian institutions. Conversely, taking account of the principle of proportionality, an abridged version of the questionnaire was produced for institutions with smaller networks of agents or distributors in Belgium, or those operating on a smaller scale.

On the basis of the analysis of the questionnaire responses supplied for the first time in 2014 by financial institutions, and in order to further enhance the questionnaire's relevance and usefulness for supervision, the Bank also updated the questionnaire during the second half of 2014. Thus, in September 2014, it sent out the questionnaire[1] that financial institutions will be requested to answer in January and February 2015 on the basis of their situation as at 31 December 2014, as experience had shown that some questions needed to be refined and that it was desirable to add an extra chapter to the questionnaire to cover obligations concerning electronic funds transfers as well. Furthermore, an English version of the questionnaire was made available to financial institutions.

The joint NBB-FSMA circular on recent developments in the prevention of money-laundering

In 2012, significant money laundering risks associated with certain transactions in gold and precious metals involving large cash movements were discovered by the Financial Intelligence Processing Unit. Since financial institutions subject to the supervisory powers of both the Bank and the FSMA are exposed to those risks, the two authorities agreed to send all those institutions a joint circular[2] on this subject. That circular draws attention to the new legal restrictions on cash payments inserted in the Anti-Money-Laundering Law of 11 January 1993 and to the recommendations on large cash movements already contained in Circular CBFA_2010_09 of 6 April 2010. The two authorities repeated that, in general, they considered the risks associated with transactions and business dealings involving large cash movements required the application of stronger vigilance measures, whatever the customer's sector of activity.

This joint circular also draws the attention of financial institutions to the statutory extension of the underlying offences of money-laundering in the sphere of tax evasion, and to the publication of the Royal Decree establishing

(1) Via Circulars NBB_2014_11 of 22 October 2014 and NBB_2014_12 of 22 October 2014.
(2) Circular NBB_2013_16/FSMA_2013_20 of 18 December 2013 on recent developments relating to the prevention of money-laundering.

the list of the third countries with anti-money-laundering legislation equivalent to the European legislation and the European public authorities and institutions regarded as presenting low risks[1].

5.2 Auditor accreditation programme

Introduction

During the year under review, the Bank conducted two accreditation programmes for auditors wishing to take on auditing mandates, one for insurance companies (in February 2014) and another for financial institutions[2] (in October 2014). The organisation of these accreditation programmes should be viewed in the context of the particular importance that the legislature attaches to these auditors' contribution to the prudential supervision of financial institutions and insurance companies.

In Belgium, every large[3] undertaking is required to appoint a statutory auditor whose primary task is to audit the annual accounts drawn up by the undertaking. In particular, he must check whether those accounts provide a true and fair view of the undertaking's assets, financial situation and results.

Given the importance to society of financial institutions and insurance companies in the financial landscape, the Belgian legislators wanted to further reinforce the auditor's function in the supervision of these institutions as opposed to non-financial corporations. From that perspective, the law first specifies that not all auditors can be appointed as the auditor of a financial institution or an insurance company. For such institutions, the post of auditor can only conferred on auditors who have been accredited for that purpose by the Bank. Next, the law also stipulates that accredited auditors who are appointed as the auditor of a financial institution or insurance company must cooperate in the prudential supervision exercised by the Bank, on their exclusive personal responsibility. That obligation implies that, apart from the tasks relating to company law, they have to carry out a range of specific tasks in connection with the Bank's supervision of those institutions.

Auditor accreditation system : conditions

Accreditation is granted separately for financial institutions on the one hand and insurance companies on the other. An auditor accredited to fulfil auditing mandates for financial institutions therefore cannot be appointed as the auditor of an insurance company unless the Bank has also granted accreditation for that purpose.

To obtain either or both of these accreditations, every auditor must take an examination arranged by the Bank in the framework of an accreditation programme. The organisation and process of such a programme and the conditions that auditors must meet in order to obtain accreditation are described in the Bank's new accreditation regulation of 21 December 2012[4], which replaces the old accreditation regulation of the Banking Finance and Insurance Commission (CBFA).

The Bank initiates the launch of an accreditation programme by publishing a call for candidates in the Belgian Official Gazette (Moniteur belge/Belgisch Staatsblad). Auditors wishing to take part have to submit an application with a statement of reasons and a dossier to the Bank by the set deadline. The Bank can then organise a written and/or oral examination to ensure that the auditors satisfy the accreditation conditions. These conditions include[5] :

- personal registration at the Institut des réviseurs d'entreprises/Instituut voor Bedrijfsrevisoren ;
- at least five years' relevant professional work to gain sufficiently broad experience, notably in regard to the planning, organisation and execution of corporate audits ;
- detailed knowledge of the nature and technique of operations specific to financial institutions and insurance companies, and of the public supervisory regime ;
- an organisation appropriate to the execution of mandates in financial institutions and insurance companies.

Auditors who pass the examination and obtain accreditation are registered on the Bank's list of accredited auditors. That list is available on the Bank's website[6]. Accredited auditors are registered for a six-year period during which they must continue to meet the accreditation conditions. Before the expiry of this first period of six years, auditors can apply to the Bank for renewal of their accreditation for a further six years. The Bank may grant or reject such requests, giving the reasons for its decision

(1) Royal Decree of 19 July 2013 establishing the list of equivalent third countries and the list of European public authorities or institutions referred to respectively in Article 37, § 2, paragraph 1, 2° and 5° of the Law of 11 January 1993 on the prevention of use of the financial system for the purpose of money-laundering and terrorist financing, Moniteur belge/Belgisch Staatsblad of 25 July 2013.

(2) Namely : credit institutions, investment firms, financial holding companies, mixed financial holding companies, settlement institutions, electronic money institutions and payment institutions.

(3) See the criteria listed in Article 15 of the Company Code.

(4) Regulation of the National Bank of Belgium of 21 December 2012 on the accreditation of auditors and firms of auditors, approved by the ministerial decree of 28 June 2013, Moniteur belge/Belgisch Staatsblad of 9 July 2013.

(5) For a complete list of the conditions, see Articles 2 and 3 of the Bank's accreditation regulation of 21 December 2012.

(6) For financial institutions : http://www.nbb.be/pub/cp/domains/ki/li/rev_li.htm?l=fr&id=er; for insurance companies: http://www.nbb.be/pub/cp/domains/vo/li/comm_li.htm?l=fr&id=cr.

in the latter case. There is no limit to the number of times that an accreditation can be renewed.

The Bank may also revoke the accreditation at any time, e.g. if the accredited auditor no longer meets certain accreditation conditions, is no longer capable of performing his duties, or cannot demonstrate the necessary competence and diligence for fulfilling his obligations to the Bank. Finally, the accreditation expires automatically in certain circumstances, such as if the accredited auditor has not executed any auditing mandate for an institution subject to prudential supervision over a three-year period.

Special tasks and obligations of accredited auditors

Accredited auditors who are appointed as auditor for a financial institution or insurance company are required to execute certain specific tasks, in addition to the ordinary tasks described in the Company Code, in connection with their duty to cooperate in the Bank's prudential supervision. Those special tasks are described in the laws on supervision, and are specified in the circular published by the Bank [1].

The accredited auditors' assignment can be divided into two sections:

- issuing a periodic opinion (twice-yearly) on the "correct and complete" character of all the prudential and financial periodic statements that the institutions are required to submit;
- evaluating the institutions' internal control measures, including those that institutions have taken to remedy identified shortcomings.

The Bank may also ask the accredited auditors to produce a special report on the organisation, activities and financial structure of the institution of which it is the auditor.

Finally, accredited auditors are also subject to a duty to report (signal function) whereby they must submit a report to the Bank on their own initiative as soon as they become aware of any of the following in the course of their mandate for a financial institution or insurance company:

- decisions, facts or developments which could have a material influence on the institution's financial situation or on its administrative or accounting organisation or its internal control;
- decisions or fact that could constitute violations of the Company Code, the articles of association or statutes, the law or any other relevant regulation;
- other decisions or other facts which could lead to refusal or reservations regarding the certification of the annual accounts.
- other decisions or other facts which could lead to refusal or reservations regarding the certification of the annual accounts.

(1) Circular NBB_2012_16 of 21 December 2012 on the duty of accredited auditors to cooperate.

B. Prudential regulation

Introduction

There were two main factors guiding the choice of priorities for prudential supervision in 2014 and 2015. First, the continued development of the new framework for that supervision, detailed in part A, had profound implications for the implementation of prudential supervision in practice, especially with the changes to the way in which it is organised following the switch to the SSM. Also, the introduction of the various new regulatory provisions influenced the method of monitoring financial risks and organising supervision processes.

The second decisive factor in the definition of the priorities relating to financial risks and supervision processes was the adverse macroeconomic environment, which is discussed in detail in the part of the Report on "Economic and financial developments". The weak economic growth and the persistence of a low interest rate environment are particularly relevant because of their impact on the financial sector. These two factors exerted pressure on the sector's interest income, with all the ensuing implications for profitability. They could also prompt an excessive quest for high-yield assets, accompanied by riskier behaviour (search for yield).

Against that backdrop, the Bank paid particular attention to analysing the business models and profitability drivers of banks, insurers and financial market infrastructures in order to assess whether they are equipped to cope with the challenges resulting from factors relating to the macroeconomic environment and to meet the more stringent regulatory requirements, both new and future. This chapter examines the priority risks for each sector before reviewing the main aspects of operational supervision, in each instance on the basis of the mapping of the financial sector and against the background of cost-cutting in the sector. Finally, cyber risk, which is cross-sectoral, is addressed in the context of the increasing digitalisation and importance of the stored data and the amounts concerned.

1. Overview of the priorities of the annual risk reviews in 2014 and 2015

As explained in its 2012 and 2013 Reports, the Bank uses a management cycle for prudential supervision to enable the Board of Directors to give clearer guidance on prudential priorities and actions. The management cycle is based on a medium-term risk analysis (a three- to five-year master plan) and a short-term analysis (annual risk review). These priorities concern the three financial sectors, namely banks, insurers and market infrastructures. They also encompass both financial risks and more qualitative priorities, such as supervision methods and organisation.

Under the master plan for 2012-2015, the work during the year under review centred on the priorities set in the 2014 risk review and on drawing up the 2015 risk review which lists the prudential priorities up to the end of 2015. Having regard to the various reforms carried out in recent years in the financial supervision regulation and architecture, those priorities are increasingly influenced by developments at European and international level. The priorities mentioned in the risk review are the guide for drawing up the action plans of each supervisory service. However, the entire process leaves sufficient scope for any adjustments that may be needed on account of new developments or risks which emerge in the various sectors and are detected at national and European level with the aid of suitable instruments.

In the medium term, the emphasis will be on continuing implementation of the two major prudential projects, CRD IV/CRR and Solvency II, in preparation for full and thorough application of the new regulations.

1.1 Risk review 2014

The priorities for the year under review, detailed in various sections of this part B, are essentially based on work which began in 2013, though the order of priority and the intensity have been changed to take account of not only the macroeconomic context, but above all the reforms to the supervision architecture in the banking sector and the new regulatory reforms concerning insurance and market infrastructures.

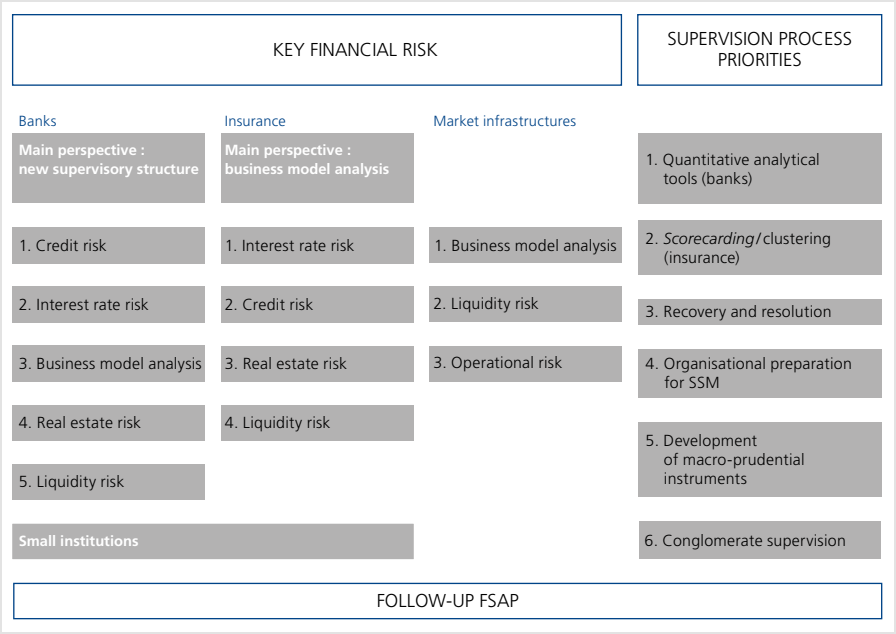
With regard to the financial risks, the preparations for the SSM and particularly the comprehensive assessment (CA) had a major impact on the work relating to Belgian banks subject to the direct supervision of the ECB since 4 November 2014 (see part A, section 1.2). In that context, at the end of 2013, the credit risk analyses had already been singled out as a priority for 2014. In regard to insurance, the interest rate risk was the main point for attention, in view of the persistently low interest rates.

Apart from these priority subjects, the Bank also expanded the examination of business models and their sustainability for the three main financial sectors in the adverse macroeconomic climate and in view of the restructuring process initiated by many Belgian financial institutions in the wake of the financial crisis. Despite the varying degrees of progress, these analyses give the Bank a clearer picture of certain vulnerabilities of individual institutions, plus a better understanding of the challenges facing the various sectors.

The liquidity position of financial institutions was one last point for attention in regard to financial risks, and the supervision concentrated on constant monitoring of the liquidity position via transversal analyses and the introduction of the harmonised liquidity standards under Basel III.

As regards the supervision process, the updated analysis instrument based on the new CRD IV/CRR reporting came into use for the banks. For insurers, the scorecarding instrument was developed to allow a more risk-based supervision. A start was made on drawing up recovery

CHART 7 RISK REVIEW 2014



Source : NBB.

plans for credit institutions of national systemic relevance, and in regard to insurance, a pilot project was launched in that respect. The Bank had to devote much attention to the organisational preparations for the SSM, as explained in detail in section 2.2 of part B and the Corporate Report 2014.

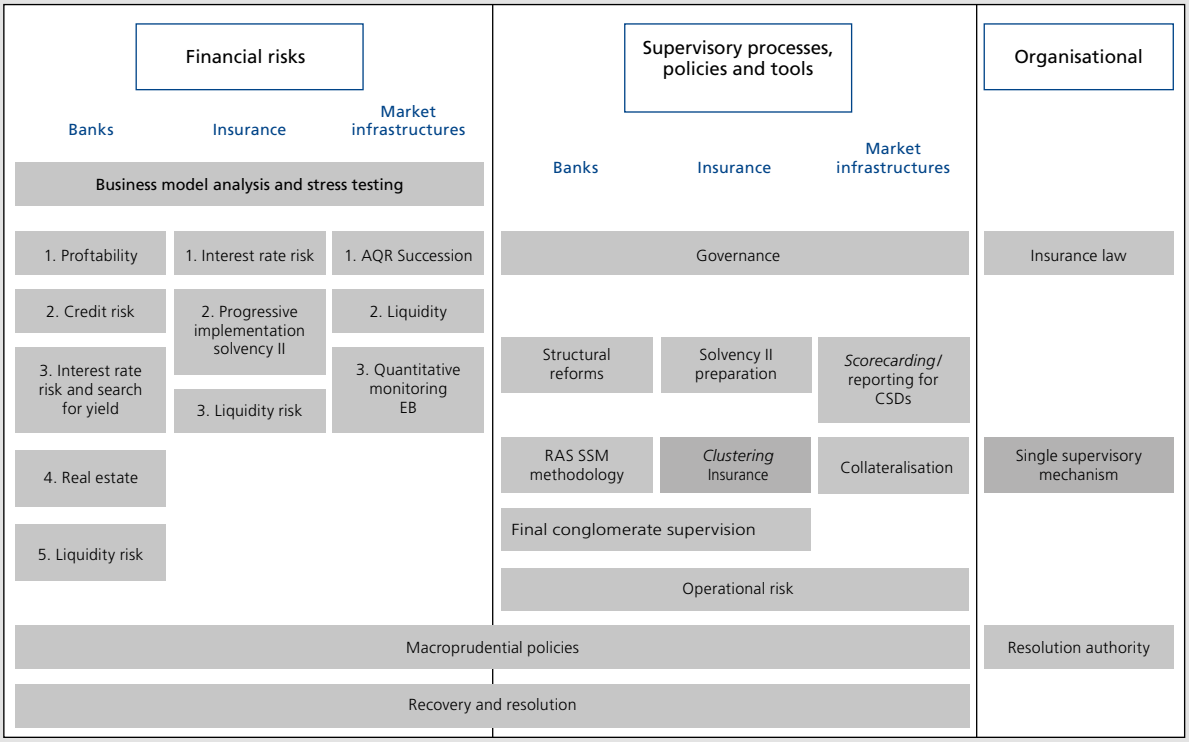
The publication of the Banking Law marked the official start of the work of the Board of Directors of the Bank as the macroprudential supervision authority. The Banking Law modified the supervision framework for conglomerates and, during the year under review, preparatory work was carried out for the further practical implementation of the Law, in the knowledge that since 4 November 2014 the ECB has exercised supervision over conglomerates for credit institutions directly subject to its supervision. The exemption from conglomerate supervision in the case of KBC was ended. The AXA insurance group restructured its activities in Belgium: both the banking and the insurance pillars now come under the direct supervision of the French parent company. The Belgian sub-group can therefore no longer be classed as a financial conglomerate. In view of these changes, the Belgian financial sector now has only three financial conglomerates in which the banking sector is dominant (KBC, Argenta and Belfius).

1.2 Risk review 2015

Generally speaking, the work which began in 2014 will continue in 2015. The list of priorities was not fundamentally changed but was refined to permit better monitoring and streamlining of the various activities. The risk review 2014 also underwent a number of adjustments that an intermediate assessment had identified as necessary. A distinction was made between priorities relating mainly to financial risks, priorities which can be chiefly defined as "supervision processes, policies or instruments", and finally, priorities which really come under the organisation of prudential supervision. There are many links between the various priorities, and the degree of supervision on banking topics will largely depend on the SSM. That is why the SSM's risk analyses were incorporated in this exercise, together with other similar analyses such as those from the ECB's Directorate General Macroprudential Policy and Financial Stability, the ESRB Secretariat and the EBA.

A key point for attention also concerns the need to link the analyses with the measures and sanctions to be applied, and to develop proportional, risk-based supervision for both small and large institutions.

CHART 8 RISK REVIEW 2015



Source : NBB.

Financial risks

In regard to financial risks, the gradual deterioration in the macroeconomic environment largely determined the priorities and their importance for 2015.

That is the context in which, during the course of 2015, the Bank will actively continue the analyses of the profitability of Belgian financial institutions, notably by means of detailed examinations of business models. These will be supplemented by specific transversal analyses on subjects such as credit risk, interest rates, and the search for yield, although it is too soon to say that the latter has become widespread. The Bank will also continue its research on the Belgian property market and will extend it to include the commercial property market in view of the increasing exposure of financial institutions to this type of asset.

For credit institutions subject to ECB supervision, monitoring of both the quantitative and the qualitative results of the CA will likewise be a priority in 2015.

For the banking sector, the priorities defined by the Bank correspond very largely to those determined by the ECB in its strategic plan 2015 for SSM banks. The differences are confined mainly to risks relating to emerging countries and the inability of banks to cover capital shortfalls. There are two factors accounting for those differences. First, Belgian banks are less exposed to those countries, notably because they have refocused on the domestic economy. Also, the risk concerning the inability to cope with a shortage of capital seems to be smaller in Belgium, as most of the banks passed the comprehensive assessment, while those that failed were either given special treatment – in view of their characteristics – or succeeded in covering the shortfall by increasing their capital.

Supervision processes, policies and instruments

For the banking and insurance sectors respectively, the implementation of the Banking Law and the preparations for Solvency II are central concerns.

A governance manual will be prepared for the banking sector on the basis of the Banking Law. The aim is to provide institutions with an overview of all the provisions by linking the current regulations on the subject and, if necessary, to update the circulars or recast them as regulations. International reference documents, such as those of the Basel Committee on Banking Supervision or the EBA guidelines, and the technical standards applicable will also be incorporated in this overview via references. In addition, there will be transversal analyses of the new governance provisions under the Banking Law, notably the restrictions on cumulating directorships and the formation of specialist committees within the board of directors. Governance also covers the need to take account in the ICAAP of the risks relating to failure to respect the honest, fair and professional treatment of customers by an undertaking or by some of its staff (conduct risk).

In order to implement the structural reforms included in the Banking Law, a series of reports will be developed. In regard to pillar 2 capital decisions taken in 2014, a transitional policy taking account of the phased introduction of Basel II and the CA was established for a one-year period, with due regard for the SSM approach on the subject. For 2015, apart from familiarisation with the SSM methodology, the main effort will concern the application of that methodology to smaller credit institutions, in order to maintain consistency within the Belgian banking sector.

For insurance companies, the cluster analysis will be put into practice. In preparation for Solvency II, the Bank will develop a policy on the options and discretionary powers under that Directive. It will also devise a policy on the implementation of this framework for smaller insurance companies. The Bank will examine the impact of Solvency II on the accounting rules for Belgian insurers and will develop a new policy on profit-sharing which will comprise harmonisation with Solvency II plus development of a backstop based on Belgian accounting law. Finally, it will scrutinise the process for the validation of internal models.

The term "operational risk" covers cyber risks and continuity risks, the risk of excessive outsourcing and the concentration risk of external internet service providers. The Bank will be proactive in analysing these subjects and will examine how existing supervision instruments can be supplemented or used in different ways to take account of the fast-changing risk environment.

As far as the supervision of conglomerates is concerned, the accent will be on the harmonisation of the reporting required of the three Belgian financial conglomerates. That should allow the conglomerate dimension to be reflected better in the SSM supervision methodology, notably in the SREP analysis, where that dimension will mainly influence the risk parameters relating to governance and the business model.

For market infrastructures, the bank scorecarding will be adapted to take account of their specific risk profile.

On the subject of recovery plans, there are various implementing measures still to be taken following the Banking Law, e.g. in order to specify the content of those plans, to define the framework of exemptions and simplified obligations, and to establish asset encumbrance indicators. Recovery plans will also be analysed for market infrastructures on the basis of the international standards on the subject.

2. Banks, investment firms and payment institutions

2.1 Analysis of some priority risks from the annual risk review

Interest rate risk

In 2013, the analysis of interest income and the interest rate risk in the banking sector was regarded as a key priority in the supervision of Belgian credit institutions. The reason for that was the exceptionally low level of interest rates, which could present specific challenges for the banking sector as explained in chapter 3, section 4 of the part of the Report on "Economic and financial developments". During the year under review, that aspect remained an important point for attention, as risk-free interest rates continued to fall in the euro area, reaching a historically low level as a result of weak economic growth and very low inflation. The priority accorded to interest rate risk in the context of supervision was reflected in a deeper analysis of recent developments in banks' interest income and the factors driving those developments.

During the year under review, in the light of the current low interest rates and the potential impact of an upturn in rates, special attention also centred on improvements to prudential reporting covering the interest rate risks in the banking book. Prudential reporting and the prudential treatment of that interest rate risk are described in circular PPB-2006-17-CPB, which is in line with the Basel Principles (2004)[1] and the CEBS/EBA guidelines (2006)[2] concerning that risk. However, on the basis of an initial, limited questionnaire, it emerged that there are substantial differences between the various institutions in regard to the underlying assumptions and methodologies used in that prudential reporting. In the second quarter, to improve the comparability of the prudential reporting data and the quality of interest rate risk reporting, the Bank sent 15 credit institutions a detailed questionnaire which included a range of options – to be evaluated by the banks – for the harmonisation of the underlying assumptions and methodologies. Following an initial consultation between the Bank and a Febelfin working group, the sector developed a set of common positions which were analysed and assessed in parallel with the banks' individual responses. Since the prudential treatment of interest rate risk in the banking book currently forms the subject of international work by the Basel Committee on Banking Supervision, the EBA and the SSM, no major changes will be made to Belgian prudential reporting for the time being. That said, it will be some time yet before that work is completed at international level, so that there is still a need for increased harmonisation of prudential reporting in the short term. However, any clarification of circular PPB-2006-17-CPB will be without prejudice to the principle of the circular whereby the interest rate risk in the banking book is a second-pillar risk that needs to be properly managed, assessed and capitalised internally, whereas prudential reporting aims to compare the interest risk in the banking book between different institutions, so as to detect any quantitative outliers. The banks are therefore expected to manage their interest rate risk positions on the basis of various possible interest rate scenarios, including persistently low rates, and in so doing to measure the impact both on the bank's income and on the economic value of the banking book. Prudential reporting is therefore still only one element that the supervisory authority uses to assess the interest rate risk in its SREP and to determine any capital surcharge under the second pillar.

(1) Basel Committee on Banking Supervision (2004), *Banking Principles for the Management and Supervision of Interest Rate Risk*, July 2004.

(2) Committee of European Banking Supervisors (2006), *Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process*, 3 October 2006.

Business model analysis

Since 2013, the business model analysis (BMA) has formed an integral part of the supervision of the main Belgian banks (Belfius, BNP Paribas Fortis, ING Belgium and KBC). The BMA is meant to enable the supervisory authority to identify at an early stage any risk positions and management actions that might be detrimental to the institution's financial situation and viability, and to financial stability in general. The BMA comprises two main stages, namely (i) analysis of the institution's current business model and its current viability, and (ii) analysis of the institution's sustainability for the coming three to five years.

In 2013, the BMA activities centred on the development, testing and implementation of the first stage, namely the analysis of the viability of the large Belgian banks. In 2014, this first stage was essentially standardised and put into operation. Thus, quantitative and qualitative reporting was arranged for each institution to provide data for the analyses; that reporting is to take place at least once a quarter. In addition, specific improvements to the quantitative and qualitative data reported were made for each institution. On the basis of these data, the actual underlying economic developments and the factors driving the profitability of the individual banks were assessed according to the financial results submitted for each institution. Changes to the activities and the stated commercial aims are frequently discussed with the people responsible for the various business activities.

Some of the conclusions of these BMAs led to prudential measures and were included in the 2014 SREP analyses. The findings concerning the trend in net interest income and the associated risks were incorporated in the interest rate risk analysis and were studied in depth.

During the fourth quarter of 2014, a start was also made on rolling out the BMA approach for other Belgian banks, and the second stage of the BMA was launched for large banks, namely the analysis of sustainability or how the business model might change as a result of strategic decisions by the institution or the impact of changes in the economic and market environment. This second stage focused primarily on a critical analysis of the institutions' strategic, financial and commercial action plans for the next three to five years.

In the SSM, the priority in 2015 will also be the analysis of business models and profitability (see chapter B, section 1), as an essential element of the SSM's prudential supervision and the SREP analysis. In that context, the Bank explained its BMA approach and the resulting prudential measures to an SSM working group. There is in fact considerable pressure on business models in the current environment featuring low interest rates, weak economic growth, strong competition, continuing impact of risky portfolios or management practices from the past within institutions and regulatory changes.

Property market risk

On the subject of credit risk, in recent years, the Bank has analysed in detail the latest developments on the Belgian mortgage market, and has ascertained the risk profile and the quality of credit institutions' mortgage loan portfolios. That analysis was based in particular on data collected from 16 credit institutions via an *ad-hoc* template for reporting data on Belgian mortgage loans granted and held by the institution.

The analyses by the Bank and by international institutions such as the ECB, the ESRB, the OECD and the IMF, drew attention to the potential risks relating to the Belgian property and mortgage markets. Although at this stage the household credit quality indicators do not show any deterioration in default rates on recently granted mortgage loans, there are some factors that could lead to increased loan losses in the future. In that regard, the FSR 2012 [(1)] drew attention to the particularly steep rise in house prices and mortgage loans in the preceding ten years, the trend towards longer loan maturities, and the relatively high (and stable) proportion of loan-to-value ratios in excess of 80 % (including ratios of more than 100 %) in new contracts. During this period, a significant number of borrowers extended the term of their loan, increased the amount borrowed and/or raised the percentage of their income spent on repaying the loan to levels which could imply a higher risk of future losses for the banks, compared to loans granted previously. In the event of more adverse developments on the Belgian housing market, the riskier segments of the stock of mortgage loans could cause the banks to incur larger-than-expected loan losses. That is why, as explained in detail in the Report 2013 [(2)], the NBB considered that it was justified in taking certain prudential measures to improve the banks' resilience and reduce the concentration risk.

The first measure, dating from the final quarter of 2013, was macroprudential and stipulated a 5 percentage point rise in the risk weightings calculated by the banks themselves, but only for those that use an internal

(1) Review of the Belgian residential mortgage loan market (2012), *Financial Stability Review*, National Bank of Belgium, 95-107.

(2) See chapter C, Box 5 of the part of the Report 2013 on "Prudential regulation and supervision".

ratings-based (IRB) model to calculate their minimum regulatory capital requirements for Belgian mortgage loans. This measure came into force via a Bank regulation approved by Royal Decree on 8 December 2013 [1], and was then implemented in 2014 under Article 458 of the CRD IV. This additional capital requirement does not apply to banks that use the standard approach to calculate their capital requirements for Belgian mortgage loans. This measure increased the average risk weighting of banks adopting the IRB approach from around 10% at the end of 2012 to almost 15 % at the end of 2013. The relatively modest size of this supplement seemed appropriate in view of the generally fairly prudent credit standards that Belgian banks have applied in the past in regard to mortgage loans, and the historically low percentage of losses on such loans. However, considering the cyclical character of this measure, the Bank kept a close eye on market developments during the year under review so that it could constantly assess the appropriate level of this supplement. It concluded that the 5 % supplement (corresponding to an extra capital requirement of around € 600 million) still provided an adequate but necessary extra capital buffer for the risks identified.

The other two measures adopted by the Bank at the end of 2013 were microprudential. One concerned the launch of a horizontal assessment of the IRB models on the basis of the results of the back-testing to be carried out by the institutions, followed by any necessary adjustments to these risk models. This measure aimed to remedy potential weaknesses in the risk parameters used in the IRB approach. In this connection, the Bank assessed the suitability of the calibration of the models for the probability of default and the loss given default used in calculating the regulatory capital according to the IRB approach (see part B, chapter 2.2 for more details). Banks using unsatisfactory calibration were required to adapt their pillar 1 models.

The other microprudential measure consisted in asking 16 credit institutions to conduct a self-assessment on the degree to which they conform to the EBA Opinion on Good Practices for Responsible Mortgage Lending and the EBA Opinion on Good Practices for the Treatment of Borrowers in Mortgage Payment Difficulties. The Bank analysed these self-assessments by the banks on the degree of prudence in their lending conditions for home loans; it found that the Belgian banks very largely satisfied the standards, notably via the fairly strict rules on the subject and other codes of conduct in the sector concerning Belgian mortgage loans.

During the year under review, as well as monitoring the three prudential measures adopted at the end of 2013, the Bank regularly reviewed the latest developments on the Belgian housing and mortgage markets. The main conclusions of that monitoring were published in the FSR 2014 [2], on the basis of a quantitative analysis of the domestic mortgage portfolios of 16 Belgian banks, similar to the analysis used for the said article in the FSR 2012. The latest data confirm that, since 2012, the banks have tightened some of their lending criteria for mortgage loans. As stated in the 2012 article, that will help to maintain the high quality of Belgian mortgage loan portfolios.

With this monitoring and these three prudential measures, the Bank aimed to strengthen the resilience of the market and of the credit institutions with the largest exposures to Belgian mortgage loans against the risk of potentially higher-than-expected loan losses on Belgian mortgage credit. In this connection, the recent slowing of house price rises and lending growth has reduced the likelihood of further imbalances developing in the future. Since subsequent changes in the tax treatment of mortgage loans could also have a moderating effect on market developments, the Bank considered that there was no need for additional measures in the year under review.

2.2 Operational supervision

Mapping of the banking sector

At the end of 2014, the population of credit institutions, investment firms, and payment and electronic money institutions came to 119, 34, 18 and 11 institutions respectively. The population of financial institutions remained more or less stable in 2014. The pause in the consolidation process that was a feature of the banking sector in recent years may be due to a wait-and-see attitude on the part of the banks throughout the year under review, in the context of the thorough health check imposed by the SSM on large banks in 2014, mapping both the asset quality and the resilience of the institutions (see part A, 1.2). Now that the results are known, there could be renewed consolidation and acquisitions in 2015. In the payment institutions sector, there has been a slight rise in new authorisations, mainly in respect of start-ups in specific niches of the sector using exempt institution status [3].

(1) Royal Decree of 8 December 2013 approving the National Bank of Belgium regulation of 22 October 2013 amending the National Bank of Belgium regulation of 15 November 2011 on the capital of credit institutions and investment firms.

(2) The Belgian mortgage market: recent developments and prudential measures (2014), Financial Stability Review, National Bank of Belgium, 113-122.

(3) Pursuant to Article 48 of the Law of 21 December 2009, "exempt institutions" are subject to a simplified regime that only comprises the obligations under Articles 21 and 22 of that Law.

TABLE 4 NUMBER OF INSTITUTIONS SUBJECT TO THE BANK'S SUPERVISION

	31-12-2013	31-12-2014
Credit institutions	121	119
Under Belgian law	39	37
Branches governed by the law of an EEA member country	55	56
Branches governed by the law of a non-EEA member country	10	10
Financial holding companies	7	6
Financial services groups	4	4
Other financial institutions[1]	6	6
Investment firms	34	34
Under Belgian law	20	20
Branches governed by the law of an EEA member country	12	12
Branches governed by the law of a non-EEA member country	0	0
Financial holding companies	2	2
Payment institutions	16	18
Under Belgian law	12	11
Exempt institutions	2	4
Branches governed by the law of an EEA member country	2	3
Branches governed by the law of a non-EEA member country	0	0
Electronic money institutions	10	11
Under Belgian law	5	5
Exempt institutions	5	5
Branches governed by the law of an EEA member country	0	1
Branches governed by the law of a non-EEA member country	0	0

Source : NBB.

(1) These are specialist subsidiaries of credit institutions or credit institutions associated with a central institution with which they form a federation.

Transition to the single supervisory mechanism

The introduction of the SSM has significant implications for the organisation of supervision. As described in part A, section 1.1, most banks have come under SSM supervision with the ECB carrying ultimate responsibility, while other institutions do not fall within the scope of the SSM.

(1) The criteria for determining whether or not an institution can be classed as significant appear in the SSM Regulation and concern the institution's size (balance sheet total of more than € 30 billion ; relative size in the country of origin) or cross-border activities, or whether the institution receives state aid.

(2) The term "significant" according to the SSM definition should not be confused with the term "credit institution of significant size" as defined in Article 3, 30 of the Belgian Banking Law of 25 April 2014.

Each of these supervision regimes has its own specific reference framework with its own articulation of supervision, so that it was necessary from an organisational perspective to divide the population of financial institutions into three groups. The first group comprises the banks or banking groups considered significant according to the SSM definition. That group comes under the direct supervision of the SSM. The second group contains banks considered less significant, which are also subject to the ultimate responsibility of the SSM, whereas the front-line supervision is exercised by the national supervisory authorities – in this case the Bank. The third group of institutions is outside the scope of the SSM. The available means of supervision were divided among these three groups with due regard for the expected scale and intensity of the supervision activities.

The group of banks considered significant includes the large banking groups[1][2] whose parent company is established in Belgium and the Belgian subsidiaries and large Belgian branches of significant foreign banking groups established in another country participating in the SSM.

That group is composed as follows :

- Belgian banking groups considered significant : 7 banks or banking groups, namely the Belgian parent company (in some cases a financial holding company or a mixed financial holding company) and its Belgian subsidiaries ;
- Belgian subsidiaries of significant foreign banking groups subject to the SSM : 6 banks, namely the Belgian subsidiaries and their own Belgian banking subsidiaries ;
- Belgian branches of significant foreign banking groups subject to the SSM.

The banks or banking groups considered significant are supervised by a JST, as described in part A, section 1.1.

The second group comprises banks established in Belgium which are considered less significant according to the SSM, and includes Belgian local banks and specialist institutions, plus the Belgian branches of banks of EU Member States not participating in the SSM. When the SSM was launched, there were 30 banks on the list of less significant banks.

The Bank remains responsible for the day-to-day supervision of these institutions, though it collaborates closely with the SSM and applies the harmonised procedures specified in the SSM manual. In addition, the SSM has the power to take charge or to take decisions at any time. For this population, the SSM focuses mainly on the largest local credit institutions, i.e. the ones incurring the highest risks.

This second group also includes the Belgian branches of less significant foreign banks subject to the SSM. Here it should be noted that the Bank's powers of supervision over branches established in the EU, particularly within the SSM, have become very limited.

A third group of financial institutions falls outside the scope of the SSM. This includes Belgian representation offices of foreign banks, Belgian stockbroking firms and Belgian branches of foreign investment firms. This group of financial institutions, whose only common feature is that they do not come under the SSM, comprises a very mixed population in terms of the nature, scale and complexity of their business and the regulations applicable (credit institutions and investment firms), and as regards the supervisory powers and the degree of supervision.

The grouping of institutions according to whether or not they are subject to the SSM is broadly reflected in the organisation of bank supervision, though without total segmentation. The supervision of these various groups still has many features in common, so it is important to avoid any silo effect that would impede the convergence of supervision methods and best practice as well as a smooth rotation of supervisory authorities from one group to another.

The introduction of the SSM also requires radical adjustments to internal processes and procedures, since supervision activities in the SSM are now carried out jointly by the Bank and the ECB, and ultimate responsibility for many decisions, particularly in the case of significant institutions, now rests with the SSM. The Bank has therefore introduced new governance procedures whereby the aim of contributing as efficiently as possible to SSM decision-making – and influencing it where necessary – in accordance with the SSM regulations and the Belgian rules applicable is reconciled with the desire to ensure that the Bank has an accurate and well-informed view of prudential banking developments in general, and particularly of Belgian institutions subject to the SSM.

Comprehensive assessment

The year under review was dominated by the comprehensive assessment that took up most of the prudential resources from January to November. Although the Bank decided from the start to outsource a major part of the assessment to firms of auditors selected for the purpose, and also called in a consultancy to take charge of the project, it deployed as many NBB prudential supervisors as possible to ensure the success of this major exercise and to familiarise them with the methodology of the exercise and its practical application. The NBB inspectors who normally conduct their audits independently of the permanent banking teams were temporarily assigned to the bank supervisory teams to monitor the progress of the activities on site. The joint efforts ensured that the work required was completed on time, in accordance with the methodology specified by the ECB. The assessment which, compared to routine prudential supervision, comprised a very extensive and particularly detailed analysis of the quality and valuation of an institution's assets, undoubtedly helped to give the supervisory authorities a clearer understanding of the conformity of the institutions' accounting practices with the IFRS rules and the degree to which those practices employ prudential concepts constituting a prudent approach to the assessment of the solvency of customers and counterparties (definition of borrower default, valuation of collateral, valuation of securities). The conclusions of the asset valuation and the results of the stress tests will be taken into account in setting the pillar 2 capital objectives.

Every year, the supervisory authorities conduct an overall assessment of the risks facing an institution, and of the resources and measures that a credit institution can use to control those risks. That risk assessment ultimately leads to a decision which determines the amount of capital that a bank must hold to cope with these known and calculated risks. In 2014, at the request of the SSM, the Bank conducted this assessment in October, to take due account of the clarification that would be available by then from the comprehensive assessment of the banks concerned. Prior to the entry into force of the SSM, the Bank submitted proposals for decisions on capital and liquidity to the SSM, which took the final decisions before the end of the year under review.

Combating money-laundering

The Bank's supervision of financial institutions' compliance with the regulations designed to combat money-laundering and terrorist financing remains a key action point (see part A, section 5.1, for more details on the regulations on this subject). Institutions which display a lack of vigilance or which have insufficient knowledge of the customers and their profile to identify suspicious transactions are subjected to prudential recovery measures intended to improve their organisation within the specified period, without prejudice to the possibility of imposing an administrative fine.

Validation of internal models

In 2014, work relating to quantitative methods focused mainly on the contribution to the AQR. This first involved assessing the methods of collective provisioning for credit risk. The banks' provisions were compared with the result of a simplified model (challenger model), devised on the basis of a methodology stipulated by the ECB. That comparison made it possible to check whether the level of provisions was sufficient and, where necessary, to formulate proposals for improving the banks' models. The next step was to examine the valuation of certain assets for which market values did not exist, and the underlying valuation processes.

In addition, there were other activities relating to the internal models used for the regulatory capital. This concerned inspection of these internal models, essentially for credit risk (internal ratings-based (IRB) approach) and for operational risk (advanced measurement approach – AMA). Thus, the results of the back-testing of the models for the probability of default and loss given default in the residential property portfolio were assessed in the context of the Bank's monitoring of the property market. This back-testing did not uncover any real outliers (banks with observed defaults or losses well in excess of the estimates).

The participation in the benchmarking activities inaugurated by the EBA, the Basel Committee on Banking Supervision and, more recently, the SSM was confirmed. The same applies to the contribution to research by the Basel Committee on consistency between the capital requirements for credit risk in the IRB models.

Box 4 – Harmonisation of reporting requirements for banks

The year 2014 marked a turning point in the development of European reporting, as the long process of European harmonisation in this field led to the publication of an Implementing Technical Standard[(1)] by the EC. This standard had been initiated by the European Committee of Banking Supervisors, which has now been renamed the EBA. In 2006, the EBA had already published recommendations on standardising financial reporting (FINREP) and reporting on capital requirements (COREP). However, as these recommendations were not binding, they allowed far too many differences to persist between the reporting requirements of national authorities. That situation entailed substantial costs for cross-border groups and prevented the efficient creation of a European database for comparing the risk profile of credit institutions. Following the 2008 financial crisis, there was evidently a need for the actual introduction of harmonised European reporting. That took place via Article 99 of the CRR which gives the EBA power to define harmonised reporting directly applicable to all institutions in the EU.

This new reporting was of course based on the previous FINREP and COREP versions. Thus, COREP was adapted to the new CRR capital requirements. It was also extended to cover new risks such as liquidity risk or the leverage effect. Moreover, FINREP now includes new information on non-performing assets and on exposures for which banks have granted restructuring or concessions owing to the deterioration in the quality of the counterparty (forbearance). In future, that information can be used for regular assessment of asset quality on a comparable basis for the whole EU. A similar change was made to address the question of encumbered assets. Finally, it was decided to reduce reporting times to 30 days in order to obtain this information more quickly. The Bank took an active part in drawing up these new regulations and kept the Belgian financial sector regularly informed of on-going developments via quarterly meetings with Febelfin.

This new reporting was successfully implemented by credit institutions from 31 March 2014. The Bank also forwarded the first data collected under these new rules to the European authorities. Since then, the ECB and the EBA thus have had the necessary information to refine their knowledge of the risk profile of financial institutions, and that will contribute to the speedier detection of fragilities in the financial sector.

(1) Commission Implementing Regulation (EU) No. 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No. 575/2013 of the European Parliament and of the Council.

In addition, the entry into force of the SSM creates new challenges, as it will represent an unprecedented opportunity to organise the collection of both monetary statistics and prudential data more efficiently. To that end, discussions are in progress at the ECB on creating a single European reporting system covering all the ECB's statistical needs, in its role as both a monetary authority and a prudential authority.

In parallel with the implementation of these new reporting schemes, the Bank revised its internal Quantitative Analytical Tools (QAT) for data reported by financial institutions. The new tool is intended to facilitate the examination of large quantities of figures reported periodically by the institutions to permit rapid identification of risk situations relating to solvency, performance and liquidity. The internal tool also provides a quick summary of the financial situation of supervised institutions on a harmonised basis for the entire sector. Finally, the tool is based on functions that ensure a more flexible and detailed analysis according to the supervision needs. These tools will also be regularly updated in line with the procedures and means developed by and within the SSM.

3. Insurance companies

3.1 Analysis of some priority risks from the annual risk review

Interest rate risk

In 2013, the Bank launched analyses for the purpose of studying in more detail the potential consequences of persistently low interest rates for the Belgian insurance sector. Historically, the insurance sector in Belgium has always featured high guaranteed yields on certain life insurance products – and it still does so – in respect of both individual and group insurance (see chapter 3, section 4, of the part of the Report on "Economic and financial developments"). The guaranteed rates offered in Belgium are among the highest in the European insurance sector.

In 2013, on the basis of an initial outlier analysis, the Bank picked out 13 companies for more detailed examination. The results of this study were then incorporated in a horizontal market analysis which gave rise to a number of conclusions and prudential measures, the most relevant of which are examined below.

The low interest rate environment currently prevailing in the euro area presents a real risk for any insurance companies tempted by an excessive search for yield. In this context, it is crucial for the supervisory authority to keep a close eye on developments in investment management and any corresponding (new) risks that companies face, such as the increasing illiquidity of the assets, heightened credit risks, etc. Since not all insurance companies are equally candid in announcing their future investment intentions, frequent, detailed monitoring is advisable. Apart from better mapping of the spreads on insurance companies' bond portfolios, the Bank also recently decided to set up more detailed monitoring of investment in derivatives, repo transactions and securities lending (see the section below on liquidity risk). Previously, this subject was only monitored more closely for large insurance companies.

On the basis of the analyses conducted, the Bank also considered that it was necessary to gain a more systematic idea of the interest rate risk facing all insurance companies on the Belgian market. For that purpose, the Bank drafted a proposal for a new standard reporting scheme comprising four parts, each one being important to obtain a proper picture of the interest rate risk situation in all insurance companies.

The first reporting component concerns a review of current guaranteed yields on the life insurance portfolio. That component is based on an *ad-hoc* questionnaire which was sent to life insurers in 2012 and 2013 in order to obtain an overview of the guaranteed interest rates on current contracts in accordance with the following dimensions: (i) weighted residual term of the guarantees, (ii) weighted average guaranteed yield, (iii) guarantees concerning future premiums (yes/no), and (iv) type of life insurance (individual or group).

The second aspect of the reporting is intended to provide an overview of the duration of the current assets and liabilities portfolio. The definition of duration corresponds to the one which will also be used for the purposes of Solvency II, namely the "Macaulay duration". Similarly, Solvency II is the reference used for the valuation basis, and more particularly the market value for assets and the best estimate for the technical provisions on the basis of the relevant risk-free interest rate curve used by Solvency II (see part A, section 2.1 for a definition of the best estimate). The durations have to be declared per segment (according to the company's own management system) and for all segments taken together, in each case for the liabilities and the assets covering them, for which a distinction is also made between fixed-income and other assets. Finally, the institutions are requested to provide a

brief description of the products and covering assets in the respective segments.

Another key component of the reporting is an overview of the cash flows relating to the assets (covering assets) and the liabilities (technical provisions). This exercise is based on the projections which will also be required under Solvency II, with the important difference that the projections must in this case be supplied per segment, and projections will also be required for the covering assets as well as for the liabilities.

The last aspect of the reporting concerns projections relating to yields on assets and liabilities, per segment and for all segments taken together. The yield projections should in principle reflect the trend in average accounting returns on both the technical provisions and the associated covering assets. Companies are also asked to detail all the assumptions used, e.g. in regard to the return on categories of underlying assets, the return on reinvestments, etc., to enable the Bank to obtain an idea of the parameters on which these projections are based.

The reporting described above should therefore become the new standard. Obviously, the existence of this standard reporting does not rule out additional initiatives, e.g. for the purpose of requesting further details from certain companies, where appropriate. When Solvency II is launched, the reporting format will also be assessed and adjusted if necessary to make it fully compliant with the Solvency II requirements on the subject.

Liquidity risk

The specific reporting of the vulnerabilities of large insurance companies, launched at the end of 2011, pays particular attention to the potential liquidity risk. In that connection, the Bank asks for the following information:

- All incoming and outgoing cash flows, particularly premiums, (partial) redemptions, expiries, deaths, etc. in the class 21 insurance portfolios.
- An overview of the liquid and less liquid assets and liabilities.
- The exposure to certain assets and derivatives presenting a potential liquidity risk, such as repos, securities lending, OTC derivatives, etc.

In 2014, the Bank developed a set of indicators to permit full, integrated monitoring of liquidity risk. These indicators are based on the said reporting and can be divided into three groups. The first group of indicators focuses on the trend in incoming and outgoing cash flows and the way in which they are linked with one another. The second examines the trend in liquid assets and liabilities and their relationship with the total assets and liabilities. The relationship between liquid assets and liabilities is also monitored. The third group of indicators looks at the trend in exposures to instruments and derivatives presenting a potential liquidity risk. The Bank is also working on a methodology whereby the exceeding of certain limits may trigger an increase in reporting frequency and/or other prudential measures.

The figures and indicators submitted as part of the reporting have long confirmed the upward trend in redemptions and the downward trend in premiums confronting a number of Belgian insurance companies. Premiums collected from the market in class 21 products were down by 17.2 % in 2013, at € 13.2 billion. That fall is due partly to the change in the tax treatment of life insurance products, as the tax on premiums was raised from 1.1 to 2 % at the beginning of 2013, and is partly exacerbated by the current low level of interest rates and the fact that an increasing proportion of the class 21 portfolio is now eight years old, so that (partial) redemptions are exempt from withholding tax. In addition, some companies are deliberately paying less attention to the marketing of class 21 products.

These developments confirm the need to monitor the quantity of liquid assets and to examine in more detail the relationship between those liquid assets and liabilities which are liquid or can be readily terminated. The data submitted show that for most companies the stock of liquid assets far exceeds the stock of liabilities that can be readily terminated. As regards the exposure to certain assets and derivatives presenting a potential liquidity risk, there is nonetheless a relatively high concentration (compared to the total assets) in some companies.

The Bank considers that in 2015 it would be desirable to extend the range of companies required to report on their liquidity; this would cover the whole of the life insurance market (excluding class 23 products) instead of just the large insurance companies. The reporting permits a quicker response to a liquidity crisis, and a proactive approach to a deteriorating liquidity situation.

3.2 Operational supervision

Mapping of the insurance sector and colleges of supervisors

At the end of the period under review, the Bank exercised supervision over a total of 97 insurance companies,

TABLE 5 NUMBER OF UNDERTAKINGS SUBJECT TO SUPERVISION[1]

	31-12-2013	31-12-2014
Active insurance undertakings	83	80
Insurance undertakings in run-off	8	4
Reinsurance undertakings	1	1
Other[2]	14	12
Total	**106**	**97**

Source: NBB.

(1) In addition, at the end of 2014, the Bank also exercised prudential supervision over ten branches of companies governed by the law of another EEA member country, although that was confined to checking compliance with the money-laundering regulations.

(2) Surety companies and regional public transport companies.

reinsurance companies, surety companies and regional public transport companies which insure their fleet of vehicles themselves. That is fewer than at the end of 2013 when the number of companies stood at 106. This decline is due to mergers, the cessation of business following the transfer of portfolios or the expiry of all the insurance commitments, and the conversion of Belgian companies into branches that come under other EEA member countries.

Supervisory authorities of cross-border groups work together in colleges. The group's consolidating supervisory authority (the home country authority) arranges the coordination, and the supervisory authorities of the group's subsidiaries and branches (host country authority) take part in these meetings. Recurring items on the agenda for these colleges include the discussion and appraisal of the financial situation, the organisation, the strategy and the risks to which the group and its subsidiaries are exposed. Coordination arrangements – namely arrangements concerning cooperation and the exchange of information – are made both for a going concern situation, such as the approval of an internal model, and for stress situations.

TABLE 6 COLLEGES FOR INSURANCE UNDERTAKINGS SUBJECT TO THE BANK'S SUPERVISION

	The Bank is the home country authority	The Bank is the host country authority
Complex groups	Ageas KBC Assurances Belfius Insurance P&V	AXA (AXA Belgium)
Local undertakings	Intégrale Ducroire TCRe	
International undertakings		Allianz (Allianz Belgium and Euler Hermes) Generali (Generali Belgium and Europe Assistance) Munich Re (ERGO Life, DAS and DKV) HDI (HDI Gerling) BNP Paribas (Cardif) Delta Lloyd / Aviva (Delta Lloyd Life) Bâloise (Baloise Belgium et Euromex) MetLife (MetLife Insurance) Nationale Suisse (Nationale Suisse Belgium and L'Européenne) ING (ING Life and ING Non-Life) Assurances du Crédit Mutuel (Partners) CIGNA (CIGNA Life and CIGNA Europe) CDA bvba

Source: NBB.

As part of the preparations for Solvency II, the colleges examined the implementation of preparatory guidelines and their impact on the functioning of the colleges. During the year under review, they continued to develop the assessment of risks at both group level and constituent entity level. Colleges for groups wishing to use an internal model from the entry into force of Solvency II started discussions during the year under review to arrive at a joint timetable for the approval process which is to take place in 2015.

Scorecarding

The revision of the scorecarding tool started at the beginning of September 2013. That revision was conducted in response to the evaluation of the tool when it was first used in 2012, and aimed to align the risk typology with that of Solvency II. The changes made should help to improve the tool's reliability by taking account of the specific characteristics of the insurance sector. Both life and non-life risks were therefore treated – and the risks defined – in a manner tailored to the insurance sector in accordance with terminology based largely on Solvency II.

The modified scorecarding tool also differs from the previous tool in taking account of qualitative criteria per risk category. It was decided to reduce the importance accorded to the qualitative criteria in order to rebalance the impact of the quantitative and qualitative aspects. At the end of 2014, the first complete analysis using the new version of the tool was finalised and led to an initial classification of insurance companies according to the risks.

Clustering

Clustering is a risk-based approach to operational supervision which aims to define the degree of supervision for companies according to the assessment of the companies' risks. This approach is based on the evaluation of each company's vulnerability to the various types of risk. That evaluation is conducted with the aid of the scorecarding tool and on the basis of remote analyses and on-site inspections. In addition, it assesses the likely impact on global and sectoral financial stability of the failure of each company in regard to the various types of risk mentioned.

On that basis, the next step is to classify the companies to determine the extent and frequency of the checks on each one. Systemic undertakings and other companies with both a high failure risk and a significant impact on sectoral stability are subject to full supervision involving application of the supervision procedures in their strictest form and according to their broadest definition. Other companies are subject to supervision in varying degrees according to their vulnerability to the specific risks associated with the nature and scale of their activities. Those which are not too vulnerable and are of only limited importance from a sectoral perspective are subject to limited, periodic supervision according to a de minimis approach.

In this connection, the service responsible for the prudential supervision of insurance and reinsurance companies is divided into two units: one unit for first-line supervision (monitoring of reporting, checking on conformity, and early warnings) and one unit for the detailed analysis of the undertakings.

Preparations for Solvency II

In 2013, the insurance sector was asked about its practices regarding the best estimate of the technical provisions (see A, section 2.1). The Bank's aim was to examine the extent to which the sector was ready for the entry into force of the new prudential regime. The survey results were analysed in 2013 and 2014, and the conclusions were forwarded to the companies which were asked to comment and, if appropriate, to produce an action plan for further improvements to the methodology used. The Bank is conducting another analysis of the companies' responses on this subject in order to make any necessary adjustments in time. The ultimate aim is still to ensure that the companies achieve an acceptable methodological level when the new prudential regime takes effect.

Under Solvency II, companies will have to include in their business strategy the regular assessment of all their solvency needs, notably in the form of the ORSA (own risk and solvency assessment). At the end of 2012, insurance companies were made aware of the need to set up an ORSA. In 2014, the Bank examined the extent to which a number of companies were prepared for the Solvency II requirements, on the basis of a qualitative assessment model designed for the purpose.

Business model analysis

The work which had begun in 2013 on the analysis of the business model of insurance companies forming part of a bancassurance group continued in 2014 and was extended to other large companies. In view of the low interest rates, attention focused mainly on analysing the profitability of the life portfolio. In the case of large (life) insurance companies, profit sources were analysed. That analysis was supplemented by specific analyses of their

activities in order to explain certain developments concerning the financial margin, the underwriting results and costs for the various (groups of) products and companies.

Prevention of money-laundering

In February 2014, the Bank received for the first time the insurance companies' responses to the questionnaire on measures to combat money-laundering (see A, section 5.1). The Bank used the information obtained to proceed with formalising the risk-based classification of insurance companies in regard to the prevention of money-laundering, and to refine its internal procedures on the subject. The framework which it devised for this purpose was already in use in 2014. Thus, two insurance companies were subjected to a full inspection of their compliance with the provisions of the Law of 11 January 1993 on prevention of the use of the financial system for the purpose of money-laundering and terrorist financing.

In the light of the resulting findings, the Bank decided to remind life insurance companies of the need to keep a constant watch on compliance with the said legal and regulatory requirements and to ensure that the resources allocated to that problem are adequate. The Bank intends to continue conducting targeted supervisory measures in this field.

Pre-application for internal models

Under the future Solvency II prudential framework, companies will be able to calculate their regulatory capital requirements on the basis of an internal model. The Solvency II Directive gives the prudential authority six months to assess the model and approve its use for regulatory purposes. It was decided to allow companies to submit a model in advance to the supervisory authority for assessment in accordance with a "pre-application" procedure. It is certainly not the intention that the supervisory authority should make a formal pronouncement on the model at this stage.

Since the start of the pre-application process in 2010, the Bank has conducted 75 assessments on site for all types of risk – financial risks, technical insurance risks and operational risks. In that context, the Bank also took part as the host institution in 12 colleges which considered the internal models (though without giving any written feedback to the insurance companies). During this process, there was also growing interaction between the group supervisory authorities and the supervisory authorities from the host Member States.

Some of the companies taking part in the pre-application postponed the date for applying the model owing to cumulative delays. As a result, those companies have more time to complete and finalise the design, documentation and validation of their model. In addition, during the use test they can conduct more detailed practical testing.

Despite the progress made as a result of the pre-application assessments, the companies were notified of many points for attention. The main points identified for the various companies are presented below.

In general, it emerged that the assumptions used are simplified without being adequately checked. Moreover, in many cases the presentation of the risk factors or exposures is insufficiently granular.

The assessment of the risk model is often still a major concern. For the purpose of that assessment, appropriate tests should be conducted to check various aspects of the model. The risk model assessment does not only encourage improvements to the model, it also offers the company support in estimating the model's residual uncertainty. Consequently, it is necessary to take account of essential uncertainties, e.g. by including prudence margins in the model or adjusting the SCR obtained.

A practical example is the aggregation of risks in an internal model, where there is much room for improvement despite the checks on the model. In general, insurance companies should pay greater attention to analysis of their aggregation model in order to demonstrate that the model incorporates common adverse events causing serious stress which could generate increased losses.

Consequently, there is often insufficient evidence that the model result corresponds to a "once in 200 years" event, which means that the calculated SCR may not be enough to absorb the losses coinciding with the 99.5 quantile imposed by the Directive. For specific types of risk, the following points for attention were also frequently found:

- In market risk simulation models, companies generally use approximate revaluation techniques which had originally been inadequately supported. In recent years, those techniques have evolved as a result of the supervisory authorities' findings. However, there is a need to continue examining whether adjustments should be made to the model results to replace the approximate values.
- Under Solvency II, the philosophy applied to non-life insurance models differs from that under Solvency I (namely a "1-year overview" instead of a "complete overview"). Companies therefore generally have less experience with the new types of non-life insurance models.

– Some companies use external commercial models. In some cases, they do so without adequate knowledge of those external modules or without conducting appropriate relevance tests on the results.
– In the case of (foreign) insurance group entities, local knowledge of the models developed at group level is sometimes inadequate. Within a group, testing at local level via a use test could be formalised via procedures for the local assessment of applicability, which would also provide an official channel for communication between the entities and the group.
– In many cases, the quality of the independent internal validation is unsatisfactory; the internal validation lacks depth and therefore cannot be used as an effective test of the modellers' work. More specifically, the validators should be sufficiently critical and question the fundamental choices made in developing the model. In addition, validators are at the very least expected to carry out some independent tests.

Inspections

On-site inspections are an essential supervision tool for establishing the prudential risk profile of insurance companies. Using commonly accepted audit principles and techniques, the inspection methodology is based on analysis of the risk exposure. This approach takes the form of an objective assessment of the way in which companies organise their business and control their risks; that assessment is used for drawing up action plans.

The inspections follow a standard procedure specified in circular NBB_2013_15 of 11 December 2013 on inspections. This work leads to preparation of an inspection report detailing the purpose of the inspection, the type of checks carried out, the shortcomings detected, and the recommendations on remedying those shortcomings. The inspection leads to a general assessment set out in the report. That assessment takes account of the number of recommendations mentioned and the associated criticality scores. The said circular gives more details on the scale of the general assessment and these criticality scores.

The inspection plan for 2014 comprised a number of inspection missions concerning 15 insurance companies. The main purpose of these inspections was to assess:
– the risk management systems and cross-control functions;
– the preparations for the Solvency II requirements, particularly the adoption of the best estimate for calculating the technical provisions;
– the adequacy of the technical provisions calculated according to Solvency I;
– the suitability and implementation of the investment strategy;
– the organisation of class 23 business and management of the associated risks;
– compliance with the legal and regulatory requirements on prevention of the use of the financial system for the purpose of money-laundering and terrorist financing, and prevention of the financing of the proliferation of weapons of mass destruction.

Some of the inspection missions also aimed to compare the management practices of different companies in certain specific fields.

Box 5 – External actuarial experts

In connection with the preparations for the introduction of Solvency II, the Bank calls on external actuarial experts to assess the quality and suitability of the best estimate (see part A, section 2.1 for a definition of this term) of the seven largest insurance companies in Belgium. The insurance supervision law provides the legal basis enabling the Bank to bring in external experts.

The best estimate forms the major part of the technical provisions under Solvency II. These technical provisions in turn constitute the bulk of the insurance companies' liabilities. As the insurance companies' own funds are determined under the new Solvency regime by the difference between the assets and liabilities, the best estimate plays a crucial role in determining the available own funds of those companies. It is therefore vital to obtain a correct figure for this balance sheet item.

The external experts are asked to give an opinion on the amount of the best estimate. That procedure is not confined to simply certifying the results. The data used, the assumptions and models must also be examined in detail during this exercise. Shortcomings detected are classified by type (error or difference in expert judgement) and according to the degree of reliability of their impact. Any shortcomings found are notified to the Bank and if necessary quantified. This gives the Bank an overview of deviations found and an estimate of their impact.

The external experts carry out their assignment in accordance with a specific work programme designed for the purpose. These in-depth assignments are the result of close cooperation between the Bank and the Institute of Actuaries in Belgium. The amount spent on this programme highlights the importance and scale of the exercise. It involved no fewer than 13 insurance companies, three reinsurers, eight actuarial consultancies, four firms of auditors and five of the Bank's Services.

During the summer of 2014, a negotiated procedure with publication was launched: 14 candidates applied to take part in the multilateral framework agreement. Seven of those candidates were selected on the basis of the price submitted and the quality of the proposed team. The assignment began in November 2014. The Bank is monitoring the project very closely and making sure that the seven assignments are properly completed. For that purpose, monthly meetings are held between the external experts and those from the Bank. The meetings provide an opportunity not only for the participants to discuss their experiences but also to fine-tune the work programme month by month according to the specific characteristics of each situation.

The Bank is aware that this exercise is an additional challenge for the seven largest Belgian insurers, and makes sure that everything necessary is done to minimise the resulting burden on those companies. The Bank will also give regular feedback to the insurance companies concerned so that they also gain significant benefits from this exercise.

During the project, the external experts produce a detailed report containing their findings and recommendations. The project is to be completed in June 2015, after which the report will be submitted to the Bank. The NBB will conduct a full appraisal of the exercise on the basis of that report and the monthly meetings. The insurance companies concerned can then expect to receive detailed feedback on that appraisal.

4. Oversight and financial market infrastructures

4.1 Analysis of some priority risks from the annual risk review

Business models, liquidity risk and operational risk were given priority by the Bank for its supervision and oversight of financial market infrastructures during the year under review. The business model analysis and the liquidity risk analysis are discussed below. In the case of operational risk, particular attention once again focused on cyber security in 2014, as explained in detail in part B section 5.

Business model analysis

With a view to the launch of TARGET2-Securities (T2S), a project which is intended to facilitate cross-border securities settlement, a number of financial market infrastructures reviewed their business model. Since the settlement of securities transactions by most European central securities depositories (CSDs) will take place on the common T2S platform, CSDs will have to offer value added services to offset the loss of revenue relating to the settlement services transferred to T2S. Collateral management is becoming increasingly important, with an ever-growing international dimension. The EMIR Regulation (European Market Infrastructure Regulation)[1] is further reinforcing that trend. The joint venture between Euroclear and its American counterpart, Depository Trust & Clearing Corporation (DTCC), is an illustration of this trend. The authorities are keeping a close watch on the increasing interdependencies, both between market infrastructures in the same category (e.g. between two (international) CSDs Euroclear and DTCC) and between different market infrastructures (e.g. between central counterparties and CSDs).

Liquidity risk

If a financial market infrastructure has insufficient liquid resources at the scheduled moment for settlement, that may lead to systemic problems, especially in illiquid or volatile markets. Although market infrastructures exposed to liquidity risk have enough sources of liquidity to meet their day-to-day obligations, they also need sufficient sources of liquidity in all the relevant currencies in extreme circumstances (such as the failure of their two biggest debtor customers). Liquidity management must also be based on regular simulations of extreme scenarios and ex-ante checks.

4.2 Organisation of supervision and oversight

The Bank is the prudential supervisory authority and overseer of market infrastructures. In exercising prudential supervision, it monitors the individual institution, whereas its oversight focuses on the actual system used by the operator. While the prudential supervision checks whether an institution complies with the rules on capital and liquidity requirements, governance as well as organisation and operational functioning, the oversight is more concerned with the stability of the financial system as a whole. In particular, the oversight examines whether systemic infrastructures are capable of ensuring the continuity of their services even in extreme circumstances. The table below indicates the Belgian infrastructures subject to the Bank's

(1) Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

TABLE 7 THE BANK'S SUPERVISION AND OVERSIGHT OF FINANCIAL MARKET INFRASTRUCTURES

	Institutions / systems subject to supervision and oversight		
	The Bank acts as the sole authority	International cooperation	
		The Bank acts as the lead authority	The Bank participates, another authority is lead authority
Prudential supervision	Belgian branch of The Bank of New York Mellon Payment and electronic money institutions		BNY Mellon SA/NV (1)
Supervision and oversight	BNY Mellon CSD Atos Worldline	Euroclear Bank Euroclear Belgium Euroclear SA/NV	CCP Colleges (3)
Oversight	NBB-SSS Bancontact / MisterCash (2) Centre for Exchange and Clearing (2) MasterCard Europe (2)	SWIFT (4)	TARGET2 TARGET2-Securities CLS (5)

Source : NBB.
(1) From the entry into force of the single supervisory mechanism.
(2) Peer review in the Eurosystem / ESCB.
(3) These are the supervisory colleges for the central counterparties LCH.Clearnet SA, LCH.Clearnet Ltd, EuroCCP, Eurex AG Clearing, CC&G, ICE Clear Europe, KDPW-CCP and Keler CCP.
(4) Society for Worldwide Interbank Financial Telecommunication.
(5) Continuous Linked Settlement.

authority and the cooperation between the Bank and the supervisory authorities for third-country infrastructures.

SWIFT

The Bank acts as lead overseer of SWIFT (Society for Worldwide Interbank Financial Telecommunication). SWIFT is subject to oversight because it is crucial to the security and efficiency of the financial messages exchanged between financial institutions and financial market infrastructures throughout the world. The oversight of SWIFT is conducted by the G10 central banks, while the oversight plan and conclusions are presented to the larger group of the SWIFT Oversight Forum, in which ten other central banks also participate.

The oversight activities concern all types of operational risks associated with the SWIFT messaging services. One type of operational risk, namely cyber risk, was the focus of much closer attention during the period under review. The development of mechanisms protecting against cyber threats is continuing. During the year, SWIFT successfully completed the modernisation of its data processing architecture, with the entry into service of a new data centre. FIN, the core application used in SWIFT messaging services, is undergoing a complete technological overhaul. The monitoring of this multi-annual project was also one of the main focal points during the year under review.

Retail payments and non-bank payment service providers

Payment institutions (as well as certain electronic money institutions) provide payment services such as money remittance or credit transfers using payment accounts, the issue and acquiring of payment and debit/credit cards. At European level, the negotiations on the second payment services Directive continued in 2014. This Directive will complete the existing regulatory framework for payment institutions and adapt it to the new market developments (the conferring of a licence as a payment institution to "third party payment service providers" and the modification of the conditions for exemption from that status).

The Bank also collaborated on the report entitled "Non-banks in retail payments" which was published by

the Committee on Payments and Market Infrastructures (CPMI) in September 2014. The main conclusions of that report concern the potential impact, in terms of operational risk, of the involvement of non-bank institutions, as well as problems relating to the level playing field, consumer protection aspects, and risks that may arise if payment services are subcontracted to a single non-bank institution or too small a group of non-bank institutions.

The Bank also takes part in a working group set up by the EBA on the security of internet payments. In October 2014, the EBA launched a consultation concerning its 'Guidelines on the security of internet payments' which payment service providers and payment schemes will have to apply from 1 August 2015. The aim is to reduce the relatively high incidence of fraud and create a level playing field for the various payment service providers.

The International Standards on Combating Money-Laundering and the Financing of Terrorism and Proliferation (FATF recommendations) led the Bank to publish new circulars for financial institutions in October 2014. These circulars [1] give institutions detailed information on the periodic questionnaire concerning the combating of money-laundering and terrorist financing which they will have to complete each year. Payment and electronic money institutions will also be subject to that obligation. The answers to this questionnaire will enable more dedicated supervision plans to be drawn up in future.

Payment infrastructures and instruments

The process of bringing the Bancontact/MisterCash debit card scheme into line with the Single Euro Payments Area (SEPA) standards is continuing. In 2014, that included opening the way to competition for payment transaction acquirers, i.e. firms that process those transactions in favour of merchants. In connection with its responsibility for the oversight of Bancontact/Mistercash, the Bank monitored these developments. This year, Bancontact/Mistercash also set up a guarantee mechanism aiming at protecting the payment transaction acquirers against the possible financial consequences of an issuer's failure, in accordance with a recommendation made by the Bank.

For the Centre for Exchange and Clearing (CEC), the Belgian automated clearing house that handles retail payments, 2014 was the first full year of operation on the technical platform of the French operator STET (Système Technologique d'Echange et de Traitement). However, the CEC is still a Belgian legal entity subject to the Bank's oversight. This year, the main development for the system is the processing of SEPA direct debits, which previously had to be processed through other infrastructures.

The Bank keeps a close eye on the implementation by MasterCard of its risk management strategy for digital payments. The digital wallets offered by MasterCard formed the focus of particular attention by the Bank in the light of the Recommendations for the security of internet payments published on the ECB website in January 2013 [2].

Central counterparties

In 2014, the Bank took part in the supervisory colleges of eight foreign central counterparties (CCPs), either as the supervisory authority of a CSD in which the central counterparty settles, or as the supervisory authority of one of the three countries with the biggest CCP clearing members. The participating supervisory authorities first examined whether the CCPs met all the EMIR requirements for obtaining authorisation. Seven of the eight CCPs for which the Bank takes part in the supervisory college obtained the authorisation of the national competent authority following a comprehensive assessment and after the college's opinion. In the event of significant changes to the models or extension of the CCP's services, the supervisory college will conduct a new assessment and issue an opinion to the national competent authority.

Securities custody and settlement

During the year under review, the Bank continued to monitor Euroclear Bank's action plan aiming at full compliance with the CPSS-IOSCO principles. One of the main measures implemented is the elimination of the 'advanced income' practice whereby bond redemptions, bond interest and share dividends were recorded before the issuer had actually paid. If the issuer failed to pay, the transactions were reversed, with the risk that the money could no longer be collected from the customer. By not releasing the money until the issuer has actually paid, this risk for Euroclear Bank is now avoided.

The Bank also worked on a CPSS-IOSCO assessment of the NBB-SSS, which brought a new settlement platform into service on 2 February 2015 with a view to the migration to T2S. As part of the preparations for the switch to

(1) NBB_2014_11 of 22 October 2014 and NBB_2014_22 of 22 October 2014.

(2) Recommendations for the security of internet payments. These recommendations are the result of work by the European Forum on the Security of Retail Payments (SecuRe Pay). That forum is a voluntary initiative concerning cooperation between overseers and supervisory authorities of payment service providers, intended to improve their knowledge and understanding of the problems relating to the security of electronic retail payment services and instruments.

T2S, settlement in Europe will from now on take place two days after the trade date (instead of three).

Finally, the Bank also devoted attention to the fine-tuning of the market infrastructures' recovery plans following the publication of the CPMI-IOSCO guidelines.

The supervision of CSDs, custodians and securities settlement systems (SSS) focused partly on the implementation of the asset quality reviews and stress tests carried out in preparation for the SSM, and partly on monitoring the proper, controlled implementation of the new strategies of various operators subject to supervision, intended to position them correctly in an environment whose structure and legal and regulatory framework have undergone major changes. In addition, certain dimensions of financial risks applicable more particularly to those operators in view of their specific activities (intra-day liquidity, large exposures) received special attention. Finally, the new standards being phased in with the implementation of the new regulations (Basel III, CRD IV, large exposures, liquidity risk and leverage ratio) are monitored both in advance and as they enter into force. For operators with credit institution status, that monitoring is based on the ICAAP-SREP and ILAAP exercises applicable to them.

As well as participating in the Crisis Management Group (CMG) of BNY Mellon with the Federal Deposit Insurance Corporation, the Federal Reserve Bank of New York (FRBNY), the Board of the Federal Reserve and the UK Prudential Regulation Authority, the Bank has also taken part since 2012 in the BNY Mellon FSB (Financial Stability Board) College, which – apart from the Bank – includes the FRBNY, the Prudential Regulation Authority and the UK Financial Conduct Authority.

5. Cyber-risks

The internal IT systems of all financial institutions and infrastructures are linked in one way or another to the internet, through which they increasingly operate their services and applications. The internet used to be an add-on for most financial institutions and infrastructures, but in recent years many internet applications and services have become vital components supporting the core business of these undertakings.

Apart from the success of the internet, due in particular to the many opportunities for innovation, its cost efficiency and convenience of use, the cyber threats confronting financial institutions and infrastructures have also increased, and attacks on internet services and internal IT systems are becoming ever more frequent, persistent and professional. This last factor is a constant, major challenge for financial institutions and infrastructures, which have to ensure that their systems and services are adequately protected at all times. Often, a temporary local defect is all it takes for the attackers to break through the defences (or at least some of them) and strike (or attempt to do so).

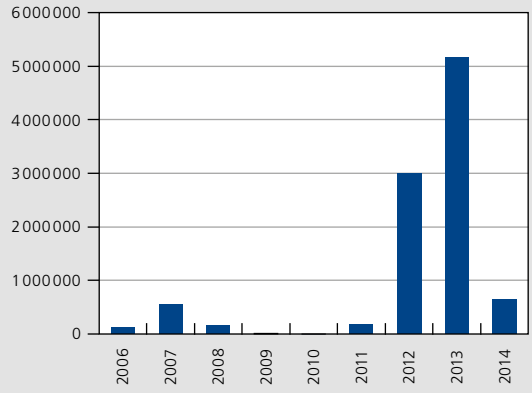
In this connection, both the prudential supervision and oversight of financial infrastructures maintained particular vigilance in 2014 regarding the protection of financial institutions and infrastructures against cyber risks. In view of the great importance and international character of the cyber threats, not only were checks and risk assessments carried out but ever-increasing attention also focused on international cooperation with other financial authorities and working groups, such as the European SecurePay Forum and the Committee on Payments and Market Infrastructures (CPMI).

In the second half of 2014, the EBA decided on close, structural cooperation with the ECB, inter alia for the purpose of combating internet payment fraud and internet banking fraud in Europe, by becoming co-chair with the ECB of the SecurePay forum. This forum was set up to prepare the European guidelines on payment security, which the EBA will then convert into European prudential regulations and the Eurosystem overseers will integrate into their oversight standards.

A CPMI working group studied the cyber risks and in November 2014 it published a report on the subject. Owing to the interdependency and interconnectedness between financial market infrastructures, cyber risks affecting a single infrastructure could spread to a whole number of infrastructures. Cyber threats are often transnational, and that presents additional challenges for an approach at company level or at national level. These findings reinforce the need to continue developing the cooperation between

CHART 9 ANNUAL FINANCIAL LOSS DUE TO E-BANKING FRAUD IN BELGIUM

(in €)



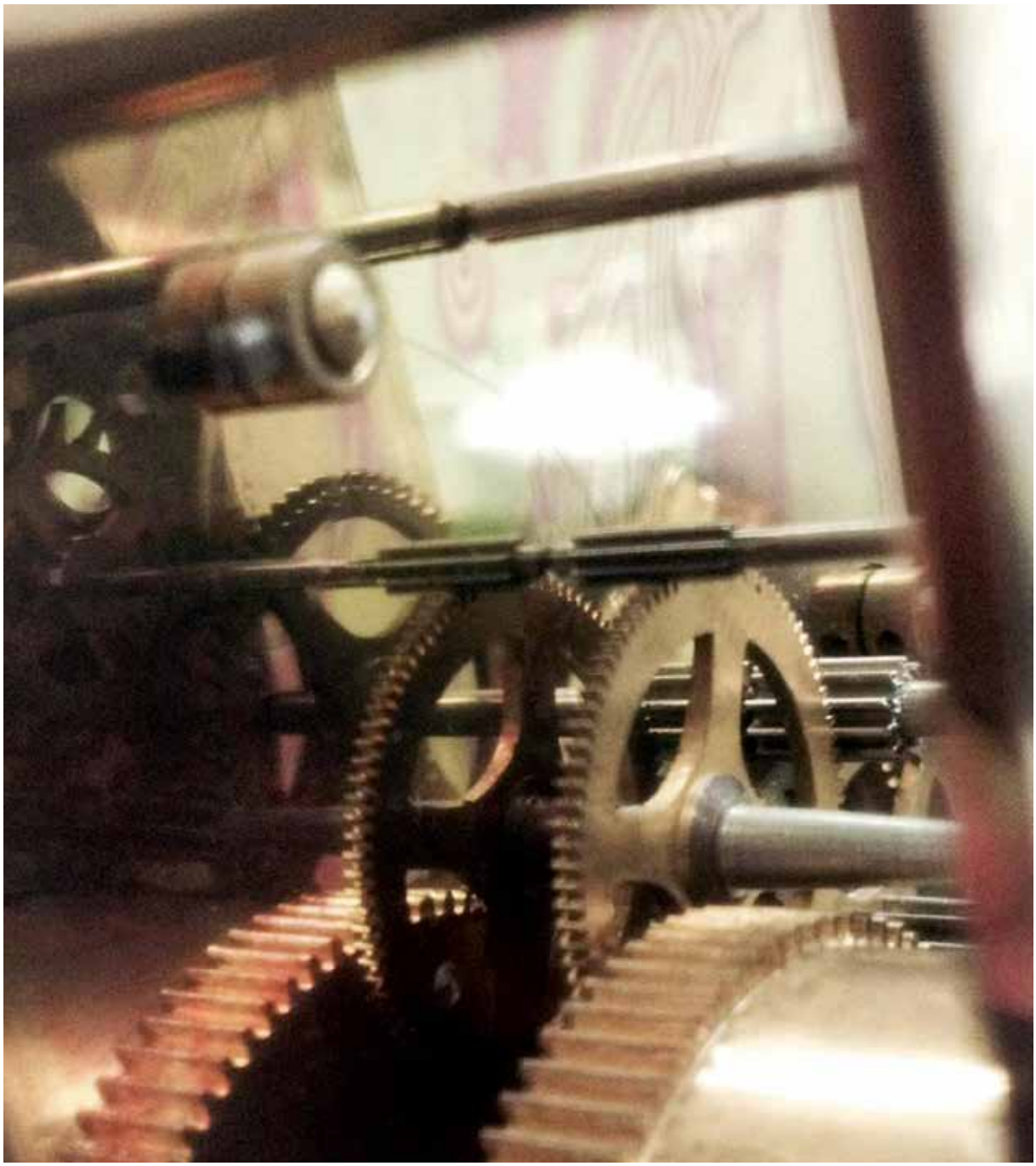
Source : NBB.

infrastructures, central banks and other regulators on the subject of cyber security in the coming years.

The close cooperation with entities such as Febelfin and the Federal Computer Crime Unit with a view to combating internet banking fraud continued in 2014. In this respect, it should be noted that instances of e-banking fraud declined considerably in Belgium in 2014, for the first time in several years, notably as a result of the efforts made by financial institutions and following some successful investigations by the Belgian police and judiciary.

As in 2013, the fraud cases recorded were due almost exclusively to fraud techniques whereby cyber criminals deceive users of e-banking services into disclosing their personal security codes, usually following a telephone call.

Another positive point is that the further expansion of mobile banking services in Belgium is not at this stage accompanied by any noteworthy degree of mobile payment fraud. Here, too, the Bank acting jointly with the sector is monitoring the existing threats and the security solutions adopted by financial institutions.



Statistical annexe

TABLE 1 MAIN MACROECONOMIC INDICATORS IN THE EURO AREA AND OTHER MAJOR ECONOMIES (1-2)

(percentage changes compared to the previous year, unless otherwise stated)

	GDP[1]			Unemployment rate[2]			Inflation		
	2012	2013	2014	2012	2013	2014	2012	2013	2014
Euro area	–0.7	–0.5	0.8	11.3	11.9	11.6	2.5	1.3	0.4
Germany	0.4	0.1	1.3	5.5	5.3	5.1	2.1	1.6	0.8
France	0.3	0.3	0.3	9.8	10.3	10.4	2.2	1.0	0.6
Italy	–2.3	–1.9	–0.4	10.7	12.2	12.6	3.3	1.3	0.2
Spain	–2.1	–1.2	1.2	24.8	26.1	24.8	2.4	1.5	–0.2
Netherlands	–1.6	–0.7	0.9	5.3	6.7	6.9	2.8	2.6	0.3
Belgium	0.1	0.3	1.0	7.6	8.5	8.6	2.6	1.2	0.5
Austria	0.9	0.2	0.7	4.3	4.9	5.3	2.6	2.1	1.5
Greece	–6.6	–3.3	0.6	24.5	27.5	26.8	1.0	–0.9	–1.4
Finland	–1.5	–1.2	–0.4	7.7	8.2	8.6	3.2	2.2	1.2
Portugal	–3.3	–1.4	0.9	15.8	16.4	14.5	2.8	0.4	–0.2
Ireland	–0.3	0.2	4.6	14.7	13.1	11.1	1.9	0.5	0.3
Slovakia	1.6	1.4	2.4	14.0	14.2	13.4	3.7	1.5	–0.1
Luxembourg	–0.2	2.0	3.0	5.1	5.9	6.1	2.9	1.7	0.7
Slovenia	–2.6	–1.0	2.4	8.9	10.1	9.8	2.8	1.9	0.4
Cyprus	–2.4	–5.4	–2.8	11.9	15.9	16.2	3.1	0.4	–0.3
Estonia	4.7	1.6	1.9	10.0	8.6	7.8	4.2	3.2	0.5
Malta	2.0	2.5	3.0	6.3	6.4	6.1	3.2	1.0	0.8
Latvia	4.8	4.2	2.6	15.0	11.9	11.0	2.3	0.0	0.7
United Kingdom	0.7	1.7	3.1	7.9	7.5	6.2	2.8	2.6	1.5
United States	2.3	2.2	2.4	8.1	7.4	6.2	2.1	1.5	1.6
Japan	1.5	1.6	0.1	4.3	4.0	3.6	0.0	0.4	2.7
China	7.7	7.8	7.4	4.1	4.1	4.1	2.6	2.6	2.1

Sources: EC, IMF, OECD, NBB.

(1) Calendar adjusted volume data.

(2) Ratio between the number of unemployed and the labour force, in %.

TABLE 2 MAIN MACROECONOMIC INDICATORS IN THE EURO AREA AND OTHER MAJOR ECONOMIES (2-2)

(in % of GDP)

	Balance of payments current account			Overall balance of general government			Public debt		
	2012	2013	2014	2012	2013	2014	2012	2013	2014
Euro area	1.9	2.4	2.5	–3.6	–2.9	–2.6	90.8	93.1	94.5
Germany	7.2	6.9	7.1	0.1	0.1	0.2	79.0	76.9	74.5
France	–2.5	–2.0	–1.9	–4.9	–4.1	–4.4	89.2	92.2	95.5
Italy	–0.5	1.0	1.5	–3.0	–2.8	–3.0	122.2	127.9	132.2
Spain	–0.4	1.5	0.5	–10.3	–6.8	–5.6	84.4	92.1	98.1
Netherlands	8.8	8.5	7.8	–4.0	–2.3	–2.5	66.5	68.6	69.7
Belgium	–0.9	0.1	0.9	–4.1	–2.9	–3.2	104.0	104.5	106.5
Austria	2.6	2.3	2.4	–2.3	–1.5	–2.9	81.7	81.2	87.0
Greece	–4.3	–2.7	–2.8	–8.6	–12.2	–1.6	156.9	174.9	175.5
Finland	–1.9	–2.0	–1.9	–2.1	–2.4	–2.9	53.0	56.0	59.8
Portugal	–2.6	–0.3	–0.2	–5.5	–4.9	–4.9	124.8	128.0	127.7
Ireland	0.9	3.8	5.5	–8.0	–5.7	–3.7	121.7	123.3	110.5
Slovakia	0.3	0.8	0.5	–4.2	–2.6	–3.0	52.1	54.6	54.1
Luxembourg	5.7	5.2	5.2	0.1	0.6	0.2	21.4	23.6	23.0
Slovenia	3.0	4.8	6.2	–3.7	–14.6	–4.4	53.4	70.4	82.2
Cyprus	–5.5	–1.3	–1.2	–5.8	–4.9	–3.0	79.5	102.2	107.5
Estonia	–3.3	–0.9	–2.8	–0.3	–0.5	–0.4	9.7	10.1	9.9
Malta	3.0	3.1	2.5	–3.7	–2.7	–2.5	67.9	69.8	71.0
Latvia	–3.5	–2.2	–2.2	–0.8	–0.9	–1.1	40.9	38.2	40.3
United Kingdom	–3.7	–4.2	–4.0	–8.3	–5.8	–5.4	85.8	87.2	89.0
United States	–2.9	–2.4	–2.2	–9.0	–5.7	–5.1	110.5	109.2	109.7
Japan	1.1	0.7	0.1	–8.7	–9.0	–8.3	216.5	224.2	230.0
China	2.6	2.0	2.4	–0.2	–0.6	–1.1	37.4	39.4	40.7

Sources: EC, IMF, OECD, NBB.

TABLE 3 GDP AND MAIN CATEGORIES OF EXPENDITURE, BY VOLUME

(calendar adjusted data; percentage changes compared to the previous year, unless otherwise stated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Household final consumption expenditure	1.3	1.5	1.8	1.8	0.2	2.8	0.6	0.8	0.3	1.0
General government final consumption expenditure	0.7	1.2	1.8	2.9	1.5	1.2	0.8	1.4	1.1	0.5
Gross fixed capital formation	6.5	3.5	6.3	2.9	–7.3	–0.1	4.0	0.0	–2.2	4.7
Housing	15.6	4.8	4.7	–2.2	–9.4	3.3	1.4	–0.5	–3.5	0.9
Enterprises	3.6	4.6	7.0	4.8	–8.2	–1.9	5.2	–0.3	–1.2	6.6
General government	6.6	–7.6	5.6	2.4	6.4	3.6	2.5	3.4	–5.4	0.7
p.m. Final domestic expenditure[1][2]	*2.2*	*1.8*	*2.7*	*2.2*	*–1.3*	*1.7*	*1.4*	*0.8*	*–0.1*	*1.7*
Change in inventories[1]	0.5	0.3	0.1	0.0	–1.0	0.3	0.8	–0.8	–0.7	–1.0
Net exports of goods and services[1]	–0.8	0.5	0.1	–1.2	–0.3	0.5	–0.5	0.1	1.0	0.4
Exports of goods and services	4.8	5.2	5.6	1.6	–9.5	10.0	6.6	1.9	2.9	4.0
Imports of goods and services	6.4	4.6	5.7	3.4	–9.1	9.6	7.4	1.8	1.7	3.6
GDP	1.9	2.6	3.0	1.0	–2.6	2.5	1.6	0.1	0.3	1.0
Trade surplus (+) or deficit (–) due to the change in the terms of trade[3]	–0.4	–0.5	0.2	–2.0	2.3	–1.2	–0.8	–0.2	0.1	0.0
Net primary incomes received from the rest of the world[3]	–0.3	0.1	0.2	0.6	–2.2	2.4	–0.8	0.7	–2.7	0.5
GNI	1.2	2.2	3.4	–0.5	–2.6	3.8	0.1	0.6	–2.4	1.5
p.m. Total domestic expenditure[4]	*2.9*	*2.2*	*3.0*	*2.3*	*–2.3*	*2.1*	*2.2*	*0.0*	*–0.7*	*0.7*
Final expenditure[5]	*3.7*	*3.5*	*4.1*	*2.0*	*–5.5*	*5.4*	*4.1*	*0.9*	*0.9*	*2.2*
General government expenditure[6]	*1.2*	*0.4*	*2.1*	*2.9*	*1.9*	*1.4*	*0.9*	*1.6*	*0.5*	*0.5*

Sources: NAI, NBB.

(1) Contribution to the change in GDP.

(2) Household and general government final consumption expenditure and gross fixed capital formation.

(3) Contribution to the change in GNI.

(4) Final domestic expenditure and change in inventories.

(5) Total domestic expenditure and exports of goods and services.

(6) Final consumption expenditure and gross fixed capital formation of general government.

TABLE 4 GDP AND MAIN CATEGORIES OF EXPENDITURE, BY VOLUME

(data adjusted for seasonal and calendar effects; percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)

	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Household final consumption expenditure	1.0	0.8	0.7	0.7	0.4	0.6	0.4	–0.1	0.4	0.6	1.1	n.
General government final consumption expenditure	1.3	1.4	1.3	1.8	1.4	1.2	1.1	0.6	0.5	0.3	–0.3	n.
Gross fixed capital formation	2.0	0.4	0.1	–2.5	–2.9	–3.1	–2.1	–0.6	2.3	3.3	9.7	n.
Housing	–0.2	–0.3	–0.4	–1.2	–3.6	–4.0	–3.6	–3.0	0.5	0.8	0.8	n.
Enterprises	2.3	0.0	0.1	–3.7	–2.1	–2.3	–1.3	1.1	3.2	4.4	14.3	n.
General government	5.7	5.0	1.2	1.9	–5.9	–6.1	–4.3	–5.4	0.2	2.2	–0.7	n.
p.m. Final domestic expenditure[1][2]	*1.3*	*0.8*	*0.7*	*0.2*	*–0.1*	*–0.1*	*0.0*	*0.0*	*0.8*	*1.1*	*2.7*	*n.*
Change in inventories[1]	0.0	–0.5	–1.4	–1.1	–0.7	–0.1	–0.8	–0.9	–1.5	–1.7	–0.5	n.
Net exports of goods and services[1]	–0.8	–0.3	0.6	1.0	0.5	0.5	1.4	1.5	1.8	1.6	–1.2	n.
Exports of goods and services	2.5	1.3	0.9	3.1	–0.6	2.3	4.7	5.1	5.1	4.6	2.6	n.
Imports of goods and services	3.6	1.7	0.2	1.8	–1.2	1.7	3.0	3.2	2.9	2.7	4.1	n.
GDP	0.5	0.0	–0.1	0.1	–0.3	0.2	0.6	0.6	1.2	1.0	1.0	0.9
p.m. GDP, percentage changes compared to the previous quarter	*0.2*	*–0.3*	*0.1*	*0.1*	*–0.2*	*0.2*	*0.4*	*0.2*	*0.4*	*0.1*	*0.3*	*0.1*
p.m. Total domestic expenditure[3]	*1.3*	*0.3*	*–0.7*	*–1.0*	*–0.8*	*–0.3*	*–0.8*	*–0.9*	*–0.6*	*–0.5*	*2.2*	*n.*
Final expenditure[4]	*1.9*	*0.7*	*0.0*	*0.8*	*–0.7*	*0.9*	*1.7*	*1.8*	*1.9*	*1.8*	*2.4*	*n.*
General government expenditure[5]	*1.7*	*1.7*	*1.3*	*1.8*	*0.7*	*0.6*	*0.7*	*0.1*	*0.4*	*0.5*	*–0.3*	*n.*

Sources: NAI, NBB.

(1) Contribution to the change in GDP.

(2) Household and general government final consumption expenditure and gross fixed capital formation.

(3) Final domestic expenditure and change in inventories.

(4) Total domestic expenditure and exports of goods and services.

(5) Final consumption expenditure and gross fixed capital formation of general government.

TABLE 5 DEFLATORS OF GDP AND THE MAIN CATEGORIES OF EXPENDITURE

(data not adjusted for calendar effects, percentage changes compared to the previous year)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Household final consumption expenditure	2.7	3.1	3.0	3.2	–0.5	1.7	3.1	2.2	1.2	0.7
General government final consumption expenditure	4.1	3.1	2.2	4.3	3.3	1.3	3.9	2.7	1.3	0.8
Gross fixed capital formation	1.5	3.5	2.7	3.6	0.1	2.1	2.9	2.1	1.0	0.0
Housing	4.8	5.7	4.5	7.8	1.2	1.6	1.4	2.7	1.7	1.5
Enterprises	0.3	2.6	2.0	2.2	–0.1	2.2	3.3	2.0	0.8	–0.4
General government	1.9	4.4	2.9	3.4	–1.6	2.4	4.2	1.7	0.3	–0.6
p.m. Final domestic expenditure(1)	*2.7*	*3.2*	*2.7*	*3.6*	*0.5*	*1.7*	*3.3*	*2.3*	*1.2*	*0.6*
Terms of trade	–0.5	–0.6	0.2	–2.6	3.4	–1.6	–1.0	–0.3	0.1	0.0
Exports of goods and services	3.9	2.7	2.3	3.9	–5.2	4.6	4.1	1.3	–0.4	–0.9
Imports of goods and services	4.4	3.3	2.0	6.6	–8.3	6.3	5.1	1.5	–0.5	–0.9
GDP	2.3	2.5	2.3	1.9	1.1	2.0	2.2	2.1	1.5	0.5
GNI	2.7	3.0	2.1	4.0	–1.1	3.2	3.0	2.3	1.5	0.6
p.m. Total domestic expenditure(2)	*2.7*	*3.0*	*2.1*	*4.0*	*–1.1*	*3.2*	*3.0*	*2.3*	*1.5*	*0.6*
Final expenditure(3)	*3.2*	*2.8*	*2.2*	*4.0*	*–2.9*	*3.8*	*3.5*	*1.8*	*0.6*	*–0.1*
General government expenditure(4)	*3.9*	*3.2*	*2.2*	*4.2*	*2.9*	*1.4*	*3.9*	*2.6*	*1.2*	*0.7*

Sources: NAI, NBB.

(1) Household and general government final consumption expenditure and gross fixed capital formation.

(2) Final domestic expenditure and change in inventories.

(3) Total domestic expenditure and exports of goods and services.

(4) Final consumption expenditure and gross fixed capital formation of general government.

TABLE 6 GDP AND THE MAIN CATEGORIES OF EXPENDITURE, AT CURRENT PRICES

(calendar adjusted data; percentage changes compared to the previous year, unless otherwise stated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Household final consumption expenditure	4.0	4.6	4.8	5.0	–0.3	4.6	3.7	3.0	1.5	1.7
General government final consumption expenditure	4.8	4.3	4.0	7.4	4.9	2.4	4.7	4.2	2.4	1.3
Gross fixed capital formation	8.1	7.1	9.2	6.6	–7.2	1.9	7.1	2.1	–1.2	4.7
Housing	21.1	10.8	9.4	5.4	–8.3	5.0	2.8	2.2	–1.9	2.4
Enterprises	4.0	7.3	9.2	7.1	–8.3	0.2	8.7	1.6	–0.4	6.2
General government	8.6	–3.5	8.6	5.9	4.7	6.1	6.8	5.2	–5.2	0.1
p.m. Final domestic expenditure[1][2]	*4.8*	*4.9*	*5.4*	*5.7*	*–0.8*	*3.4*	*4.6*	*3.0*	*1.1*	*2.3*
Change in inventories[1]	0.6	0.2	–0.4	0.5	–2.6	1.8	0.6	–0.7	–0.3	–1.0
Net exports of goods and services[1]	–1.1	0.2	0.4	–3.3	1.9	–0.6	–1.3	–0.1	1.0	0.4
Exports of goods and services	8.8	8.0	8.0	5.5	–14.2	15.1	10.9	3.2	2.5	3.0
Imports of goods and services	11.1	8.1	7.8	10.2	–16.7	16.6	13.0	3.4	1.2	2.6
GDP	4.3	5.2	5.4	2.9	–1.5	4.6	3.9	2.2	1.8	1.6
Net primary incomes received from the rest of the world[3]	–0.3	0.1	0.2	0.6	–2.2	2.5	–0.7	0.7	–2.7	0.5
GNI	3.9	5.3	5.6	3.5	–3.7	7.1	3.1	2.9	–1.0	2.1
p.m. Total domestic expenditure[4]	*5.7*	*5.2*	*5.2*	*6.4*	*–3.4*	*5.3*	*5.3*	*2.3*	*0.8*	*1.2*
Final expenditure[5]	*7.0*	*6.4*	*6.4*	*6.0*	*–8.2*	*9.4*	*7.8*	*2.7*	*1.5*	*2.0*
General government expenditure[6]	*5.1*	*3.6*	*4.4*	*7.2*	*4.8*	*2.7*	*4.9*	*4.2*	*1.7*	*1.2*

Sources: NAI, NBB.

(1) Contribution to GDP growth.

(2) Household and general government final consumption expenditure and gross fixed capital formation.

(3) Contribution to GNI growth.

(4) Final domestic expenditure and change in inventories.

(5) Total domestic expenditure and exports of goods and services.

(6) Final consumption expenditure and gross fixed capital formation of general government.

TABLE 7 GDP AND THE MAIN CATEGORIES OF EXPENDITURE, AT CURRENT PRICES

(data not adjusted for calendar effects, in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Household final consumption expenditure	156 580	163 842	171 766	180 423	179 906	188 095	195 103	200 936	203 970	207 440
General government final consumption expenditure	69 123	72 067	74 949	80 477	84 385	86 437	90 483	94 242	96 503	97 753
Gross fixed capital formation	69 178	74 085	80 887	86 208	79 998	81 537	87 301	89 139	88 045	92 184
Housing	16 560	18 344	20 065	21 154	19 402	20 366	20 938	21 395	20 983	21 489
Enterprises	46 083	49 433	53 970	57 801	53 003	53 115	57 755	58 687	58 473	62 099
General government	6 535	6 308	6 852	7 253	7 594	8 057	8 608	9 057	8 590	8 596
p.m. Final domestic expenditure[1]	*294 881*	*309 993*	*327 602*	*347 108*	*344 289*	*356 069*	*372 886*	*384 316*	*388 518*	*397 378*
Change in inventories	4 519	5 025	4 177	6 128	–3 201	3 206	4 749	2 164	1 440	–2 810
Net exports of goods and services	11 750	12 350	13 289	1 830	8 615	6 472	2 355	1 775	5 304	6 924
Exports of goods and services	229 469	247 740	267 493	282 285	242 214	278 845	309 335	319 267	327 126	336 887
Imports of goods and services	217 720	235 390	254 204	280 456	233 599	272 373	306 980	317 492	321 822	329 963
GDP	311 150	327 368	345 069	355 066	349 703	365 747	379 991	388 254	395 262	401 492
Net primary incomes received from the rest of the world	2 816	3 228	4 035	6 221	–1 852	6 813	4 078	6 842	–3 982	11 379
GNI	313 966	330 596	349 104	361 287	347 851	372 560	384 068	395 096	391 281	412 871
p.m. Total domestic expenditure[2]	*299 400*	*315 018*	*331 780*	*353 236*	*341 088*	*359 275*	*377 636*	*386 480*	*389 958*	*394 568*
Final expenditure[3]	*528 870*	*562 758*	*599 273*	*635 521*	*583 302*	*638 120*	*686 971*	*705 747*	*717 084*	*731 454*
General government expenditure[4]	*75 658*	*78 375*	*81 801*	*87 730*	*91 978*	*94 494*	*99 091*	*103 298*	*105 093*	*106 349*

Sources: NAI, NBB.

(1) Household and general government final consumption expenditure and gross fixed capital formation.

(2) Final domestic expenditure and change in inventories.

(3) Total domestic expenditure and exports of goods and services.

(4) Final consumption expenditure and gross fixed capital formation of general government.

TABLE 8 VALUE ADDED OF THE VARIOUS BRANCHES OF ACTIVITY, BY VOLUME

(data not adjusted for calendar effects, percentage changes compared to the previous year)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	*p.m. In % of the 2013 GDP*
Agriculture, forestry and fishing	–3.0	8.8	–0.7	1.4	–5.6	6.9	–2.6	–4.5	3.3	*0.7*
Industry, energy and water	1.0	1.9	4.1	0.0	–7.7	5.2	–0.9	–0.1	–0.6	*15.3*
Mining and quarrying	7.8	8.7	4.7	22.1	–5.6	4.8	13.6	–3.2	–13.0	*0.1*
Manufacturing industry	1.7	1.7	4.4	0.0	–11.7	5.3	–0.7	2.5	–0.1	*13.0*
of which:										
Food, beverages, tobacco	1.4	2.7	6.6	5.7	–0.9	1.2	8.6	9.6	–0.7	*1.8*
Textiles, wood, paper and printing	–2.5	4.8	5.2	–2.4	–11.5	–1.7	4.9	–0.6	–2.8	*1.2*
Chemicals and rubber[1]	5.9	2.0	3.6	4.0	–12.1	7.5	–8.0	1.9	2.1	*5.1*
Metallurgy and metal-working industry	–7.8	2.0	10.4	–6.6	–11.3	11.1	–0.2	3.8	–1.7	*1.6*
IT products and electrical equipment	–4.3	1.1	–5.3	–5.5	–15.4	2.7	0.0	1.5	–3.3	*0.8*
Machinery and equipment, transport equipment	10.6	–1.1	4.4	–3.9	–23.5	6.8	4.0	–4.5	–0.7	*1.9*
Other manufacturing industries	–7.6	–4.7	–3.0	0.8	3.4	–1.7	8.3	11.6	–0.1	*0.6*
Electricity and gas	–2.5	6.6	2.2	0.9	23.2	3.1	–4.6	–19.7	–3.4	*1.6*
Water	–7.8	–4.0	1.8	–4.5	0.1	9.4	4.0	6.1	–2.6	*0.8*
Construction	4.5	9.9	1.8	1.1	–1.5	1.0	7.9	1.9	–1.3	*5.0*
Services										
Trade and repairs	–2.7	0.2	7.0	0.3	–3.8	2.2	0.5	–2.7	0.2	*11.2*
Transportation and storage	6.2	0.4	2.5	2.9	–6.1	2.0	4.2	0.9	–3.6	*4.8*
Accommodation and food service activities	3.8	2.4	–3.4	2.3	–11.7	–1.1	0.7	–1.5	0.3	*1.6*
Information and communication	–0.6	2.4	3.6	2.6	0.6	–1.4	2.9	0.5	0.3	*3.6*
Financial services	3.7	7.4	–4.0	1.0	1.1	3.9	2.2	4.4	–0.8	*5.4*
Real estate activities	–0.5	1.2	0.7	2.1	–0.5	2.1	2.9	1.9	0.2	*7.8*
Legal and administrative services, R&D	9.3	5.9	6.6	2.7	–2.3	3.2	5.3	–5.7	2.6	*11.9*
Public administration and education	1.8	1.2	0.9	2.0	1.0	1.4	–0.4	1.9	2.1	*13.4*
Human health and social work	0.0	0.1	2.2	1.9	3.6	–1.2	2.1	4.1	0.8	*6.8*
Other services	1.9	1.8	0.6	3.1	–4.7	1.6	2.8	1.7	1.1	*1.9*
Value added of branches, at basic prices	1.9	2.6	3.0	1.5	–2.7	2.3	1.9	0.0	0.4	*89.6*
Taxes net of subsidies on products[2]	0.2	0.4	0.4	–0.4	–0.2	0.4	–0.1	0.1	–0.1	*10.4*
GDP	1.9	2.6	3.0	1.0	–2.6	2.5	1.6	0.1	0.3	*100.0*

Source: NAI.

(1) This heading also includes manufacture of coke and the pharmaceutical industry.

(2) Contribution to the change in GDP.

TABLE 9 LABOUR MARKET

(annual averages, thousands of persons)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Population of working age (1)	6 879	6 942	7 012	7 074	7 124	7 180	7 225	7 247	7 259	7 269
Labour force	4 918	4 962	4 982	5 036	5 078	5 123	5 166	5 194	5 205	5 234
National employment	4 333	4 383	4 456	4 535	4 527	4 558	4 621	4 635	4 621	4 636
Frontier workers (balance)	73	75	77	78	79	80	79	80	79	79
Domestic employment	4 260	4 307	4 379	4 458	4 449	4 479	4 542	4 555	4 543	4 558
Self-employed	695	699	706	716	720	726	736	745	752	759
Employees	3 566	3 608	3 673	3 742	3 728	3 752	3 806	3 810	3 791	3 799
Branches sensitive to the business cycle (2)	2 255	2 285	2 335	2 382	2 344	2 347	2 378	2 371	2 347	2 346
Public administration and education	758	763	770	780	793	800	804	803	805	805
Other services (3)	553	560	567	580	591	605	623	637	639	648
Unemployment (4)	585	579	526	500	551	565	545	559	584	598

Sources: DGS, FPB, NAI, NEO, NBB.

(1) Persons aged 15 to 64.

(2) The branches agriculture; industry; construction; production and supply of electricity, gas, steam and air conditioning; water supply; sewerage, waste management and remediation activities; trade; repair of motor vehicles and motorcycles; transportation and storage; accommodation and food service activities; information and communication; financial and insurance activities; real estate activities; specialist, scientific and technical activities and administrative and support service activities.

(3) The branches human health and social work, culture, entertainment and recreational activities; other service activities and activities of households as employers.

(4) Unemployed job-seekers, consisting of wholly unemployed persons receiving benefits (excluding older unemployed persons not seeking work), and other compulsorily or voluntarily registered job-seekers. Job-seekers working via the local employment agencies were excluded since they are already included in employment.

TABLE 10 EMPLOYMENT RATE

(in % of the corresponding labour force aged 20 to 64[1], annual averages)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014[2]
Total	66.5	66.5	67.7	68.0	67.1	67.6	67.3	67.2	67.2	67.2
p.m. Total (from 15 to 64 years)	*61.1*	*61.0*	*62.0*	*62.4*	*61.6*	*62.0*	*61.9*	*61.8*	*61.8*	*61.8*
According to sex										
Women	58.7	58.8	60.3	61.3	61.0	61.6	61.5	61.7	62.1	62.9
Men	74.3	74.0	75.0	74.7	73.2	73.5	73.0	72.7	72.3	71.4
According to age										
20 to 29	63.3	64.0	64.5	64.5	61.8	61.0	60.5	59.4	57.9	57.5
30 to 54	78.2	78.3	79.7	80.5	79.9	80.5	79.8	79.9	79.8	79.8
55 to 64	32.3	32.0	34.4	34.5	35.3	37.3	38.7	39.5	41.7	42.3
According to Region										
Brussels	59.2	57.9	59.4	60.2	59.5	59.2	58.2	58.2	56.8	58.4
Flanders	70.4	70.6	71.9	72.3	71.5	72.1	71.8	71.5	71.9	71.8
Wallonia	61.8	61.6	62.6	62.8	61.7	62.2	62.2	62.5	62.3	61.7
According to educational level										
Lower secondary education or less	48.8	48.8	49.5	49.1	47.7	48.4	47.3	47.1	46.8	46.5
Upper secondary education	68.8	68.3	69.3	70.1	68.8	69.1	68.9	68.5	68.6	67.0
Higher education	82.9	82.4	83.7	83.0	81.9	81.9	82.0	81.8	81.0	81.8
According to nationality										
Belgian	67.8	67.8	68.9	69.1	68.4	68.8	68.7	68.6	68.7	68.5
Other EU nationals[3]	61.9	61.5	63.4	65.4	62.4	65.0	65.1	65.2	63.6	65.4
Other	36.6	36.3	40.3	42.1	40.9	40.4	39.6	38.9	39.9	41.3

Source: DGS.

(1) These employment rates are calculated on the basis of the harmonised data taken from the labour force survey.

(2) Averages of the first three quarters.

(3) Except Croatia which joined the EU on 1 July 2013.

TABLE 11 UNEMPLOYMENT RATE

(in % of the corresponding labour force aged 15 to 64[1], annual averages)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014[2]
Total	8.5	8.3	7.5	7.0	8.0	8.4	7.2	7.6	8.5	8.6
According to sex										
Women	9.6	9.4	8.5	7.6	8.1	8.6	7.2	7.4	8.2	7.9
Men	7.7	7.5	6.7	6.5	7.8	8.2	7.2	7.7	8.7	9.2
According to age										
15 to 24	21.5	20.5	18.8	18.0	21.9	22.4	18.7	19.8	23.7	23.6
25 to 54	7.4	7.2	6.6	6.1	6.8	7.3	6.4	6.7	7.4	7.6
55 to 64	4.4	4.8	4.2	4.4	5.1	4.6	4.0	4.5	5.4	5.0
According to Region										
Brussels	16.5	17.7	17.2	16.0	15.9	17.4	17.1	17.5	19.3	18.7
Flanders	5.5	5.0	4.4	3.9	5.0	5.2	4.3	4.6	5.1	5.0
Wallonia	11.9	11.8	10.5	10.1	11.2	11.5	9.5	10.1	11.4	12.0
According to educational level										
Lower secondary education or less	14.1	14.0	13.0	12.5	13.7	15.4	14.1	14.2	16.0	16.5
Upper secondary education	8.5	8.2	7.6	7.0	8.1	8.2	6.8	7.8	8.3	8.8
Higher education	4.5	4.5	3.8	3.6	4.5	4.5	3.8	4.0	4.9	4.7
According to nationality										
Belgian	7.7	7.5	6.8	6.3	7.1	7.5	6.3	6.5	7.4	7.6
Other EU nationals[3]	10.0	11.7	9.8	9.1	11.0	11.0	10.3	11.1	12.5	11.9
Other	34.1	33.2	29.6	27.4	29.5	30.6	27.8	30.7	29.9	29.6

Source: DGS.

(1) These unemployment rates are calculated on the basis of the harmonised data taken from the labour force survey.

(2) Averages of the first three quarters.

(3) Except Croatia which joined the EU on 1 July 2013.

TABLE 12 INACTIVITY RATE

(in % of the corresponding population aged 15 to 64[1], annual averages)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014[2]
Total	33.3	33.5	32.9	32.9	33.1	32.3	33.3	33.1	32.5	32.4
According to sex										
Women	40.5	40.5	39.6	39.2	39.1	38.2	38.9	38.7	37.7	37.2
Men	26.1	26.6	26.4	26.7	27.2	26.6	27.7	27.5	27.3	27.7
According to age										
15 to 24	65.2	65.3	66.1	66.6	67.6	67.5	68.0	68.5	69.0	70.0
25 to 54	15.4	15.5	14.7	14.3	14.4	13.7	15.3	15.0	14.7	14.3
55 to 64	66.6	66.4	64.1	63.9	62.8	60.8	59.7	58.6	55.9	55.4
According to Region										
Brussels	34.3	35.1	33.9	33.8	34.5	33.7	35.1	34.6	34.9	33.5
Flanders	31.4	31.6	30.9	30.8	30.8	30.1	30.8	31.0	30.2	30.2
Wallonia	36.3	36.4	36.3	36.4	36.7	35.9	37.0	36.3	35.6	35.9
According to educational level										
Lower secondary education or less	53.0	53.4	53.5	54.6	55.2	53.7	55.3	55.6	55.3	55.5
Upper secondary education	28.4	29.1	28.7	28.0	28.8	28.5	29.6	29.3	28.9	30.3
Higher education	13.4	13.7	13.1	13.8	14.2	14.3	14.7	14.9	14.8	14.1
According to nationality										
Belgian	32.8	33.0	32.5	32.6	32.7	32.1	32.8	32.6	32.0	32.0
Other EU nationals[3]	34.2	33.6	32.2	31.3	33.1	30.0	30.6	30.1	30.7	29.6
Other	47.9	49.7	45.8	45.1	45.0	44.9	48.2	47.8	46.4	45.1

Source: DGS.

(1) These inactivity rates are calculated on the basis of the harmonised data taken from the labour force survey.

(2) Averages of the first three quarters.

(3) Except Croatia which joined the EU on 1 July 2013.

TABLE 13 EMPLOYMENT RATE: REGIONAL DETAILS

(in % of the corresponding population aged 20 to 64[1], annual averages)

	Brussels				Flanders				Wallonia			
	2011	2012	2013	2014[2]	2011	2012	2013	2014[2]	2011	2012	2013	2014[2]
Total	58.2	58.2	56.8	58.4	71.8	71.5	71.9	71.8	62.2	62.5	62.3	61.7
p.m. Total (from 15 to 64 years)	*53.8*	*54.0*	*52.5*	*54.0*	*66.2*	*65.9*	*66.2*	*66.3*	*57.0*	*57.3*	*57.0*	*56.4*
According to sex												
Women	52.5	52.3	52.4	53.8	66.4	66.2	66.9	67.5	55.8	56.8	56.9	57.8
Men	64.1	64.3	61.3	63.2	77.0	76.7	76.8	76.1	68.7	68.2	67.7	65.7
According to age												
20 to 29	46.7	47.6	44.1	46.9	67.1	65.5	65.1	64.2	54.6	53.6	51.0	50.2
30 to 54	66.5	66.9	65.5	66.2	85.2	84.9	85.0	85.1	74.5	75.3	75.3	74.8
55 to 64	45.0	41.9	43.6	46.8	38.9	40.5	42.9	43.7	36.9	37.1	39.1	38.9
According to educational level												
Lower secondary education or less	39.6	39.5	38.1	39.9	52.0	51.7	52.0	51.9	43.1	43.0	42.6	41.1
Upper secondary education	52.9	54.3	52.2	52.0	74.0	72.9	73.4	71.7	62.9	63.6	63.6	61.7
Higher education	77.0	75.8	75.5	76.4	83.8	83.9	83.2	84.2	80.8	80.0	79.0	79.5
According to nationality												
Belgian	59.8	59.9	57.9	58.1	72.7	72.4	72.7	72.7	63.4	63.6	63.8	63.1
Other EU nationals[3]	68.1	65.4	66.7	70.1	68.5	70.3	69.3	69.4	58.9	60.2	55.4	56.3
Other	36.0	39.1	37.6	41.1	46.3	42.8	46.4	46.2	33.8	31.6	32.3	32.6

Source: DGS.

(1) These employment rates are calculated on the basis of the harmonised data taken from the labour force survey.

(2) Averages of the first three quarters.

(3) Except Croatia which joined the EU on 1 July 2013.

TABLE 14 UNEMPLOYMENT RATE: REGIONAL DETAILS

(in % of the corresponding labour force aged 15 to 64[1], annual averages)

	Brussels				Flanders				Wallonia			
	2011	2012	2013	2014[2]	2011	2012	2013	2014[2]	2011	2012	2013	2014[2]
Total	17.1	17.5	19.3	18.7	4.3	4.6	5.1	5.0	9.5	10.1	11.4	12.0
According to sex												
Women	15.5	16.8	17.0	16.2	4.4	4.5	5.0	4.9	10.1	10.0	11.4	10.9
Men	18.4	18.1	21.2	20.8	4.2	4.6	5.1	5.1	9.0	10.2	11.4	13.0
According to age												
15 to 24	35.3	36.4	39.9	41.7	12.7	12.8	16.6	15.8	25.2	27.1	32.8	32.8
25 to 54	16.8	16.4	18.5	17.9	3.5	3.9	4.0	4.2	8.5	8.9	9.9	10.6
55 to 64	6.5	12.3	12.2	10.4	3.4	3.0	3.8	3.2	4.4	5.0	6.4	6.9
According to educational level												
Lower secondary education or less	30.5	29.3	33.2	31.6	8.6	8.4	8.9	9.2	16.6	17.7	20.1	21.8
Upper secondary education	19.3	21.1	21.9	22.4	3.9	4.7	5.0	5.3	10.3	11.0	11.9	12.8
Higher education	8.5	9.0	10.1	10.2	2.6	2.6	3.5	3.0	4.3	4.5	5.7	5.9
According to nationality												
Belgian	15.6	15.4	17.9	17.7	3.8	3.9	4.5	4.5	9.1	9.6	10.8	11.3
Other EU nationals[3]	12.5	14.6	15.6	13.7	8.2	8.9	9.3	8.9	10.3	9.5	12.7	13.2
Other	35.6	34.4	34.3	34.6	19.9	24.6	22.7	19.1	29.4	36.0	36.8	40.0

Source: DGS.

(1) These unemployment rates are calculated on the basis of the harmonised data taken from the labour force survey.

(2) Averages of the first three quarters.

(3) Except Croatia which joined the EU on 1 July 2013.

TABLE 15 INACTIVITY RATE: REGIONAL DETAILS

(in % of the corresponding population aged 15 to 64[1], annual averages)

	Brussels				Flanders				Wallonia			
	2011	2012	2013	2014[2]	2011	2012	2013	2014[2]	2011	2012	2013	2014[2]
Total	35.1	34.6	34.9	33.5	30.8	31.0	30.2	30.2	37.0	36.3	35.6	35.9
According to sex												
Women	42.5	41.7	41.6	40.5	35.9	36.1	35.0	34.6	43.1	42.2	41.1	40.6
Men	27.5	27.5	28.1	26.4	25.9	25.9	25.5	26.0	31.0	30.4	30.1	31.1
According to age												
15 to 24	72.6	72.4	74.5	73.6	66.3	67.7	66.8	68.4	69.4	68.6	70.9	71.6
25 to 54	21.5	21.0	21.2	20.1	11.9	12.0	11.9	11.4	19.1	18.3	17.3	17.5
55 to 64	51.9	52.2	50.4	47.7	59.8	58.2	55.4	54.9	61.4	60.9	58.2	58.2
According to educational level												
Lower secondary education or less	52.7	53.5	52.8	51.9	54.1	54.8	54.7	54.6	57.9	57.3	57.2	58.1
Upper secondary education	37.4	34.3	36.1	36.3	27.0	27.4	26.9	28.3	33.0	31.9	30.9	32.5
Higher education	15.9	16.7	16.1	14.9	14.0	13.9	13.8	13.3	15.6	16.2	16.2	15.6
According to nationality												
Belgian	35.3	35.2	35.8	35.9	30.5	30.6	30.0	29.8	36.6	35.7	34.9	35.3
Other EU nationals[3]	26.0	27.5	24.3	22.2	29.3	26.5	28.3	28.9	36.4	36.3	38.9	38.0
Other	47.5	43.3	46.0	40.6	45.6	48.1	43.5	47.4	54.2	54.5	52.4	49.0

Source: DGS.

(1) These inactivity rates are calculated on the basis of the harmonised data taken from the labour force survey.

(2) Averages of the first three quarters.

(3) Except Croatia which joined the EU on 1 July 2013.

TABLE 16 HARMONISED INDEX OF CONSUMER PRICES

(percentage changes compared to the corresponding period of the previous year)

	Total	Energy	Unprocessed food[1]	Processed food	Underlying trend in inflation[2]			*p.m. National consumer price index*	*p.m. Health index*[3]
						Non-energy industrial goods	Services		
2006	2.3	7.3	3.2	2.1	1.6	0.9	2.1	*1.8*	*1.8*
2007	1.8	0.2	3.0	4.7	1.4	0.9	1.9	*1.8*	*1.8*
2008	4.5	19.8	2.8	7.8	1.8	1.3	2.3	*4.5*	*4.2*
2009	0.0	–14.0	0.4	1.7	2.1	1.4	2.6	*–0.1*	*0.6*
2010	2.3	10.0	3.5	1.0	1.1	0.8	1.4	*2.2*	*1.7*
2011	3.4	17.0	0.2	3.1	1.5	1.0	1.9	*3.5*	*3.1*
2012	2.6	6.0	3.4	3.1	1.9	0.9	2.5	*2.8*	*2.7*
2013	1.2	–4.6	4.4	3.2	1.4	0.8	1.9	*1.1*	*1.2*
2014	0.5	–6.0	–1.3	2.2	1.5	0.5	2.3	*0.3*	*0.4*
2013 January	1.1	–4.3	1.7	2.4	1.7	0.9	2.3	*1.1*	*1.3*
February	1.0	–3.5	0.2	2.1	1.6	0.7	2.2	*1.0*	*1.2*
March	0.9	–3.0	–0.5	2.3	1.5	0.5	2.1	*0.9*	*1.0*
April	0.9	–6.9	0.6	2.9	1.8	0.5	2.7	*0.6*	*0.7*
May	0.8	–4.9	–2.5	2.9	1.7	0.7	2.4	*0.4*	*0.3*
June	0.7	–4.7	–3.5	2.7	1.7	0.7	2.3	*0.3*	*0.1*
July	0.6	–6.0	–1.1	2.9	1.5	0.2	2.3	*0.3*	*0.2*
August	0.4	–6.5	–2.3	2.3	1.5	0.6	2.1	*0.0*	*0.0*
September	0.2	–8.2	–2.4	1.9	1.6	0.5	2.3	*–0.1*	*0.0*
October	0.3	–6.2	–2.4	1.5	1.5	0.3	2.3	*0.1*	*0.1*
November	0.1	–7.3	–1.8	1.1	1.3	0.2	2.0	*–0.1*	*0.0*
December	–0.4	–11.3	–2.1	1.1	1.3	0.2	2.0	*–0.4*	*0.0*

Sources: EC, DGS.

(1) Fruit, vegetables, meat and fish.

(2) Measured by the HICP excluding food and energy.

(3) NCPI excluding the prices of products considered harmful to health, namely tobacco, alcoholic beverages, petrol and diesel.

TABLE 17 SUMMARY ACCOUNT OF HOUSEHOLDS, AT CURRENT PRICES[1]

(data not adjusted for calendar effects, in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
1. Gross primary income	225 347	236 243	249 050	263 081	261 157	266 860	275 087	280 882	285 291	289 939
Wages and salaries[2]	156 777	164 537	173 358	182 836	184 481	188 202	196 554	203 326	207 512	209 714
Property incomes[3]	27 523	28 307	30 257	33 630	31 252	31 936	31 114	29 376	28 279	29 515
Gross mixed income	21 725	22 770	23 284	23 881	23 524	24 439	24 505	24 949	25 595	25 957
Gross operating surplus	19 322	20 629	22 151	22 733	21 900	22 282	22 914	23 230	23 904	24 753
2. Current transfers[3]	–42 014	–42 845	–45 865	–48 610	–43 277	–46 140	–49 243	–50 315	–52 393	–52 238
Transfers received	65 400	67 181	69 145	73 110	78 873	80 196	82 860	86 767	89 995	91 805
Transfers paid	107 414	110 025	115 009	121 721	122 150	126 336	132 103	137 081	142 388	144 043
3. Gross disposable income (1 + 2)	183 333	193 399	203 185	214 471	217 880	220 720	225 844	230 567	232 897	237 701
p.m. In real terms[4]	*214 158*	*219 155*	*223 615*	*228 669*	*233 539*	*232 552*	*230 758*	*230 567*	*230 217*	*233 286*
(percentage changes compared to the previous year)	*(1.0)*	*(2.3)*	*(2.0)*	*(2.3)*	*(2.1)*	*(–0.4)*	*(–0.8)*	*(–0.1)*	*(–0.2)*	*(1.3)*
4. Change in households' entitlements to supplementary pensions accruing in the context of an occupational activity	1 768	1 860	2 232	2 688	2 668	3 387	2 906	2 815	2 817	2 817
5. Final consumption expenditure	156 580	163 842	171 766	180 423	179 906	188 095	195 103	200 936	203 970	207 389
6. Gross savings (3 + 4 – 5)	28 521	31 417	33 650	36 736	40 642	36 012	33 647	32 447	31 745	33 129
p.m. In % of gross disposable income[5]	*15.4*	*16.1*	*16.4*	*16.9*	*18.4*	*16.1*	*14.7*	*13.9*	*13.5*	*13.8*
7. Capital transfers[6]	–1 195	–1 331	–1 101	–1 212	– 919	–1 241	– 413	–1 024	–1 579	–1 858
8. Gross capital formation	19 103	21 069	22 920	23 949	22 074	22 970	23 829	23 924	23 568	24 218
9. Overall balance (6 + 7 – 8)	8 224	9 018	9 630	11 574	17 649	11 801	9 406	7 498	6 598	7 053

Sources: NAI, NBB.

(1) The data in this table are calculated in gross terms, i.e. before deduction of consumption of fixed capital.

(2) Remuneration (excluding that of owner entrepreneurs), including social security contributions and civil service pensions.

(3) These are net amounts, i.e. the difference between incomes or transfers received from other sectors and those paid to other sectors, excluding transfers in kind.

(4) Data deflated by means of the household final consumption expenditure deflator.

(5) In % of gross disposable income in the broad sense, i.e. including the change in households' entitlements to additional pensions accruing in the context of an occupational activity.

(6) These are net amounts, i.e. the difference between transfers received from other sectors and those paid to other sectors, including net acquisitions of non-financial non-produced assets and net acquisitions of valuables.

TABLE 18 SUMMARY ACCOUNT OF CORPORATIONS, AT CURRENT PRICES[1]

(data not adjusted for calendar effects, in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
1. Gross primary income	58 781	62 516	67 202	65 084	54 526	71 031	72 823	75 455	65 688	81 504
Gross operating surplus	76 418	81 105	86 709	85 961	81 993	91 470	95 533	93 515	94 644	96 560
Property incomes[2]	–17 637	–18 590	–19 507	–20 877	–27 467	–20 439	–22 710	–18 060	–28 955	–15 056
2. Current transfers[2]	–8 211	–9 675	–8 822	–8 784	–5 883	–5 991	–8 110	–10 107	–10 932	–10 688
Transfers received	19 732	20 384	22 846	23 611	24 729	26 034	25 340	25 141	24 949	25 493
Transfers paid	27 943	30 059	31 668	32 395	30 612	32 025	33 450	35 248	35 881	36 182
3. Gross disposable income (1 + 2)	50 571	52 841	58 380	56 300	48 643	65 040	64 713	65 348	54 756	70 816
4. Adjustment for change in pension entitlements (supplementary pensions accruing in the context of an occupational activity)	–1 767	–1 857	–2 233	–2 685	–2 674	–3 394	–2 913	–2 823	–2 825	–2 825
5. Gross savings (3 + 4)	48 804	50 984	56 147	53 616	45 969	61 646	61 800	62 526	51 932	67 991
6. Capital transfers[3]	8 772	1 959	1 902	1 645	3 436	2 878	3 646	8 830	4 038	5 505
7. Gross fixed capital formation	43 443	46 608	51 010	54 902	50 262	50 437	54 989	55 999	55 907	59 319
8. Change in inventories	4 668	5 156	4 352	6 108	–3 474	2 963	4 141	1 839	1 207	–3 018
9. Overall balance (5 + 6 – 7 – 8)	9 464	1 178	2 687	–5 749	2 616	11 123	6 316	13 517	–1 145	17 195

Sources: NAI, NBB.

(1) The data in this table are calculated in gross terms, i.e. before deduction of consumption of fixed capital.

(2) These are net amounts, i.e. the difference between transfers received from other sectors and those paid to other sectors, excluding transfers in kind.

(3) These are net amounts, i.e. the difference between transfers received from other sectors and those paid to other sectors, including net acquisitions of non-financial non-produced assets and net acquisitions of valuables.

TABLE 19 SUMMARY ACCOUNT OF THE REST OF THE WORLD, AT CURRENT PRICES[1]

(data not adjusted for calendar effects, in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
1. Gross primary income	–2 816	–3 227	–4 035	–6 221	1 852	–6 813	–4 078	–6 842	3 982	–11 379
Compensation of employees[2]	–4 220	–4 484	–4 602	–4 745	–4 949	–5 133	–5 223	–5 329	–5 448	–5 509
Taxes on production and imports[2]	374	508	774	948	573	583	704	650	589	643
Property incomes[2]	1 030	749	– 207	–2 425	6 228	–2 262	442	–2 162	8 841	–6 513
2. Current transfers[2]	4 675	4 560	3 869	4 780	5 142	4 595	5 216	6 208	7 129	6 711
Transfers received	9 560	9 285	9 825	10 307	11 217	11 887	12 084	12 859	13 128	12 723
Transfers paid	4 886	4 725	5 955	5 527	6 075	7 293	6 868	6 650	5 999	6 012
3. Transactions in goods and services	–11 750	–12 350	–13 289	–1 830	–8 615	–6 472	–2 355	–1 775	–5 304	–7 027
Imports by Belgium	217 720	235 390	254 204	280 456	233 599	272 373	306 980	317 492	321 822	329 957
Exports by Belgium	229 469	247 740	267 493	282 285	242 214	278 845	309 335	319 267	327 126	336 984
4. Net current transactions (1 + 2 + 3)	–9 891	–11 018	–13 455	–3 271	–1 622	–8 690	–1 217	–2 408	5 807	–11 695
5. Capital transfers[3]	316	6	982	1 305	466	309	376	–2 685	205	675
6. Overall balance (4 + 5)	–9 575	–11 012	–12 473	–1 966	–1 156	–8 381	– 841	–5 093	6 012	–11 019

Sources: NAI, NBB.

(1) In accordance with the national accounts conventions, transactions are recorded from the point of view of the rest of the world. A positive (negative) figure for the balances of the various items therefore corresponds to net expenditure (revenue) for Belgium in relation to the rest of the world. In particular, a positive (negative) overall balance corresponds to net borrowing (lending) by Belgium in relation to the rest of the world.

(2) These are net amounts, i.e. the difference between incomes or transfers received from other sectors and those paid to other sectors, excluding transfers in kind.

(3) These are net amounts, i.e. the difference between transfers received from other sectors and those paid to other sectors, including net acquisitions of non-financial non-produced assets and net acquisitions of valuables.

TABLE 20 REVENUE, EXPENDITURE AND OVERALL BALANCE OF GENERAL GOVERNMENT

(in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Revenue (1)	150 203	156 895	164 310	171 671	166 946	176 852	187 401	196 781	203 614	205 576
Fiscal and parafiscal revenue	133 501	139 321	146 071	151 772	146 836	154 856	163 395	171 176	177 006	179 755
Levies weighing chiefly on earned income	78 002	79 838	84 091	89 080	88 828	92 090	97 017	100 154	103 505	104 913
Personal income tax (2)	36 212	36 321	37 760	40 108	38 786	40 945	43 321	44 358	46 403	47 121
Social security contributions (3)	41 790	43 516	46 332	48 972	50 043	51 145	53 696	55 796	57 103	57 792
Taxes on profits of companies (4)	9 814	11 369	11 760	11 598	8 113	9 261	10 692	11 689	12 294	12 442
Levies on other income and in respect of property (5)	10 945	12 005	12 486	12 883	12 114	13 199	14 125	15 367	17 326	17 637
Taxes on goods and services	34 740	36 110	37 734	38 211	37 781	40 306	41 561	43 966	43 881	44 763
Non-fiscal and non-parafiscal revenue (6)	16 702	17 574	18 240	19 898	20 110	21 996	24 006	25 604	26 608	25 821
Expenditure excluding interest charges	145 267	143 275	151 042	162 097	173 379	178 872	189 414	199 446	202 568	206 213
Social insurance benefits	67 835	69 949	73 587	79 189	84 978	87 331	91 498	96 055	99 420	101 284
Replacement incomes	38 710	40 082	42 117	44 952	48 346	49 983	52 343	55 201	57 893	58 968
Pensions	25 921	27 022	28 895	30 952	32 731	33 867	35 845	38 028	39 894	40 934
Private sector pensions	17 321	17 823	18 441	19 807	20 900	21 507	22 724	24 128	25 241	26 065
General government pensions	8 600	9 199	10 454	11 145	11 830	12 360	13 121	13 900	14 653	14 869
Old people's guaranteed income	276	269	340	430	390	436	450	456	500	504
Unemployment benefits with employer top-up (7)	1 257	1 301	1 359	1 443	1 502	1 592	1 637	1 626	1 610	1 545
Unemployment benefits	6 121	6 097	5 746	5 774	6 903	6 817	6 605	6 816	7 102	6 770
Career breaks and time credit	556	590	647	700	750	783	814	832	833	829
Sickness and disability insurance benefits	3 636	3 839	4 144	4 554	4 922	5 335	5 802	6 172	6 620	7 002
Industrial accidents and occupational diseases	503	503	508	531	518	520	481	487	504	514
Integration allowance	440	463	478	570	631	634	709	783	830	872
Other social insurance benefits (8)	29 126	29 867	31 470	34 237	36 632	37 348	39 155	40 854	41 527	42 317
of which :										
Health care	18 896	19 256	20 286	22 262	23 778	24 488	25 809	26 880	27 574	28 070
Family allowances	4 691	4 849	4 973	5 226	5 458	5 549	5 805	5 995	6 202	6 233
Other primary expenditure	77 431	73 326	77 455	82 908	88 400	91 541	97 916	103 392	103 147	104 929
Compensation of employees	35 853	37 542	39 157	41 396	43 027	44 174	45 956	47 743	49 309	49 762
Current purchases of goods and services	11 904	12 465	12 458	13 398	14 046	14 269	14 854	15 500	15 660	15 759
Subsidies to enterprises	5 677	6 477	7 661	8 478	8 758	10 471	11 517	11 461	11 617	12 119
Current transfers to the rest of the world	3 521	3 501	3 557	3 837	4 342	4 456	4 501	4 711	5 133	4 969
Other current transfers	3 800	4 013	3 687	4 151	4 889	5 045	5 341	5 465	5 436	5 814
Gross fixed capital formation	6 535	6 308	6 852	7 253	7 594	8 057	8 608	9 057	8 590	8 585
Other capital expenditure	10 141	3 021	4 083	4 394	5 745	5 070	7 139	9 455	7 403	7 921
Net amount excluding interest charges	4 936	13 620	13 269	9 574	–6 432	–2 020	–2 013	–2 666	1 046	–638
Interest charges	13 049	12 804	13 112	13 433	12 676	12 523	12 869	13 257	12 511	12 234
Overall balance	–8 113	816	157	–3 859	–19 109	–14 543	–14 882	–15 922	–11 464	–12 872

Sources : NAI, NBB.

(1) In accordance with the ESA 2010, general government revenues do not include the tax revenues transferred to the EU.

(2) Mainly withholding tax on earned income, advance payments, assessments and proceeds of additional percentages on personal income tax.

(3) Total social contributions, including the special social security contribution and the contributions of non-active persons.

(4) Mainly advance payments, assessments and the withholding tax on income from movable property payable by companies.

(5) Mainly the withholding tax on income from movable property payable by households, the withholding tax on income from immovable property (including proceeds of additional percentages), inheritance taxes and registration fees.

(6) Property incomes, imputed social security contributions, current and capital transfers from other sectors and sales of produced goods and services.

(7) New name for pre-pensions (early retirement).

(8) Apart from the two main sub-categories mentioned in the table, this item also includes mainly allowances to handicapped persons and transfers to the institutions accommodating them, payments by subsistence funds and pensions to war victims.

TABLE 21 OVERALL BALANCE OF GENERAL GOVERNMENT, BY SUB-SECTOR

(in € million)

	Entity I			Entity II			General government
	Federal government	Social security	Total	Communities and Regions	Local authorities	Total	
2005	–7 949	–530	–8 479	454	–89	366	–8 113
2006	–177	735	559	559	–302	257	816
2007	–3 085	1 468	–1 617	1 301	472	1 774	157
2008	–5 524	1 343	–4 181	–438	760	321	–3 859
2009	–13 407	–2 546	–15 953	–2 757	–399	–3 155	–19 109
2010	–10 882	–603	–11 485	–2 684	–374	–3 058	–14 543
2011	–13 254	226	–13 028	–1 136	–718	–1 854	–14 882
2012	–13 395	–430	–13 824	–184	–1 914	–2 098	–15 922
2013	–9 571	–216	–9 787	–705	–973	–1 678	–11 464
2014 e	–10 352	–137	–10 490	–2 140	–242	–2 382	–12 872

Sources: NAI, NBB.

TABLE 22 CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT[1]

(end-of-period outstanding amounts, in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1. Official debt of the Treasury	269 160	270 601	285 226	310 215	321 389	341 193	363 462	364 815	371 401	380 599
In euro	267 420	269 145	284 288	305 700	320 826	341 075	363 462	364 815	370 812	380 599
At up to one year	31 036	32 243	37 891	54 162	47 232	49 797	52 758	39 324	32 080	35 116
At over one year	236 384	236 902	246 397	251 539	273 593	291 278	310 704	325 491	338 732	345 484
In foreign currencies	1 740	1 456	937	4 515	563	118	0	0	590	0
2. Valuation difference[2]	525	786	1 072	1 012	283	252	411	86	28	11
3. Other ajustments[3]	0	0	0	0	0	6	78	15	12	9
4. Other federal government liabilities[4]	12 990	12 737	9 538	9 246	4 964	5 179	6 375	11 246	13 542	n.
5. Consolidation between federal government units[5]	22 687	21 454	30 814	29 749	27 269	35 466	38 011	33 169	33 705	n.
of which: Ageing Fund assets[6]	13 504	14 661	15 494	16 183	16 901	17 628	18 388	19 174	19 963	n.
6. Consolidated gross debt of federal government (1 + 2 + 3 + 4 – 5)	259 988	262 670	265 021	290 724	299 368	311 165	332 315	342 994	351 279	n.
7. Consolidated gross debt of Communities and Regions	25 192	25 367	26 051	28 343	37 950	41 662	44 615	46 898	47 049	n.
8. Consolidated gross debt of local authorities	17 116	17 558	18 186	17 487	17 161	18 927	19 737	21 301	22 380	n.
9. Consolidated gross debt of social security	2 769	2 514	2 734	2 981	4 179	5 178	6 010	6 608	7 585	n.
10. Consolidation between the general government sub-sectors[7]	10 236	10 944	12 118	11 992	11 490	12 784	14 550	14 074	15 048	n.
11. Consolidated gross debt of general government[1] (6 + 7 + 8 + 9 – 10)	294 828	297 165	299 874	327 543	347 168	364 148	388 128	403 726	413 246	427 498 e

Sources: FPS Finance, NAI, NBB.

(1) Concept of debt as defined in Council Regulation (EC) No. 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.

(2) Adjustment to the valuation of Treasury Certificates and Treasury bills to convert the discounted value to the face value.

(3) Adjustments permitting the transition from a net debt concept to the gross debt concept; certain assets being recorded in the official debt of the Treasury.

(4) Mainly the debudgeted Treasury debt, the debts of the *Caisse des dépôts et Consignations – Deposito- en consignatiekas*, SHLAF (until 2006), and the RIF (from 2005 to 2008), coins in circulation and the imputed debt resulting from Belgium's participation in the mutual support mechanism of the European Financial Stability Fund (EFSF) (from 2011).

(5) Federal government debt, the counterpart of which is an asset of a federal government unit.

(6) Including the capitalised interest on "Ageing Fund Treasury Bonds".

(7) Debt of a general government sub-sector, the counterpart of which is an asset of another general government sub-sector.

TABLE 23 DETERMINANTS OF THE CHANGE IN THE CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT[1]

(in % of GDP, unless otherwise stated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 e
Debt level (at end of period)	94.8	90.8	86.9	92.2	99.3	99.6	102.1	104.0	104.5	106.5
Change in the debt	–1.9	–4.0	–3.9	5.3	7.0	0.3	2.6	1.8	0.6	1.9
Endogenous change[2]	–1.4	–4.9	–4.7	–1.4	6.9	–0.4	0.2	1.9	1.1	1.6
Primary balance required to stabilise the debt	0.2	–0.8	–0.9	1.3	5.0	–0.9	–0.3	1.2	1.3	1.4
Implicit interest rate on the debt	4.5	4.3	4.4	4.5	3.9	3.6	3.5	3.4	3.1	3.0
Nominal GDP growth[3]	4.3	5.2	5.4	2.9	–1.5	4.6	3.9	2.2	1.8	1.6
Actual primary balance	1.6	4.2	3.8	2.7	–1.8	–0.6	–0.5	–0.7	0.3	–0.2
Change resulting from other factors[4]	–0.5	1.0	0.8	6.7	0.1	0.7	2.4	–0.1	–0.5	0.3
Net acquisition of financial assets										
Cash and deposits	0.2	–0.1	0.4	0.8	0.4	0.5	0.3	0.0	–0.2	0.1
Shares and other equity	0.0	0.1	0.2	3.9	1.1	0.1	1.1	–0.7	–1.1	0.1
Securities other than shares[5]	0.0	–0.1	0.0	0.3	0.0	–0.2	0.0	0.0	0.0	0.0
Loans	0.2	0.2	0.3	0.4	0.6	0.5	0.7	1.4	0.7	0.1
Valuation effects										
Impact of exchange rate differences	0.0	0.0	0.0	–0.1	0.0	0.1	0.0	0.0	0.0	0.0
Impact of issue and redemption premiums	–0.3	0.0	0.1	0.1	–0.2	–0.3	0.1	–0.8	–0.4	–0.8
Difference between interest on accrual basis and cash interest	0.2	0.2	0.2	0.0	0.0	0.1	0.1	0.1	0.2	0.2
Volume effects										
Changes in sectoral classification and other volume changes	–0.4	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.2	0.1
Other effects										
Net change in other accounts payable and receivable	0.1	0.8	–0.4	0.4	–0.3	0.2	0.0	0.0	0.3	0.5
Financial derivatives	–0.1	–0.1	0.0	0.0	–0.1	–0.7	–0.1	0.0	–0.2	0.0
Statistical adjustment	–0.3	0.0	0.1	0.9	–1.6	0.3	0.2	0.0	0.1	n.

Sources: NAI, NBB.

(1) Concept of debt as defined in Council Regulation (EC) No. 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.

(2) The endogenous change in the public debt is indicated by the difference between the primary balance required to stabilise the debt in % of GDP – i.e. the balance equal to the difference between the implicit interest rate on the debt and the nominal GDP growth rate, multiplied by the ratio between the debt at the end of the previous year and the GDP in the period considered – and the actual primary balance.

(3) Percentage changes compared to the previous year.

(4) A positive (negative) value means a factor increasing (reducing) the debt.

(5) Excluding financial derivatives.

TABLE 24 CURRENT AND CAPITAL TRANSACTIONS ACCORDING TO THE BALANCE OF PAYMENTS

(in € million)

	2012			2013			First nine months 2014[1]		
	Credits	Debits	Balances	Credits	Debits	Balances	Credits	Debits	Balances
1. Current account	375 581	378 977	–3 396	381 717	381 149	568	289 018	287 048	1 970
Goods and services	318 695	322 021	–3 326	327 561	328 193	–632	251 398	250 860	538
Goods	235 478	246 029	–10 551	241 771	249 453	–7 682	183 820	187 505	–3 685
General merchandise	230 721	244 575	–13 854	236 791	248 375	–11 584	180 312	186 955	–6 643
Non-monetary gold	1 737	1 454	283	1 943	1 078	865	1 222	550	672
International merchanting	3 020	0	3 020	3 037	0	3 037	2 286	0	2 286
Services	83 217	75 992	7 225	85 790	78 740	7 050	67 578	63 355	4 223
Goods for processing	4 597	1 516	3 081	3 069	928	2 141	2 457	459	1 998
Repairs to goods	801	487	314	951	630	321	472	317	155
Transportation	20 849	17 141	3 708	18 565	16 349	2 216	14 036	12 915	1 121
Tourism and travel	9 837	15 773	–5 936	10 091	16 463	–6 372	7 901	13 677	–5 776
Communication, data processing and information services	7 103	5 454	1 649	8 123	6 008	2 115	6 376	4 874	1 502
Construction	2 029	1 616	413	2 146	1 904	242	2 598	1 685	913
Insurance	1 364	1 846	–482	1 383	1 616	–233	962	1 177	–215
Financial services	4 858	3 330	1 528	6 004	4 151	1 853	4 385	2 423	1 962
Royalties and licence fees	2 070	2 187	–117	2 527	2 515	12	1 900	1 867	33
Other services to enterprises	26 752	24 420	2 332	29 957	26 010	3 947	24 004	22 416	1 588
Personal, cultural and recreational services	577	666	–89	671	684	–13	770	617	153
Services provided or received by general government, not mentioned elsewhere	1 590	226	1 364	1 506	192	1 314	1 077	68	1 009
Services not allocated	790	1 330	–540	797	1 290	–493	640	860	–220
Primary income	50 036	43 420	6 616	47 602	38 516	9 086	33 230	25 763	7 467
Earned income	7 883	2 799	5 084	8 221	2 836	5 385	6 280	2 207	4 073
Income from direct and portfolio investment	41 027	38 885	2 142	38 272	33 975	4 297	26 559	21 650	4 909
Other primary income	1 126	1 736	–610	1 109	1 705	–596	391	1 906	–1 515
Secondary income	6 850	13 536	–6 686	6 554	14 440	–7 886	4 390	10 425	–6 035
Secondary income of general government	1 385	5 196	–3 811	1 523	6 350	–4 827	931	4 650	–3 719
Secondary income of other sectors	5 465	8 340	–2 875	5 031	8 090	–3 059	3 459	5 775	–2 316
2. Capital account	3 375	1 053	2 322	627	755	–128	393	658	–265
Capital transfers	2 622	674	1 948	313	417	–104	296	312	–16
Acquisitions and sales of non-produced non-financial assets	753	379	374	314	338	–24	97	346	–249
3. Net lending to the rest of the world (1 + 2)	378 956	380 030	–1 074	382 344	381 904	440	289 411	287 706	1 705

Source: NBB.

(1) Owing to different revision schedules, the figures in the annex and the balance of payments statistics display temporary differences from the data used in the analytical section. Those data were updated when the Report went to press.

TABLE 25 FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF HOUSEHOLDS[1]

(in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	First nine months 2013	First nine months 2014	*p.m. Outstanding amount at the end of September 2014*
Formation of financial assets	27 762	28 034	28 796	20 544	32 807	34 090	39 235	26 462	23 744	17 464	18 667	*1 146 611*
Notes, coins and sight deposits	7 419	1 224	556	2 033	4 506	3 048	1 701	5 816	7 233	4 442	6 163	*85 679*
Savings deposits	8 335	1 740	–8 773	1 793	32 854	20 894	4 318	16 625	13 535	10 343	3 523	*233 681*
Time deposits	–437	10 125	18 874	2 018	–22 964	–9 018	6 961	–3 224	–1 437	–663	–777	*34 173*
Fixed-interest securities	–13 413	–14 431	–5 071	12 065	7 527	–4 581	10 960	–9 221	–8 974	–8 412	–6 530	*81 382*
Mutual funds shares	10 434	6 641	–668	–14 734	–10 145	–4 896	–569	–1 095	2 446	5 153	10 669	*144 669*
Monetary	326	–798	622	1 438	–3 350	–90	2 705	–2 107	480	446	161	*1 942*
Non-monetary	10 108	7 439	–1 290	–16 172	–6 795	–4 806	–3 274	1 012	1 966	4 706	10 508	*142 727*
Shares and other equity	–5 526	8 596	7 463	12 618	8 397	8 639	8 441	5 082	2 869	1 318	946	*274 975*
Insurance products	20 678	13 165	14 164	4 901	14 656	20 002	6 814	11 559	6 538	4 834	4 420	*275 672*
Insurance technical reserves	279	1 165	425	172	1 204	671	–245	980	438	525	1 166	*21 201*
Life insurance entitlements	17 971	10 418	9 394	4 506	8 420	14 327	5 037	6 795	3 640	2 709	3 017	*180 213*
Pension entitlements	2 429	1 582	4 345	224	5 033	5 004	2 023	3 783	2 460	1 600	237	*74 258*
Other assets[2]	271	974	2 251	–152	–2 024	1	609	920	1 532	449	253	*16 380*
New financial liabilities	12 701	14 400	15 603	14 499	3 193	11 320	14 066	8 806	8 099	5 348	7 955	*245 575*
Mortgage loans	10 759	11 248	12 412	12 065	6 639	11 727	12 180	8 246	5 972	4 200	3 764	*185 542*
Consumer loans	579	2 065	1 293	1 283	589	–40	1 551	374	–131	43	1 276	*19 862*
Other loans	1 611	805	204	1 020	–3 147	–33	–53	275	1 847	1 258	2 244	*22 759*
Other liabilities[2]	–248	281	1 693	131	–887	–333	389	–88	412	–153	670	*17 412*
Financial balance[3]	15 061	13 634	13 193	6 044	29 614	22 771	25 169	17 656	15 644	12 116	10 712	*901 036*

Source: NBB.

(1) Households and non-profit institutions serving households.

(2) This item comprises other financial instruments within the meaning of the ESA 2010, for example, trade credit and other accounts receivable/payable.

(3) The balances of the financial accounts of the domestic sectors do not correspond to the net financing capacities or requirements as recorded in the real accounts, owing to the differences between the dates of recording of the transactions in these two accounts, statistical adjustments or errors and omissions.

TABLE 26 FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

(in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	First nine months 2013	First nine months 2014	*p.m. Outstanding amount at the end of September 2014*
Formation of financial assets	26 548	89 007	112 577	127 784	35 058	70 955	118 186	8 147	–46 266	–27 607	–4 797	*1 268 218*
Notes, coins and sight deposits	2 090	3 746	2 583	–3 711	4 773	3 755	12 737	–15 555	1 352	3 168	–211	*43 695*
Other deposits	–2 728	11 084	11 343	–3 966	7 901	447	–11 335	20 436	4 831	10 418	1 673	*72 950*
Trade credit	7 281	8 702	12 981	–3 947	–4 082	6 392	10 101	–7 051	2 238	–12 445	–11 338	*135 179*
Other, excluding trade credit	4 294	12 466	8 380	81 459	10 940	16 605	48 595	–7 448	–63 798	–54 010	5 163	*371 025*
Debt securities	1 000	–2 124	1 897	4 063	2 419	4 176	2 125	1 248	–4 485	–1 146	–8 435	*11 568*
Shares and other equity	11 458	38 211	32 322	31 961	23 244	36 129	29 826	9 489	1 399	13 183	12 007	*508 325*
of which:												
Listed shares	–9 600	5 444	6 588	5 663	7 740	6 555	15 005	6 383	2 408	3 279	499	*90 492*
Unlisted shares	24 513	14 403	11 759	17 751	10 695	23 691	38 854	12 346	–3 796	8 139	8 658	*320 304*
Other assets[1]	3 152	16 922	43 071	21 925	–10 137	3 451	26 137	7 029	12 197	13 225	–3 656	*125 476*
New financial liabilities	25 882	105 669	99 764	123 536	36 053	77 483	121 797	487	–33 049	–8 096	–5 330	*1 637 175*
Commercial credit	6 460	13 233	11 163	194	–4 065	8 679	6 099	–10 349	8 309	–8 267	–12 234	*120 682*
Loans granted by credit institutions	–2 271	6 014	14 958	26 572	–14 433	–2 001	3 296	3 531	7 381	–1 912	–301	*146 520*
At up to one year	–1 566	2 542	5 435	5 140	–6 955	–1 578	2 267	–1 114	6 335	–1 425	–276	*52 951*
At over one year	–705	3 472	9 523	21 432	–7 477	–423	1 029	4 645	1 046	–486	–25	*93 569*
Other loans	9 015	13 647	24 906	35 818	34 747	1 271	76 799	1 986	–42 292	–10 658	6 261	*357 950*
Debt securities	–2 536	1 662	2 428	1 555	8 396	–2 481	3 376	7 154	2 460	2 021	2 325	*40 830*
At up to one year	–447	–1 080	1 392	418	1 465	–4 173	280	898	–595	–878	501	*4 487*
At over one year	–2 090	2 742	1 036	1 137	6 931	1 692	3 095	6 256	3 055	2 899	1 824	*36 343*
Shares and other equity	9 985	57 687	44 475	57 244	14 390	72 153	29 345	–2 159	–7 123	8 933	–2 094	*946 508*
of which:												
Listed shares	–20 461	2 127	2 592	6 175	503	49	–4 709	–448	4 436	2 875	3 257	*228 995*
Unlisted shares	30 177	43 985	15 023	44 772	5 711	36 149	20 593	14 267	8 221	815	–16 061	*514 869*
Other liabilities[1]	5 229	13 425	1 833	2 153	–2 982	–139	2 882	324	–1 784	1 787	712	*24 685*
Financial balance[2]	666	–16 662	12 813	4 248	–995	–6 527	–3 611	7 660	–13 217	–19 511	533	*–368 957*

Source: NBB.

(1) This item comprises other financial instruments within the meaning of the ESA 2010, such as investment fund shares, insurance technical reserves, derivatives and other accounts receivable/payable. It also covers errors and omissions on Belgium's financial account vis-à-vis the rest of the world which, for consistency between the accounts, are regarded as unrecorded capital movements.

(2) The balances of the financial accounts of the domestic sectors do not correspond to the net financing capacities or requirements as recorded in the real accounts, owing to the differences between the dates of recording of the transactions in these two accounts, statistical adjustments or errors and omissions.

TABLE 27 FORMATION OF FINANCIAL ASSETS AND NEW FINANCIAL LIABILITIES OF MONETARY FINANCIAL INSTITUTIONS [1]

(data on a territorial basis, in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	First nine months 2013	First nine months 2014	*p.m. Outstanding amount at the end of September 2014*
Formation of financial assets												
Deposits and interbank claims	61 560	50 020	132 112	–52 051	–98 096	–41 726	42 253	–62 810	–50 826	–38 061	–6 358	*298 095*
Belgian MFIs	15 979	2 942	32 116	28 839	–33 960	–35 919	53 282	–19 917	–29 828	–26 002	–7 482	*55 952*
Foreign MFIs	45 581	47 078	99 996	–80 890	–64 135	–5 808	–11 029	–42 893	–20 998	–12 060	1 124	*242 143*
Loans [2]	–5 460	29 895	49 948	–7 392	–27 454	1 603	4 279	837	18 679	17 496	13 047	*297 404*
of which:												
Households	13 430	12 306	7 916	–23 684	–10 621	5 199	–932	4 890	9 036	6 677	11 036	*128 646*
Non-financial corporations	1 151	1 718	10 130	7 722	–4 953	–2 378	3 037	–175	2 240	858	–1 263	*97 765*
Debt securities	7 632	–5 827	3 273	42 145	8 463	–2 586	26 407	–23 976	–15 189	–12 467	–4 477	*252 543*
of which:												
General government	–178	–2 594	–15 111	1 350	8 233	5 628	5 868	6 783	–7 096	–7 303	–2 503	*68 066*
Rest of the world	8 596	–3 645	16 662	5 006	–24 556	–12 320	9 208	–33 611	–2 037	–2 837	2 345	*108 591*
Other assets	69 229	24 369	31 625	37 759	–58 090	–12 174	36 549	–44 434	–26 200	3 371	48 406	*308 212*
Total	132 961	98 456	216 959	20 461	–175 177	–54 883	109 488	–130 383	–73 536	–29 661	50 618	*1 156 254*
Households	13 435	12 573	8 483	–23 506	–11 664	4 890	–835	4 691	9 174	6 626	11 139	*130 505*
Non-financial corporations	1 245	3 480	10 575	12 452	–10 629	–4 143	3 253	1 019	2 133	1 415	–904	*102 202*
General government	–476	–1 928	–14 487	2 995	4 546	8 789	13 141	6 145	–4 989	–3 766	175	*112 773*
Financial institutions	13 113	35 958	72 410	115 340	–42 498	–36 740	80 846	–71 139	–76 562	–54 639	–7 606	*213 932*
Rest of the world	105 644	48 373	139 978	–86 820	–114 932	–27 678	13 084	–71 099	–3 293	20 703	47 814	*589 811*
New financial liabilities												
Deposits and interbank claims	89 327	74 420	111 646	–97 295	–132 224	–60 847	57 757	–64 015	–72 324	–64 217	–3 754	*223 148*
Belgian MFIs	15 979	2 942	32 116	28 839	–33 960	–35 919	53 282	–19 917	–29 828	–26 002	–7 482	*55 952*
Foreign MFIs	73 347	71 479	79 530	–126 134	–98 263	–24 929	4 475	–44 098	–42 496	–38 216	3 728	*167 197*
Cash and deposits [2]	667	–67 452	63 568	91 455	22 185	15 020	14 950	56 147	28 013	24 875	14 323	*412 282*
of which:												
Households	15 923	12 329	9 776	9 631	17 131	18 685	12 375	21 027	18 674	13 521	8 285	*342 374*
Non-financial corporations	2 366	6 879	8 460	–4 919	–1 893	10 086	–866	–1 047	4 202	6 844	2 182	*81 428*
Debt securities	–9 602	–270	14 980	6 825	23 200	–18 837	–10 086	4 271	–1 104	–302	714	*68 102*
Other liabilities	57 183	84 025	40 982	17 726	–85 716	443	50 605	–123 806	–36 145	7 543	43 655	*441 912*
Total	137 575	90 724	231 176	18 711	–172 555	–64 221	113 227	–127 404	–81 560	–32 102	54 937	*1 145 444*
Households	7 922	8 883	15 088	13 027	21 259	14 201	13 976	14 363	16 541	13 625	7 434	*374 784*
Non-financial corporations	2 804	7 639	15 267	–2 398	–7 929	8 360	2 974	–1 252	5 995	8 264	3 204	*91 700*
General government	748	–693	1 452	12 133	–6 122	–311	3 174	998	–4 815	890	2 193	*37 455*
Financial institutions	19 360	11 962	65 412	82 000	–61 545	–44 740	71 268	–71 863	–72 445	–54 986	–2 032	*154 486*
Rest of the world	106 741	62 933	133 957	–86 050	–118 217	–41 732	21 834	–69 649	–26 835	105	44 138	*487 019*
Financial balance [3]	–4 614	7 731	–14 217	1 750	–2 622	9 338	–3 739	–2 980	8 024	2 440	–4 319	*10 810*

Source: NBB.

(1) Credit institutions, monetary UCIs and monetary authorities.

(2) Other than those included in interbank transactions.

(3) The balances of the financial accounts of the domestic sectors do not correspond to the net financing capacities or requirements as recorded in the real accounts, owing to the differences between the dates of recording of the transactions in these two accounts, statistical adjustments or errors and omissions.

TABLE 28 FORMATION OF ASSETS AND NEW LIABILITIES OF FINANCIAL INTERMEDIARIES OTHER THAN MONETARY INSTITUTIONS

(in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	First nine months 2013	First nine months 2014	*p.m. Outstanding amount at the end of September 2014*
Non-monetary investment funds												
Formation of financial assets	5 722	7 928	–1 920	–14 354	298	–4 399	–11 677	–1 662	10 665	7 223	12 590	*121 633*
Deposits	1 861	–655	–6 996	–2 990	–3 331	–4 123	–2 134	–1 853	–1 202	–1 212	–714	*5 787*
Debt securities	–1 123	3 130	7 450	–1 192	6	–323	–3 221	–3 628	810	401	272	*26 465*
Shares and other equity	–356	–1 230	–4 320	–1 170	4 048	–1 793	–5 186	3 882	1 212	1 696	4 840	*41 759*
Investment fund shares	5 856	5 058	–141	–5 350	1 296	2 405	–333	1 076	9 983	5 808	6 256	*40 772*
Other assets[1]	–515	1 624	2 086	–3 652	–1 720	–565	–804	–1 139	–137	530	1 935	*6 850*
New financial liabilities	6 492	7 935	–1 851	–13 982	267	–4 337	–12 001	–1 688	10 843	7 283	12 345	*121 991*
Shares issued by:	6 492	7 935	–3 269	–11 868	–437	–3 798	–11 684	–1 552	10 091	5 941	10 241	*117 732*
Bond UCIs	1 219	54	–397	–223	1 447	–998	–1 011	761	1 448	968	–67	*14 353*
Equity UCIs	1 791	1 059	–689	–2 701	3 873	–1 033	–4 152	4 129	964	1 197	4 483	*33 068*
Savings-pension funds	221	200	–323	684	856	476	298	128	236	155	216	*15 279*
Other UCIs	3 261	6 622	–1 860	–9 628	–6 612	–2 243	–6 820	–6 570	7 443	3 622	5 609	*55 031*
Other liabilities[1]	0	0	1 419	–2 114	704	–539	–317	–136	753	1 341	2 104	*4 259*
Financial balance[2]	–771	–8	–70	–372	31	–62	324	26	–178	–59	245	*–358*
Insurance companies and institutions for occupational retirement provision												
Formation of financial assets	21 637	15 165	16 694	7 707	14 284	14 467	9 983	7 655	3 644	5 901	5 959	*327 392*
Cash and deposits	15	–932	–1 083	2 060	–3 173	–1 069	2 680	–1 622	–906	860	1 889	*10 556*
Debt securities	15 989	14 823	14 871	5 229	17 386	16 408	7 279	4 665	–2 725	–790	–2 184	*210 282*
Loans	–673	241	–36	1 242	769	365	483	4 350	4 118	2 859	2 995	*25 088*
Shares and other equity	1 431	–1 628	1 483	3 218	–1 725	–709	622	623	2 920	2 431	–984	*26 698*
Investment fund shares	4 192	2 411	1 345	–5 672	814	–1 032	–2 999	138	1 481	1 813	3 769	*43 722*
Other assets[1]	682	249	115	1 629	214	503	1 918	–499	–1 244	–1 273	474	*11 047*
New financial liabilities	22 031	16 322	15 058	8 186	14 055	13 880	10 337	8 712	6 983	6 849	3 656	*296 215*
Net claims of households on life insurance reserves and institutions for occupational retirement provision	4 214	3 309	4 699	954	6 062	6 862	2 491	4 206	3 110	2 412	2 351	*107 448*
Other insurance technical reserves	16 102	9 482	8 911	4 261	6 225	7 148	4 699	5 525	2 273	1 572	1 709	*149 365*
Other liabilities[1]	1 716	3 531	1 447	2 971	1 769	–130	3 147	–1 019	1 599	2 865	–405	*39 402*
Financial balance	–394	–1 158	1 636	–480	229	587	–354	–1 057	–3 339	–949	2 304	*31 177*
Other financial institutions[2]												
Formation of financial assets	5 167	69 763	113 068	112 920	80 923	–3 684	87 545	–63 958	–32 049	–12 969	–1 565	*766 957*
Cash and deposits	–132	5 968	2 974	4 331	4 743	–9 004	2 887	3 682	2 381	4 409	1 245	*35 730*
Debt securities	749	11 280	13 337	3 123	12 421	–9 346	–1 940	–1 171	–11 769	–7 646	2 766	*20 984*
Loans	16 629	37 507	39 631	93 821	61 773	5 648	39 007	–23 197	–45 075	–19 316	1 623	*447 409*
Shares and other equity	–12 661	14 361	57 070	11 177	3 726	7 918	46 833	–42 316	22 684	6 608	–7 917	*254 809*
Other assets[1]	583	647	54	468	–1 741	1 100	758	–956	–269	2 976	718	*8 025*
New financial liabilities	–1 580	63 126	113 709	115 006	92 507	–1 597	88 700	–63 774	–30 779	–26 235	–6 342	*800 990*
Debt securities	113	1 600	5 776	37 454	23 983	13 531	11 753	–1 828	–2 511	399	–6 603	*99 724*
Loans	5 563	19 834	20 244	8 962	34 521	–2 356	20 363	1 184	–16 821	–15 392	1 993	*176 163*
Shares and other equity	–7 692	41 433	86 768	65 163	38 035	–13 298	57 635	–62 084	–11 319	–11 285	–1 768	*519 443*
Other liabilities[1]	436	258	921	3 427	–4 031	527	–1 051	–1 046	–128	43	36	*5 660*
Financial balance	6 748	6 637	–642	–2 086	–11 585	–2 087	–1 156	–184	–1 270	13 265	4 777	*–34 032*

Sources: Belgian Association of Pension Institutions, BEAMA, FSMA, NBB.

(1) This item comprises other financial instruments within the meaning of the ESA 2010, such as investment fund shares, insurance technical reserves, derivatives and other accounts receivable/payable.

(2) Other financial intermediaries, financial auxiliaries and captive financial institutions and money lenders.

TABLE 29 OVERVIEW OF INSTITUTIONS SUBJECT TO NATIONAL BANK OF BELGIUM SUPERVISION[1]

(end-of-period data)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Financial holding companies										
Total	*9*	*7*	*7*	*7*	*6*	*6*	*7*	*7*	*7*	*6*
Credit institutions										
Credit institutions governed by Belgian law	54	51	52	51	48	48	47	42	39	37
Belgian branches of credit institutions governed by the law of a non-EEA country	9	8	9	9	9	9	9	9	10	10
Belgian branches of credit institutions governed by the law of another EEA country	41	46	49	47	47	50	52	53	55	56
Total credit institutions	*104*	*105*	*110*	*107*	*104*	*107*	*108*	*104*	*104*	*103*
Payment institutions governed by Belgian law	**0**	**0**	**0**	**0**	**0**	**0**	**9**	**10**	**12**	**11**
Electronic payment institutions	**–**	**–**	**–**	**2**	**2**	**2**	**2**	**2**	**5**	**5**
Total	*–*	*–*	*–*	*2*	*2*	*2*	*11*	*12*	*17*	*16*
Settlement institutions governed by Belgian law and organisations similar to settlement institutions licensed in Belgium										
Total	*2*	*2*	*2*	*2*	*2*	*2*	*1*	*2*	*2*	*2*
Insurance companies										
Insurance companies governed by Belgian law	110	107	106	100	97	97	95	88	84	81
Belgian branches of insurance companies governed by the law of another EEA country	56	54	50	51	50	48	47	45	45	46
Belgian branches of insurance companies governed by the law of another non-EEA country	3	0	0	0	0	0	0	0	0	0
According to specialisation										
Life insurance companies	30	29	30	30	29	28	26	24	23	23
Non-life insurance companies	114	109	103	99	94	91	89	83	81	79
Mixed insurance companies	25	23	23	22	23	24	25	25	24	24
Reinsurance companies	0	0	0	0	1	2	2	1	1	1
Total insurance companies	*169*	*161*	*156*	*151*	*147*	*145*	*142*	*133*	*129*	*127*
Freedom to provide services										
Credit institutions	489	506	522	564	571	587	641	667	673	683
Insurance companies	740	762	791	878	873	893	915	942	933	950
Total freedom to provide services	*1 229*	*1 268*	*1 313*	*1 442*	*1 444*	*1 480*	*1 556*	*1 609*	*1 606*	*1 631*
Stockbroking firms with Belgian licence[2]										
Total	*36*	*31*	*27*	*26*	*23*	*23*	*23*	*21*	*20*	*20*

Source: NBB.

(1) This item comprises other financial instruments within the meaning of the ESA 2010, such as investment fund shares, insurance technical reserves, derivatives and other accounts receivable/payable.

(2) Other financial intermediaries, financial auxiliaries and captive financial institutions and money lenders.

TABLE 30 BALANCE SHEET STRUCTURE OF CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW, BY PRODUCT[1]

(end-of-period consolidated data, in € billion)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	September 2014
Assets										
Loans and advances to credit institutions	277.3	285.7	320.8	213.2	156.1	195.8	174.3	130.4	117.7	114.5
Loans and advances other than to credit institutions	591.8	591.0	666.2	555.6	536.5	506.6	509.4	504.7	518.1	549.5
p.m. Mortgage loans[2]	*154.7*	*189.7*	*208.3*	*132.2*	*158.3*	*178.5*	*183.9*	*188.3*	*190.8*	*206.0*
Debt instruments	320.0	319.3	296.2	298.8	264.7	231.9	212.0	193.3	181.9	201.2
Equity instruments	48.0	64.4	52.8	15.9	8.8	5.8	4.7	6.3	4.1	6.3
Derivatives	–	51.8	120.5	223.1	135.1	133.2	167.0	120.3	64.9	74.9
Other assets	132.2	109.7	122.0	115.6	89.3	77.7	79.8	93.7	73.9	77.2
Total assets	**1 369.3**	**1 422.0**	**1 578.4**	**1 422.1**	**1 190.5**	**1 151.1**	**1 147.3**	**1 048.7**	**960.6**	**1 023.6**
Liabilities										
Debts to credit institutions	412.6	415.3	431.7	276.2	167.6	177.2	128.5	115.0	103.0	109.8
Deposits[3]	502.7	556.4	582.4	557.4	541.8	511.4	513.9	508.9	525.4	573.4
p.m. Regulated savings deposits[3]	*153.8*	*142.7*	*131.1*	*129.2*	*163.5*	*186.4*	*183.7*	*198.0*	*201.5*	*198.2*
Bonds and other debt securities	119.5	159.3	179.1	124.4	150.0	125.3	101.3	111.5	96.6	94.5
Derivatives	–	72.1	122.3	232.7	147.8	148.5	184.4	131.9	72.5	85.4
Subordinated liabilities	24.3	25.7	36.0	37.0	30.2	29.4	26.4	20.3	17.8	15.3
Other liabilities	273.2	145.9	159.6	145.3	99.4	102.1	140.2	100.7	83.9	80.0
Equity capital and minority interest	37.0	47.3	67.3	49.1	53.7	57.2	52.8	60.4	61.4	65.2
Total liabilities	**1 369.3**	**1 422.0**	**1 578.4**	**1 422.1**	**1 190.5**	**1 151.1**	**1 147.3**	**1 048.7**	**960.6**	**1 023.6**

Source: NBB.

(1) Data based on Belgian accounting principles until 2005 (Belgian GAAP) and on IAS/IFRS standards from 2006 onwards.

(2) Mortgage loans included in the loans and receivables IAS/IFRS category from 2005 to 2013.

(3) Deposits booked at amortised cost.

TABLE 31 MAIN COMPONENTS OF THE INCOME STATEMENT OF CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW[1]

(consolidated data, in € billion)

										First nine months	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2013	2014
Net interest income	12.7	12.8	13.3	14.5	14.9	13.8	14.0	13.6	13.3	9.9	10.8
Capital result other than the net interest result	12.8	13.0	12.6	4.2	3.3	5.6	4.7	4.5	7.0	5.9	5.0
Net fees and commission[2]	*7.9*	*5.8*	*6.9*	*6.1*	*5.0*	*4.3*	*4.4*	*4.5*	*5.0*	*3.9*	*4.1*
Profits and losses realised on assets	*2.2*	*3.6*	*3.8*	*–3.8*	*–2.7*	*0.0*	*–0.8*	*0.0*	*0.8*	*1.1*	*0.3*
Other	*2.7*	*3.6*	*1.9*	*1.9*	*1.0*	*1.3*	*1.2*	*0.0*	*1.3*	*0.9*	*0.6*
Gross operating income (banking product)	25.5	25.7	25.9	18.7	18.2	19.3	18.7	18.1	20.3	15.8	15.8
Operating expenses (–)	18.5	13.9	15.6	16.0	14.0	12.5	12.3	13.0	12.4	9.4	9.6
Staff expenses	*7.9*	*8.1*	*8.6*	*8.6*	*7.3*	*6.6*	*6.6*	*6.9*	*6.5*	*5.0*	*5.0*
Impairment losses and provisions (–)	–0.4	0.4	3.2	13.3	7.4	1.8	5.0	2.6	3.0	1.4	1.0
Other income and tax expense (income) relating to the result	–0.8	–1.7	–0.4	–10.6	1.9	0.5	–1.0	–0.8	–1.6	–1.5	–1.6
Net profit or loss	**6.6**	**9.7**	**6.7**	**–21.2**	**–1.2**	**5.6**	**0.4**	**1.6**	**3.3**	**3.5**	**3.6**

Source: NBB.

(1) Data based on Belgian accounting principles until 2005 (Belgian GAAP) and on IAS/IFRS standards from 2006 onwards.

(2) Excluding fees and commission paid to agents up to 2005 as these had been reported under the staff expenses heading.

TABLE 32 KEY FIGURES FROM CREDIT INSTITUTIONS GOVERNED BY BELGIAN LAW[1]

(end-of-period consolidated data; in € billion, unless otherwise stated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	September 2014
Large banking groups										
Balance sheet total	*1 229.2*	*1 348.0*	*1 488.8*	*1 326.8*	*1 092.0*	*1 003.2*	*967.8*	*857.1*	*774.7*	*831.6*
Customers' holdings	532.0	667.4	700.9	612.8	622.5	559.8	518.4	518.2	516.5	535.8
Loans and advances to customers	535.1	553.8	619.0	505.0	481.7	450.7	441.4	432.8	447.7	475.9
Risk asset ratio (in %)	*11.1*	*11.2*	*10.8*	*16.2*	*17.0*	*19.2*	*18.2*	*17.9*	*18.5*	*17.3*
Common equity Tier I ratio (in %)	–	–	–	–	–	–	–	–	–	*14.3*
Net after-tax results	5.7	9.2	6.2	–20.9	–1.5	5.0	–0.1	1.2	2.6	3.0
Return on average assets (in %)	0.5	0.7	0.4	–1.4	–0.1	0.5	0.0	0.2	0.3	0.5
Return on average equity (in %)	19.9	23.1	13.7	–40.8	–3.8	11.1	–0.1	10.8	5.6	8.1
Cost/income ratio (in %)	72.3	54.1	59.8	87.1	77.1	64.2	65.2	71.5	60.0	60.8
Total Belgian credit institutions governed by Belgian law										
Balance sheet total	*1 369.3*	*1 422.0*	*1 578.4*	*1 422.1*	*1 190.5*	*1 151.1*	*1 147.3*	*1 048.7*	*960.6*	*1 023.6*
Customers' holdings	622.1	715.7	761.6	681.8	691.9	636.7	615.2	620.4	622.1	667.9
Loans and advances to customers	591.3	591.0	666.2	555.6	536.5	506.6	509.4	504.7	518.1	549.5
Risk asset ratio (in %)	*11.5*	*11.9*	*11.2*	*16.2*	*17.3*	*19.3*	*18.5*	*18.2*	*18.7*	*17.9*
Common equity Tier I ratio (in %)	–	–	–	–	–	–	–	–	–	*14.9*
Net after-tax results	6.6	9.7	6.7	–20.6	–1.2	5.6	0.4	1.6	3.3	3.6
Return on average assets (in %)	0.5	0.7	0.4	–1.3	–0.1	0.5	0.0	0.2	0.3	0.5
Return on average equity (in %)	18.5	22.4	13.2	–36.5	–2.6	10.5	0.7	4.1	5.9	8.2
Cost/income ratio (in %)	72.6	54.1	60.2	85.6	76.9	64.5	65.8	72.1	61.1	60.8

Source: NBB.

(1) Data based on Belgian accounting principles until 2005 (Belgian GAAP) and on IAS/IFRS standards from 2006 onwards.

TABLE 33 MAIN COMPONENTS OF INSURANCE COMPANIES' BALANCE SHEET

(end-of-period non-consolidated data, in € billion)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	September 2014[2]
Assets										
Investments	166.5	183.7	201.7	202.7	214.9	229.5	233.8	242.1	249.6	254.5
All activities with the exception of class 23	*141.7*	*158.3*	*177.2*	*184.6*	*195.8*	*209.9*	*215.2*	*218.4*	*223.5*	*226.1*
Shares[1]	17.9	18.8	19.8	13.4	11.4	11.9	9.6	9.3	11.6	12.8
Debt securities	101.2	115.2	130.0	136.6	151.5	165.9	172.0	173.3	171.7	171.2
Land and buildings	2.6	2.5	2.6	3.1	3.1	3.0	3.2	3.4	3.2	3.1
Investments in affiliated undertakings	9.2	11.0	14.2	15.7	16.9	16.8	15.5	15.7	16.6	17.3
Mortgage loans and others	10.8	10.7	10.6	15.9	13.0	12.3	14.9	16.8	20.3	21.7
Class 23	*24.8*	*25.5*	*24.6*	*18.1*	*19.1*	*19.5*	*18.6*	*23.7*	*26.2*	*28.4*
Shares[1]	19.5	21.2	19.5	13.6	14.9	15.2	14.6	13.7	14.7	n.
Debt securities	4.1	3.8	4.6	4.2	3.9	4.1	3.6	9.1	10.7	n.
Other	1.3	0.4	0.5	0.3	0.3	0.2	0.4	0.8	0.7	n.
Reinsured part of technical provisions	5.2	4.9	4.8	7.0	6.6	6.8	7.2	7.4	6.1	6.5
Claims and other assets	13.3	13.2	13.8	14.1	12.9	12.0	15.6	15.1	15.0	16.5
Total assets	**185.0**	**201.9**	**220.4**	**223.8**	**234.4**	**248.5**	**256.6**	**264.5**	**270.7**	**277.6**
Liabilities										
Own funds	10.2	10.7	11.9	14.2	14.5	14.6	13.7	13.7	13.7	15.0
Technical provisions	156.5	169.9	185.5	188.0	198.5	210.9	218.3	226.6	231.6	237.4
Life insurance (with the exception of class 23)	103.7	115.2	130.6	139.4	149.2	160.4	167.7	170.9	172.6	174.4
Class 23	25.0	25.7	24.7	18.2	19.2	19.6	18.6	23.7	26.2	28.4
Non-life insurance	22.7	23.3	24.0	24.8	24.2	24.9	25.9	25.4	25.8	26.9
Other provisions	5.1	5.7	6.2	5.5	5.9	6.0	6.0	6.6	7.0	7.7
Reinsurance companies' deposits	2.7	2.6	2.7	4.8	4.7	4.9	5.1	5.2	4.3	4.2
Debts	13.5	16.5	17.6	14.5	14.3	15.4	16.7	16.3	18.6	18.2
Other liabilities	2.0	2.2	2.6	2.3	2.5	2.7	2.8	2.7	2.5	2.8
Total liabilities	**185.0**	**201.9**	**220.4**	**223.8**	**234.4**	**248.5**	**256.6**	**264.5**	**270.8**	**277.6**

Source: NBB.

(1) Including shares in undertakings for collective investment.

(2) On a quarterly basis.

TABLE 34 MAIN COMPONENTS OF INSURANCE COMPANIES' INCOME STATEMENT

(non-consolidated data; in € billion, unless otherwise stated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	First nine months[1] 2013	First nine months[1] 2014
Technical account in life insurance											
Net premiums written	25.2	20.4	21.9	19.5	18.6	18.9	18.4	20.7	15.9	11.4	11.8
Individual classes 21, 22 and 26	14.9	12.6	14.5	13.1	12.2	12.5	11.7	11.2	8.1	n.	n.
Group classes 21 and 22	3.9	3.8	4.2	4.4	4.6	4.6	4.6	5.0	5.4	n.	n.
Class 23	6.4	4.1	3.2	1.9	1.7	2.0	2.1	4.8	2.7	n.	n.
Claims paid (–)	10.2	13.0	13.0	15.3	13.5	12.7	15.5	18.4	18.3	13.8	13.7
Change in the provisions for claims (–)	20.5	12.4	13.3	2.9	11.5	11.8	6.1	9.0	4.2	2.3	4.2
Premiums after insurance costs	**–5.4**	**–5.0**	**–4.4**	**1.3**	**–6.5**	**–5.5**	**–3.2**	**–6.6**	**–6.6**	**–4.7**	**–6.0**
Net operating expenses (–)	1.3	1.4	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.2	1.3
Insurance results before investment income	**–6.8**	**–6.4**	**–6.0**	**–0.3**	**–8.0**	**–7.1**	**–4.8**	**–8.3**	**–8.2**	**–5.9**	**–7.3**
Net investment income	8.0	7.4	6.9	–3.4	8.8	7.8	4.0	9.5	8.9	6.3	7.6
Technical result life insurance	**1.2**	**1.0**	**1.0**	**–3.7**	**0.7**	**0.8**	**–0.7**	**1.3**	**0.6**	**0.4**	**0.3**
Technical account non-life insurance											
Net premiums written	8.9	9.3	9.3	9.7	9.2	9.5	10.4	10.8	11.1	8.3	8.9
Claims paid (–)	5.6	5.9	6.3	6.5	6.6	6.8	7.2	7.2	7.3	5.4	5.9
Change in the provisions for claims (–)	1.1	0.8	0.5	0.4	0.4	0.4	0.1	0.6	0.7	0.4	0.3
Premiums after insurance costs	**2.3**	**2.6**	**2.5**	**2.8**	**2.2**	**2.3**	**3.0**	**3.0**	**3.2**	**2.5**	**2.7**
Net operating expenses (–)	2.7	2.8	2.7	2.8	2.6	2.7	3.0	3.1	3.2	2.4	2.6
Insurance results before investment income	**–0.4**	**–0.2**	**–0.2**	**0.0**	**–0.4**	**–0.4**	**0.0**	**–0.1**	**–0.1**	**0.1**	**0.1**
Net investment income	1.5	1.3	1.5	0.2	1.0	1.1	0.9	1.2	1.2	1.0	0.9
Technical result non-life insurance	**1.1**	**1.2**	**1.3**	**0.2**	**0.7**	**0.7**	**0.9**	**1.1**	**1.2**	**1.1**	**1.0**
Non-technical account											
Total technical result life and non-life insurance	2.3	2.2	2.2	–3.5	1.4	1.5	0.2	2.3	1.8	1.5	1.3
Residual net investment income	0.7	0.5	1.7	0.3	–0.7	0.2	–0.9	0.9	0.3	0.1	0.2
Other and exceptional results and taxes	–0.6	–0.5	–0.1	–0.7	0.2	–0.3	–0.2	–0.7	–0.7	–0.5	–0.5
Net result for the year	**2.4**	**2.2**	**3.8**	**–3.9**	**0.9**	**1.4**	**–0.9**	**2.4**	**1.4**	**1.0**	**1.0**
p.m. Return on equity (in %)	*23.3*	*20.8*	*31.7*	*–27.3*	*6.3*	*9.9*	*–6.7*	*17.8*	*10.2*	*7.0*	*6.7*
p.m. Combined ratio non-life (in %)	*104.3*	*101.7*	*102.1*	*100.2*	*103.8*	*104.5*	*99.6*	*100.9*	*100.6*	*98.6*	*99.3*

Source: NBB.

(1) On a quarterly basis.

TABLE 35 LEVEL AND COMPOSITION OF INSURANCE COMPANIES' SOLVENCY MARGIN

(end-of-period non-consolidated data; in € billion, unless otherwise stated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	September 2014[2]
Life										
Explicit margin	6.9	7.8	8.5	11.0	12.3	12.3	11.2	11.5	11.7	10.4
In % of required margin	*144*	*146*	*144*	*177*	*185*	*172*	*150*	*151*	*151*	*135*
Implicit solvency margin	4.2	4.3	2.4	1.1	1.5	1.4	1.4	1.8	2.9	3.2
Future profits[1]	0.7	0.7	0.5	0.4	0.3	0.2	0.2	0.2	0.2	1.6
Unrealised capital gains	3.5	3.7	2.0	0.8	1.2	1.2	1.2	1.6	2.7	1.6
In % of required margin	*88*	*81*	*41*	*18*	*23*	*20*	*18*	*23*	*23*	*61*
Total solvency margin	**11.1**	**12.1**	**11.0**	**12.2**	**13.8**	**13.8**	**12.6**	**13.3**	**14.6**	**13.6**
In % of required margin	***232***	***227***	***185***	***195***	***208***	***192***	***169***	***175***	***175***	***197***
Non-life										
Explicit margin	4.8	5.0	5.7	5.8	5.1	5.0	5.3	5.4	5.5	5.8
In % of required margin	*280*	*275*	*302*	*301*	*284*	*274*	*264*	*255*	*255*	*288*
Implicit solvency margin	0.9	1.0	0.7	0.3	0.5	0.5	0.4	0.4	0.5	0.4
Unrealised capital gains	0.9	1.0	0.7	0.3	0.5	0.5	0.4	0.4	0.5	0.4
In % of required margin	*54*	*54*	*37*	*14*	*27*	*25*	*20*	*20*	*20*	*23*
Total solvency margin	**5.8**	**6.0**	**6.4**	**6.1**	**5.5**	**5.5**	**5.7**	**5.8**	**6.0**	**6.2**
In % of required margin	***334***	***329***	***340***	***315***	***312***	***299***	***284***	***275***	***275***	***312***
All activities										
Explicit margin	11.7	12.8	14.2	16.8	17.4	17.3	16.5	16.9	17.2	16.2
In % of required margin	*180*	*179*	*183*	*206*	*206*	*193*	*174*	*174*	*174*	*169*
Implicit solvency margin	5.1	5.3	3.1	1.4	2.0	1.9	1.8	2.2	3.4	3.7
Future profits[1]	0.7	0.7	0.5	0.4	0.3	0.2	0.2	0.2	0.2	1.6
Unrealised capital gains	4.4	4.6	2.7	1.0	1.7	1.7	1.6	2.0	3.2	2.1
In % of required margin	*79*	*74*	*40*	*17*	*24*	*21*	*19*	*23*	*23*	*53*
Total solvency margin	**16.9**	**18.0**	**17.3**	**18.2**	**19.4**	**19.2**	**18.3**	**19.1**	**20.5**	**19.9**
In % of required margin	***259***	***253***	***223***	***223***	***230***	***214***	***193***	***197***	***197***	***222***

Source: NBB.

(1) In life insurance.

(2) On a quarterly basis.

TABLE 36 NET ISSUES OF SECURITIES[1] BY FINANCIAL[2] AND NON-FINANCIAL CORPORATIONS AND GENERAL GOVERNMENT

(in € million)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	First nine months 2013	First nine months 2014	*p.m. Outstanding amount at the end of September 2014*
Debt securities	–7 062	1 905	32 909	69 139	70 042	12 499	24 721	17 091	3 692	6 686	4 532	*650 894*
Financial and non-financial corporations	–11 745	3 492	23 181	46 522	55 974	–8 167	5 227	9 688	–1 351	2 135	–3 634	*211 164*
Securities at up to one year	–3 143	–1 181	5 370	2 376	8 443	–7 046	–4 851	8 488	–1 153	–1 137	5 490	*30 814*
Securities at over one year	–8 602	4 673	17 811	44 146	47 532	–1 122	10 078	1 200	–198	3 272	–9 124	*180 350*
General government	4 683	–1 586	9 728	22 617	14 068	20 666	19 494	7 403	5 043	4 551	8 166	*439 729*
Securities at up to one year	304	386	4 258	18 914	–9 954	2 026	489	–10 163	–7 242	–2 226	8 646	*37 329*
Securities at over one year	4 380	–1 972	5 469	3 703	24 022	18 640	19 005	17 567	12 286	6 776	–479	*402 401*
Shares	3 888	100 041	155 265	133 246	52 098	57 397	91 844	–63 958	–20 377	–1 406	–3 453	*1 533 694*
Listed shares	–20 698	5 347	10 789	12 804	2 965	720	–3 990	3 041	4 558	2 868	2 105	*292 706*
Unlisted shares and other equity	24 586	94 694	144 475	120 442	49 134	56 677	95 834	–66 999	–24 935	–4 274	–5 557	*1 240 987*
p.m. Recourse by financial and non-financial corporations to the securities market	*–7 857*	*103 532*	*178 446*	*179 769*	*108 073*	*49 230*	*97 071*	*–54 271*	*–21 728*	*729*	*–7 087*	*1 744 858*

Sources: Euronext Brussels, FSMA, NBB.

(1) Excluding derivatives and mutual fund shares.

(2) Excluding NBB.

TABLE 37 INTEREST RATES

(end of quarter, annual percentages)

		Yield on the interbank market		Yield on the Belgian secondary market in securities issued by Belgian general government				
		Overnight [1]	Three-month [2]	Three-month Treasury Certificates	Linear bonds (OLO)			Ten-year benchmark linear bond (OLO)
					At one year	At two years	At five years	
2010	Q1	0.40	0.63	0.31	0.62	1.05	2.34	3.55
	Q2	0.54	0.77	0.35	0.69	1.06	2.38	3.46
	Q3	0.88	0.89	0.42	0.89	1.18	2.21	3.09
	Q4	0.82	1.01	0.63	1.57	2.04	3.24	3.97
2011	Q1	0.90	1.24	0.96	1.57	2.17	3.54	4.24
	Q2	1.72	1.55	1.35	1.63	2.22	3.47	4.13
	Q3	1.46	1.55	0.83	0.84	1.62	3.08	3.70
	Q4	0.63	1.36	0.05	0.58	1.89	3.36	4.06
2012	Q1	0.39	0.78	0.17	0.57	1.16	2.43	3.54
	Q2	0.38	0.65	0.17	0.42	0.80	2.12	3.23
	Q3	0.11	0.22	0.00	0.10	0.33	1.31	2.54
	Q4	0.13	0.19	0.00	0.03	0.10	0.90	2.04
2012	Q1	0.11	0.21	0.02	0.13	0.25	0.97	2.23
	Q2	0.21	0.22	0.04	0.21	0.47	1.52	2.61
	Q3	0.18	0.23	0.03	0.19	0.41	1.40	2.58
	Q4	0.45	0.29	0.06	0.19	0.33	1.36	2.55
2014	Q1	0.69	0.31	0.19	0.20	0.29	0.98	2.18
	Q2	0.34	0.21	0.00	0.05	0.10	0.58	1.71
	Q3	0.20	0.08	–0.04	–0.05	–0.04	0.28	1.25
	Q4	0.14	0.08	–0.07	–0.06	–0.06	0.15	0.82

Sources: ECB, NBB.

(1) The weighted average interest rate on the interbank market of the euro area for unsecured overnight transactions (i.e. transactions not backed by securities) in euro (Eonia).

(2) Average interest rate offered on the interbank market of the euro area for unsecured three-month transactions in euro (Euribor).

Methodological note

Unless otherwise indicated, when data are compared from year to year, they all relate to the same period of the years in question. In the tables, the totals shown may differ from the sum of the items owing to rounding.

In order to provide an update on various key economic data relating to Belgium in the year 2014 as a whole, it was necessary to make estimates, as the statistical material for that year is sometimes still fragmentary. In the tables and charts, these estimates, which were finalised at the end of January 2015, are marked "e". They represent mere orders of magnitude intended to demonstrate the trends which already seem to be emerging. The Belgian sources used are mainly the NAI, the DGS and the Bank. The comments on the international environment and the comparisons between economies are usually based on the latest data or estimates originating from institutions such as the EC, the IMF, the OECD and the ECB.

The monetary unit used in the Report for the data concerning the euro area member countries is the euro. Amounts relating to periods before the introduction of the euro, on 1 January 1999 for Belgium and for most of the member countries, are converted at the irrevocable euro conversion rates. Except in the chapters on monetary policy and prices, where the definition coincides with the historical reality, the euro area is defined wherever possible in this Report as consisting of all the EU countries which adopted the single currency during the period 1999-2014. Apart from Belgium, the area therefore consists of Austria, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain. For convenience, the term "euro area" is also used to designate this group of countries for periods prior to the start of Stage 3 of EMU. For some analyses, the preferred source was the OECD which includes in the euro area only the countries which are members of that international institution, i.e. excluding Cyprus and Malta. In view of the small size of those economies, the OECD data are perfectly representative of the euro area as a whole.

In September 2014, the new European standard ESA 2010 for calculating national accounts came into force; it replaces the ESA 95, introduced from 1998. This methodological revision falls under the international guidelines of the System of National Accounts – 2008 – (SNA 2008), drawn up jointly by the United Nations, the IMF, Eurostat, the OECD and the World Bank. Concomitantly, the sixth version of the IMF's manual on methodology for the balance of payments and the net international investment position also came into force in 2014. Moreover, in Belgium as in the other countries, implementation of these new methodologies also provided an opportunity to make some other improvements to the national statistics.

Generally speaking, the principles and the overall structure of the accounts have been preserved under the new methodology. The amendments are designed to better reflect the changes that economies are going through. Although the NAI has already set out these changes in detail, it seems appropriate to comment on the main new features[1].

– Capitalisation of R&D expenditure

Under the ESA 2010, the results of R&D activities are considered as produced assets, rather than intermediate consumption. Therefore, they come into both the creation of value added and form part of investment. Among a host of other smaller changes, such as the inclusion in the national accounts of illegal activities and the revision of estimations for the black market economy, this is the biggest factor in the revision of the level of GDP. Overall, for recent years, GDP has been revised upwards by about 3 %.

– Adaptation of the classification of financial corporations.

In the national accounts and the financial accounts, the financial sector now has a wider sub-classification. It comprises a new sub-sector entitled "captive financial institutions and non-institutional money lenders", which groups together, for example, holding companies and private equity firms (also called "treasury centres"), which are now quite distinct from head offices. As illustrated in Box 6 of the Economic and Financial Developments part of this Report, this change has major repercussions for financial statistics – notably the calculation of debt ratios –, because it gives rise to a transfer of financial assets and liabilities from the non-financial corporations sector to the financial corporations sector.

– Wider definition of the boundary of general government.

The ESA 2010, as well as the Manual on Government Debt and Deficit, clarifies several issues relating to general government and public corporations. In particular, the use of qualitative criteria to decide on the classification of market and non-market activities has led to an increase in the number of units classified under the general government sector. With more complete data available from the Regions and Communities, as well as local authorities, the NAI has reclassified almost 700 units in the general government sector. This mainly concerns units involved in financing social housing, local authority associations, autonomous municipality-owned utilities and other local public enterprises. These reclassifications, related to the ESA 2010 and also to other occasional revisions, along with some other changes, including those mentioned in the following indent, have had the effect of raising the level of the public debt by around 8 % of GDP in 2013. Taking account of the concomitant upward revision of GDP, the ratio of public debt to GDP has been revised upwards by about 4.5 % of GDP. The impact on the financing balance of general government as a result of widening the boundary is nevertheless limited.

– Changes in the treatment of various government transactions.

In net terms, they have had the effect of reducing the financing balance of general government by some 0.3 % of GDP in 2013, mainly because of the recording of conditional investment aid at the moment the payment obligation arises, rather than at the time of the actual payment.

– Changes in the presentation of the balance of payments current account.

Various changes have been made to the method of accounting for certain transactions with the rest of the world (for example as regards merchanting or goods sent abroad for processing). Likewise,

(1) NAI (2014) ESA 2010 – The new reference framework for the national accounts, September. http://www.nbb.be/doc/dq/en_method/M_ESA2010_EN.pdf

the old factor income and transfer accounts have been restructured according to a presentation in line with that uses for the national accounts. These various adaptations barely affect the current account balance in the balance of payments. However, they have led to shifts between the headings under the current account balance and gross flows of revenue and expenditure.

As far as possible, this Report has made use of the statistics compiled using the new methodology standards and the resultant definitions. In Belgium's case, these data are available back to the year 1995 for the national accounts and the general government sector accounts, to 1999 for the quarterly financial accounts and 2008 for the balance of payments. Wherever necessary, figures have been retropolated for earlier periods.

For the sake of simplicity, the sectoral breakdown groups together, under the heading "individuals", households and non-profit institutions serving households, which constitute separate sectors according to the ESA 2010 methodology. Nevertheless, the terms "individuals" and "households" are used as synonyms. The terms "corporations" and "enterprises" are also frequently used as synonyms, whereas in the commentary from the GDP expenditure angle, "enterprises" also covers self-employed people, who are included under households in the real and financial sectoral accounts.

In the section devoted to the international environment, the presentation is also consistent with the ESA 2010 or its equivalent, the SNA 2008. Nevertheless, the statistics from the sources to which reference is made in the Report, usually the EC and the OECD, are not always uniform, because the periods for which the methodological revision or the conversions from one system to the other have been carried out still vary greatly from one country to another.

Conventional signs

–	the datum does not exist or is meaningless
n.	not available
p.m.	*pro memoria*
e	estimate by the Bank

Abbreviations

Euro area countries in 2014

EA	Euro area
EU15	European Union, excluding countries that joined after 2003
EU27	European Union, excluding Croatia

BE	Belgium
DE	Germany
EE	Estonia
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
CY	Cyprus
LV	Latvia
LU	Luxembourg
MT	Malta
NL	Netherlands
AT	Austria
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland

Other European Union countries

EU	European Union
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
HR	Croatia
LT	Lithuania (joined the euro area on 1 January 2015)
HU	Hungary
PL	Poland
RO	Romania
SE	Sweden
UK	United Kingdom

Other countries

JP	Japan
US	United States

Other abbreviations

ABS	Asset-backed securities
AFS	Available for sale
ALM	Asset liability management
AMA	Advanced measurement approach
AML	Anti-money-laundering
AQR	Asset quality review
BEAMA	Belgian Asset Managers Assocation
BLS	Bank lending survey
BMA	Business model analysis
BNY Mellon	Bank of New York Mellon
BRRD	Bank Recovery and Resolution Directive
CA	Comprehensive assessment
CBFA	Banking, Finance and Insurance Commission
CBPP3	Covered bond purchase programme
CCGT	Combined cycle gas turbine
CCP	Central counterparty
CDO	Collaterised debt obligation
CEBS	Committee of European Banking Supervisors
CEC	Central Economic Council
CEC	Centre for Exchange and Clearing
CEPR	Centre for Economic Policy Research
CET 1	Common equity Tier 1
CICR	Central Individual Credit Register
CIS	Community Innovation Survey
CLS	Continuous Linked Settlement System
CMG	Crisis Management Group
CO2	Carbon dioxide
Corep	Common solvency ratio reporting
CPB	Central Planning Bureau (Netherlands)
CPMI	Committee on Payments and Market Infrastructures
CRD	Capital Requirements Directive
CREG	Commission for Electricity and Gas Regulation
CRR	Capital Requirements Regulation
CPSS	Committee on Payment and Settlement Systems
CSD	Central securities depository
CVA	Credit Valuation Adjustment
DG	Directorate General
DGS	Directorate General Statistics
DTCC	Depository Trust & Clearing Corporation

EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
Ecofin	Economic and Financial Affairs Council
EDP	Excessive deficit procedure
EEA	European Economic Area
EEC	European Economic Community
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
EMU	Economic and Monetary Union
Eonia	Euro Overnight Index Average
ESA	European System of Accounts
ESCB	European System of Central Banks
ESES	Euroclear Settlement for Euronext-zone Securities
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
ESRB	European Systemic Risk Board
Euribor	Euro Interbank Offered Rate
FATF	Financial Action Task Force
FCI	Financial conditions index
FEBIAC	Belgian motor vehicle and cycle federation
Federgon	Federation of HR service providers
FIN	SWIFT messaging service
FINREP	Financial reporting framework
FOMC	Federal Open Market Committee (United States)
FPS	Federal Public Service
FPS ELSD	Federal Public Service Employment, Labour and Social Dialogue
FRBNY	Federal Reserve Bank of New York
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSMA	Financial and Securities Markets Authority
FSR	Financial Stability Review
FT	Financing of terrorism and proliferation
G10	Group of Ten
GAAP	Generally Accepted Accounting Principles
GDP	Gross domestic product
GECE	Group of Experts on Competitiveness and Employment
GIMF	Global Integrated Monetary and Fiscal Model
GNI	Gross national income
G-SIB	Global systemically important bank
G-SII	Global systemically important insurer
GW	Gigawatt
HFCN	Household Finance and Consumption Survey
HICP	Harmonised index of consumer prices
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards

ICAAP	Internal Capital Adequacy Assessment Process
ICT	Information and communication technology
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IORP	Institutions for occupational retirement provisions
IOSCO	International Organisation of Securities Commissions
IRB	Internal ratings-based approach
JST	Joint Supervisory Team
LCR	Liquidity coverage ratio
LEA	Local employment agency
LFS	Labour force survey
LTG	Long-term guarantee
LTRO	Longer-term refinancing operations
MBS	Mortgage-backed securities
MFI	Monetary financial institution
MIP	Macroeconomic imbalance procedure
MIR	Monetary financial institution interest rates
MSCI	Morgan Stanley Capital International
MTO	Medium-term objective
MW	Megawatt
NACE	Nomenclature of economic activities of the European Community
NAI	National Accounts Institute
NBB	National Bank of Belgium
NCPI	National consumer price index
NEO	National Employment Office
NPI	Non-profit institution
NPISH	Non-profit institution serving households
NSFR	Net stable funding ratio
NSSO	National Social Security Office
OECD	Organisation for Economic Cooperation and Development
OFI	Other financial intermediaries
OIS	Overnight Index Swap
OLO	Linear bond
OMT	Outright monetary transactions
OPEC	Organisation of Petroleum Exporting Countries
OPI	Occupational pension institution
ORSA	Own risk and solvency assessment
OTC	Over-the-counter (derivatives)
PIT	Personal income tax
PMR	Product Market Regulation Indicator
PRIME	Prudential Supervision Improvement and Extension Programme
QAT	Quantitative Analytical Tool

R&D	Research and development
RAS	Risk Assessment System
RES	Renewable energy sources
S&P	Standard & Poor's
SA	Société anonyme (public limited company or Plc)
SAFE	Survey on the Access to Finance of SMEs in the euro area
SCR	Solvency capital requirement
SEP	Supervisory Examination Programme
SEPA	Single Euro Payments Area
SCA	Study Committee on Ageing (formerly SGA)
SICAFI	Real estate investment fund with fixed capital
SME	Small and medium-sized enterprise
SMP	Securities Markets Programme
SNCB	Belgian national railway company
SPV/SPE	Special purpose vehicle/special purpose entity
SRB	Single resolution board
SREP	Supervisory Review and Evaluation Process
SRM	Single resolution mechanism
SSM	Single supervisory mechanism
SSS	Securities settlement system
STET	Système technologique d'échange et de traitement (French company)
SVAR	Structural vector autoregression
SWIFT	Society for Worldwide Interbank Financial Telecommunication
T2S	TARGET2-Securities
TFP	Total factor productivity
TLTRO	Targeted longer-term refinancing operation
UCI	Undertaking for collective investment
UJS	Unemployed job-seeker
VAT	Value added tax
VIX	Volatility Index
WTO	World Trade Organisation

List of legislative acts

BRRD : Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council

CRD IV : Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

CRR : Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012

Solvency II : Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance

Omnibus II Directive : Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No. 1060/2009, (EU) No. 1094/2010 and (EU) No. 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority)

Banking Law : Law of 25 April 2014 on the legal status and supervision of credit institutions.

Organic Law : Law of 22 February 1998 establishing the Organic Statute of the National Bank of Belgium

EMIR Regulation : Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

SSM Regulation : Regulation (EU) No. 1024/2013 of the Council of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions

SRM Regulation : Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit

institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010

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