Foreword

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More than five years after the eruption of the financial crisis in 2007, the global economy is still wrestling with the consequences. Growth slowed throughout the world, from 3.9 % in 2011 to 3.2 % in 2012, although there were signs of an upturn at the end of the year. Dealing with a period of excessive debt accumulation is a delicate balancing act involving a fairly long period of sluggish growth, and possible threats to the sustainability of public finances.

That point was reached first in the euro area countries where the largest imbalances had developed. The unavoidable efforts to consolidate the budget and restore competitiveness depressed economic activity, which contracted by 0.4% in the euro area in 2012, but at the same time those efforts lay the foundations for a return to sustainable growth. In the United States and Japan, the economy suffered from uncertainty over future fiscal policy. In most advanced countries, sustainable fiscal consolidation and structural reforms are inevitable sooner or later. A failure to make that clear undermines confidence and implies risks for financial stability, and more generally, for macroeconomic stability.

The debt reduction process has proved particularly delicate in the euro area, partly because in some Member States a strong negative feedback loop had developed between the banks' problems and those of the government. A factor conducive to this mechanism is that banking supervision, the resolution of banks in difficulty, and the associated budgetary safety nets have remained a matter of national competence. In 2012, all this led to a clear financial fragmentation along national borders, certainly in the summer when the irreversibility of the euro was increasingly coming into question.

In this turbulent environment, the Eurosystem continued to guarantee stability. The key interest rate was cut further, and vigorous measures were also taken to safeguard the transmission of monetary policy, threatened by financial fragmentation. The three-year refinancing operations spared the banks from having to proceed with disorderly balance sheet reduction. In addition, at the beginning of August 2012, the ECB Governing Council announced Outright Monetary Transactions (OMTs) – purchases of government bonds on the secondary market, subject to strict conditions – as a resolute response to the growing doubts about the irreversibility of the euro.

However, monetary policy cannot solve the crisis in the euro area. It can only buy time for the essential adjustment process to take place gradually, avoiding destructive scenarios that would imply downside risks to price stability; that is entirely in accordance with the Eurosystem's mandate.

The key elements of the fundamental solution are to be found largely in the real sphere, where other players must take on responsibility, both in the national economies and at European level. Since the outbreak of the sovereign debt crisis in May 2010, considerable progress has been achieved

in both areas. However, further action is necessary. The Member States must continue to rectify their fiscal and other macroeconomic imbalances, and strengthen their growth potential. The new framework for more economic governance will assist them. If the framework is applied consistently, that could restore credibility and prevent new derailments. Establishment of a banking union will help to break the vicious circle between banks and national governments, and foster durable restoration of financial integration. In 2012, it was precisely here that an important step forward was taken in setting up a single supervisory mechanism. To function at its best, the latter must be quickly supplemented by a single resolution mechanism and a common deposit guarantee system.

Although this new step is crucial, it presents major challenges for both the ECB and the national supervisory authorities – in our case the Bank, which has been responsible for prudential supervision in Belgium since April 2011. The ECB will have to ensure that monetary policy is kept totally independent from prudential policy, while also taking account of the interactions and synergies. To create an efficient system, the ECB must also be able to rely on the maximum support of the expertise and experience available in the Member States. This is not only necessary in the case of the smaller banks, for which the national supervisory authorities can continue to take prudential decisions, but also for preparing decisions on the major banks – around 200 large banking groups – to be taken by the ECB. Good knowledge of the relationship between banks in the national jurisdiction and the macroeconomy is also the reason why the national authorities must remain responsible for macroprudential policy, albeit in consultation with the ECB.

Fears that the essential restructuring of the Belgian financial sector would lead to severe restrictions on lending have so far proved largely unfounded. Despite this somewhat encouraging finding, it must 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.

The public is entitled to have high expectations of financial institutions, in terms of both support for the economic revival and rigorous management of activities and risks, as well as governance. The Bank has therefore clarified its criteria for assessing the expertise and integrity of the managers of financial businesses, and continued its horizontal analysis of remuneration policy. Furthermore, the government has asked the Bank to report on the feasibility of a structural reform aimed at separating the traditional activities of deposit banks from the more volatile business of investment banks. In an initial interim report, the Bank drew attention to the disadvantages of such a split for a country that depends on exports by SMEs. A group of experts, chaired by the Governor of the Finnish central bank, Erkki Liikanen, and instructed by the Commission to examine the advisability of this type of reform, subsequently also made recommendations stating that a split was considered appropriate only once the more volatile activities exceed a certain threshold. The Commission will now prepare specific guidelines which the Bank will take into account in its final proposals.

The Bank has adopted a multidisciplinary approach for implementing its prudential policy. It thus established internal coordination committees to take maximum advantage of the synergies with the Bank's other activities. For 2013, a multiannual action plan puts the emphasis on a risk-based approach which implies an in-depth analysis of the business models and profitability of the large Belgian financial institutions. This action plan also focuses on credit, liquidity and interest rate risk as well as some specific components of the supervision procedures and methods for both banks and insurance companies. In conducting risk analyses, care is taken to combine the micro- and macroprudential dimensions. The Bank regularly monitors leading financial institutions' plans for switching to the new solvency and liquidity rules which form an essential risk management parameter.

During 2012, Belgium underwent an IMF Financial Sector Assessment Program (FSAP) which assesses the soundness of the Belgian financial system and the quality of the supervision and legislation.

The assessment findings will be published in May 2013. That will enable the Bank to make further improvements to the quality of supervision, contributing to a more resilient financial system.

With slightly negative growth of 0.2 % in 2012 and employment down by 17 000 units, the Belgian economy felt the effects of the crisis in the euro area, even though the impact on Belgium has so far been less severe than on the hardest hit countries. In 2012, pension and labour market reforms were implemented following a long period of political deadlock and measures were taken to cut the public deficit. As a result, the structural primary balance improved in 2012 by around 1 % of GDP and the deficit worked out at 3 % of GDP if it is assumed that the 0.8%-of-GDP capital injection in favour of Dexia only has to be included in the public debt, but not in the budget balance. Otherwise, the deficit would come to 3.7 % of GDP, just as high as the 2011 figure. Against that backdrop, the interest rate on Belgian government paper declined steeply. Yet there is no room for complacency, and further essential steps down the current path are absolutely necessary.

There is a need to raise the economy's growth potential and to ensure the sustainability of public finances, in view of the high debt ratio – which had risen to 99.6 % of GDP at the end of 2012 – and the heavy costs associated with population ageing. Belgium must match its ambitions to the best-performing European countries, and devise a plan which takes account of the complementarity between the two spheres.

Boosting the growth potential makes it easier to restore sound public finances, while the way of achieving fiscal consolidation will have an impact on productive capacity. A further increase in the effective retirement age, tailored to longer life expectancy, is beneficial in both respects. By expanding the labour supply, it supports growth potential and at the same time moderates the costs of ageing. Moreover, the quality of the labour supply also needs to be enhanced. Further pension system reforms will be necessary to spread the effort more fairly across successive generations and strengthen the sustainability of our social security system.

So that the economy can create jobs on a lasting basis, labour costs must also keep in step with productivity. In this respect, Belgium is rather vulnerable in several ways. Inflation and – via automatic indexation – labour costs react quickly to commodity price fluctuations. The fiscal and parafiscal burden on labour is among the highest in the advanced countries, productivity lagged behind that in the main neighbouring countries between 1996 and 2012, and the supply of goods is based too heavily on products that are easy to copy.

In the face of these problems, the government reformed the pricing of gas and electricity. In addition, it announced a package of measures to reduce the hourly labour cost gap between Belgium and the three main neighbouring countries – which stands at roughly 5 % according to the available criterion – and it wants to close this gap within a six-year period. If the growing productivity differentials in relation to the three neighbouring countries are taken into account as well, then the gap is almost 13 % ; true, this is only due to a handicap relative to Germany, but the latter is Belgium's main trading partner. The level of hourly labour costs, which is particularly high in Belgium, clearly shows that this problem needs to be tackled urgently. It is particularly difficult to correct a competitive disadvantage in an environment where, in practice, the only available scope lies in real negotiated wage increases. That is precisely why the Bank, following the publication of its study on indexation, examined various adjustment options and called on the social partners and the government to draw the appropriate conclusions for setting both wages and prices. Bold reform is the only way to provide the economy with lasting protection against the detrimental consequences of a price-wage spiral and avoid the need to resort to complex correction mechanisms afterwards.

Furthermore, to generate growth, it is essential to stimulate entrepreneurship and innovation, and to remove the factors hampering business creation or market access. In the long run, rotation whereby

new products, new production processes or new businesses replace the existing ones determines the dynamism of the economy.

In view of the heavy fiscal and parafiscal levies on labour incomes and the complexity of the Belgian tax system, there is a need to examine how the various types of taxes and exemptions affect economic growth, competitiveness and employment. That analysis should point the way to a thorough reform and simplification of the tax system. However, that must not threaten the sustainability of public finances, which is a major challenge in itself.

Both the level of the public debt and the impending population ageing mean that the budget path outlined in the stability programme must be adhered to and that a credible programme for achieving a structural balance in 2015 has to be drawn up. A balanced budget is necessary to bring down the debt ratio; by reducing the interest charges, that will free up the necessary resources to cover part of the cost of population ageing. The first requirement is to keep a close eye on the implementation of the 2013 budget, and make any adjustments if need be.

The government's primary expenditure has now risen to over 50 % of GDP. For that reason, the restoration of sound public finances must be based primarily on curbing the growth of that expenditure, especially the spending that does the least to stimulate growth potential and employment, or to attenuate social inequality. An increase in tax on labour is not an option, as it is already particularly high and a further rise would impair growth potential. The scale of the fiscal consolidation is such that all levels of government must share the burden. Appropriate implementation of the State reform could make a contribution here.

In short, Belgium needs a coherent action plan to support growth potential, safeguard financial stability and guarantee the sustainability of public finances. That is the only way to restore consumer and business confidence, return to sustainable growth, and protect the high standard of living and the existing social model.