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

1. The global economy between the heritage of the past and the challenges of the future

1. More than five years after the financial crisis erupted in 2007, the global economy is still wrestling with the consequences. The expansion of activity slowed throughout the world, dropping from 3.9 % in 2011 to 3.2 % in 2012. The recovery that set in during 2009 and 2010, after the great recession, still looked hesitant in 2012, although there were some signs of an upturn at the end of the year.

2. As in the case of past financial crises, the exit from a period of excessive debt accumulation proved to be an arduous process for most of the advanced economies, involving a fairly long period of slow economic growth, not only because that process depresses demand but also because, following the distortions that had occurred in the run-up to the crisis, it entails a substantial reallocation of resources on the supply side of the economy. It also means a significant rise in the public debt ratio, whereas before the crisis rising debt leverage was seen mainly in the private sector. One reason is the intervention in support of the financial system, but the main factor is the negative impact on public finances implied by declining economic activity. In situations where the private sector greatly reduces its debt ratio, debt financing by the government can to some extent act as a counter-balance. However, since the public debt of many advanced economies was already relatively high before the crisis, there was the danger that this could threaten the sustainability of public finances.

3. The euro area countries where the largest imbalances had built up were the first to reach this point, partly because a strong adverse feedback loop had developed between the banks' problems and those of governments. This mechanism works in two mutually reinforcing directions, and a contributory factor is that banking supervision, the resolution of banks in difficulty, and the associated budgetary safety nets have remained a matter for the national authorities, even though monetary union had already brought close financial integration. As the euro area battled with a real sovereign debt crisis for the third consecutive year, this perverse mechanism led to marked financial fragmentation along national borders so that financing costs, and even access to funding, varied greatly from one country to another.

* Two Regents withheld their approval in respect of a number of paragraphs.

4. In that situation, the volume of GDP in the euro area shrank by 0.4 % in 2012. This was due to the reduction in debt leverage by the private sector, the fiscal consolidation efforts, the decline in disposable income of individuals and the erosion of consumer and business confidence in the absence of any prospect of a prompt and comprehensive response to the crisis. At first, the slowdown in activity occurred mainly in the countries where the biggest imbalances had built up before the crisis, and where the need for adjustment was therefore greatest. Those were also the countries that suffered most from the effects of the financial fragmentation. From the second quarter of 2012, the decline became more general, and also reached the core of the euro area.

5. In July, since the growth outlook was becoming gloomier and the upside risks linked to inflation were diminishing, the Eurosystem cut its key interest rate to 0.75 % and the rate on the deposit facility – which attracts money market rates in a situation of abundant liquidity – was reduced to zero following two successive 25 basis point cuts in the key interest rates at the end of 2011. Moreover, as will be explained later, vigorous action was taken to ensure that this easing would actually influence the real economy in all euro area countries, because the financial fragmentation was a threat to the smooth transmission of monetary policy.

6. In addition, at their June meeting, the euro area Heads of State or Government announced significant steps towards a financial union as a fundamental response to the trilemma whereby it is impossible to reconcile financial integration, financial stability and prudential supervision that is left to individual nations. These measures could weaken the adverse feedback loop between banks and national governments.

7. Deleveraging by the private sector similarly depressed growth in the other advanced economies, although in the United States there were signs of an improvement in the housing market situation. In the United Kingdom, growth was also held back by the continuation of the fiscal consolidation which had begun in 2010, whereas in the United States and Japan it was uncertainty over future fiscal policy that hampered the economy. Both countries in fact lack a credible medium-term budgetary path, while the American economy was also at risk of an abrupt and severe fiscal tightening in 2013, the so-called fiscal cliff. This source of uncertainty did not diminish until the beginning of 2013, although the starting date for cutting certain public expenditure was postponed to March 2013 pending further negotiations. Moreover, these economies felt the repercussions of the crisis in the euro area, where imports declined. Overall, growth in 2012 came to 2.3 % in the United States and 2 % in Japan. Like the euro area, the United Kingdom suffered a recession.

8. In these countries, too, the already highly accommodating monetary policy was relaxed further. In the United States, the Federal Reserve launched two new securities purchase programmes. In December, it announced that it considered the low policy interest rate would remain appropriate so long as the unemployment rate remained above 6.5 % and inflation expectations were firmly anchored, whereas it had previously always referred to a specific period of time. The Bank of England and the Bank of Japan also stepped up their securities purchase programmes and both launched specific refinancing operations aimed at stimulating lending to households and non-financial corporations.

9. In the advanced economies with their anaemic growth, unemployment remains persistently high. By the end of 2012 it had risen to almost 12 % of the labour force in the euro area, with extremes of around 15 % in Portugal and Ireland, and over 25 % in Greece and Spain. In the United States too, despite a slight fall, unemployment stood at almost 8 % at the end of 2012, a particularly high figure by historical standards. In consequence, income inequality increased on both sides of the Atlantic, depressing economic growth and testing social cohesion.

10. Slackening growth in advanced economies and, more particularly, in the euro area also affected the rate of expansion in emerging countries. Trade relations with the euro area are important

for central and eastern Europe, and for many Asian countries, including China. Nonetheless, the decline in growth from 6.3 % in 2011 to 5.1 % in 2012 is also attributable to the previous tightening of policy in a number of emerging countries. Thus, in 2010 and 2011, China had tightened its monetary policy on account of the risk of overheating, accelerating inflation and soaring house prices. In view of the slower pace of growth, the country reintroduced an expansionary macroeconomic policy in 2012.

2. Policy choices are crucial for the future of the world economy

11. The fragility of the recovery is a reminder that, in the short term, not all the risks have yet been overcome. Insufficient attention to that could have an adverse effect on growth and on the process of debt reduction. Conversely, concentrating solely on short-term considerations implies the risk of inadequate encouragement for the necessary adjustments on the supply side of the economy, and could mean failure to reduce unsustainable debt positions. The entire adjustment process is therefore clearly a complex and delicate balancing act in which policy-makers must take account of both short-term risks and long-term challenges.

12. All spheres of economic policy have to make that trade-off between the short and the long term.

13. By allowing the necessary time, monetary policy can ensure that the adjustment process is gradual, thus avoiding the highly destructive deflation scenario. However, the other players must also make effective use of that time, otherwise today's accommodative policy will cause problems tomorrow. After all, monetary policy itself cannot bring about the necessary fundamental adjustments because they are largely located in the real sphere.

14. In all advanced countries, fiscal consolidation is inevitable sooner or later, although it could be phased in to some extent, depending on the fiscal credibility that the various countries enjoy. The euro area has already made a start, under pressure from the financial markets. While the debt ratio rose to almost 93 % of GDP in 2012, the primary deficit has been virtually eliminated. Regaining confidence in public finances is crucial to put the euro area back on the road to financial stability and sustainable growth. In general, other major advanced economies such as the United States, Japan and the United Kingdom not only have a higher debt ratio, but in 2012 they also continued to record large primary deficits. Moreover, in the United States and Japan there are as yet no clear, credible medium-term consolidation strategies. Failure to define a clear strategy presents a serious risk to financial stability and, more generally, macroeconomic stability.

15. Structural policy is the best way to tackle long-term challenges. It can boost the economy's growth potential and adjustment capability, e.g. by creating the conditions facilitating the necessary reallocation of resources. The G20 countries also highlighted structural reforms as a way of rebalancing world demand, so that the global imbalances can be further corrected without any contraction in demand.

16. Structural reforms in the financial sector must also be part of a long-term vision, while taking account of more immediate constraints and risks. Producing a vigorous but gradual response to the numerous shortcomings and defects revealed by the crisis implies reconciling market pressure with the need for transitional periods, to ensure that over-hasty adjustments do not harm economic activity, and preventing shifts in activity towards institutions not subject to regulation. It is not enough to impose stricter quantitative standards of solvency and liquidity. These standards need to be supplemented by measures to ensure better harmonisation, between institutions, of the assessments of risks and asset quality, and also to prevent financial intermediaries from increasing the risk of contagion by combining activities which are too

disparate or from promoting complex instruments which expose the users to disproportionate risks.

17. In addition, the euro area needs to build an institutional architecture to match the integration achieved by monetary union. That will lay the foundations for monetary union to function more efficiently in the future.

3. The euro area: from an imperfect institutional architecture to decisive steps towards a genuine Economic and Monetary Union

18. Nowhere else in the world has the debt reduction process been such a delicate balancing act as in the euro area. The reason lies in the imperfect institutional architecture at the start of stage 3 of Economic and Monetary Union (EMU) in 1999. Not only did it lead to serious imbalances, it also made those imbalances difficult to correct. Consequently, that architecture needs adjusting to ensure smoother functioning in the future. 2012 was the third successive year in which crisis management was combined with a strengthening of EMU.

19. EMU was initially viewed as a structure with a common monetary policy but a largely decentralised fiscal, economic and prudential policy. The Treaty on the Functioning of the European Union and the Stability and Growth Pact only imposed binding restrictions on fiscal policy. From the start, sound public finances were seen as essential for a workable monetary union. Moreover, that was also meant to ensure that, at national level, sufficient scope was available if necessary to absorb asymmetric shocks via the automatic stabilisers.

20. The crisis exposed the minimalism of this institutional architecture. A number of fundamental weaknesses became apparent.

21. First, from 2003 onwards, the fiscal rules were not properly respected and in 2005 they were actually relaxed when some large countries had difficulty in complying with them: that is still undermining the credibility of fiscal policy in Europe to this day. One of the consequences was that insufficient use was made of the favourable economic climate preceding the crisis to create buffers for the future.

22. In addition, during the pre-crisis years, substantial current account imbalances were built up. In Greece and Portugal, they largely coincided with public deficits. However, in Spain and Ireland, they were due to excessive debt accumulation in the private sector. Financial integration resulting from monetary union made it easier to finance those deficits, certainly as financial markets were over-optimistic and consequently did not perform the disciplinary role that had been expected of them at the start of monetary union. The unbridled expansion of domestic demand in countries with current account deficits also caused a surge in wages and prices, leading to a loss of competitiveness. This exacerbated the distortion of the production structure in favour of sectors focusing on the domestic market, a factor which subsequently hampers the adjustment process. Not only did financial markets fail to ensure the necessary discipline, but economic policy and financial supervision, which both remained a national competence, paid insufficient attention to this broader perspective.

23. Very soon it also emerged that in the countries where the imbalances had accumulated in the private sector, public finances came under severe pressure in the downward phase. Furthermore, when market sentiment suddenly went into reverse, financial integration became synonymous with contagion between countries and an abrupt reversal of capital flows.

24. What followed was a process of fiscal consolidation and correction of the other macroeconomic imbalances, a process that continued in 2012. In the euro area, the budget deficit declined

further from 4.1 % of GDP in 2011 to 3.3 % in 2012. The consolidation efforts were generally more intense in the countries with the greatest need for adjustment. Spain, Portugal, Greece and Ireland also saw a considerable improvement in their current account balance and competitiveness compared to 2008. In many countries, this was accompanied by structural reforms aimed at supporting growth potential, because it soon became clear that the adjustment could not be based solely on fiscal consolidation. This process is laying the foundations for a return to sustainable growth, even if – in the short term – it has adverse socio-economic effects. That is one reason why, in 2012, the Ecofin Council revised the budget targets initially imposed on Spain and Portugal. In the case of Greece, it was actually necessary to deviate from the path defined in the second programme, even though the private sector had already agreed to a bond swap which had been completed earlier in the year. In contrast, in Ireland, the implementation of the adjustment plan defined in November 2010 is on schedule, and in the summer of 2012 the country regained access to the market.

25. To avoid such derailments in the future, but also to restore credibility so as to limit the short-term costs of the adjustment, it is vital to reinforce economic governance, a process in which greater policy coordination must give substance to the economic and budgetary pillar of EMU.

26. To that end, in November 2011, the European Union had already approved a set of six rules – known as the Six Pack – with a dual objective. On the one hand, the rules encourage greater fiscal discipline by supplementing the Stability and Growth Pact, particularly by aiming to make the imposition of financial sanctions more automatic. In addition, a new procedure is being introduced to identify macroeconomic imbalances – such as the derailment of competitiveness or the accumulation of excessive debt – in good time. The crisis has shown that fiscal developments are not the only potential source of instability. This procedure was applied for the first time in 2012. Moreover, at the end of 2011, all EU Member States except the United Kingdom and the Czech Republic concluded the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. This Treaty includes a substantial budgetary section, often referred to as the Fiscal Compact. Its main provision is that every Member State must include in its national law, preferably in its constitution, the principle of a budget which is structurally balanced or in surplus. The central feature of the European fiscal framework is thus firmly anchored in national law as well. Finally, negotiations are in progress on two new Regulations, known as the Two Pack. The first Regulation aims at better monitoring of draft budgets in order to strengthen the preventive arm of the Stability and Growth Pact. The second aims to ensure closer supervision of the Member States experiencing, or at risk of, serious financial difficulties. This new framework for economic governance is therefore already well on the way, but its credibility will depend on its coherent and balanced implementation.

27. Another striking fact is that EMU was totally ill-equipped to deal with crisis situations, and crisis management mechanisms had to be created along the way. Thus, the European Stability Mechanism (ESM) was launched on 8 October 2012 as a permanent stabilisation mechanism. It replaced the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), temporary mechanisms introduced earlier. The EMS has a lending capacity of up to € 500 billion, in addition to the roughly € 200 billion already allocated to the programmes for Greece, Ireland and Portugal under the EFSF.

28. Provided the Member States satisfy the required conditions, the ESM can grant them loans or a precautionary credit facility, purchase debt instruments on the primary and secondary markets, and fund the recapitalisation of financial institutions. For the time being, this last facility is only available via a loan to the government of the country concerned. At the beginning of December 2012, Spain thus received a loan of € 39.5 billion for the purpose of recapitalising its banking sector, which was hard hit by the crisis.

29. On 29 June 2012, the euro area Heads of State or Government decided to set up a single mechanism for banking supervision. Once this mechanism becomes operational, the ESM will also be able to directly recapitalise banks which are subject to European supervision. This is an important step forward, which should help to break the vicious circle between banks and national governments.

30. As the crisis spread, the limited ability of individual Member States to absorb shocks became clear, especially as some of them already had substantial public debt before the crisis. The lack of a common safety net for banks is a decisive factor here, because in some Member States the interactions between the problems in their financial sector, the critical situation of their public finances, and the contraction of their economic activity triggered a negative spiral. As a result, banks in those countries also saw their funding dry up.

31. By the end of 2011, this problem had already become particularly acute. The Eurosystem responded with two three-year refinancing operations, one in December 2011 and the other in February 2012. Together, they injected net liquidity amounting to € 520 billion. Banks under funding stress – often banks from the most vulnerable countries – were therefore assured of liquidity for a period of three years, preventing a disorderly reduction in their balance sheets and protecting the real economy.

32. Intermediation via the Eurosystem balance sheet thus replaced financial integration, but it was unable to halt the actual process of fragmentation, certainly not when the irreversibility of the euro was increasingly questioned during the summer. In the case of certain countries, investors feared that they would no longer be repaid in euros. The pricing of this – unfounded – risk of redenomination drove up still further the interest rates on government paper issued by the most fragile countries. In those countries, cuts in the key policy interest rate were no longer passed on, and that seriously disrupted the transmission of monetary policy.

33. At the beginning of August, the ECB Governing Council therefore announced Outright Monetary Transactions (OMTs). These permit the purchase on the secondary market of government bonds issued by countries which fulfil the conditions specified in an EFSF/ESM programme. There are no predetermined limits on OMTs, but purchases are only possible if the conditions are strictly fulfilled, in order to ensure that Member States do not relax their consolidation efforts because of OMTs. The announcement of the OMTs quickly turned the financial markets around and improved the operation of the transmission mechanism.

34. The intermediate aim of these exceptional Eurosystem measures is to restore the transmission of the common monetary policy, and not to conduct a different monetary policy in the various jurisdictions. Their ultimate aim is to prevent destructive scenarios causing downside risks to price stability in the euro area, an aim which is perfectly in line with the task entrusted to the Eurosystem. In 2012, not only did inflation subside to 2.2 % at the end of the year, but inflation expectations also remained firmly anchored.

35. Apart from the elimination of macroeconomic imbalances, a key element of the fundamental solution is the establishment of a banking union, which should contribute to a lasting restoration of financial integration and of the monetary policy transmission mechanism.

36. A unified structure is therefore to be set up for the exercise of banking supervision. The ECB will be in charge of that supervision, but in close association with the national authorities, and, as for prudential regulation, taking account of the specific role of the European Banking Authority (EBA). This new architecture will make it possible to harmonise the supervision framework and methods in the EU, and also establishes the conditions for the possible direct recapitalisation of euro area banks via the ESM.

37. The agreement reached at the 12 December meeting of the Ecofin Council specifies that the ECB will take charge of the supervision of around 200 major banking groups in 2014, and will monitor the supervision of the other, smaller institutions in the euro area, while still being authorised to exercise direct supervision over them if financial stability so requires. Despite extensive decentralisation, the ECB will have to deploy powers and expertise which currently reside with the Member States and which, furthermore, bear the marks of a national culture and country-specific characteristics. This project will need to cover tasks as diverse as bank licensing, the collection of financial data, surveillance in situ and case monitoring, risk profile assessment, verification of compliance with the prudential rules and the solvency and liquidity requirements, and regular stress tests on systemic banks, as well as the imposition of sanctions.

38. The ECB will implement monetary policy as well as prudential policy, both of which are vital to the smooth operation of the economy. It will have to ensure that the two policies are conducted independently of each other, while taking account of the interactions and synergies, and of geographical differences if European countries which are not members of the euro area decide to join the banking union.

39. The characteristics of the recent financial crisis highlighted the need for instruments which go beyond assessing the risks for each institution individually; there is also a need for instruments capable of being used to prevent developments threatening the stability of a country's entire financial system. In this area, the national authorities are in the front line and the European Systemic Risk Board (ESRB) has asked each country to make a specific body responsible for a policy designed to prevent such systemic risks, a recommendation that Belgium is to follow by setting up a Macroprudential Surveillance Board during 2013. The specific role which the ESRB thus assigned to the national authorities requires close coordination with the European authorities. In particular, that role must be reconciled both with the ECB's integration of the macroprudential dimension in the exercise of its exclusive monetary and microprudential responsibilities, and with the European Commission's justified efforts to ensure that bank regulations are unified in order to preserve the Single Market.

40. The banking union will be unable to function at its best if it consists solely of a single supervisory mechanism. It also needs the support of a common resolution authority and a common deposit guarantee system, which presupposes budgetary arrangements.

41. The creation of the single supervisory mechanism which, as recommended by the European Council, should soon be supplemented by a single resolution mechanism, marked a crucial new stage in the development of EMU in 2012. All the same, the edifice is still incomplete: further steps are needed to achieve a genuine Economic and Monetary Union. According to the final report produced by the President of the European Council, Herman Van Rompuy, it is important not only to strengthen integration in regard to the financial, economic and budgetary pillars of the Union, but also to improve the Union's democratic legitimacy.

4. Belgium at the heart of EMU: three major challenges for enhancing prosperity

42. The Belgian economy, with slightly negative growth of 0.2 %, felt the inevitable effects of the hesitancy of the global economic recovery, and more particularly the crisis in the euro area. Economic activity contracted sharply in the second quarter of 2012, and recorded a slight fall in the last two quarters of the year as well.

43. The decline in activity was evident in employment sooner than at the time of the great recession. During the year, employment was down by 17 000 units and the harmonised unemployment rate stood at 7.4 % at the end of 2012, compared to 7.2 % a year earlier. The stagnation of

household disposable income and the increase in the savings ratio which accompanied the uncertain outlook for employment led to a 0.7 % fall in the volume of private consumption. These factors also curbed investment in housing, while firms scaled down their investment during the year as a result of deteriorating demand prospects and the decline in the capacity utilisation rate. The tightening of credit conditions by the banks – more on account of a heightened risk perception rather than increased funding costs or balance sheet constraints – may also have depressed domestic spending, though lower demand was also a factor in the decline in lending to non-financial corporations and households. The positive growth contribution of net exports was attributable to a sharp slowdown in the import growth rate, and cannot conceal the fact that exports also lost momentum.

44. So far, the crisis has had a less serious impact on Belgium than on the euro area countries which have suffered the most. Despite the hesitant recovery, GDP in 2012 was still above the 2008 figure, which is far from being the case for all euro area Member States. Except in the financial sector, Belgium had not accumulated any significant macroeconomic imbalances during the period preceding the crisis, so today it is still one of the few European countries where the economy as a whole has net financial claims on the rest of the world. Nonetheless, the crisis did leave its mark on production potential, the financial sector and public finances; in addition, it is damaging social cohesion.

45. While the impact of the crisis on the financial sector was addressed immediately in order to avoid a worse situation and to contain the repercussions on the real economy, pension and labour market reforms were finally implemented in 2012, following a long period of political deadlock, and measures were taken to reduce the budget deficit. However, to secure the country's prosperity and the high level of social protection, further essential steps are needed in that direction.

46. Here, Belgian policy has to be fitted into the new framework of reinforced economic governance at European level. It is a mistake to think that this will seriously restrict political room for manoeuvre, or that it will reduce the need to act. Indeed, the new framework focuses on the same challenges as those which arise from an exclusively national viewpoint, namely boosting growth potential and avoiding unsustainable debt positions, in both the private and the public sectors. Encouraging the Member States to take prompt action will save them from the abrupt adjustments that would otherwise be imposed sooner or later by the financial markets. Owing to its central position in the euro area and its open character, the Belgian economy also has everything to gain from the improved operation of EMU which will result from the greater coordination of policies.

Boosting the growth potential of the Belgian economy

47. The production potential is currently considerably lower than might have been hoped on the basis of the trends apparent before the crisis, because – for the advanced countries as a whole – those trends were based partly on excessive debt. Although that was less true of Belgium, it still impaired the potential owing to the heavy dependence on global developments. Moreover, there is a danger that the crisis will also curb potential growth as a result of a higher risk perception or the possible conversion of cyclical unemployment into structural unemployment, while population ageing will weigh heavily on the labour supply in any case, unless there is a change of policy. Although it is hard to measure potential growth accurately, it is telling that the European Commission currently estimates this growth at 1 % for Belgium, whereas before the crisis the figure was in the region of 2 %.

48. On the other hand, there are a number of notable trends which were already apparent before the crisis and which still continue to imply significant challenges for the future: technological

progress, the increasing globalisation of the economy, climate change and the emerging costs of ageing. Those costs are very sensitive to changes in the underlying macroeconomic situation, as was evident from the latest report by the Study Group on Ageing. That applies both to the level of activity at the start of the projection – a level which declined as a result of the crisis – and to future productivity gains which, together with the use of labour and capital, form an important source of potential growth. Reinforcing growth potential is therefore of vital importance, and in an open economy the crucial points for attention are the labour supply, competitiveness, as well as innovation and productivity.

49. In 2012, the federal government carried out some essential structural labour market reforms in order to expand the labour supply. Under the Europe 2020 strategy, Belgium set itself the target of increasing the employment rate from its 2011 level of 67.3 % to 73.2 % by 2020, a 6 percentage point rise. The aim of the pension reform is gradually to achieve a substantial increase in the employment rate of the 55-64 age group. However, the impact on the total employment rate is relatively small, and the reduction in ageing costs will also be only moderate because the effect of the fall in the number of pensioners is offset by an increase in the average pension as a result of a longer career. Additional robust measures are therefore necessary, tailored to longer life expectancy. The unemployment benefit reform is intended to make job-seekers take more responsibility; combined with the necessary guidance and activation, that will increase their chances on the labour market. This reduces the risk that the rise in unemployment will become structural after a time, certainly for younger people who have been hardest hit by the crisis. Apart from that, it is noticeable that even now there is a labour shortage in a number of segments.

50. Furthermore, the quality of the labour supply also needs to be improved by ensuring that education is better geared to the needs of the business world and by working to reduce the number of young people leaving school without adequate qualifications. Systematic further training throughout working life should become the norm, otherwise in a world of rapid technological changes and constant adjustments to the organisation of labour, skills soon become obsolete. Finally, it is vital to take the necessary steps to integrate persons of foreign origin into working life. Failure to mobilise this large group of fellow citizens damages the growth potential of the economy and is also a cause of social exclusion which should not be underestimated.

51. So that the economy can create jobs on a lasting basis, developments in labour costs must also keep in step with productivity. Moreover, Belgium's competitiveness is decisive for the country's full integration into the world economy. Many factors play a role here. They concern both price and cost competitiveness, and less tangible aspects which foster innovation and which – via the quality and diversity of the products offered and the organisation of the production process – determine the general efficiency of an economy. That efficiency is usually measured on the basis of total factor productivity.

52. In this respect, Belgium is rather vulnerable in several ways. First, inflation responds strongly to commodity price fluctuations which are themselves more pronounced than they used to be, owing to globalisation. Consequently, inflation in 2012 was again higher than in the three main neighbouring countries. Despite a marked deceleration from the second quarter, inflation over the year as a whole was still running at 2.6 %. Owing to automatic indexation, these sharper fluctuations in inflation have a rapid impact on wages. For instance, gross wages per hour in the private sector rose by 3 % in 2012, compared to 2.6 % in 2011. For the two years together, the wage increase is almost entirely due to the indexation effect, which came to 5.5 %. Conversely, the real negotiated adjustments were very small at 0.2 %. Nonetheless, the gap which has opened up since 1996 in hourly labour costs in relation to the average for the three main neighbouring countries did not narrow during the period 2011-2012. It stood at around 5 % at the end of 2012, excluding wage subsidies the impact of which cannot be

measured at present, in the absence of comparable data for the neighbouring countries. In addition, productivity is lagging behind that in the neighbouring countries, partly because of low total factor productivity. The wage gap in terms of unit labour costs is therefore even larger, amounting to almost 13 %. The reason lies in a handicap with Germany, which outweighs the competitive advantage built up between 1996 and 2012 in relation to the Netherlands and France. Viewed over a longer period, Belgium has also lost more export market shares than the three neighbouring countries, on average. The fact that the loss of market share in Belgium exceeds that in Germany but is less than in France tallies with the relative movement in unit labour costs. However, the Netherlands gained market share despite a less favourable trend in labour costs. Finally, the fiscal and parafiscal burden on labour in Belgium is among the heaviest in the advanced countries, driving up labour costs and depressing the labour supply.

53. The great sensitivity of inflation to fluctuations in energy prices is due partly to the consumption pattern of Belgian households and the relatively low excise duties on energy products. However, in the case of gas and electricity, another factor is that, until recently, suppliers adjusted their tariffs monthly on the basis of indexation formulas which were no longer a true reflection of the movement in costs. The federal government therefore decided to restrict the number of price adjustments to a maximum of four per year, and from April 2013 these adjustments can only be based on market prices for the products themselves, and not on the oil price. In anticipation of this last decision, prices were frozen between April and December 2012, so that the movement in gas and electricity prices was more in line with that in the neighbouring countries. The mechanical impact on inflation was only –0.1 percentage point, but the public debate on pricing prompted consumers to change their suppliers more often than in the past, and to look for the lowest price. This increase in the effective level of competition may continue to play a disciplinary role in the future. It is also important to ensure that distribution tariffs, including the public service obligation elements, are kept in check. In the summer, in order to provide more general encouragement for competition, the federal government decided to strengthen the competition authority and to promote more interaction with the Price Observatory. In addition, the regulations in a number of sectors are still open to simplification, and that could stimulate competition and the creation of new businesses.

54. In its November policy statement, the government also announced measures to reduce the hourly labour cost gap between Belgium and the three main neighbouring countries. To that end, social security contributions are being reduced from April 2013 by € 400 million on an annual basis. The calculation of the national consumer price index is also being revised so that the index better reflects the true pattern of consumption, and the social partners are being asked not to grant any real negotiated wage increases in the interprofessional consultations covering the period 2013-2014. In addition, a group of experts is to investigate to what extent wage subsidies affect the size of the labour cost gap ; a reform of the 1996 Law on the Promotion of Employment and the Preventive Safeguarding of Competitiveness is also under consideration. In addition, the legal status of blue-collar and white-collar workers needs to be further harmonised by mid-2013.

55. The scale of this package of measures illustrates the importance attached to the restoration of competitiveness. However, at the same time, the government's own assumption that it could take six years before the labour cost gap is entirely closed shows how difficult it is to correct a competitiveness handicap in terms of prices and costs in an environment where, in practice, the only scope for that lies in real negotiated wage increases which are already small as a result of the crisis. That is precisely why, when publishing its study on indexation at the end of June 2012, the Bank examined various possible adjustments, setting out their advantages and disadvantages, and invited the social partners and the government to draw the appropriate conclusions for setting both wages and prices, without questioning the actual principle of compensating for inflation. The aim is prevention rather than cure, while leaving the social partners scope to express their own priorities via consultation.

56. In view of the high level of fiscal and parafiscal levies on labour incomes, it would be desirable to reduce them, though without compromising the sustainability of public finances; that is in itself a major challenge. Other sources of taxation might perhaps be explored here; greater tax harmonisation at European level could facilitate this process. Moreover, the Belgian tax system is extremely complicated. Not only are the tax rates high, there are also numerous tax allowances and exemptions. An examination of the impact that the various types of levy and exemption have on economic growth, competitiveness and employment must therefore constitute the guide to thorough reform and simplification of the tax system.

57. Moreover, to generate growth, support the increase in total factor productivity and alleviate the competitiveness constraint that is holding back incomes, it is necessary to encourage entrepreneurship and innovation, and eliminate the factors hampering the creation of businesses or market access. The economy is dynamic by nature. In the short term, its progress depends mainly on the success with which existing firms manage to market their traditional products. In the longer term, the rotation of new products or production processes to replace existing ones is much more important. If that progression works smoothly, the reallocation of resources which has become necessary following the crisis is also made easier. New products can succeed because they respond appropriately to new needs, e.g. those associated with population ageing or the desire for greater energy efficiency and greater ecological sustainability. Their success may equally be due to their intrinsic quality, their specific design, or persuasive marketing. Demand for that type of product will generally be less price-sensitive, whereas the Belgian economy and exports are currently still based far too heavily on products that are easy to copy.

58. It is crucial to encourage R&D and to create networks of producers and research centres so that knowledge leads to a higher performing economy. Lifelong learning and appropriate occupational mobility are labour market aspects that go hand in hand with a dynamic knowledge economy. A modern, efficient public administration must provide the right support, for instance via a simplified licensing policy. In addition, entrepreneurs must be able to find the necessary funding for their new projects, and that emphasises the need for a stable and efficient financial intermediation system.

A stable financial system serving the economy

59. Financial intermediaries have a major role to play in promoting the growth potential of the Belgian economy, because they are the main source of funding and risk hedging for small and medium-sized firms which form the basis of the country's productive capacity. Fears that the essential restructuring of the financial sector in Belgium may lead to severe restrictions on lending have so far proved largely unfounded. Banks remain active on the market in lending to Belgian individuals and businesses, and are maintaining their presence in a number of foreign countries which are strategically important to some of them, especially in central and eastern Europe.

60. Though this is rather reassuring, it should not be forgotten that some large systemic institutions still need to rid themselves of a substantial residue of depreciated assets, and that is a serious constraint on their management which, in view of the guarantees granted, could constitute a risk for public finances.

61. In the case of Dexia, the recurrent problems in refinancing a massive portfolio of very long-term, illiquid securities and loans obliged the authorities to dismantle the group more quickly. A revised plan, approved by the European Commission, provides for the sale of the group's remaining operational entities and the sale of Dexia Municipal Agency (DMA) to a new credit institution in which the French State is the majority shareholder. The plan also includes a capital increase of € 5.5 billion in Dexia SA by the Belgian and French States. Finally, it reduces the

tripartite guarantee provided by the Belgian, French and Luxembourg States to a maximum of € 85 billion, while cutting the part borne by the Belgian State by € 11 billion.

62. In 2008 and 2009, the KBC Group also received official support from the Belgian federal government and the Flemish regional government totalling € 7 billion. In December 2012, the group repaid the balance of € 3 billion to the federal government, plus a 15 % premium. In accordance with its commitment to comply with the new Basel III rules from 2013, KBC increased its capital via a share issue totalling € 1.25 billion and via the announcement of an additional issue of non-diluting capital securities amounting to € 0.75 billion in the first half of 2013.

63. In view of the scale of the official intervention necessitated by the financial crisis, the public is entitled to have high expectations of financial institutions, both in terms of support for the economic recovery and in regard to the rigorous management of activities and risks. That requires in particular that the authorities pay close attention to the organisation and governance models of the individual institutions. In that context, the Bank – which has been responsible for prudential supervision since April 2011 – prepared a draft circular which has now been submitted to the sector for consultation, clarifying its criteria for assessing the expertise and professional integrity of the managers of financial businesses, while spelling out its expectations concerning the assessments to be conducted by the institutions themselves. The Bank also continued its horizontal analyses of remuneration policies in large financial institutions. The aim is closer alignment of the criteria for identifying the staff most likely to exercise a significant influence on the firm's risk profile, and of the variable part of the remuneration paid to those staff.

64. To simplify the structures of financial corporations and contain the risks more effectively, a number of countries are considering a more fundamental reform aimed at separating the traditional activities of deposit banks from the more volatile activities of investment banking. While greater segmentation may help to reduce the contagion effects, a total split would also have its drawbacks. By preventing banks from carrying out any transactions in certain products, it could be detrimental to customers and even weaken some institutions by encouraging them to adopt positions which are too heavily concentrated on the markets to which they still have access.

65. Moreover, such a reform can hardly be carried out on a national basis in Europe, because it would not apply to branches of banks from other EU countries. The Commission therefore instructed a group of experts chaired by the governor of the Finnish central bank, Mr Liikanen, to examine whether such an approach is advisable at Community level. The action that the European Commission takes on the basis of the conclusions of this group, which recommends isolating market-making activities and own-account trading above a certain threshold, will be taken into account in the final report that the Bank has to draw up for the government on the feasibility of this type of structural reform in Belgium.

66. Apart from these government projects and initiatives, the financial institutions themselves need to revise their business model. Methods of organisation established in the past are often unsuitable and oversized for institutions which had to start operating on a smaller scale. Adjustments are necessary to cut costs, preserve profitability and secure stable sources of funding. In Belgium, the banks have reverted to generating most of their income from their traditional business of intermediation with a customer base concentrated on a highly competitive domestic market. Insurance companies are seeing their life insurance products become less attractive in an environment where households have a marked preference for liquidity, and long-term interest rates are at a historically low level.

67. While Belgian financial intermediaries have access to substantial household savings surplus for developing their activities, that potential also attracts numerous foreign institutions. Tax incentives are currently channelling most of that surplus into saving deposits. Following in-depth

analysis, that could justify a review of the impact of the tax system on financial circuits in Belgium, which are currently heavily concentrated on the banking sector to the detriment of direct shareholding and financing via the issue of securities or through institutional investors. For the banks themselves, this «single-product» structure does have its risks, because it makes them very sensitive to the parameters which determine the pattern of these deposits. The new legislation authorising the issue of covered bonds in Belgium opens up some attractive scope for diversification, though it must be used in moderation, otherwise the banks' balance sheets could be bereft of assets capable of covering non-preferential debtors.

68. The Bank is keeping a close eye on the restructuring and reorganisation taking place in the Belgian financial sector, being very attentive to the risk implications. Even though the Belgian banks' recent difficulties were due mainly to operations with foreign counterparties, it is essential not to under-estimate the potential sources of fragility that could result from refocusing on domestic customers, and specifically on the mortgage market which is an important area of activity for Belgian banks. Although mortgage lending criteria have remained fairly conservative overall, the average term of the loans has increased recently while, for a large proportion of contracts, the personal contribution from the borrower is very small and the loan covers almost the whole value of the property to be financed. In view of the marked rise in property prices in recent years, and the negative impact on employment of the slowdown in economic activity, the Bank has recommended credit institutions to maintain a sound, cautious policy. In the past few months, there has been some tightening of the criteria for granting mortgage loans.

69. In general, the percentage of defaults on bank loans to private customers in Belgium, both individuals and companies, is modest, but as a result the provisions being formed are fairly small. In this context, even a minor deterioration in the financial soundness of these categories of borrowers could quickly lead to a significant increase in write-downs which would soon erode profitability. The Bank conducts regular loan quality assessments and, from 2013, will be able to rely on the more extensive quantitative and qualitative information to be supplied by credit institutions via the Central Corporate Credit Register.

70. The financial charges borne by borrowers were recently eased by the reduction in capital market interest rates. In principle, that is conducive to financial stability, while financial intermediaries have also been able to record large capital gains on their portfolios of securities. However, this low interest rate environment complicates the balance sheet management of financial intermediaries.

71. For the banks, the impact will only be evident in the long run, in the event of rapid adjustments to the respective interest rate conditions for assets and liabilities. That threatens to depress profitability all the more, as institutions will have previously tried to boost their profits by allocating a large proportion of their liabilities at low variable rates to the acquisition of assets at higher fixed rates. The Bank recently stepped up its examination of the interest rate risk management arrangements of the main credit institutions.

72. Insurance companies are struggling to generate enough income to pay out the guaranteed yields to their customers. To deal with this vulnerability, it would be prudentially justifiable to make regular adjustments to the rules setting a ceiling on the guaranteed yields that can be offered on life insurance contracts. Failing that, the Bank will ensure, via its individual checks, that each institution sets the guaranteed yields on its life insurance contracts at levels compatible with the risks and returns on its assets and with its cost structure.

73. The regulatory standards concerning solvency and liquidity form an essential risk management parameter for financial intermediaries. The latter will need to adapt to the radical changes to be made to those rules in the years ahead.

74. In the banking sector, on expiry of a transitional period which runs from 2013 to 2018, implementation of the new Basel III solvency rules will mean a significant increase in capital requirements. The Bank regularly monitors the leading credit institutions' plans for switching to these new rules, taking account of business model modifications, profitability forecasts, possible developments concerning risks, and, if need be, any action envisaged, including the issue of equity capital instruments. Regarding liquidity, the application of specific ratios since 2011 in Belgium and the very regular monitoring by the Bank of the cash positions of credit institutions should enable the latter to meet the new standards immediately without recourse to the intermediate stages provided for by the Basel Committee.

75. In the insurance sector, too, a start has been made on revising the solvency rules under the EU Solvency II Directive. Entry into effect of these new rules was originally scheduled for 2012, but was postponed because, in the case of financial commitments accompanied by long-term guarantees, the application of the valuation methods proposed by the Directive led to large fluctuations in the equity valuations of insurance companies. The Bank is closely involved in the current work on adjustments at European level, and in the meantime, has already begun work on the transposition into Belgian law of some of the provisions of the Solvency II Directive. It has also asked a number of large Belgian insurance companies to take part in the study, launched by the EU in July 2012, on the impact of the new rules.

76. For the purpose of its prudential policy, the Bank has opted for a multidisciplinary approach, setting up internal coordination committees in order to maximise synergies with its other activities. This framework should ensure that information flows readily and promptly between the supervision departments and the entities which have to intervene on financial markets, or those engaged in research and the collection of statistics which may shed light on and enhance prudential supervision. In conducting risk analyses, care is taken to combine the microprudential and macroprudential dimensions.

77. To define the work of these coordination committees more clearly, the Bank set some priorities. For 2013, a multiannual action plan focuses on a detailed analysis of the business models and profitability of the large Belgian financial institutions, as well as credit, liquidity and interest rate risks and some specific components of the supervision procedures and methods for both banks and insurance companies.

78. To assess whether its prudential policy is working adequately, the Bank can refer to the external opinion of the IMF under the Financial Sector Assessment Programme (FSAP), whereby countries of systemic importance for financial stability, including Belgium, regularly undergo assessment. This expert mission which is currently in progress examines whether the methods of supervising banks and insurance companies and the procedures for crisis management and the conduct of macroprudential policy conform to international best practices. It also analyses the overall stability of the Belgian financial system and uses stress tests to gauge the ability of the large institutions to withstand shocks. This IMF assessment programme should lead to recommendations aimed at strengthening the stability of the Belgian financial system and thus making the sector better equipped to face the many challenges ahead.

79. The fundamental changes in the prudential supervision regulations and architecture will in fact have profound implications, both for financial institutions and for financial authorities. These massive projects will require concentrated attention, while also entailing substantial resources which must be mobilised if these projects extending over several years are to be brought to a successful conclusion. However, this long-term effort must not be at the expense of any relaxation of the vigilance still required in the surveillance of individual institutions.

Safeguarding the sustainability of public finances

80. A third major policy challenge is the consolidation of public finances. The period in which the budget was mostly in balance and public debt was constantly declining came to an abrupt end in 2008. Since 2009, a recession year in which the budget deficit increased to 5.5 % of GDP, Belgium has been among the countries in an excessive public deficit situation. To remedy that, the deficit had to be brought below 3 % of GDP in 2012, as specified by the Ecofin Council, and the stability programme defined a path for restoring a balanced budget in 2015.

81. Thanks to the efforts of the Communities and Regions, and especially the federal government, the structural primary balance improved by around 1 % of GDP in 2012. Despite the decline in activity, the public deficit therefore came to 3 % of GDP, against 3.7 % in 2011. In this respect, it was assumed that the capital injection amounting to 0.8 % of GDP in favour of Dexia need not be included in the deficit, even though there is no certainty about this. The public debt, which was affected in any case, increased to 99.6 % of GDP at the end of 2012, compared with 97.8 % a year earlier. That rise is also attributable to the deterioration in the economic climate and Belgium's contribution to the efforts to limit the impact of the debt crisis in the euro area, while the repayment of the aid to KBC had a downward effect equal to 1.1 % of GDP. Although the debt ratio is therefore higher than that of the euro area, the gap has narrowed, shrinking from almost 40 percentage points at the end of 2000 to 7 points at the end of 2012.

82. Taking account of this high debt level and the heavy costs connected with ageing, it is vital to continue the efforts and to adhere to the path defined in the stability programme. These two factors also explain why Belgium has a relatively high medium-term objective, and the minimum requirement has been revised upwards in 2012 to a structural surplus of 0.75 % of GDP. The inauguration of the federal government at the end of 2011 and its programme of structural reforms and fiscal consolidation were an undeniable factor in the marked fall in interest rates on Belgian government securities in 2012. This has already reduced interest charges by 0.3 % of GDP over that one year, and the resulting savings will continue to grow in the coming years. Sticking to the path of fiscal consolidation is the only way to anchor the credibility regained, whereas any procrastination would only make the unavoidable adjustment more expensive, owing to the rise in interest charges, especially if there were a resurgence of risk aversion in relation to Belgian public debt on the financial markets. Moreover, as the crisis in the euro area has unfolded, it has shown that a rise in interest rates on government borrowing has significant adverse repercussions on the banking sector and on the financing costs of households and businesses.

83. In that respect, the first consideration is close monitoring of the implementation of the 2013 budget, with adjustments if necessary. This must be done because the budget was drawn up on the basis of the growth figure assumed in the September 2012 Economic Budget, which did not take account of the further deterioration in the economy during the fourth quarter of 2012. Moreover, the consolidation effort announced for the public authorities as a whole is less than the initial estimate, which in fact reckoned on a substantial additional effort by the Communities, Regions and local authorities, on top of the budgetary measures already unveiled. Nonetheless, for the subsequent period, it is even more important to devise a clear and credible plan for achieving a structural balance in 2015. Such an approach is in fact better for confidence than a hesitant consolidation of public finances.

84. Meanwhile, primary expenditure of general government now exceeds 50 % of GDP, whereas it was only 42.5 % in 2000. This growth is evident for the federal government, social security, the Communities and Regions, and local authorities. Not only has the growth rate of public spending not been adjusted in line with the weaker growth potential, but it has also remained high compared to the pre-crisis growth rate of the Belgian economy. The consolidation of public

finances must therefore be based mainly on curbing the growth of primary expenditure, especially the spending that contributes least towards a rise of growth potential and employment, and the attenuation of social inequality, while the costs of ageing must be reduced by a further rise in the effective retirement age. In view of the scale of the effort, the need to find additional revenues cannot be avoided. However, increasing tax on labour incomes is not an option, as it is already particularly high, and a further rise would impair growth potential. Moreover, efforts must be devoted to efficient tax collection and fraud prevention, while simplification of the tax system might reduce tax evasion.

85. All levels of power must be involved in the fiscal consolidation effort. Their respective contributions therefore need to be clearly spelt out and, as specified in the agreement on State reform, certain variables in the Special Finance Act for the Communities and Regions must be finalised. In addition, there is a need for close budgetary coordination between the federated entities and the federal government, with each level committing itself to achieve clear medium-term budget targets. Furthermore, Belgium is among the countries which have yet to ratify the Fiscal Compact and include the budgetary rule in national legislation.

86. The Belgian economy has many strengths which have facilitated the attainment of a high standard of living. However, if Belgium wants to maintain that standard of living in the future and safeguard the existing social model, against the backdrop of increasing globalisation and population ageing, then it must address a number of important challenges which the crisis has thrown into even sharper relief. There is a need for a coherent action plan to support the growth potential and the transition to a knowledge economy, to guarantee financial stability and ensure the sustainability of public finances. That is the only way to restore consumer and business confidence and return to sustainable growth. Postponement is not an option. In other euro area countries, experience has shown how painful the adjustments are in the event of a late response. The various political authorities and the social partners both carry a crucial responsibility here.

Brussels, 30 January 2013