Foreword

Luc Coene
Governor

In 2011, the tasks of the Bank were extended substantially. Our institution took over responsibility for the prudential supervision of financial institutions. With the introduction of the "Twin Peaks" model, on 1 April 2011, financial supervision is now based on two pillars. One pillar is the Bank, which is now in charge of not only macroprudential but also microprudential supervision. The other is the Financial Services and Markets Authority, which oversees the operation of the securities markets, compliance with the code of conduct, and consumer protection.

The financial crisis clearly revealed the limits of the conventional division between microprudential supervision, focusing on individual financial institutions, and macroprudential supervision of the stability of the financial system as a whole. The interconnections between institutions and markets and the specific role of systemic banks in financial contagion led to a strong interaction between the microprudential and macroprudential dimensions. The crisis also confirmed that central banks, as the lenders of last resort, need accurate, up-to-date information on financial institutions.

A fundamental reform also took place at European level, with the creation on 1 January 2011 of the European System of Financial Supervision. This comprises the European Systemic Risk Board, a body responsible for macroprudential supervision, and three European Supervisory Authorities, which are to strengthen microprudential supervision in the banking, insurance and securities markets sectors and ensure better protection of investors.

A new form of organisation was designed at the Bank to give maximum effect to the synergy between the traditional tasks of a central bank and the new prudential responsibilities. This was based on the "four-eyes" principle, combining a vertical and a horizontal approach, in which the analysis of individual financial institutions is checked against systematic examination of each risk category. This integrated risk assessment process is supported by the Bank's other entities which make available their expertise in macroeconomic analysis or their knowledge of the financial markets for the purpose of prudential supervision.

As a result of these changes, the Bank also decided to modify the structure of the Report. The traditional section on "Economic and financial developments" is expanded to include an analysis of prudential policy, and is published in three volumes: "Preamble", "Economic and financial developments" and "Financial stability and prudential supervision". Just as in previous years, the Corporate Report will be published in March.

Over the last 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, credit restrictions hampering economic activity, additional government intervention in the banking sector, and further downgrades of sovereign debt. Economic policy in Europe responded with a range of measures, not just emergency assistance and fiscal consolidation programmes but also substantial reforms in European economic governance.

The sovereign debt crisis clearly pointed up the flaws in the structure of the European Economic and Monetary Union. It demonstrated that membership of a single currency in a single economic and financial market creates extremely strong and complex interdependencies. Much closer integration of economic policy is absolutely vital.

The history of the European Monetary Union also highlights the limits and excesses of market forces. In the first ten years of the euro area, markets hardly responded while macroeconomic imbalances grew larger. Their subsequent reaction was late and overblown, further disrupting the economy.

In accordance with its mandate, the Eurosystem kept watch over the anchoring of inflation expectations, in order to avoid both inflation and deflation. For that purpose, the central policy rate was raised during the summer, as the risks to price stability increased, but was later cut back against the backdrop of the deteriorating economic situation. To safeguard the transmission of this policy to borrowing costs, the Eurosystem took a major series of non-conventional measures concerning the provision of liquidity, including a three-year refinancing operation which attracted substantial interest.

The European Union also set up new financial stabilisation mechanisms (the European Financial Stability Facility and the European Stability Mechanism), but they were slow to come into operation. Doubts about this and about the speedy and full implementation of fiscal consolidation plans created uncertainty and contributed to a loss of confidence on the financial markets. Clear, resolute action is essential in these areas.

However, the foundations for a substantial strengthening of European economic governance were also laid in 2011. The Six Pack and the new Fiscal Compact were particularly important. A primary aim of the Six Pack is to tighten fiscal discipline by reinforcing the Stability and Growth Pact. There will also be economic surveillance of macroeconomic imbalances and competitiveness. The new Fiscal Compact embodies a fundamental revision of the fiscal rules and new commitments by the euro area Member States in the fiscal policy sphere. Further elaboration and rigorous implementation of these commitments are crucial. Fiscal consolidation must also be accompanied by a resolute and ambitious programme of structural reforms. This is essential to enhance the competitiveness and growth potential of the euro area.

The sovereign debt crisis again highlighted the structural handicaps of European financial institutions. The balance sheets of several European banks are still excessively large, comprising many rather illiquid assets. It takes time to carry out restructuring and to wind down activities, to refocus on more stable funding sources and to reinforce the capital structure. In Belgium, these problems apply primarily to the systemic banks. The financial crisis forced them to revise their business model based on foreign expansion.

The Dexia group was particularly hard hit in 2011, because of its large exposures to sovereign risks and its heavy dependence on interbank funding. This implied 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. The Bank contributed to designing the restructuring plan, especially in regard to the reorganisation of the Belgian activities

in an independent entity. This is intended to reduce systemic risks and preserve the commercial activities in Belgium.

With GDP growth of 1.9 %, the Belgian economy proved relatively resilient in 2011, just as in preceding years, mainly thanks to a strong first quarter. Belgian economic policy faces two crucial challenges: the consolidation of public finances and the strengthening of the growth potential against a backdrop of population ageing.

According to the April 2011 stability programme, the public deficit was to be cut to 3.6 % of GDP in 2011. However, it came to 4 % of GDP, mainly because the decline in the structural deficit was too small. The Belgian public debt, which increased to 98.6 % of GDP in 2011, still exceeds the figure for the euro area although the gap has narrowed considerably. Moreover, the problem of the sustainability of public finances is exacerbated by the impact on the budget of population ageing.

The new federal government has taken some important steps to put Belgium back on the path of the stability programme, adopting a multi-annual perspective. Resolute implementation and close monitoring are essential. If there is any risk of failure to meet the target of cutting the deficit to 2.8 % of GDP in 2012, then steps must be taken immediately to ensure sustainable fiscal consolidation.

The second challenge facing Belgian policy-makers involves strengthening the growth potential of the economy. Structural reforms are absolutely essential here, particularly on the labour market and in regard to competitiveness.

On the labour market, it is necessary not only to expand the labour supply but also to improve its quality. This is crucial in order to raise the employment rate of the 20-64 age group, which is still below the European average. Improving the quality of the labour supply implies upgrading the level of skills. The primary need is to invest in training for critical occupations and in jobs for the future.

Competitiveness also needs to be reinforced. This depends on various factors, such as the type of products offered, geographic export markets, 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.

One weakness of the Belgian economy is the strong reaction of consumer prices to commodity price rises. Just as in previous flare-ups, inflation increased sharply in Belgium in 2011, rising to 3.5 % compared to 2.3 % in 2010. That is due partly to the fairly heavy weight of energy products in the consumer price index, the relatively lower excise duties, and the method of setting gas and electricity tariffs which has made end-users bear the full impact of energy price fluctuations. It is necessary to review the tariff-setting formulas for these products and encourage more competition on the markets in question.

The accelerating inflation led to a stronger rise in hourly labour costs in the private sector, partly as a result of the automatic wage indexation system. As regards wage development, the aims of the 1996 Law on Employment Promotion and the Preventive Safeguarding of Competitiveness have not been adequately achieved. In that 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. In the wage formation process, it is generally advisable to take greater account of productivity developments and the specific situation of the various sectors and firms. It is also important to correct the specific vulnerability of the Belgian economy, particularly that due to the rapid transmission of energy prices in the event of external shocks.

Finally, to augment the growth potential of the Belgian economy it is vital to encourage sustainable entrepreneurship, innovation and greater economic dynamism. Belgium must be a full participant

in the Europe 2020 strategy which is centred on "intelligent" economic growth. Renewal of the 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 too.

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 domains, and a multi-annual perspective. Also, 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. That is why Belgium, too, needs to devise a system of economic governance in which the country's various public authorities pursue a sound, coherent and credible economic policy and to avoid the State apparatus becoming even more complex. That will strengthen confidence and encourage sustainable economic growth.