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

1. In the past year, the sovereign debt crisis in Europe escalated and became systemic in character. The contagion affected not only countries with relatively good economic fundamentals, such as Belgium, but also the banking system which traditionally regarded sovereign debt instruments as the most secure assets. This raised the spectre of a vicious circle of bank balance sheet deleveraging, additional government intervention in the banking sector, and further downgrades of sovereign debt instruments. Economic policy in Europe responded with a range of measures, not only emergency assistance and fiscal consolidation programmes but also substantial reforms in European economic governance. The crucial aims are to restore confidence and set Europe back on the road to sustainable economic growth.

1. International environment: a faltering economic recovery and a flight to safety on the financial markets

2. After the strong revival of global economic growth in 2010, the pace of growth subsided again last year. Global GDP growth declined from 5 % in 2010 to an estimated 3.8 % in 2011, with growth slowing down in almost all the large economic regions. At the beginning of the year it remained robust, continuing the momentum of 2010, but subsequently slowed down as the very steep rise in commodity prices in the first four months of the year eroded household incomes and curbed consumption. The earthquake and the tsunami which hit Japan in March not only had a severe impact on that country's economic output, but also disrupted production chains in other economic regions. By the summer, the slowdown was more marked, partly owing to the sovereign debt crisis in Europe which dented consumer and business confidence. Throughout the year, fiscal consolidation in various countries also depressed demand.

3. As in previous years, there were significant geographic differences. In the emerging economies, though growth slackened pace it remained strong, especially in China and India, where GDP grew by 9.3 and 7.7 % respectively. In the oil-producing countries, the expansion was actually more vigorous than in 2010 as a result of the higher oil prices. In the developed countries, growth was more restrained. In the United States, still battling with significant problems on the property and labour markets, GDP grew by 1.7 %, while in Japan it contracted by 0.3 % in the wake of the catastrophic events of 2011.

* One Regent did not give his approval to this Report, as he disagreed with certain remarks and recommendations in it.

4. The heterogeneity of economic performance also largely determined the monetary policy stance. Most of the developed countries, such as the United States, the United Kingdom and Japan, maintained an expansionary policy. In the United States, the Federal Reserve continued to pursue its government securities purchase programme adopted in November 2010. In September 2011, it also decided to extend the average maturity of its portfolio of Treasuries ("Operation Twist"), in order to drive down long-term interest rates. Conversely, in emerging economies such as China, the monetary authorities initially tightened their policy to contain inflation. Some of them did loosen the reins towards the end of the year, however. For instance, on 30 November the Chinese central bank reduced the monetary reserve ratio for the first time in three years.

5. World trade expanded by 6.7 % in 2011, a sharp slowdown compared to the 2010 figure of 12.6 %. There were wide fluctuations during the year. Growth got off to a very strong start, then flagged in the second quarter on account of the disasters in Japan. A recovery set in from the third quarter, but was held back when economic growth lost momentum.

6. Balance of payments remained distorted worldwide. The surplus on China's current account contracted from 5.2 % of GDP in 2010 to 3.1 % in 2011, but the United States' deficit shrank only marginally from 3.2 to 3 % of GDP. On the other hand, the current account of the euro area as a whole was broadly in balance. However, the increase in oil prices in the first half of the year led to a strong expansion of the oil-producing countries' surplus. These balance of payments imbalances remain a source of vulnerability and tension in the world economy. They encourage protectionism and imply a serious risk of a disorderly correction. In November, the G20 countries meeting at the Cannes summit drew up an action plan for growth and employment. More vigorous measures are still needed to rebalance global demand in the world economy, in particular to boost savings in deficit countries and to stimulate domestic demand in surplus countries. It is also advisable to strengthen the role of the IMF in the surveillance of the world economy.

7. However, the year under review was dominated by a very marked flight to safety on the financial markets. This was reflected in the soaring prices of gold, the Swiss franc and the Japanese yen, and in the decline in yields on US, Japanese and German government bonds. At the beginning of the year, the risk aversion was due partly to the political uncertainty over events in North Africa and the Middle East. Later in the year, there was growing concern about the economic policy to control the public debt in both the United States and Europe. This applied particularly to the euro area, which may seem paradoxical as the euro area is doing better than the United States in many respects, such as with the external account, the public deficit and the public debt. All in all, this suggests that the European sovereign debt crisis is due principally to the lack of coherence in the economic policy of the euro area.

2. Worsening of the sovereign debt crisis in Europe

8. The sovereign debt crisis marked the start of a new phase in the global financial crisis, which had begun in the summer of 2007 with the very serious problems concerning subprime loans in the United States. The crisis reached a first peak after the collapse of Lehman Brothers, in September 2008, which caused severe disruption in the financial system, forcing the central banks to take over most of the functions of the interbank market. The crisis also had a significant impact on public finances. Not only did the State have to support the financial system in a number of countries, but public finances were also weakened by the recession, through the effect of both the automatic stabilisers and the stimulus plans.

9. Even after the economic recovery in 2010, the crisis still had an impact on both public finances and the financial system. As in previous banking crises, economic growth was weakened by the efforts to reduce the debt positions which had accumulated in both the private and public sectors. Moreover, the rise in structural unemployment and the tightening of borrowing conditions for businesses in some countries affected the growth potential of the economy.

10. The sovereign debt crisis also clearly revealed the flaws in the structure of the European Economic and Monetary Union. With a single currency but no political union, the European Monetary Union was navigating in uncharted waters. The sovereign debt crisis has rekindled the debate on the link between monetary and political union. The crisis has undeniably demonstrated that membership of a single currency in a single economic and financial market creates extremely strong and complex interdependencies. That is why much stronger integration of economic policy is absolutely vital. Fiscal policy is one of the first areas here : fiscal discipline is clearly essential for a sustainable monetary union. It was always one of the central themes of discussions on the economic governance of the European Monetary Union. The Delors Report of 1989 explicitly stated that "binding fiscal rules" were essential to the smooth functioning of a monetary union. Fiscal policy rules were set out in the Maastricht Treaty and in the Stability and Growth Pact. Unfortunately, when it emerged that large countries were not complying with this pact, the rules were relaxed in 2005. Thus, peer pressure turned into peer neglect. A second problem that attracted far less attention concerned more general economic imbalances and competitiveness. The convergence of nominal interest rates in the monetary union was a factor which stimulated economic expansion in some countries, such as Spain and Ireland, and especially in the property sector. This drove up prices and wages much more steeply than elsewhere, which in turn damaged the competitiveness of those countries. Furthermore, both substantial increases in income and lower real interest rates continued to stimulate domestic demand. This exacerbated the imbalances in these economies, with excessive bank lending and debt accumulation, property market bubbles, and often massive current account deficits on the balance of payments. Yet there was virtually no reaction by economic policy, since the prevailing idea was rather that real convergence was taking place. The result was a serious boom-bust cycle.

11. The history of European Monetary Union also highlights the limits and excesses of market forces. In the first ten years of the euro area, markets hardly responded to the growing macroeconomic imbalances. Their subsequent reaction was too late and overblown, further disrupting the economy. The contagion affecting European financial markets in 2011 was unprecedented, although there were similarities with the European Monetary System crisis of 1992-1993. The contagion initially concerned the sovereign debt markets of countries with structural problems. Thus, investors sold the public debt of countries such as Spain and Italy in order to reduce their exposure to the weaker economies.

12. At first, however, the response by the European policy-makers was very hesitant and did little to tackle the crisis vigorously. The scale of the Greek debt crisis was recognised far too late and it was not tackled with sufficient determination. The question mark over the involvement of the private sector in a restructuring of the Greek public debt also deterred investors. The new European crisis mechanisms initially appeared to be inadequate and slow to be implemented. In the beginning, insufficient progress was achieved in the reform of European economic governance. Moreover, policy announcements concerning the new measures were often unclear. As a result of their hesitancy, policy-makers lost control of the financial markets and created uncertainty, leading to seriously excessive reactions by the markets. The policy-makers were clearly not living in the same world as the financial markets. Under severe pressure from the markets, they were slow to respond, devising measures which were based on compromises and lacked transparency. Conversely, the financial markets – which abhor uncertainty – wanted immediate, clear measures. This naturally resulted in a serious loss of confidence on the financial markets, and speculation developed – especially from the autumn – over the break-up of the

euro area. The result was higher market volatility and a further weakening of demand for sovereign debt instruments. The rising interest rates fuelled debate over the sustainability of the public debt and there was a danger of investors' expectations proving correct.

13. The sovereign debt crisis spread not only to countries with relatively sound fundamentals but also to banks holding substantial portfolios of government securities. Those banks therefore saw their sources of funding dry up, their borrowing costs increase and their solvency decline. Owing to the deleveraging of banks' balance sheets, this triggered a dangerous spiral. It not only had direct repercussions for governments – as the banks were selling off government bonds – but also threatened to create a credit shortage for companies and households, which would damage economic growth. Moreover, in some countries, governments had to intervene to support the banking system, making public finances more vulnerable. In addition, in the case of some countries, the financial markets began to doubt the government's ability to react, and that led to further widening of the spreads on government bonds.

14. The tensions on the financial markets also had an impact on economic activity in the euro area. In the first quarter, building on the vitality of 2010, growth remained very robust. From the second quarter it lost momentum, and in the second half of the year it stalled, primarily because of flagging domestic demand. Over 2011 as a whole, euro area GDP grew by 1.6 %, compared to 1.8 % in 2010. There was wide geographical heterogeneity. Germany, Austria, Finland, Slovakia and Estonia recorded strong growth. In contrast, the GDP of Greece and Portugal contracted. In the euro area as a whole, and also in most of the Member States, GDP has not yet regained its 2007 level. That applies primarily to countries where growth was previously based on excessive debt accumulation. The public deficit in the euro area declined from 6.2 % of GDP in 2010 to 4.1 % in 2011, principally as a result of consolidation measures. Only four countries (Estonia, Luxembourg, Finland and Germany) recorded a deficit of less than 3 % of GDP. At the beginning of the year, inflation continued to gather pace, propelled mainly by the price rises on the commodity markets. In 2011, the harmonised index of consumer prices increased by 2.7 %.

3. Economic policy in Europe: not only crisis management, but also radical reforms of economic governance

15. The European authorities reacted to the sovereign debt crisis with a raft of measures, not only crisis management but also new stabilisation mechanisms and radical reforms of economic governance in the euro area. These measures aimed to restore calm on the financial markets and give a structural boost to the growth potential of the European economy.

16. The Eurosystem responded to the financial turmoil in accordance with its mandate and the principles of modern central banking. The primary aim of safeguarding medium-term price stability is accorded priority.

17. The monetary policy framework of the Eurosystem is based on the separation principle, distinguishing between interest rate decisions, on the one hand, and liquidity policy directed primarily at lending to financial institutions, on the other. During the financial crisis, the Eurosystem – like most of the world's central banks – introduced a number of non-conventional policy measures. Their main aim was to preserve the monetary policy transmission mechanism, so that interest rate policy could play its full role in ensuring price stability. Those non-conventional measures thus support the banks and hence the funding of the real economy. They also help to limit contagion on the financial markets.

18. In 2011, monetary policy initially faced growing risks to price stability. Those risks were due mainly to the gradual recovery of activity at the beginning of the year and the danger that previous commodity price increases would be passed on in a context of strengthening growth.

In April and July, the ECB Governing Council raised the central policy interest rate, by 25 basis points on each occasion, bringing it to 1.50 %. However, by the summer the economic situation was changing significantly. In particular, the worsening sovereign debt crisis had a serious impact on the expectations of businesses and consumers. Since inflation is set to fall in 2012, the central policy rate was cut in November and December by 25 basis points at a time, restoring it to 1 %. In accordance with its task of ensuring medium-term price stability, the Eurosystem thus contributed to anchoring inflation expectations, an essential condition for safeguarding price stability and preventing both inflation and deflation.

19. The intensification of the sovereign debt crisis, which seriously disrupted the functioning of the banking and financial system, prompted the Governing Council to adopt new non-conventional measures. In August 2011, it was decided that purchases of government bonds under the Securities Markets Programme should be extended to include Spanish and Italian public debt instruments. In October, the Governing Council announced a second programme for the purchase of covered bonds. Two additional longer-term refinancing operations were also announced in that month, one for October and one for December 2011, with terms of around 12 and 13 months respectively. In December a new package of credit-supporting measures was approved. They included two refinancing operations with a term of three years and an option of early repayment after one year, a reduction in the monetary reserve ratio from 2 to 1 %, and extension of the list of eligible collateral.

20. As part of the European crisis management, financial assistance programmes were devised for a number of countries in collaboration with the IMF. Stringent conditions were attached in the form of drastic economic measures. As had been done for Greece and Ireland in 2010, a programme was set up for Portugal in May 2011. These countries have made progress in the field of fiscal consolidation and – except for Greece – in the restoration of their competitiveness. Ireland's performance was particularly encouraging. However, despite ambitious measures, Greece did not make sufficient progress, partly because of the contraction of output, and in July and October 2011 the European Council decided to arrange a new support package involving the private sector.

21. The European Union also established new stabilisation mechanisms. They form part of a set of reforms which, by considerably reinforcing European economic governance, address the causes of the sovereign debt crisis.

22. In May 2010, two temporary financial stabilisation mechanisms were created, namely the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). At the December 2010 European summit, agreement was also reached on a limited amendment to the Treaty concerning the establishment of a future permanent crisis mechanism, the European Stability Mechanism (ESM). At the euro area summit on 21 July 2011, the Heads of State and Government decided to increase the flexibility of the EFSF and the ESM, so that both can also be used for lending to non-programme countries for the recapitalisation of financial institutions and for interventions on the secondary bond markets. Later, at the euro area summit on 26 October 2011, it was decided to augment the firepower of the EFSF via leverage. At the euro area summit on 9 December 2011, it was also agreed that entry into force of the treaty on the ESM should be brought forward to July 2012. This treaty will also be amended so that, where the involvement of the private sector is concerned, there will be strict compliance with IMF principles and practices, while the voting rules will be supplemented by an emergency procedure. Furthermore, the Member States will examine whether additional resources can be made available to the IMF in the form of bilateral loans.

23. Of course, it is necessary to address the causes of the debt crisis in Europe in order to find a permanent solution. Economic governance – strengthening the economic pillar of EMU – thus became a key topic. In that context, a special task force was set up, chaired by the permanent

President of the European Council, Herman Van Rompuy. The final report of this task force was approved at the October 2010 European Council. At the end of September 2010, for the purpose of strengthening economic governance, the European Commission developed six legislative proposals, dubbed the Six Pack. They were approved by the European Parliament on 28 September 2011 and by the Ecofin Council on 4 October 2011. The first aim is to improve fiscal discipline by tightening up the Stability and Growth Pact. To strengthen the effectiveness of the pact, penalties can be applied at an earlier stage under the preventive arm, and the reverse majority rule was introduced for their approval. Under this new rule, European Commission recommendations are adopted unless the Council rejects them by a qualified majority vote. The second aim concerns economic surveillance of macroeconomic imbalances and competitiveness. For that purpose, a new "excessive imbalance procedure" was introduced. In addition, *ex ante* policy coordination was reinforced by the so-called "European Semester", introducing a single timetable for all supervision mechanisms and requiring national reform programmes and stability or convergence programmes to be submitted to the European Commission by the spring. The European Semester was implemented on 1 January 2011.

24. At the European summit on 9 December 2011, new steps towards a stronger economic union were agreed, and in particular a new Fiscal Compact, establishing a new fiscal principle whereby the annual structural deficit must not, as a rule, exceed 0.5 % of GDP. The Member States have to introduce this rule in their national legal system at constitutional or equivalent level. There is also provision for an automatic correction mechanism which is triggered in the event of deviation from the rule. Furthermore, the coordination of economic policy will be reinforced. Thus, the excessive government deficit procedure is being tightened up, notably by extending the use of the reverse majority rule.

25. Overall, the foundations for substantial strengthening of European economic governance were laid in 2011. The Six Pack and the new Fiscal Compact were particularly important. Further elaboration and rigorous implementation of these agreements will be crucial for restoring confidence on financial markets. Fiscal consolidation must also be accompanied by a resolute and ambitious programme of structural reforms, essential to enhance the competitiveness and growth potential of the euro area. It is also necessary to proceed to implement and apply the new stabilisation mechanisms, in order to calm the tension on the financial markets. The Eurosystem will continue to perform its role as a stability anchor. Ensuring price stability and anchoring inflation expectations are the best way for the Eurosystem to contribute towards sustainable growth, job creation and financial stability.

4. A new framework for financial stability in Europe and in Belgium

26. The financial crisis also highlighted the need to reinforce the arrangements for the prudential function in Europe, which must be embedded in the broader perspective of adjustments to the general governance structure of the EU. An important step in that direction was taken on 1 January 2011 in establishing the European Systemic Risk Board (ESRB), a European macroprudential surveillance authority, and the European Supervisory Authorities (ESAs), intended to strengthen microprudential supervision in Europe, particularly for cross-border aspects, in the three sectors comprising banking, insurance and the securities markets. Together, the ESRB and the ESAs are to play a vital role in detecting systemic risks, and in improving and harmonising supervisory practices and cooperation between national authorities, notably by issuing recommendations or drawing up supervision rules.

27. Belgium's seamless insertion into this European framework was facilitated by the introduction, on 1 April 2011, of a new "Twin Peaks" model which entrusts the prudential supervision of financial institutions to the Bank while another institution, the Financial Services and Markets Authority (FSMA), is responsible for ensuring the smooth operation of the securities markets,

observance of the rules of conduct, and consumer protection. The integration into a single authority of the surveillance of the stability of the financial system as a whole and of each of its constituent institutions makes it possible to check the examination of individual institutions against systematic analyses for each risk category.

28. These new supervision structures, which were immediately put to the test by the tension on the financial markets, need to be backed by tougher regulations aimed in particular at rapid improvements to bank solvency. Dividend and bonus payments must be strictly subject to compliance with the new Basel Committee rules. As those rules imply a substantial increase in capital, the Committee has arranged a fairly long transitional period to give institutions time to adapt. However, the markets are concerned about the length and difficulty of that adjustment process, which could entail the risk of a shortage of bank credit, harmful to the economy.

29. These problems were particularly apparent during the stress tests on systemic banks in the EU, coordinated by the European Banking Authority (EBA). A first exercise conducted in the first half of 2011 did prompt a number of institutions to anticipate the publication of the results in late July by increasing their capital or proceeding with new restructuring efforts at the beginning of the year. However, these measures produced little response because the markets were concentrating most of their attention on the efforts still needing to be made. The EBA therefore had to organise a new test at the end of the year, specifically targeting the risks associated with the exposure of the large European banks to sovereign debt. This additional exercise placed particular emphasis on the negative impact on solvency of the valuation losses on government debt, but it also highlighted the massive constraints which credit institutions face in order to improve their capital base. The scope available from retaining earnings – the most natural option – is limited by the economic situation which is hitting profitability, while current market conditions are rendering new share issues extremely expensive, if not impossible. The banks may then be tempted to act quickly to cut the size of their balance sheet, even at the risk of restricting the supply of credit. Such rationing is not yet apparent in Belgium, but there seem to be early signs of it in some EU countries.

30. European harmonisation of the definition and calibration of capital is not confined to the banking sector but also applies to the insurance sector for which a new regime, known as Solvency II, will be introduced gradually in 2013, becoming fully operational on 1 January 2014. The regulations aim to cover a number of other dimensions as well as the level of capital. There is still much progress to be made, particularly in regard to risk quantification, because there are wide divergences both in the internal models of individual banks and in the practices of the national supervisory authorities. The sovereign debt crisis has shown that the risks on what are, at first sight, very standardised positions, such as a portfolio of securities issued by one State, could be accorded very different weightings.

31. Contagion effects due to the interconnections between institutions or markets may also give rise to systemic risks which could jeopardise the overall stability of one or more national financial systems. The EU Member States ought therefore to retain some latitude, within clearly defined limits, to set stricter minimum requirements if that is justified by macroprudential priorities.

32. Finally, it is essential to ensure that credit institutions have sufficient high-quality liquid resources on the assets side of the balance sheet, and stable sources of funding on the liabilities side, to enable them to cope with liquidity problems. While these new prudential requirements must be met, above all, at consolidated level, they should also be respected for the individual components, which implies limiting intra-group flows and containing any risks of concentration regarding exposures of one entity in relation to another.

33. Admittedly, such rules will impose constraints on large credit institutions. However, these restrictions are inevitable so long as the management and resolution of bank crises remain essentially a matter for the national authorities. Indeed, recent developments have drawn attention to the fact that the European procedures in this area are still at the embryonic stage. In order to reduce the costs and ensure that the burden of bank failures affecting cross-border institutions is fairly shared, the European Commission is drafting proposals for reinforcing and harmonising the arsenal of preventive, curative and crisis resolution measures, including contribution from creditors, mechanisms for coordination between national authorities, and a mediation role for the EBA in the event of disagreements.

5. The sovereign debt crisis and the Belgian financial system

34. The sovereign debt problem has again highlighted the structural handicaps which were revealed by the 2008 crisis and which the financial sector has only partially rectified since then. The balance sheets of some European banks are still excessively large with many rather illiquid assets. It has often proved impossible to carry out plans for restructuring and the winding down of activities owing to the adverse financial climate, while it takes time to refocus on more stable funding sources and to reinforce the capital structure. In Belgium, these problems apply particularly to the systemic banks, forced by the financial crisis to revise a business model which they had developed many years ago. At the time, these banks had tried, by venturing into foreign markets, to exploit the competitive advantage represented by the large deposit base which clearly exceeded the financing needs of the national economy.

35. For a long time, there was a fairly broad social consensus on their international expansion policy since it led to jobs, tax revenues and the development of centres of expertise in Belgium. Nonetheless, it gave rise to two types of problem. First, the funding needs generated by the new activities soon exceeded the net resources collected from Belgian savers, forcing the banks to turn to the international interbank market; the drying up of that market was one of the principal features of the two recent crises. Some of the Belgian banks, in common with many financial institutions in other countries, were deluded into believing that the increase in their profitability was attributable solely to their good management or the fruits of a successful diversification policy, when it was actually due largely to more aggressive risk-taking. In some cases, and especially for the Dexia group, this supervision problem was exacerbated by a system of corporate governance in which the business was partly managed by entities – and supervised by authorities – in different countries.

36. The 2008 crisis brought an abrupt end to this period of expansion. It obliged the large Belgian banks to launch massive restructuring programmes, in consultation with the Belgian and European authorities. However, the process of implementing these plans, which received substantial government aid, clearly revealed the discrepancy between the time required to plan and redirect increasingly complex financial activities and the speed of market reactions. The measures taken did help to attenuate the risk profiles, reduce recourse to wholesale funding, strengthen capital and restore profitability. After suffering a serious loss of € 21.2 billion in 2008, the Belgian banking sector was thus able to keep its deficit down to € 1.2 billion in 2009, and made a profit of € 5.6 billion in 2010. However, the resurgence of tension on the financial markets in 2011 led to deteriorating results; overall, the figures were just in balance for the first nine months of the year.

37. The Dexia group was particularly hard hit because of its heavy dependence on interbank funding and its large exposures to sovereign risks or risks associated with other public authorities. This meant that the group had to undergo radical reorganisation. The Belgian, French and Luxembourg States granted the group a financing guarantee for a maximum of € 90 billion, and several group entities were offered for sale. Dexia Bank Belgium and its subsidiary Dexia

Insurance Belgium were acquired by the Belgian State for € 4 billion. The Bank contributed to designing the restructuring plan, notably in regard to the reorganisation of the Belgian activities in an independent entity, in order to reduce the systemic risks and preserve the commercial activities in Belgium.

38. The economic slowdown and its impact on employment are another source of risk for the financial sector, materialising more specifically on certain markets highly sensitive to the business cycle, such as the property market. Belgian financial intermediaries thus had to form ample provisions for mortgage loans granted in countries such as Ireland and Hungary. While there are not currently any obvious signs of a sharp deterioration on the Belgian property market, the virtually uninterrupted price rises mean that vigilance is all the more necessary, as a further increase in unemployment could impair the borrowers' ability to repay the loans. Moreover, as the effects of the sovereign debt crisis spread to a greater number of euro area countries, that also impacted on a number of Belgian banks or insurance companies, owing to the long-standing dominance of these two sectors in public debt financing.

39. With the large banks now falling back on their domestic market to some extent, that is in fact focusing the spotlight once again on the structural strengths and weaknesses that the financial sector had specifically tried to come to terms with when embarking on international expansion. The Belgian financial market has dense coverage so that, overall, there is little scope for an increase in profits; that is a handicap in a context where the retention of earnings is regarded as a key means of building up capital. Conversely, owing to the scaling down of foreign activities, the deposits collected from households make up a larger proportion of the total funding structure of the Belgian banks, while these resources also attract foreign banking groups tempted to set up in Belgium. While the fairly stable funding based on private deposits must be allowed to move freely within the Single Market, the rules of good management require the proper fixing of internal transfer prices between the various activities and the various subsidiaries of the same banking group, especially as financial intermediaries are in competition with the securities markets where lenders and borrowers come into direct contact with one another. The recent success of the Belgian State's direct appeal to households when issuing the latest government bonds is an example of the possible shifts in the flow of funds. It also shows that cross-subsidies between financial products or markets will be increasingly difficult to maintain and justify, whether they are motivated by commercial strategies or based on tax legislation.

6. Economic policy in Belgium: consolidating public finances and strengthening growth potential

40. The strengthening of economic governance at European level also has considerable implications for Belgian economic policy. Belgium has to fit into this new European framework which increases the transparency of Belgian policy, augments its credibility and offers clear guidelines. The latter actually coincide with the challenges facing policy in Belgium, namely the consolidation of public finances – which, as in most other countries, will be influenced by the growing cost of population ageing – and the reinforcement of the growth potential, so that Belgium can secure its position in a globalised economy.

41. The year 2011 did not only bring significant developments concerning European economic governance: in Belgium, the new government agreement provides for a sixth State reform which will see a substantial transfer of responsibilities from the federal State to the Communities and Regions, greater fiscal autonomy for the Regions and a reform of the Special Finance Act for the Communities and Regions.

42. In 2011, the Belgian economy proved relatively resilient, thanks to a good performance at the beginning of the year. GDP growth came to 1.9 %, which was once again well above the euro area average (1.6 %), though it was lower than the 2010 figure (2.3 %). In contrast to 2010, domestic spending was the main factor driving growth. Taking an average over the year, employment expanded by around 56 000 units, while the harmonised unemployment rate was down from 8.4 % in 2010 to 7.3 % in 2011. These good results for the year are due mainly to a strong first half, building on the momentum of 2010. In the second quarter, the expansion began to flag while in the second half of the year growth was very slightly negative.

43. As a result of the Belgian economy's relatively strong performance, spreads between Belgian and German government bonds have been fairly small in recent years, though they did widen in 2010, mainly because of the sovereign debt crisis. However, from the summer of 2011, the crisis worsened, causing a steep rise in the Belgian spread on ten-year linear bonds to more than 300 basis points, partly due to the political crisis in Belgium and the associated lack of any vigorous economic policy response. The spread diminished again at the end of the year. The formation of a new government in December 2011 – following a political crisis lasting 541 days – with an ambitious but necessary programme adopted in accordance with European requirements offers hope that clear progress can be made in the consolidation of public finances and the reinforcement of the Belgian economy's growth potential. This programme requires rigorous implementation and strict monitoring, as the economic outlook is deteriorating. Additional measures will also be necessary. They must be taken under a medium-term plan so that Belgium fulfils the commitments made in the national reform programme and the national stability programme.

44. Public finances present the first policy challenge. Since 2009, a year in which the public deficit had grown strongly as a result of the economic crisis, Belgium has been among the countries with an excessive public deficit. According to the April 2011 stability programme, the public deficit should have been cut to 3.6 % of GDP in 2011, with a balanced budget being achieved by 2015. However, the target for 2011 was not attained. The deficit is estimated at 4 % of GDP, the same as in 2010, mainly because of a too limited reduction of the structural deficit. In 2011, the Belgian deficit equalled the average for the euro area. Belgium's public debt increased from 96.2 % of GDP in 2010 to 98.6 % in 2011. Although the debt still exceeds the average for the euro area, the gap has narrowed considerably, from around 40 % in 2000 to 10 % in 2011.

45. A significant new feature of the Stability and Growth Pact is that more attention is paid to the debt position. A reduction in the public debt is decidedly necessary in Belgium, as an excessively high debt ratio implies that public finances are very vulnerable, especially in a climate of uncertainty on the financial markets. This may lead to an increase in the risk premium on Belgian government paper and difficulties for the sustainability of public finances. Moreover, the problem of that sustainability is made more acute by the impact on the budget of population ageing. The higher interest rate which all this may bring would also restrain business investment, thus weakening the economy's growth potential.

46. Furthermore, in recent years, the expected budgetary impact of ageing in relation to GDP had increased sharply. This was attributable not only to some government measures, but also to the economic and financial crisis which depressed the growth potential of the economy. Structural measures to curb the budgetary costs of ageing are indispensable.

47. The new federal budget contains significant measures to set Belgium back on the path of the stability programme from a multi-annual perspective. Resolute implementation and close monitoring of the budget are naturally essential. If the deficit target for 2012 is compromised, then the necessary steps must be taken immediately to ensure sustainable fiscal consolidation. It is also advisable to draw up a genuine multi-annual budget.

48. Finally, greater political and institutional stability could also contribute to better, stronger public finances. In that respect, it is important that all levels of government enter into commitments regarding their finances not just for the short term but also for the long term. The success of the consolidation strategy will also depend on a strengthening of the budgetary institutions and procedures. There must be close fiscal coordination between the federated entities and the federal government in order to ensure that the commitments given in the stability programme do not lose their credibility. Belgium will also have to meet the requirements of the new European governance. Thus, the summit meeting of euro area Heads of State and Government in December 2011 agreed on a new Fiscal Compact, which introduces a new fiscal rule whereby the annual structural deficit must not, as a rule, exceed 0.5 % of GDP. Belgium will also have to incorporate this new rule in national law at constitutional or equivalent level. The existing Belgian medium-term target (a general government structural surplus of 0.5 % of GDP) still stands. The Belgian medium-term target is stricter than the new fiscal rule because the Belgian public debt exceeds the reference value of 60 % of GDP, and because it was assumed that, in the future, the pressure of ageing on the Belgian budget would exceed the EU average. To strengthen the Belgian fiscal framework, it is also necessary for reliable and timely data to be available for the whole government sector. In a highly decentralised country such as Belgium, this also implies that all tiers of government must satisfy the new European reporting obligations.

49. The second challenge facing the policy-makers concerns boosting the growth potential of the Belgian economy. Structural reforms are absolutely essential here. They must be aimed at stimulating sustainable entrepreneurship, innovation and a more dynamic economy. For these reforms to succeed, the cooperation of all economic stakeholders is indispensable.

50. The labour market is crucial to these reforms, needing not just an increase in the quantity of the labour supply but also an improvement in its quality. Seeking to increase the labour supply at a time when the economic downturn is weakening demand for labour only appears to be paradoxical. On the one hand, some vacancies – known as critical occupations – are structurally difficult or even impossible to fill, and as the economy picks up, the labour shortage will quickly become more acute, as in the 2010 upturn. On the other hand, it is necessary to take account of the time required to implement certain measures. In future, as a result of the new State reform, the regional authorities will have more influence over labour market policy levers. It will therefore be up to them to respond more quickly to specific labour market needs in their region and to help to improve the functioning of the Belgian labour market. Of course, it is vital that the various authorities work well together to ensure the mutual reinforcement of the measures taken.

51. To increase the labour supply and thus augment the economy's growth potential, it is essential to raise the employment rate, which is still below the European average for the population aged between 20 and 64 years. Under the Europe 2020 strategy, Belgium set itself the target of raising the employment rate from 67.6 % in 2010 to 73.2 % by 2020. It is therefore important to promote employment. Several measures in the government agreement are heading in the right direction. For instance, job-seekers will be given more encouragement to look for work or to accept an available job. The efforts to assist and train the unemployed also need to be stepped up in order to enhance employability. This is also a way of addressing long-term unemployment, which is relatively high in Belgium. The employment rate of vulnerable groups, particularly people over the age of 55, also needs to increase. The pension reform is an important step forward here. In addition, it is necessary to promote the inclusion in the working world of low-skilled young people and workers of immigrant origin.

52. There is a need not only to expand the labour supply but also to improve its quality. Raising the level of skills is crucial here. The key focus should be on training for critical occupations and jobs for the future. Under the Europe 2020 strategy, Belgium is committed to increasing the number of young adults between the ages of 30 and 34 with higher education qualifications,

and significantly reducing the number of young school-leavers without a certificate of lower secondary education. Lifelong learning must also be encouraged. Finally, enhancing the functional and geographical mobility of the labour force could help to alleviate the mismatch between demand for labour and the supply.

53. Boosting the growth potential of the Belgian economy also entails enhancing competitiveness. That depends on various factors, such as the type of products offered, productivity developments and the movement in prices and wages. In the euro area the new pillar of macroeconomic surveillance will pay particular attention to competitiveness.

54. Just as during the previous surge in 2007-2008, the year under review saw inflation rise sharply from 2.3 % in 2010 to 3.5 % in 2011, significantly exceeding the figure of 2.7 % for the euro area. The main reason for this surge was the strong rise in energy prices, up by 17 %. Partly as a result of the automatic wage indexation system, the accelerating inflation led to a steeper rise in hourly labour costs in the private sector, namely 2.7 % in 2011, against 0.9 % in 2010. Owing to the weakening of economic activity, productivity gains also diminished so that unit labour costs in the private sector rose by 2.5 % in 2011, whereas they had remained stable in 2010.

55. One weakness of the Belgian economy is the strong reaction of consumer prices to commodity price rises. That is due partly to the fairly heavy weight of energy products in the consumer price index and the relatively lower excise duties, and also to the method of setting gas and electricity tariffs that passes on fluctuations in energy prices fully to the end-user. In 2011, gas and electricity prices accounted for roughly half of the inflation gap in relation to the three neighbouring countries. This raises questions about the reliability of the tariff formulas used and the desirability of monthly indexation. It is therefore advisable to review the method of setting gas and electricity tariffs, particularly the automatic, mechanical nature of the price adjustments for these energy products. A first move might be to incorporate the third package of energy Directives into Belgian legislation. It is also important for the competent regulators to examine the level and structure of the distribution tariffs, including the public service obligations. More generally, competition should be encouraged, especially by strengthening the Competition Council, and the Price Observatory should perform its role to the full. In various economic sectors – such as retailing – there is scope for simplifying the regulations, too.

56. As regards labour cost development, the aims of the 1996 Law on Employment Promotion and the Preventive Safeguarding of Competitiveness have not been adequately achieved. This is the outcome of divergent developments in relation to the three reference countries, against a backdrop of repeated oil price hikes. According to the technical report of the Secretariat of the Central Economic Council, over the period 1996-2011 as a whole, leaving aside wage subsidies, hourly labour costs in Belgium increased less steeply than in France and the Netherlands but much more sharply than in Germany. During this period, the rise in hourly labour costs in Belgium was 3.9 % above the average in the three neighbouring countries. This is slightly better than in the period 1996-2010. However, for the period 1996-2012, the gap is likely to widen further to 4.6 %. Owing to the more adverse trend in productivity in Belgium, the labour cost handicap – measured by unit labour costs in firms – increased considerably to around 13 % in 2011. The reason lies in the strong growth of the handicap in relation to Germany, far outweighing the slight improvement in relation to France and the Netherlands. In this context, the tendency of Belgium's export performance to fall behind that of the other European countries is also worrying, as is the high level of long-term unemployment. It is important to give full rein to the correction mechanisms provided by the law. More generally, when setting wages, it is advisable to take greater account of productivity developments and the specific characteristics of the various sectors and firms. It is also important to correct the characteristic vulnerability of the Belgian economy in the event of external shocks, due particularly to the rapid transmission of energy prices to the consumer price index, and then via the health index partly to wages.

57. Finally, to boost the growth potential of the Belgian economy it is vital to encourage innovation, entrepreneurship and sustainability. "Intelligent" economic growth is one of the central ideas of the Europe 2020 strategy. Renewal of production structures and the introduction of new products for which demand is less price-sensitive are essential in an ever more closely integrated global economy with increasing competition, from the emerging countries as well. Belgium still does not specialise sufficiently in research-intensive products which are difficult to copy. The innovation policy should be spearheaded by the promotion of R&D (expenditure in this area should reach 3 % of GDP by 2020), the conversion of knowledge into innovation (e.g. by encouraging exchanges between scientists and businesses), the transformation of innovation into economic dynamism (particularly by fostering entrepreneurship), and investment in human capital.

58. The innovation policy should pay special attention to the development and application of technologies which help to cut the consumption of fossil fuels and other commodities, and which are kinder to the environment. A supply of goods and services meeting economic and ecological sustainability criteria could also create new export opportunities. Such a strategy is the best way of ensuring the prosperity of the Belgian population.

59. Fundamental changes are taking place in the organisation of economic policy in Belgium. On the one hand, the strengthening of European economic governance implies a stricter framework for national economic policy, in regard to both fiscal and structural aspects, and a multi-annual perspective. On the other hand, as a result of the State reform, some important responsibilities – particularly concerning the labour market – will be transferred to the federated entities. Those entities will also have greater fiscal autonomy. This could open the way to a more effective policy, which could contribute to the consolidation of public finances and the strengthening of the Belgian economy's growth potential. Those opportunities must be fully exploited. Hence the need to establish a coherent system of economic governance at Belgian level, too, which can improve the coordination of economic policy – with each tier of government clearly assuming its responsibilities – and which ensures that the policy effectively addresses the weaknesses of the Belgian economy. In this period of economic and financial crisis, the various public authorities in Belgium must pursue a sound, coherent and credible economic policy. In so doing, they will strengthen confidence and encourage sustainable economic growth.

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