Report 2013

Preamble

NationalBank
OF BELGIUM
Eurosystem

Foreword

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Governor

Five years after the crisis began, the effects on the real economy are still apparent in the advanced economies. The adjustments are taking place very gradually, with large divergences between the various regions. In 2013, global economic growth remained moderate at 3 %. While growth lost momentum in the emerging countries, it gathered pace in the advanced economies. That applied particularly in the United States, prompting the Federal Reserve to start cautiously tapering its large-scale asset purchases from the beginning of 2014. However, at the same time, it announced that the key interest rate was likely to remain at its current low level for a considerable time. It is possible that the normalisation of the monetary policy stance may be accompanied by increased financial market volatility, as was already the case in 2013. In this context, it is crucial to calibrate the timing and pace of the exit accurately, and to communicate the chosen strategy in an appropriate way.

In the euro area, economic activity was down by a further 0.4 % year-on-year, but a turnaround was apparent from the second quarter, primarily in the peripheral countries, which was accompanied by a restoration of confidence. However, the reduction of the high debt ratios in the private and public sectors, high unemployment and the tight financing conditions that persisted in some Member States continued to dampen domestic demand. Nonetheless, considerable progress was made with fiscal consolidation and in correcting the current account deficits, though further efforts are needed to lay the foundations for a return to sustainable growth.

Throughout this adjustment process, the Eurosystem ensures stability. In the summer of 2012, the programme of outright monetary transactions (OMTs) was announced with the aim of quelling the doubts that had arisen over the irreversibility of the euro. Together with the macroeconomic rebalancing efforts and progress towards the banking union, that programme turned the financial markets around. Moreover, the ECB's key interest rate was cut in May and November 2013, bringing it down to 0.25 %, and forward guidance on interest rates was provided from July onwards. The ECB Governing Council will do everything possible to prevent a persistent fall in inflation – let alone deflation – from hampering the economic recovery. It aims to maintain inflation not just below 2 %, but close to that figure in the medium term.

The accommodative monetary policy is making a fundamental contribution towards the economic recovery and thus ensuring positive feedback effects on financial stability. Nevertheless, a long period of very low interest rates also implies specific risks for financial stability. From a medium-term perspective, monetary policy must also be wary of such risks, even though undesirable side effects of low interest rates must also be contained by prudential policy.

In the euro area, the continuing differences between national markets can thus be taken into account, while the interest rate policy can only be calibrated at monetary union level. Macroprudential policy therefore accords a particular role to a national component. In Belgium, a draft law on macroprudential policy entrusts that task to the Bank, in view of the latter's expertise in analysing systemic risks.

2013 was above all the year in which further crucial steps were taken towards developing the banking union. With the establishment of the single supervisory mechanism (SSM), the ECB will exercise direct supervision over the 130 or so largest banking groups in the euro area from November 2014.

Since the SSM must be credible from the start, the large banks are undergoing an in-depth assessment. If that reveals structural weaknesses or inadequate capital, then action must be taken, in the first place by the private sector but if necessary also via direct government support. This opportunity must be seized to restore confidence in the European banks so that the currently still disrupted lending process begins functioning properly again and can thus support the economic recovery.

The financial crisis management mechanisms must be integrated at a comparable pace. To that end, in December 2013, the EU Council approved a proposal for a Regulation establishing a single resolution mechanism, intended to bring together the national resolution authorities at euro area level. The Council also approved the principle of a single resolution fund, financed by contributions from the banking sector and gradual pooling of the national compartments.

In exercising its supervision over Belgian financial institutions, the Bank has paid particular attention to the risks associated with the changing business models, keener competition between banks, and the low interest rate environment. Low interest rates may in fact prompt financial institutions to seek riskier assets and, in the case of credit institutions, extend the maturity transformations. Checks were also done to see whether life insurance companies are adjusting guaranteed yields regularly in line with market conditions.

In addition, the risks associated with the banks' loan portfolios were examined, thus anticipating the general process of assessment by the ECB. This brought to light occasionally significant divergences in the way in which the various banks weigh up the same risk, and the capital buffers for housing loans proved to be smaller than in most other European countries. The Bank consequently decided to increase the weighting coefficients for the risks in the internal models used for mortgage loans. That will make the banks more resilient to potential property market shocks.

During the period of transition to the SSM, the Bank will need to deploy considerable resources, and will retain important functions even after prudential supervision is transferred to the ECB, as the authorities in the home and host countries of the principal subsidiaries of the large banking groups will play a key role in the multinational supervision teams. The national supervisors will thus enhance the system with their long-standing knowledge of individual institutions and familiarity with the local markets. In addition, the Bank will retain primary responsibility for supervising small credit institutions. Overall supervision of insurance companies and front-line supervision of the large payment and settlement infrastructures based in Belgium will also remain the responsibility of the Belgian authorities.

In 2013, agreement was also reached on a new banking law in Belgium. It provides for a structural reform designed to contain risk-taking by the banks. On the one hand, additional capital requirements will apply if a bank's trading activities exceed a certain threshold. Also, trading for own account is prohibited in principle, except for a small margin to take account of the fact that certain positions are actually inherent in risk management or the bank's intermediation role in support of economic activity.

The new banking law also transposes into Belgian law the new European Directive on access to the activity of credit institutions and on supervision of credit institutions, and the European Regulation incorporating the new prudential requirements of the Basel Committee into Community law. It also anticipates certain aspects of the Directive on the recovery and resolution of credit institutions, and aims to strengthen bank governance.

Economic activity picked up in Belgium, too, from the second quarter of 2013. Owing to the negative carry-over effect of the contraction in the previous year, the economy grew by barely 0.2 % year-on-year. The recovery was still too weak to generate a revival in employment, which declined by a further 11 000 units, bringing the unemployment rate to 8.4 % at the end of the year.

Nevertheless, the Belgian economy withstood the crisis fairly well. Belgium is one of the few euro area countries where activity has already regained its pre-crisis level. All the same, the crisis has left its mark on production potential, employment and public finances. In addition, developments on the current account and competitiveness fronts and the low potential growth point to fragility in the creation of prosperity.

In the past two years, steps have been taken to turn the tide. In a zero-growth environment, the public deficit was cut from 3.7 % in 2011 to 2.7 % in 2013. Pension and labour market reforms have been launched, and measures have been taken to foster competition in the network industries and improve the competitiveness of firms. Nonetheless, major challenges remain and there is a need to continue preparing for the future in a context which, even without the crisis, would feature the challenges associated with increasing globalisation, climate change, and above all, the costs of population ageing. Moreover, those costs are particularly high in Belgium.

Without straying from the path mapped out by the Belgian government in the 2013 stability programme, the period 2014-2016 must be used for structural consolidation of public finances in a manner conducive to growth, before the costs of ageing become fully apparent. Additional measures are also needed to control those costs and safeguard solidarity between the generations, including a further extension of working life.

Since the government's primary expenditure has now risen to 51 % of GDP, public finances must first be consolidated by control over spending, which is less detrimental to growth. The sixth State reform must be seized as an opportunity for tailoring policy more closely to the specific needs of the different Communities and Regions. That could create new levers for increasing efficiency and providing stronger support for the economy's growth potential.

There is little scope for raising additional revenue. It would actually be advisable to reduce the particularly high levies on labour incomes. The Pact for Competitiveness and Employment already includes plans for three cuts in those levies in 2015, 2017 and 2019 respectively, each amounting to € 450 million. Apart from spending cuts, other revenue sources could be used to finance reductions in the burdens on labour, such as indirect taxes, environment taxes, or taxes on property incomes. There is a need here for tax reforms that promote growth and employment, and preferably also simplify the tax system.

The restoration of sound public finances requires the support of sufficiently vigorous economic development. So, there is an urgent need for reform in many other areas, aimed at boosting growth potential and employment and thus strengthening the basis of social protection. Furthermore, in a small open economy, prosperity is fundamentally dependent on the ability of firms to secure a place in the global value chains.

In regard to price and cost competitiveness, Belgium has proved vulnerable in various respects over recent years. Not only are exports highly energy-intensive, but a substantial competitiveness handicap has also developed in terms of labour costs in relation to the three neighbouring countries. That is due to a handicap in relation to Germany. Experience over recent years has shown that such a discrepancy is hard to eliminate. In addition, wage-setting is insufficiently geared to productivity, and needs to accord greater importance to increasing job opportunities for the unemployed. To keep wage costs more in line with productivity, safeguard competitiveness and promote employment it is necessary to reflect on wage-setting procedures.

In the longer term, integration into the global economy depends primarily on the ability to innovate; firms therefore bear a significant responsibility here. Investing in R&D is absolutely vital to create a dynamic economy. There is a need for more networks between producers and research centres, and entrepreneurship must be encouraged and supported by a modern, efficient public administration. Product market reforms must remove the factors hampering the establishment of businesses or market access, boost competition and lead to appropriate pricing.

A dynamic knowledge economy also needs an adequate supply of high-quality labour. Investing in training, support and activation for job seekers is therefore a priority, and a complement to the increased responsibility which was the aim of the unemployment benefit reform. The quality of education is another crucial factor. Lifelong learning must become the norm. Facilitating and encouraging labour mobility is another essential objective. Creating new businesses and jobs rather than protecting existing ones without potential is the driving force behind economic progress.

Overall, the aim must be to maximise returns in the medium term, rather than focusing on immediate results. The fact that structural measures take time to produce their full effects is no reason for failing to take them; on the contrary, it should be an incentive for launching them as soon as possible. Consistency between the various spheres of action and – in a federal country such as Belgium – between the various levels of power should be another crucial focus of attention.

The challenges facing policy-makers are considerable, but if they are tackled promptly and consistently, they are not insurmountable. The need is greater than ever for a large-scale societal project geared to the future, supported by all elements of society and all levels of power, otherwise the high standard of living and high degree of social protection will inevitably come under strain.

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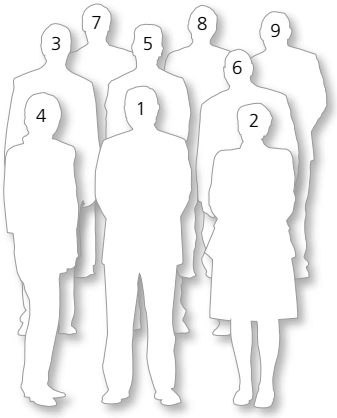

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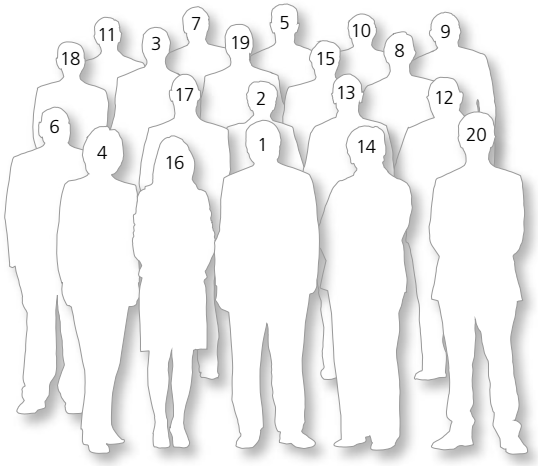

Report presented by the Governor on behalf of the Council of Regency *

1. Shifts in global growth dynamics and repricing of risk

1. At 3 %, the growth of the global economy was once again moderate in 2013, and 0.1 percentage point lower than in 2012. While the debt reduction process still affected economic activity in the advanced economies, there were nevertheless signs of more robust growth dynamics during the year. In contrast, growth lost momentum in the emerging countries where it came to 4.7 %, around 2 percentage points below the average for the past decade. The associated fall in commodity prices gave additional impetus to the process of inflation reduction in the advanced economies.

2. The transition to stronger growth dynamics was evident primarily in the United States, where it was supported by accommodative monetary policy, the reduced debt level in the private sector, the house price revival, the rise in household wealth and the gradual fall in the unemployment rate. However, the recovery remained fragile, and with public debt now up to 104 % of GDP, the American economy faces a formidable fiscal challenge. In addition, the fiscal policy decision-making process has proved particularly complex in recent years. At the beginning of the year, this led to a sharp fiscal tightening which was, moreover, largely linear on the expenditure side, cutting the budget deficit abruptly from 9.3 % of GDP in 2012 to 6.5 %. In the autumn, the extension of the federal government's spending authority and the raising of the debt ceiling also created much uncertainty. Some public services actually shut down. These factors continued to put a brake on growth in 2013, although at the end of the year agreement was reached on the budgets for 2014 and 2015.

3. The most notable development in 2013 was that, against this backdrop of gradual recovery, there loomed the prospect that the Federal Reserve might soon slow down its large-scale asset purchases. The Federal Open Market Committee (FOMC) had in fact indicated in the spring that if the labour market situation continued to improve, the purchases might be gradually reduced. This triggered a sharp rise in the ten-year interest rate, namely from 1.7 % at the beginning of May to almost 3 % in September. The increase concerned not only the term premiums incorporated in the long-term interest rate, but also the latter's expectations component, since

* One of the Regents abstained over a number of paragraphs because of the one-sided emphasis on controlling expenditure in the recommendations on fiscal consolidation and different views on the wage gap and the role of the indexation mechanism. Another Regent abstained on account of the recommendations for an extension of working lives and for drawing up a long-range plan for fiscal consolidation and also with regard to the analysis of the wage gap and the role of the indexation mechanism.

a faster rise in the key interest rate was anticipated. As the recovery was still fragile at first, it was not until December that the FOMC decided to start cautious tapering of the securities purchase programme from the beginning of 2014. It was also made clear that the key rate was likely to be held at its current low level for a long time, even after this programme had ended.

4. The developments in the United States had a clear impact on financial markets throughout the world. In the other advanced economies, financial conditions were influenced primarily via spillovers on the risk-free long-term interest rate – i.e. the rate on financial instruments with no credit risk – while the effect on risk premiums was rather limited. That is in stark contrast to the abrupt reversal in capital flows facing some emerging countries and causing a substantial tightening of financial conditions. Nonetheless, the relatively modest rise in the long-term interest rate in the advanced economies other than the United States was not always in phase with their cyclical position. It therefore presented an additional challenge for monetary policy, since greater differentiation was needed.

5. In view of a still hesitant economic recovery and falling inflation, the ECB Governing Council decided to cut the interest rate further in May and November, and from July onwards it provided forward guidance on key interest rates. In the United Kingdom, the Bank of England announced in August that it had no plans to raise the benchmark interest rate or to reduce its balance sheet, at least so long as unemployment remained above 7 % and there was no threat to either price stability or financial stability. In Japan, the central bank opted in April for a programme of quantitative and qualitative easing, intended to halt deflation and restore inflation to the 2 % target set at the beginning of 2013. The provision of additional monetary stimuli is one of the components of a three-pronged strategy aimed at revitalising economic activity. The second part of that strategy comprises short-term fiscal stimuli and medium-term consolidation, while the third component consists of structural reforms to support growth potential.

6. The accommodative monetary policy is fundamental to the economic recovery and to avert the risk of deflation, both of which have positive feedback effects on financial stability. They are also necessary preconditions for a sustainable return to a higher interest rate environment. Nevertheless, a lengthy period of extremely low interest rates erodes savers' yields. Moreover, it entails risks for financial stability because it may open the way to new financial excesses, it affects the profitability of financial institutions and it weakens the incentives for debt reduction. In the first instance, undesirable side effects of the low interest rates have to be contained by prudential policy – particularly macroprudential policy – which thus needs to lay the foundations for a financial system equally capable of functioning under a different interest rate constellation. Monetary policy itself must also be aware of such risks from a medium-term perspective, because if those risks were to materialise, they would pose an additional threat to the real economy and be a new source of deflationary pressure.

7. The process of normalisation of the monetary policy stance – which is getting underway earlier in the United States – faces a dual challenge. On the one hand, the timing and pace of the exit must be accurately calibrated. Determinants here are the strength of the economic recovery, the risks to price stability and the seriousness of potential financial distortions. On the other hand, the chosen strategy must be appropriately communicated in order to limit financial market uncertainty and volatility, thus avoiding unnecessary stress on both the real economy and the financial system. That is essentially little different from other periods when an accommodative policy gives way to tightening. However, the scale of the stimuli given and the fact that both the interest rate instrument and the central bank balance sheet and forward guidance have been used as levers make this a delicate exercise and heighten the risk of volatility.

8. The growth slowdown in the emerging countries is partly cyclical and is due to overheating in some countries. It was exacerbated by the tightening of financial conditions accompanying the reversal in financial market sentiment during the spring. As usual in periods of risk repricing, the

effect was most severe in the countries with the weakest fundamentals. High inflation, rising public deficits and substantial external debt positions fuelled the capital outflow. In emerging Asia, it was India and Indonesia that were the worst affected, while in China new fiscal stimuli counteracted the cyclical downturn. Restoring sound fundamentals is vital for the future. In principle, exchange rate flexibility makes the adjustment process easier, though excess volatility may be a disruptive factor, while the use of prudential instruments may help to control capital flows.

9. In addition, following the exceptionally strong growth figures of recent years, growth potential has declined in many emerging countries. Nonetheless, their potential growth undeniably exceeds that of the advanced economies. The scale of this transition to a lower growth potential varies from country to country, but it is clearly considerable in China – the second largest economy in the world – and in India. In some countries, infrastructure investment and the elimination of barriers to market access may remove existing impediments and form a new source of expansion. In China, rebalancing growth in favour of consumption may open the way to slower but perhaps more balanced, sustainable growth, not only in China itself but also worldwide, partly via the impact on commodity prices.

2. Continued implementation of the reform agenda is crucial to support the hesitant recovery in the euro area, to overcome the sovereign debt crisis, and to deepen Economic and Monetary Union

10. In 2013, economic activity in the euro area was down by 0.4 % year-on-year. However, following a year and a half of decline, an upturn became apparent from the second quarter, though growth remained modest. The reversal of the high debt level in the private and public sectors, high unemployment and – in some Member States – the still tight financing conditions depressed domestic demand, while adjustment was also necessary on the supply side following the distortions that had occurred in the pre-crisis period. Nevertheless, the crisis management is beginning to produce results, as is evident from the timid upturn seen in 2013.

11. The crisis management approach is essentially based on two pillars. On the one hand, the Member States need to eliminate their macroeconomic imbalances in order to lay the foundations for a return to sustainable economic growth. On the other hand, work is needed on the further development of Economic and Monetary Union (EMU), because the crisis has shown that the integration dynamics brought about by the single currency had insufficient underpinning in the form of an extension to the fiscal, economic and financial sphere. Since the sovereign debt crisis erupted in 2010, a new economic governance framework has been devised, intended to give greater substance to the economic and fiscal pillars of EMU via closer policy coordination, and it was decided to set up a single supervisory mechanism for banks as a first step towards a full banking union. In 2013, further steps were taken both in the Member States themselves and at Union level, but it is crucial to continue implementing this reform agenda.

12. Thus, the countries that had large current account deficits before the crisis have made considerable progress towards rebalancing both domestic demand and exports, and activity in the tradable and non-tradable sectors. Their external deficits have now been largely eliminated, mainly as a result of the decline in imports accompanying the fall in domestic demand. Nonetheless, exports have become the driving force behind the recovery, even though this transition has not yet compensated for the loss of activity and jobs in the non-tradable sector. Conversely, there has been little change in the current account of the countries which had long recorded a substantial surplus, so that the euro area as a whole now has a surplus of well over 2 % of GDP. That is putting latent upward pressure on the euro exchange rate,

though the appreciation in 2013 is also attributable to the restoration of confidence in the single currency and the reversal of capital flows worldwide. Under the procedure designed to detect macroeconomic imbalances, the European Commission decided that, in the spring of 2014, it would analyse the factors behind Germany's persistent current account surplus. While Germany's export performance is not in itself an issue, this analysis will examine to what extent flagging domestic demand is due to malfunctioning which could hamper growth and could be resolved by structural reforms. Symmetrical implementation of structural reforms is in the interests of every Member State, and will also ensure that EMU functions more harmoniously.

13. Fiscal consolidation also continued in 2013, so that the structural balance for the euro area as a whole improved by 0.7 percentage point and the nominal deficit fell to 3.1 % of GDP. That improvement in the structural balance is sizeable, though not as large as in the two preceding years. In 2013 the focus of fiscal governance shifted to the structural balances, so that the automatic stabilisers can operate freely around the adjustment path. Application of this principle prompted the Ecofin Council to grant the Netherlands and Portugal one extra year to correct their excessive deficits; France, Slovenia and Spain were actually given two years.

14. If it is rigorously applied, such a medium-term strategy can promote greater macroeconomic stabilisation, conducive to the credibility of fiscal governance, even if it makes that more complicated owing to the difficulty of measuring structural balances in real time. Consistent, transparent application of the principles adopted is very important here. In the future it will therefore be necessary to stick to the structural paths defined, particularly if growth gathers pace. However, when assessing the draft budgets for 2014, the European Commission found that the planned structural effort fell short of what had been announced in the stability programmes, and that several countries run the risk of failing to comply with the rules of the Stability and Growth Pact. Since the debt ratio increased to 95.7 % of GDP in the euro area in 2013, and there are many countries where the debt dynamics have not yet stabilised, continuing consolidation of public finances is a priority, otherwise it will not be possible to create new budgetary scope by halting the interest rate snowball effect. Moreover, there could be another reversal in market sentiment, which in turn would seriously hamper the entire adjustment process.

15. Against the backdrop of fiscal consolidation, unemployment in the euro area increased to over 12 %, with extremes of around 27 % in Spain and Greece. Among young people on the labour market, no fewer than one in four are jobless, and in the hardest hit countries the ratio actually exceeds one in two. Unemployment is in the first place a scourge for those affected, and it also increases income inequality while threatening social cohesion and placing a burden on public finances. In addition, it implies the risk that talent may not be fully developed, thus undermining future production potential. It is therefore vital at all costs to prevent unacceptably high unemployment becoming a lasting legacy of the crisis. Apart from an appropriate macroeconomic policy mix, there is a need for labour market reforms, support and activation for the unemployed, and measures specifically targeting newcomers. To that end, the European Council on 28 June 2013 brought forward the implementation of the Youth Employment Initiative and the Youth Guarantee Scheme, which aims to help young people into work or training within four months. It also announced a reinforcement of the social dimension of EMU.

16. Another key point is that investment in the euro area has fallen very sharply compared to the level prevailing prior to the great recession. The property market corrections depressed investment in housing, while the process of fiscal consolidation curbed public investment. In addition, business investment declined steeply as a result of under-utilisation of production capacity, uncertainty over the demand outlook, and – in some countries – tight financial conditions and high corporate debt ratios. A persistently low level of investment implies an additional risk for the production potential.

17. Throughout the adjustment process that inhibited growth in the short term, the Eurosystem continued to ensure stability via its monetary policy stance and by measures aimed at calming the financial market turmoil. The same was true in 2013. Inflation declined steadily as growth was minimal and the production potential was persistently under-used. Moreover, the fall in commodity prices and the appreciation of the euro also had a moderating effect. To ensure that inflation expectations remained firmly anchored, the main policy rate was cut by 25 basis points in both May and November, reducing it to 0.25 %. The interest rate on the deposit facility was held at 0 %. In addition, from July onwards, the Governing Council stated after each of its meetings that it expected the key interest rates to remain at or below their current level for a considerable time. Even after the November interest rate cut, it reiterated that rates could fall still further. The provision of forward guidance on interest rates acts as a lever for the future, also restraining forward interest rates and making them less volatile. This provides an additional stimulus for economic recovery and curbs the downside risks to price stability accompanying the contraction of demand.

18. Safeguarding price stability – the ECB Governing Council aims to keep inflation below, but close to, 2 % in the medium term – is the best way for monetary policy to support the economy. If inflation expectations are firmly anchored, that averts the risk of deflation. Moreover, keeping the level of average inflation for the euro area up facilitates the process of adjusting relative wages and prices in the countries most seriously affected by the crisis, and prevents an increase in the weight of the debt. Those were precisely the arguments which, in 2003, led to refinement of the definition of price stability.

19. In the summer of 2012, the ECB Governing Council had announced the programme of outright monetary transactions (OMTs) with the aim of assuaging the doubts which had arisen over the irreversibility of the euro. Combined with the progress achieved in tackling the crisis, this programme turned the financial markets around. Since then, in the countries worst affected by the crisis, interest rate differentials on government bonds have narrowed sharply in relation to Germany, and financial fragmentation along national borders has diminished. In those countries, banks regained access to market financing, the cost of that financing declined, and it became possible to strengthen the deposit base. That made the banks less dependent on liquidity provided by the Eurosystem, permitting early repayment of part of the liquidity previously taken up in the two three-year refinancing operations. However, the financial fragmentation has not disappeared. There are still considerable divergences in retail interest rates – especially on loans to non-financial corporations – and in the volume of lending, albeit partly on account of differences in debtor risk and in the size of the banks' capital buffers. It is SME financing that has suffered the most, because SMEs have less access to alternative sources of funding than large firms. In November, in view of the persistent fragmentation, the ECB Governing Council announced that the fixed-rate tenders with full allotment would continue for all operations with a term of up to three months until at least mid-2015, well after the due date of the last three-year refinancing operation.

20. The crisis has highlighted all the potential instability risks of a monetary union combined with closely interwoven markets and financial institutions, in the absence of a similarly integrated prudential policy. The banking union project fills this gap by centralising bank supervision and opening up the prospect of establishing a single resolution authority and a common deposit guarantee system. In order to revitalise growth dynamics, this project aims to curb the fragmentation of the financial centres – detrimental to the financing of large parts of the European economy – and to halt the adverse interaction caused by the crisis between vulnerable public finances and the financing problems of the banks, and even of the economy as a whole.

21. Setting up the banking union is an ambitious but complex aim which can only be achieved by strong political commitment and a rigorous institutional process. The European authorities therefore entrusted the establishment of a single supervisory mechanism (SSM) to the ECB,

which will exercise direct supervision over the 130 or so largest banking groups of the euro area, while the other institutions will in principle remain subject to supervision by the national authorities, albeit according to harmonised procedures.

22. The SSM needs to be credible from the start. A thorough look at the state of affairs is essential here. The big banks in the system will examine their strengths and weaknesses, assess the quality of their assets which is still suffering from the vestiges of the financial crisis, and demonstrate their ability to cope with adverse circumstances. If that survey reveals structural vulnerability or inadequate capital, then remedial action is needed – preferably by the private sector. Should those measures prove insufficient, direct government support will not be ruled out. However, that support must be conditional in order to avoid distortions of competition and stipulate a contribution not only from existing shareholders – whose share in the capital will have to be diluted – but also, if necessary, from non-preferential creditors. All these factors will promote greater transparency regarding the balance sheet situation of banks, and help to restore confidence in the banking system.

23. The procedure must be implemented diligently and consistently, although there are numerous pitfalls here since the motivations of banks undergoing the process are sometimes at odds with those of the supervisors and the States. The first issue here is the actual reputation of the ECB, which could be seriously damaged if the rigour of the exercise were in doubt. Next, this process is keenly awaited by the market, which recently upgraded its assessment of the soundness of European banks but only subject to stock-taking. And finally, it is a political requirement since this examination of capital adequacy is decisive for recourse to the European Stability Mechanism for any subsequent recapitalisation of banks under the SSM.

24. The interactions established for this general assessment process will presage the network of connections and coordination that the SSM will devise jointly with all parties involved in prudential policy. First, it will be necessary to exploit the synergies between the ECB – which will make available the resources for efficient management of the banking supervision – and the national supervisory authorities – which will enhance the new system by their proximity to the local markets and their long-standing knowledge of individual institutions. There will also be close links between the SSM and the international bodies responsible for prudential regulation of not just the banks but also insurance companies and financial markets, since the SSM will cover conglomerates operating in multiple financial sectors.

25. The impending establishment of the SSM requires a similar rate of progress in the integration of financial crisis management mechanisms in the EU. To that end, in December 2013 the EU Council approved a draft Regulation establishing a single resolution mechanism to bring together at euro area level the national resolution authorities to be set up in each Member State in accordance with an EU Directive. That Regulation confirms the principle whereby non-preferential creditors have to help rescue banks in difficulty. To avoid endangering financial stability, it will be necessary to ensure that banks issue sufficient debt instruments of this type. The Council also agreed with the principle of a single resolution fund comprising contributions from the banking sector, with gradual pooling of the national compartments over a ten-year period.

26. Harmonisation of both the prudential rules and the conduct of supervision and crisis management will not be enough to eliminate the structural differences or cyclical divergences between national markets. The countries participating in the SSM must therefore retain the option of taking specific measures if the stability of their own financial system is at risk, especially as they can no longer use the interest rate instrument for that purpose, and remain responsible for the financial consequences of a crisis afflicting their economy. Following a recommendation by the European Systemic Risk Board (ESRB) calling on each Member State to designate a specific authority for that task, a draft law on macroprudential policy assigns

that responsibility to the Bank in Belgium. However, in an integrated financial system like that in the euro area, a national crisis is liable to spread rapidly and virulently to the other participating countries. The autonomy of those countries will therefore have to be regulated all the more since some of the instruments available will be the same as those used for supervising individual institutions. In the case of those institutions, the national authorities and the ECB will be able to raise, but not lower, the standard of the requirements; this asymmetry should ensure that the implementation of macroprudential policy does not lead to any relaxation of the prudential rules.

27. The exercise of bank supervision must not jeopardise the maintenance of price stability, which remains the ECB's primary objective. Appropriate governance structures must be established to guarantee that monetary policy remains independent from supervision, while exploiting the synergies between these two tasks and taking account of the interactions revealed by the financial crisis. To that end, the ECB has formed a Supervisory Board to ensure the autonomy of the supervision function while the ECB Governing Council remains the supreme decision-making authority.

28. In order to improve the functioning of EMU, it is crucial to finalise the banking union project without delay and to continue enhancing the coordination of fiscal and economic policy. But even after that process has ended, the edifice will remain incomplete. By analogy with other monetary unions, EMU should preferably also be equipped with a supplementary buffer against asymmetric shocks, namely a fiscal policy partially transferred to Community level so that the operation of the automatic stabilisers is no longer confined to purely national level. While this would create a mechanism for risk-sharing between the Member States, promoting the shock absorption capability of the Union as a whole, its design is extremely complex. Such a mechanism must not become a source of permanent one-way transfers between Member States, nor must it undermine the incentives for pursuing an appropriate economic and fiscal policy at national level. Moreover, such a fiscal union can only come about if it has sufficient democratic support and is backed by a genuine political union. Nonetheless, these are both an essential part of the longer-term reform agenda and the completion of EMU.

3. The Belgian economy at the crossroads

29. Economic activity picked up in Belgium, too, from the second quarter of 2013, driven mainly by private consumption and exports. Owing to the negative carry-over effect of the contraction of activity in the preceding year, the economy grew by barely 0.2 % year-on-year. The recovery was also too weak to generate any revival in employment, which contracted by a further 11 000 units, and at the end of the year, unemployment had risen to 8.4 % of the labour force, and actually exceeded 20 % in the case of young people under the age of 25. Against that backdrop, inflation was also down from 2.6 % in 2012 to 1.2 % in 2013. The moderating effect of weak domestic demand was combined with the impact of lower commodity prices, more competitive pricing for gas and electricity, and the wage moderation initiated by the federal government at the end of 2012. Both the reform of the consumer price index and the freezing of real wages helped to slow the rate of increase of hourly labour costs in the private sector from 3.7 % in 2012 to 2.2 % in 2013.

30. Business investment and investment in housing continued to fall, the latter actually declining more sharply than in 2012. In those circumstances, bank lending to non-financial corporations and households also slowed down. That was due mainly to flagging demand, while the Belgian banks eased their lending criteria somewhat. The restrictive effect of the increased risk perception contrasted with the easing that resulted from less stringent bank balance sheet constraints and keener competition between banks. That said, many small firms are still having difficulty in their search for finance.

31. While the Belgian financial institutions' restructuring has put them back in profit and therefore strengthened their solvency, the business climate remains unfavourable, hampering a lasting return to profitability. The 2013 profits are due largely to exceptional factors, particularly the gains on securities which, owing to the current low interest rates, are unlikely to continue rising in future years. Conversely, the stagnation of the volume of business associated with weak demand for credit and the decline in life insurance business has seriously depressed the recurrent results and was hardly offset by a number of more structural measures, such as reductions in operating costs or tariff adjustments.

32. Although the recovery is in sight and – in comparison with most euro area countries – the Belgian economy has come through the crisis fairly well, the latter has still left its mark on public finances, production potential, employment and the financial sector. Furthermore, the deterioration in the current account balance, the tendency towards a relatively sizeable loss of export market share, as well as the fact that net job creation over the last few years has largely been concentrated in the non-market sectors, also give cause for concern. In the past two years, there have been steps to turn the tide. The restructuring of the financial sector is in progress, the public deficit is down, pension and labour market reforms have been launched, and measures have been taken to foster competition in the network industries and to improve business competitiveness. Nonetheless, preparations still need to be made for the future in a context which, even without the crisis, would feature the challenges associated with increasing globalisation, climate change, and – above all – the costs of population ageing.

33. Those costs are particularly high in Belgium. The Study Group on Ageing puts them at 5.4 % of GDP by 2060, if policies remain unchanged; moreover, such estimates are by their very nature subject to great uncertainty. The projections of the European Ageing Working Group, based on different assumptions, predict even bigger increases in expenditure. Furthermore, the full impact of those costs will soon be felt. The coming years therefore offer a vital opportunity for resolutely tackling the ageing problem. That opportunity must be seized without delay in order to preserve the country's prosperity and keep the social protection system both adequate and affordable, without passing on a disproportionate part of the burden to future generations. In view of the scale of that challenge, every potential lever must be used and every effort made to maximise synergy between the various spheres of action. There is therefore a need for a coherent action plan designed to continue the task of enhancing growth potential, raising the activity rate, restoring sound public finances and establishing a stable financial system in the service of the economy.

Structural budgetary adjustment and sustainable growth as levers for a high standard of living and a high degree of social protection

34. Despite weak growth, the public deficit was cut from 4 % of GDP in 2012 to 2.7 % in 2013. The structural balance improved by 0.8 %. An additional improvement resulted from the reversal of temporary factors. In 2012, such factors had widened the deficit as a result of the capital injection for Dexia, whereas in 2013 they raised a one-off amount of 0.4 % of GDP, notably as a result of tax regularisation.

35. Since Belgium had not succeeded in eliminating its excessive deficit on time in 2012, the Ecofin Council decided, in June 2013, to step up the current procedure against Belgium. According to that decision, the excessive deficit was to be permanently erased from 2013, and in 2014 there must be sufficient progress towards attaining the medium-term objective. In November 2013, the European Commission considered that the draft budget submitted for 2014 was broadly in accordance with the rules of the Stability and Growth Pact – particularly because the deficit was to remain below 3 % of GDP in that year, too – but perceived a risk that the structural balance might not converge sufficiently towards the medium-term objective.

36. It remains important not to deviate from the path defined by the Belgian government in the April 2013 stability programme, providing for a structural balance in 2015 and aiming at attainment of the medium-term objective – a structural surplus of 0.75 % of GDP – in 2016. That aim is ambitious because it was set with due regard for both the public debt – amounting to 99.7 % of GDP – and the costs of ageing. Since the latter costs will soon become fully apparent, it is vital to progress towards the medium-term objective without delay. That is why it is preferable to devise a clear multiannual plan in 2014 defining the whole path up to 2016. That will rapidly remove the uncertainty surrounding the fiscal consolidation, thus promoting confidence, and as the economy picks up, it could ensure that the restrictive effect of consolidation is offset by a decline in the private sector's propensity to save. In any case, foreign demand also plays a major role in Belgian economic developments, while the structural character of the adjustment path obviates the need for immediate correction of any cyclical setbacks.

37. The path described above will ensure that the public debt is cut relatively quickly; via the reduction in interest charges, that will create scope for absorbing part of the cost of ageing. In addition, at a later stage it will be possible to tap into the budget surplus to some extent. However, that will not offer sufficient scope to cover all the fiscal costs of ageing, so that it will also be absolutely essential to take measures to reduce those costs themselves. The pension reform implemented by the federal government is a significant step in that direction, but average working life needs to be further extended, taking account of life expectancy, specific career characteristics and labour force developments. That has two effects. A longer working life not only cuts the costs of ageing, but it also helps to maintain the labour supply, thus ensuring that ageing does not diminish the growth potential on top of the direct costs it entails. Such measures only produce their full effect in the longer term, but it is best to implement them as soon as possible so as to stifle any uncertainty over future prospects. Along the way, there may be additional scope for other policy initiatives, such as growth-generating investment in infrastructure, research and education, or efforts to enhance ecological durability.

38. Under the sixth State reform which takes effect on 1 July 2014, the powers of the Communities and Regions will be extended by more than a third in budgetary terms, giving them freedom of action in important socio-economic spheres such as child allowances, certain aspects of health and personal care, elements of employment policy and fiscal expenditure relating to housing, service vouchers and energy-saving investment. In addition, the new Finance Act gives the Regions more fiscal autonomy. The reform must be seized as an opportunity for tailoring the policy more closely to the specific needs of the various Communities and Regions. That could create new levers for increasing efficiency and providing stronger support for the economy's growth potential. At the same time, it is necessary to ensure that the policy initiatives taken at the various levels are mutually consistent and do not result in more complex legislation and additional administrative burdens, because those two factors impede entrepreneurship and job creation. There will be a need for closer consultation and specific cooperation agreements between the various government entities.

39. The new Finance Act also promotes a balanced allocation of the available resources between the federal government – which will bear most of the costs of ageing – and the Communities and Regions. Nevertheless, all levels of power in Belgium need to contribute towards restoring sound public finances. That requires cooperation agreements with clear and binding budget targets for each entity, as requested incidentally by the Ecofin Council in June 2013. At present, such agreements only exist for 2013 and 2014. The agreement concluded in December 2013 between the federal government and the Communities and Regions enshrines the principle of a balanced budget, in accordance with the European Fiscal Compact. It also stipulates that, for the updating of the stability programme and on the basis of a recommendation by the High Council of Finance, the annual budget targets in nominal and structural terms are to be allocated among the various levels of government. That allocation must conform to the medium-term objective or the corresponding adjustment path, and requires the approval of

the Consultative Committee between the federal government and the governments of the Communities and Regions.

40. A watchful eye on the composition of the budgetary adjustment is crucial for maximising synergy with higher growth potential and, hence, lessening the adjustment required. The government's primary expenditure has now risen to 51 % of GDP. Controlling expenditure by improving the quality and efficiency of government intervention at all policy levels will thus be a major task. In addition, choices may be influenced by the contribution that the various types of expenditure make towards promoting growth potential, sustainable development of the economy and the attenuation of social inequality. From this point of view, money spent on encouraging labour participation is very effective, because work does not only support the economy, it also offers the best guarantee against poverty and social exclusion. Moreover, public investment and public spending on research – where Belgium lags behind other countries – must be safeguarded and, if possible, actually stimulated because they benefit growth potential.

41. Since the fiscal pressure is already significant, there is little scope for increasing it further, although every effort must be made to ensure that taxes are duly collected and to prevent tax and benefit fraud. It would actually be appropriate to reduce the particularly high tax on labour incomes, because they are the main reason why labour costs in Belgium are higher than in neighbouring countries, threatening competitiveness, job creation and activity, even in sectors not exposed to foreign competition. That is precisely why, in the Pact for Competitiveness and Employment, the federal government planned three reductions in charges for 2015, 2017 and 2019, each amounting to € 450 million or 0.3 % of the wage bill.

42. Reductions in charges on labour can be financed not only by cutting expenditure but also perhaps by tapping other revenue sources such as indirect taxes, environment taxes, or taxes on property incomes. In line with the analysis conducted by the Bank and the Federal Planning Bureau in 2011 concerning alternative sources of finance for social security, in order to lay the foundations for a tax reform conducive to growth and employment, there is a need for detailed research into the effect of both the various levies and the numerous tax exemptions that companies and individuals can claim. Considered from that angle, the reduction in VAT from April 2014 on private consumption of electricity – also an element of the Pact for Competitiveness and Employment – is atypical. Even though that reduction delays indexation, from a long-term perspective it is advisable to transfer the burden from labour to other levies. Moreover, a broad tax reform should preferably also simplify the tax system, making it easier to combat tax evasion.

43. However, fiscal policy alone cannot carry the whole burden of the adjustment, but needs the support of sufficiently vigorous economic development. In addition, the budgetary choices are not the only lever for dynamising the economy. The low level of potential growth in Belgium, due largely to the meagre contribution from total factor productivity, therefore highlights the urgent need for reforms in many other spheres in order to boost that growth potential and strengthen the basis of social protection.

44. Moreover, in a small, open economy, prosperity is fundamentally dependent on competitiveness. The ability of firms to secure their place in global value chains is an important catalyst in that respect because it gives access to fast growing markets, even for firms that are not directly engaged in exporting or have no presence in those specific markets. Belgium's central location in Europe and the existing port infrastructure are two key advantages here. Moreover, such integration into the global production chains implies that competitiveness is a broad concept that extends beyond the export sector and also concerns all suppliers in the export chain, who quite often operate in the service sector. Furthermore, competitiveness is multipolar. It is naturally connected with costs, but also with the quality of the institutions, the production factors and the goods and services offered. Tackling the existing weaknesses in each of these

areas offers numerous opportunities for generating more growth and employment in the future.

45. As for price and cost competitiveness, Belgium has proved vulnerable in various respects over recent years. First, inflation here has responded more noticeably to commodity price fluctuations than in neighbouring countries. The reform of gas and electricity pricing triggered by the federal government's measures reduces the risk of that happening again; however, the danger has not gone away altogether. In addition, Belgium's production is highly energy-intensive, and that is especially true of its exports. A substantial competitive handicap has also accumulated in regard to labour costs. Excluding wage subsidies, the hourly labour cost gap which has developed since 1996 in relation to the average of the three neighbouring countries stood at 4.8 % in 2013. Productivity has also lagged behind that in the three neighbouring countries, so that the gap in terms of unit labour costs is actually over 12 %. This situation is due to a handicap in relation to Germany, whereas a competitive advantage accrued in relation to the Netherlands between 1996 and 2013. Furthermore, the disparities apparent in that respect between sectors and firms show that wage-setting is insufficiently geared to productivity.

46. The further implementation in 2014 of the wage moderation decided in 2012 and the measures under the Pact for Competitiveness and Employment could result in a gradual narrowing of the wage gap. The government estimates the total impact at 2.96 percentage points by 2019, but a small part of this effort is already reflected in labour cost developments in 2013. It is absolutely essential to maintain control over labour costs in Belgium, as those measures will only have a favourable impact on competitiveness and employment if they are not used as extra scope for increasing gross wages. From that point of view, it is also inadvisable, when determining the wage gap, to deduct service vouchers and wage subsidies aimed at promoting employment in non-market sectors. The impact of subsidies on the wage gap must be assessed by the government in consultation with the social partners. Even though indexation is a source of wage moderation in periods of declining inflation, it may under certain circumstances lead to a further widening of the wage gap and jeopardise the efforts already made. It also reduces the scope available for wage differentiation. Moreover, experience has shown in recent years that indexation makes it harder to eliminate a wage handicap because, in practice, only real negotiated wage increases or measures entailing a budgetary cost provide scope for that purpose, and that scope is also limited. These elements must be taken into account in any cost-benefit analysis of indexation. To keep wage costs more in line with productivity, safeguard competitiveness and promote employment, it is necessary to reflect on wage-setting procedures.

47. In the short term, cost control is vital for smooth integration into the global economy. However, in the longer term, that integration depends on the ability to innovate; businesses therefore bear a significant responsibility. Boosting productivity gains in that way and using product differentiation to secure a place in high-value-added niche markets (which are often less price-sensitive) creates lasting scope for real income growth. The position of its own production segment in the value chain plays a crucial role here. The closer that segment to the end user, the greater the value creation appears to be. Belgium still specialises too little in such segments, making the country more vulnerable in the event of a rise in labour costs or commodity prices. Thus, in recent years, some branches of industry have faced substantial differences in energy commodity costs compared to firms in North America. Moreover, since value creation consists largely of the provision of services – ranging from product development and design to distribution, marketing and sales –, those segments also offer significant growth opportunities, as do creative projects responding to the new needs connected with population ageing or the quest for greater ecological sustainability.

48. To create a dynamic economy it is absolutely vital to invest in R&D. In Belgium, government funding for that type of investment is inadequate, while at corporate level this investment is too heavily concentrated in certain branches of activity, or even in a few companies.

Overall, that investment needs to increase in order to meet the 3 % target set under the Europe 2020 strategy. Furthermore, innovation concentrates primarily on improving production processes or designing variants of existing products, thus focusing too little on genuine inventiveness. There is a need for more networks between producers and research centres, and entrepreneurship has to be encouraged and supported by a modern, efficient public administration. In addition, entrepreneurs need ready access to finance for their new projects, and the support of an efficient, stable system of financial intermediation

49. A dynamic knowledge economy also needs a sufficient supply of high-quality labour. Though the crisis is currently depressing demand for labour, that does not imply a need for less labour in the future – certainly not in view of the progress of ageing. However, for certain risk groups, particularly low-skilled young people, there is a danger that a lengthy period of unemployment may cause them to give up altogether. It is also noticeable that, even today, a number of segments face a labour shortage. Investing in training, support and activation for job-seekers is therefore a priority, and a supplement to the increased responsibility which was the aim of the unemployment benefit reform. For some young people, temporary contracts and agency work are an appropriate route into the labour market, yet care must be taken to ensure that the weakest among them do not end up getting stuck in a protracted series of such contracts. Specific attention also needs to focus on integrating people of foreign origin into the labour market. To prevent any further widening of the gap between insiders and outsiders, the process of organising the labour market and setting wages needs to accord greater importance to enhancing job opportunities for the unemployed, especially for the weakest among them. Their under-employment does not only imply substantial economic costs, it is also a significant source of social exclusion. The quality of education is another crucial factor. In its latest PISA survey, the OECD confirms, for the French Community, the challenge of augmenting the average quality, but it also points to very sizeable divergences in the results for the two large Communities. Social origins are clearly a decisive factor, whereas education should specifically aim at equal opportunities for all. It is vital to offer specific assistance to reduce the number of young people leaving school without sufficient qualifications. In many cases, alternate training schemes, notably through vocational training contracts, ease the passage from school to working life. Society needs to attach more value to technical and vocational training. Harmonising the status of blue-collar and white-collar workers could contribute towards that, and would also benefit job mobility. Facilitating and encouraging worker mobility remains an essential objective. Creation of new businesses and jobs rather than protection of existing ones without potential is the driving force behind economic progress. Lifelong learning must become the norm, so that workers can keep up with rapid technological innovation and adjustments in working processes. The pension reform is a first, essential step in coping with the implications of ageing for the labour supply, but a further extension to working life is necessary.

50. Combining a growth dynamic based on innovation with appropriate wage-setting and an improvement in both the quantity and the quality of the labour supply is the only way to create sufficient jobs to achieve a 6 percentage point increase in the employment rate by 2020 and thus attain the 73.2 % target set by the Europe 2020 strategy. Complementarity is essential : a one-sided focus on just a few spheres of action will not be enough.

The stability of the Belgian financial system

51. Although the crisis in the financial sector brought the pace of long-term growth to an abrupt halt, it still has a very important role to play in fostering the economy's development potential. The restructuring and tightening of regulatory requirements necessary to ensure the financial stability of this sector are therefore accompanied by a wider debate concerning the actual conditions for the conduct of financial activities, with the aim of reconciling business strategies, prudential motivations and society's choices. In Belgium, in view of the dominant role of banks

and insurance companies in financial intermediation, the debate centres mainly on the ways in which these two main categories of institutions raise funds and provide finance.

52. The high savings ratio of Belgian households is a definite advantage for the financial sector. In recent years, individuals have tended to invest in the form of savings deposits exempt from withholding tax. That concentration is one factor increasing the liquidity of credit institutions, but it does have its drawbacks both for the financial system and for other economic agents. The shift towards a single product limits the scope for Belgian banks to diversify their product range in order to face up to the competition from foreign banks that take advantage of the favourable tax status of savings deposits to collect resources in Belgium which may go to fund activities on other markets. It also implies interest rate or liquidity risks which could suddenly materialise in the event of a change in individuals' preferences or in the interest rate structure. Moreover, the preferential tax arrangements for one type of asset create a bias in the mix of financial assets which could affect long-term precautionary savings intended to supplement the statutory pension. The large *bancassurance* groups may internalise part of this discrimination between financial investment categories by reorienting their customers away from life insurance products to savings deposits.

53. The debate is not confined to the savings structure but also concerns the financing of the economy. Banks are currently almost the only providers of mortgage loans for households and credit for the many small and medium-sized enterprises in Belgium. That strong market position secures a regular source of income for Belgian credit institutions. It also offers undeniable advantages in risk management: their good knowledge of the borrowers, often combined with the provision of sound guarantees, explains the low level of losses on this business in the past.

54. However, liquidity constraints exacerbated by the financial crisis are causing banks to prefer assets which can be mobilised quickly. In the case of housing loans, that need can be met by issuing mortgage-backed bank bonds, made possible by the introduction of a specific legal framework in Belgium, while banks can contribute towards financing public authorities without reducing their liquidity since sovereign debt instruments are actively traded on the secondary markets. Conversely, the banks' desire not to tie up their assets is an impediment to long-term financing for businesses. This might be resolved by rebalancing the taxation of income from movable property in favour of long-term savings, or by measures to diversify financial circuits.

55. The total debt ratio of households in Belgium is still below the EU average, although the gap is closing. That overall picture nevertheless conceals very different individual positions. The Bank therefore conducted a more detailed examination of the risks inherent in the banks' loan portfolios, thus anticipating the ECB's general banking sector assessment process.

56. In the case of housing loans, this analysis showed that, within a generally conservative portfolio, there is a significant proportion – varying from one bank to another – of mortgage loans combining multiple high-risk factors. Caution is all the more necessary since the capital buffers calibrated by the banks with reference to a period with no mortgage crisis have proved to be far smaller than those established in most other European countries. The Bank therefore decided to increase the risk-weighting coefficients of the internal models used for mortgage loans.

57. Business loan criteria are harder to standardise but, in contrast, direct comparisons between the risk parameters applied by different lenders are easier in that firms often have relations with more than one bank. The ongoing work at the Bank, based in particular on the new data from the Central Corporate Credit Register, is uncovering sometimes substantial divergences in the calibration of the same risk by different banks.

58. The specific way in which financial resources are collected and allocated in Belgium is one of the factors determining whether financial institutions can record recurrent profits. The business

climate, with weak growth and low interest rates, is another factor which, in addition, encourages fiercer competition and makes it difficult for the large financial institutions to implement their business plans. The Bank keeps a close eye on these individual strategies for adapting to environmental changes because they often have implications for risk-taking. This is no longer the time for major expansion into foreign markets or large-scale extension of the product range; instead, rigorous cost control, more systematic pricing of the services offered and better differentiation in the ranking of debit and credit interest rates are the order of the day.

59. In recent years, the protracted downward trend in interest rates made it easier to adjust, enabling financial institutions to record substantial gains on their securities portfolios. However, that source of income looks likely to dry up, as rates have fallen to an all-time low. While low interest rates favour economic activity and the liquidity management of the financial system, they put pressure on some of the main components of the profitability of banks and insurance companies. Banks now gain hardly anything from the advantage of access to unremunerated sight deposits, while insurance companies have difficulty in garnering the income needed to honour the guaranteed yields for life insurance policy-holders. As a result, some financial institutions feel obliged to seek assets offering higher yields, but also entailing higher risks, and some credit institutions want to enhance their interest rate margin by lengthening maturity transformations. Financial institutions must ensure proper control over these credit and interest rate positions, while the prudential authorities have to verify the criteria applicable to lending or asset acquisition. Those authorities must also check that insurance companies regularly adjust the guaranteed yields for policy-holders in line with market conditions.

60. While risks are inherent in intermediation activity, there is a need to ensure that the banks do not multiply the risks by taking positions on their own account. The crisis demonstrated that the additional income obtained from such operations is extremely volatile and may turn into heavy losses if the markets go into reverse. The government intervention occasioned by those losses prompted a number of countries to embark on structural reform to separate traditional deposit banking activities from riskier investment banking business. The intention is clear, but the practicalities are complex, which accounts for the almost universal delays in actually implementing the reform. If the split is too radical, it will impede recourse to certain instruments for the management of banking risks, or be detrimental to corporate customers wishing to use derivatives to provide cover on favourable terms, or governments wanting to rely on market makers to stimulate the secondary market in their debt. The Belgian legislation has satisfied these aims. On the one hand, additional capital requirements apply once total trading activities exceed a certain threshold. On the other hand, trading for own account is banned in principle, except for a small margin to take account of the grey areas which exist in practice between own-account positions and positions relating to risk management or to the bank's role as an intermediary supporting economic activity.

61. The structural reform has become the emblem of the new banking law, but the latter is much broader in scope. Its primary aim is to transpose into Belgian law the new European Directive on access to the activity of credit institutions and on prudential supervision of credit institutions, known as the Capital Requirements Directive (CRD IV), and the EU Regulation adopting in Community law the new prudential requirements of the Basel Committee, known as the Capital Requirements Regulation (CRR), while taking account of the implications of the creation of the SSM. The banking law also anticipates certain aspects of the Directive on the recovery and resolution of credit institutions. In addition, it aims to reinforce the supervision over credit institutions at the level of their statutory management body, via the structure of their operational organisation, and with the prior approval of the supervisor for any strategic decisions.

62. The progress in the European harmonisation of the financial rules is not confined to banks. In the insurance sector, entry into force of the Solvency II Directive, amending the overall

prudential supervision framework, has been postponed until 1 January 2016 because capital is too sensitive to the methods of valuing assets and liabilities at market prices. However, that has not stopped the implementation of a transitional phase already introducing a number of the directive's provisions on governance, risk management methods, and data transmission obligations. In the sphere of market infrastructures, the new EU Regulation on privately traded derivatives, central counterparties and registers, called the European Market Infrastructure Regulation (EMIR), increases the transparency and security of transactions in these derivatives by establishing central clearing obligations and introducing risk reduction techniques and compulsory transaction reporting. This measure will need to be backed by close supervision of these central counterparties in order to avoid any concentration risk in the event of failure of an institution of that type.

63. These prudential measures under European and Belgian law are gradually completing the major financial law reforms initiated by the Financial Stability Board (FSB) shortly after the outbreak of the crisis and outlined by leading international bodies such as the IMF and the Basel Committee. At the same time, the prudential supervision architecture has also undergone fundamental changes both in Belgium – with the transfer of prudential responsibility to the Bank – and in the euro area, with the major European initiative centralising this function at the ECB.

64. The new Belgian supervision structure was examined in depth in 2013 during the IMF's assessment of the financial sector. The IMF found that considerable progress had been made in the consolidation of the Belgian financial system, reflected in the ability of the large institutions to withstand the economic or financial shock scenarios to which they were subjected by the IMF. The latter also stressed that Belgium achieves a high degree of compliance with good international practices relating to the supervision of banks and insurance companies. It drew attention to the improvement in risk monitoring, which has become more systematic with greater focus on priorities, but also stressed the need for further progress. The IMF issued a series of other recommendations which have been or are being implemented, notably via the new banking law. They concerned the introduction of institutional provisions to establish a coordination structure with the FSMA and to designate macroprudential and resolution authorities, the development of technical expertise in the validation of internal risk management models, the conduct of stress tests and the supervision of conglomerates, and finally, the operational supervision arrangements. The latter need to be consolidated via closer interaction with auditors, regular individual contact with the senior management of the leading financial institutions, and more formalised inspection procedures.

65. Some of these new provisions will need to be adapted following the creation of the SSM. However, they can already be used in current banking supervision, for which the Bank is still responsible, and will continue to apply in the supervision of small institutions for which the national authorities will retain primary responsibility. The competences recently developed also mean that the specific features of the Belgian financial system can be properly reflected in the preparations and operational choices concerning the entry into force of the SSM.

66. During this transitional period, the Bank will need to mobilise substantial resources, plus the support of external experts. It will also retain important functions once prudential supervision has been transferred to the ECB. On the one hand, the supervisors of the home and host countries of the main subsidiaries of large banking groups under the SSM will have a key role to play in the multinational teams supervising those groups. On the other hand, large parts of the prudential supervision, particularly all supervision of insurance companies and the front-line supervision of the large payment and settlement infrastructures based in Belgium, will remain the responsibility of the Belgian authorities.

4. Conclusion

67. The advanced economies must take advantage of the fragile recovery that is emerging, to continue correcting their structural weaknesses, while it is for the monetary and prudential authorities to ensure price stability and financial stability. Only then can the hitherto cyclical upturn be converted into sustainable growth. The crisis has brought a steep rise in public debt ratios everywhere, making it an absolute priority to define clear and credible consolidation paths for the medium term. In addition, work is needed on structural reforms to enhance the economy's growth potential and its ability to adapt.

68. The Belgian economy is also timidly recovering, after coming through the crisis relatively well. Belgium is one of the few euro area countries where activity has already regained its pre-crisis level. In that respect, Belgium is doing better than France, and especially the Netherlands, but not as well as Germany. Nonetheless, the crisis has left its mark on the financial sector, production potential, employment and public finances. Moreover, the picture in terms of the current account and competitiveness indicates fragility. In the past two years, there have been steps to turn the tide. In a zero growth environment, the public deficit was cut from 3.7 % in 2011 to 2.7 % in 2013. Pension and labour market reforms have been launched, and measures have been taken to boost competition in the network industries and improve firms' competitiveness. A new banking law will shape the reform of the financial sector.

69. However, it is vital to continue down this road and intensify the efforts, otherwise the high standard of living and high degree of social protection will inevitably come under strain. There is no scope for losing precious time, certainly not in an environment where other countries are also introducing reforms. The period 2014-2016 must be used for structural consolidation of public finances in a manner conducive to growth, before the costs of ageing become fully apparent. Additional measures are also needed to control those costs. At the same time, the emphasis must be on product and labour market reforms, encouragement for entrepreneurship and the promotion of a stable and efficient system of financial intermediation, both as the route to innovation and productivity, and to ensure commensurate price and wage setting and job creation. That will generate sustainable growth which will ease the burden of fiscal adjustment and, by controlling the dependency ratio between the non-active and the active, will safeguard the basis of social protection. The aim must be to maximise returns in the medium term, rather than focusing on immediate results. The fact that structural measures take time to produce their full effects is no reason for failing to take them ; on the contrary, it should be an incentive for launching them as soon as possible. That will also produce benefits in the form of a speedier restoration of confidence. Consistency between the various spheres of action and – in a federal country such as Belgium – between the various levels of power should be another crucial focus of attention. The challenges facing policy-makers are considerable, but if they are tackled promptly and consistently, they are not insurmountable. The need is greater than ever for a large-scale societal project geared to the future, supported by all elements of society and all levels of power.

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