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

1. The complex interactions between short- and long-term challenges are weighing on the global economy, and especially the economy of the euro area

1. In 2014, as in the previous year, global growth amounted to 3.3 %, which was once again below expectations. The worsening geopolitical tensions in the Middle East and Ukraine were only part of the reason, as they have had little impact so far. Nonetheless, any further escalation would imply considerable risks, mainly via confidence effects and the impact on energy supply. Moreover, repercussions of the rising tensions are already being felt more acutely in a number of countries – many of them European – which have close trade links with Russia and Ukraine. Despite the turmoil, crude oil prices plummeted in 2014, especially in the second half of the year. Other commodity prices were also down. This was due partly to sluggish demand in the global economy, although favourable supply factors also played a role. While there was an increased supply of oil extracted by unconventional means – mainly from reservoir rocks and shale oil – the OPEC countries maintained their production, triggering a very steep fall in oil prices at a time of weak demand. These price falls could provide a boost for the advanced economies, most of which are net energy importers, because they imply a strong improvement in the terms of trade, stimulating disposable income and hence demand. Conversely, they may also complicate the conduct of monetary policy, especially if their influence on inflation extends beyond the direct effect. However, these price falls have an adverse impact on the oil-exporting countries and other emerging economies for which commodity exports are important.

2. The main reason for the mediocre performance of the global economy – which, seven years after the crisis began, is still battling with excess capacity, or in other words under-employment – is less obvious but no less fundamental. Broad swathes of the global economy are still suffering from the repercussions of the crisis, notably in the form of a high debt level. At the same time, there are long-term challenges linked both to the decline in growth potential resulting from slackening productivity and demographic trends, and to climate change. Complex interactions are emerging between these short- and long-term challenges, and in 2014 they continued to leave their mark on economic activity, particularly in the euro area.

* One of the Regents abstained over section 4. Another Regent did not endorse the recommendations put forward in section 4 and in the conclusion.

3. Is the global economy, or part of it, facing secular stagnation ? This expression refers to a situation in which, precisely because of this combination of cyclical and structural factors, the balance between savings and investment can only be achieved if real interest rates are significantly negative. Conventional monetary policy has little scope for implementing such interest rates in view of the existence of a policy rate floor and the low level of inflation. Thus, savings may remain excessive and investment inadequate for a protracted period, threatening to consign the economy to virtually permanent stagnation and under-employment. Furthermore, these surplus savings and the accompanying low interest rates imply substantial risks for financial stability. In recent years, certain trends and developments seem to point towards such a secular stagnation, although it may not be equally severe everywhere. For example, Japan has been suffering stagnation for a long time now, while the euro area is beginning to show some symptoms of it. Yet the question is not only whether stagnation is a fact, but also what can be done to overcome it. That requires a broad policy mix, which must also be adapted to the specific circumstances of the various economies.

4. In the advanced economies, the risk of stagnation appears to be lowest in the United States and the United Kingdom, countries where the recovery has made most progress. The key role played here by the accommodative monetary policy of the Federal Reserve and the Bank of England shows that the limitations of conventional monetary policy – a major premise in the secular stagnation debate – can be overcome by resorting to unconventional instruments. Moreover, the United States in particular has benefited from speedier deleveraging in the private sector and stronger potential growth than in the euro area and Japan, alleviating the need for negative real interest rates despite the sharp cyclical downturn.

5. Meanwhile, monetary policy in the United States has embarked on a gradual normalisation. In October 2014, the Federal Reserve ended its programme of massive purchases of securities, and the expectation is that it might start gradually raising interest rates during 2015. That process should preferably continue to abide by the normalisation principles that the Federal Reserve has already announced, and be accompanied by appropriate communication. That would curb the uncertainty and volatility on the financial markets, since the normalisation process, taking place when other advanced economies are still heading in the opposite direction, is bound to affect the exchange rate configuration and international capital flows.

6. In 2013 and early 2014, a number of emerging economies had already experienced a sudden reversal in capital flows, causing a contraction of activity, even though it often followed a period of overheating, with rising inflation and current account deficits. However, the easing of financial conditions in the second half of the year benefited some countries, while others – especially Venezuela and Russia – came under additional pressure as a result of the slump in oil prices. In the aftermath, the rouble collapsed and both the government and large State enterprises and banks face a refinancing risk in foreign exchange.

7. In China – the world's second largest economy –, growth also flagged slightly in 2014 against a backdrop of a property market correction, risks in the shadow banking sector and uncertainty surrounding local government debt ratios. However, China benefited from the American economic recovery. Thanks to the additional support provided by fiscal policy in the form of investment in social housing and infrastructure, the provision of more abundant liquidity and a central bank interest rate cut, growth there still came to 7.4 %.

8. More fundamentally, it seems that the potential growth of the emerging economies has also declined. That is partly a reflection of a rebalancing in favour of more sustainable growth, as in China, but it also demonstrates that, in many countries, activity has been held back by supply side constraints and a lack of adequate infrastructure. Today, that is a weakness, but at the same time it is an opportunity for tomorrow's global economy. In fact, the continuing integration of emerging economies in Asia, Latin America and Africa, where the population is still growing

and where both the needs and the catching-up potential are huge, will in principle offer great scope for investment capable of mobilising the excess savings of economies with an ageing population and opening up new markets. Of course, this presupposes that the countries with catching-up potential establish a stable and efficient economic and institutional framework which can nourish investment and sustainable growth, and that the international financial system functions efficiently to channel the capital into the most productive projects. This global dimension and the ensuing policy implications are important in the secular stagnation debate, as the balance between savings and investment has to be achieved at global level.

9. In Japan, the policy of quantitative and qualitative easing aimed at ending deflation had to be stepped up at the end of October owing to emerging doubts about the credibility of the increase in inflation expectations towards the 2 % target. That shows the importance of preventing deflation from becoming ensconced in the economy, because this process is quite obviously difficult to reverse. The VAT rise in April triggered another fall in growth, so that a second increase initially planned for 2015 has been postponed to 2017. There is practically zero scope for providing fiscal support for the economy. Conversely, a long-term plan could safeguard the sustainability of public finances, while structural reforms could also boost the particularly low growth potential of the Japanese economy.

10. The economy of the euro area is also caught between the legacy of the past and the challenges of the future. Since the second quarter of 2014, the recovery has lost momentum. Year-on-year growth came to just 0.8 %, and the forecasts had to be revised downwards again. The possibility that growth in the euro area could grind to a halt is currently a serious risk for the global economy.

11. The economic and financial crisis left the private and public sectors with huge debts and also weakened balance sheets in the banking sector. In addition, it highlighted the need for rebalancing and caused a surge in unemployment. Furthermore, the sovereign debt crisis led to marked financial fragmentation along national borders, seriously disrupting the transmission of monetary policy and prompting the banks to tighten their lending criteria, whereas bank intermediation specifically plays a major role in financing the euro area's economy, and more particularly the many SMEs.

12. Today, these factors are still hampering the recovery. In 2014, almost all components of domestic expenditure remained below their 2008 level. Net exports alone made a positive contribution to growth, swelling the current account surplus to more than 2.5 % of GDP. Since the savings ratio was down slightly, private consumption declined by less than disposable income, which was hit mainly by wage moderation, job losses and fiscal austerity during the period 2010-2013. This last factor also depressed public investment, which dipped sharply between 2008 and 2014. After the residential property market bubbles had burst in a number of countries, investment in housing actually fell more steeply, while business investment in 2014 was also almost 10 % below its 2008 level. This situation is attributable to the weak outlook for demand, the continuing low level of capacity utilisation, the high debt ratio of non-financial corporations and the tight credit conditions applied by the banks, although greater recourse to market financing brought some respite for large companies.

13. Nevertheless, a number of positive developments emerged in 2014. It was possible to slow the rate of fiscal consolidation, and employment picked up slightly, even though the unemployment rate still stood at 11.5 % at the end of 2014. In addition, the financial fragmentation moderated. In the wake of the significant narrowing of spreads on government bonds, bank financing costs also improved in the countries hardest hit by the crisis. During the year, their borrowing conditions eased slightly for the first time, and retail interest rates on loans to non-financial corporations are evidently responding again to the downward pressure exerted by monetary policy. For the first time in a long while, most of those countries also returned to

positive growth. The slackening of economic activity that began during 2014 in the core euro area countries shows that the crisis is deeply rooted in the euro area and that there is no easy way of combating it.

2. Policy challenges in the euro area: demand, supply and financing of the economy

14. The contraction of economic activity has persisted for so long that it is creating complex interactions between the cyclical downturn and long-term potential – i.e. between demand today and supply tomorrow – which, without an adequate response, may give rise to stagnation. Thus, the high unemployment and weak investment, though initially cyclical, may impair growth potential since talents are liable to be lost for ever on the labour market and there is insufficient expansion of the capital stock. Following the distortions which emerged in the period preceding the crisis, the erosion of demand was also very marked in certain branches of activity, necessitating a substantial reallocation of resources and a rebalancing of supply. Conversely, a depressed growth potential also has significant implications for current demand. It affects permanent incomes and confidence and therefore drags down consumption and investment. Moreover, it reduces the real equilibrium interest rate, making the problem of the policy rate floor more acute. That problem may be further exacerbated if structural reforms designed to remedy the weakness of growth potential curb demand in the short term and produce deflationary effects. This all shows the need for a comprehensive policy mix, combining a macroeconomic policy aimed at encouraging demand with structural reforms to revitalise supply and a policy that facilitates the financing of the economy. The stimulation of demand and support for supply cannot be substituted for one another, as they are complementary. The euro area must grow and reform simultaneously.

15. Monetary policy clearly has a key role to play in encouraging demand. The substantial under-utilisation of production capacity has in fact led to a sharp fall in inflation, although the downward movement in energy and food prices and, until recently, the exchange rate appreciation have also played a part. Inflation was even slightly negative in December, and if the most volatile components are excluded, core inflation was no more than 0.7 %. In addition, during 2014, inflation expectations were revised downwards in the short and medium term, and – later in the year – even in the long term. An excessively long period of low inflation is now looming, potentially jeopardising the recovery, because the decline in inflation expectations drives up real interest rates, thus reducing consumption and investment. What is more, low inflation hampers the ongoing debt reduction process in the private and public sectors and slows the adjustment of competitive positions between euro area countries. It is therefore not enough to avoid deflation; it is necessary to quickly restore inflation to 2 %, in accordance with the ECB Governing Council's definition of price stability.

16. In order to combat disinflation, the Governing Council cut the key interest rates in June and September. Both the rate on the main refinancing operations and the deposit facility rate, which becomes more relevant in an excess liquidity situation, were reduced by 10 basis points at a time, to 5 and –20 basis points respectively. The key interest rates thus reached their floor. In addition, a series of targeted longer-term refinancing operations (TLTROs) was announced in June, and programmes for the purchase of asset-backed securities (ABSs) and covered bonds were launched in September. These additional measures are intended – each via their own specific channels – to stimulate bank lending to the non-financial private sector because the weak expansion of lending continues to hamper the recovery.

17. At its first monetary policy meeting in 2015, the Governing Council decided to include the above-mentioned purchases of securities issued by the private sector in an expanded asset purchase programme. From March 2015 onwards, bonds issued by euro area central

governments, agencies and European institutions will also be purchased on the secondary market. Combined monthly purchases will amount to € 60 billion. These asset purchases are intended to be carried out at least until September 2016 and in any case until there is evidence of a sustained adjustment in the path of inflation – in line with the target of achieving inflation rates of below, but close to, 2 % over the medium term. This programme will influence not only the yield on the assets purchased but also the price of other assets, via portfolio reallocation, and it will encourage banks to grant more loans, thus permitting a more general easing of financial conditions. What is more, it will play a key signalling role and reinforce the Governing Council's forward guidance indicating that the policy rates will be held at their current low level for quite some time yet. This signal is all the stronger in that the policy of credit easing pursued up to now is supplemented by a significant quantitative component: the size of the central bank's balance sheet is no longer determined by demand for refinancing operations on the part of credit institutions – which is why the balance sheet has contracted considerably in the past eighteen months – but is actively managed by the monetary authority itself via purchases of securities. The size and composition of the balance sheet and its rate of expansion are monetary policy parameters which remain available even when the key interest rates have reached their floor. Furthermore, by explicitly linking use of these parameters to the objective of restoring inflation close to 2 %, they have a bigger impact on inflation expectations.

18. Although the impact on short-term interest rates has been limited – owing to the policy rate floor – this has nevertheless led to a substantial flattening of the yield curve for risk-free debtors. For instance, the yield on ten-year German government bonds dropped to around 0.4 % at the end of January 2015. Moreover, the low interest rate environment has triggered a quest for yield, which has continued to depress the premiums incorporated in riskier financial asset prices. This trend became even more marked at the beginning of 2015 following the announcement of the expanded asset purchase programme. In addition, as the monetary policy stance increasingly diverged from that of other leading advanced economies, the movement in long-term interest rates in the euro area became totally decoupled from that in the United States, and the euro depreciated sharply between May 2014 and January 2015. All these factors could bolster the recovery and support inflation. Against this backdrop, inflation expectations showed the first signs of turning round in January.

19. Owing to the weakness of demand in the economy, fiscal policy also needs to exploit any available scope, especially as that policy becomes more efficient when the key interest rate reaches its floor. Nonetheless, it must be borne in mind that the scope is limited, not only because of the existence of the Stability and Growth Pact and the associated governance, but also because the average debt ratio in the euro area has now already climbed to nearly 95 % of GDP and is even well above 100 % in a number of countries. The Pact must be respected, because – in the specific context of Economic and Monetary Union – it enables the authorities to retain their credibility, not only in the eyes of the financial markets but also for households and businesses. With that in mind, in its assessment of the budget plans for 2015, the European Commission warned that seven countries, including Belgium, France and Italy, risked failing to satisfy the provisions of the Pact, while stating that Germany had considerable scope – approximately 1 % of GDP – for reviving public investment. By concentrating on the structural balances, the Pact also gives free rein to the automatic stabilisers, and interest charges and the primary balance can function as communicating vessels so that the accommodative monetary policy stance facilitates the work of the fiscal authorities in a very direct way. The fiscal policy mix must also be more conducive to growth by lowering charges and shifting them towards tax sources that are less harmful for employment, as well as steering expenditure towards investment. Finally, the European Commission's investment plan may also stimulate economic recovery and national authorities will be encouraged to get involved in it via favourable treatment under the European fiscal framework. Public investment should preferably be based on the existing infrastructure, which is often in need of maintenance and modernisation, while new initiatives could give

priority to continuing to develop the connections between the network industries of the various Member States and reducing greenhouse gas emissions.

20. In the context of a high debt ratio in both the public and the private sector, progressive population ageing, slow productivity growth, and the risk of higher structural unemployment, there is also a need for reforms to strengthen the supply side of the economy. Those reforms will enhance the effectiveness of the support for demand, because an improvement in future prospects will shorten the deleveraging process, create more scope for expenditure by households, businesses and governments, and encourage investment. Moreover, these reforms will ensure that demand is channelled towards the right sectors, and the emphasis on the quality of the labour supply and on activation will enable employment to respond more promptly to rising demand. In addition, resolute commitment to structural reforms could lessen the uncertainty about the future, encouraging a decline in precautionary savings.

21. It is in the countries hardest hit by the crisis that reforms have made the most progress. That process is beginning to yield results, as those countries are returning to economic growth. Nonetheless, in strongly focusing on bringing about internal devaluation, those reforms have curbed demand in the short term. By reforming the labour and product markets too, and trying to boost productivity by innovation rather than relying solely on cost reductions, the structural reforms will be more expansionary. If such reforms are also implemented in the core euro area countries which are trailing behind in that respect, that will not only amplify their impact but will also create more markets for the countries which have already carried out reforms, so that they can valorise their improved competitiveness. Such a global, more balanced approach will also secure broader support in society.

22. The rebalancing of financial positions is another important aspect of the structural adjustments needed to develop growth potential in Europe. The crisis has shown how the economic agents can cause derailments by excessive borrowing, and what damage the financial institutions themselves can cause by following suit and exploiting loopholes in the regulations to make excessive use of leveraging. In recent years, governments have endeavoured to prevent the excesses by massive reform programmes, but they also need to ensure that the return to an over-cautious approach does not cause obstructions for both borrowers and financial intermediaries, preventing credit from playing its full part in the economic recovery.

23. Setting up the banking union will be a cornerstone of this restoration of confidence. By conducting a full appraisal – the comprehensive assessment (CA) – of the quality of assets held by banks and their ability to absorb economic and financial shocks, the ECB intended to ensure that the single supervisory mechanism (SSM) for which it is responsible could start on a sound basis. In addition to the lessons that the assessment yielded for individual countries and institutions, the general conclusions were well received. By further clarifying provisioning policies and procedures for the restructuring or repeated renewal of loans, the asset review should improve the allocation of financial resources in the euro area via its positive influence on lending practices and the monitoring of bank loans. The stress test results were in line with expectations, especially as many banks had anticipated the conclusion of the CA and increased their capital in the initial months of 2014. The markets also appreciated the ECB's transparent and exhaustive approach to publishing the data. This communication effort concerned not only the results but also the specific recovery measures to be taken by institutions failing to meet the required minimum standards.

24. The standardisation of national rules and practices and the alignment with best supervisory practice need to be combined as effectively as possible with the intimate knowledge of banks that the national supervisory authorities have built up via their close contact with individual institutions. To that end, two major coordination structures have been set up. On the one hand, each of the 130 banks subject to direct ECB supervision is monitored by a joint supervisory team

directed by an ECB coordinator and comprising staff from the ECB and the national authorities. Also, a number of transverse functions concerning such matters as licensing, the organisation of on-site inspections, examination of internal models, supervision policies and the development of methodology, will each be discussed separately by networks of national experts in order to pool experience and define more precisely the procedures to be applied.

25. Creation of the SSM is inconceivable without a unified structure for resolving bank crises, otherwise there is a risk that taxpayers in one country alone would be saddled with the consequences of decisions which will from now on be taken at supranational level. That is precisely the rationale for the other two elements of the banking union, one of which – the introduction of a common deposit guarantee system – is still only at the stage of harmonising national systems, while the other – the establishment of a single resolution mechanism (SRM) – formed the subject of an EU Regulation dated 15 July 2014. This new mechanism is based on a resolution board responsible for adopting resolution plans and schemes for all banks subject to direct ECB supervision, and a resolution fund consisting of contributions from the banks via national compartments which will be gradually pooled. In compliance with this Regulation's requirement for each Member State to set up a national resolution authority, a new body, the Resolution College, was established under the NBB's Organic Law. That body, chaired by the Governor, is responsible for carrying out this new task.

26. The establishment of the banking union does not cover all financial intermediation activities. Indeed, the predominance of the banks in Europe is often seen as one of the structural handicaps facing the EU, in comparison with other economies, especially that of the United States, which make much greater use of the stock markets to diversify the options for borrowing and attracting savings. The European Commission therefore wants to launch a project for unifying the capital markets, thus confirming that the many harmonisation measures which it has already introduced in the context of the Single Market have not been enough to develop a genuine alternative to bank funding. The financial centres of Europe remain divided by many discrepancies, not only with regard to market regulations but more broadly in accounting standards, audit assignments, bankruptcy law, taxes on income from movable property, and the processes for the operation and supervision of financial infrastructures. In a sector less clearly defined than banking, it will be necessary to reconcile the efficiency gains offered by more fluid markets with the need to prevent the development of activities or the emergence of intermediaries whose sole purpose is to circumvent the prudential regulations.

27. Although the downbeat economic environment requires an accommodative monetary policy, the very low nominal interest rates could give rise to renewed excesses on the financial markets and depress the profits of financial firms. To maintain their profitability, those firms may be tempted to seek the extra yields offered by poorer quality assets. Central banks thus face the challenge of trying to stimulate economic risk-taking while ensuring that the financial risks do not become excessive. This context has led the authorities to extend their range of instruments by implementing a macroprudential policy. This means that monetary policy can focus on its primary objective – the maintenance of price stability – which also primarily has positive spillover effects on financial stability, while macroprudential policy can curb the side effects of the accommodative monetary policy and the accompanying potential risks.

28. The development of this new policy, long confined to the conceptual stage, recently entered an operational phase. Many euro area countries have lately introduced macroprudential measures, either to reduce the danger of excessive credit expansion in certain specific sectors such as property, or to protect against a strong concentration of risks relating, in particular, to the presence of a few very large operators who have acquired a systemic position on the markets. This targeted use of macroprudential policy also has the advantage of being able to focus on potential sources of instability.

29. Macroprudential policy remains closely linked to microprudential policy, with which it shares a large proportion of its means of action. Moreover, circumscribed use of macroprudential measures usually involves a concept of geographical coverage which will have to be reconciled with the desire to preserve and develop what the EU has achieved in the banking union and the Single European Market. The existence of these various interdependencies may explain – though it cannot justify – the current complexity of the European rules on the implementation of macroprudential policy. The Bank, which – pursuant to the Law of 25 April 2014 – is responsible for conducting this new policy in Belgium, has had to conform to these provisions in introducing its first two macroprudential measures concerning mortgage loans and trading activities. The EU arrangements, which not only list the types of instruments that can be used but also specify detailed notification and authorisation procedures, absolutely have to be simplified to ensure effective coordination in the conduct of this new policy between the ECB, the national macroprudential structures and the European authorities.

3. The Belgian economy in 2014 : hesitant recovery, falling inflation and low interest rates

30. In Belgium, the economy grew by 1 % in 2014, outpacing growth in the previous two years. Nonetheless, as in the euro area, growth faltered during the year. Employment was up by 15 000 units, providing support for disposable income and private consumption which grew by around 1 %. That said, job creation was not enough to offset the expansion of the labour force. The unemployment rate thus climbed to 8.6 %. Investment in housing and business investment also returned to positive growth, but remained below their pre-crisis levels. Non-financial corporations are still not inclined to embark on major investment projects, as is also evident from the fact that they want to take on fewer new commitments and their liquidity buffer remains very substantial. The negative contribution of stock-building to growth is likewise a sign of the doubts surrounding the sustainability of the recovery. The weakening of demand on foreign markets during the year and the associated flagging of exports are certainly factors here.

31. Inflation continued to fall, dropping from 1.2 % in 2013 to 0.5 % in 2014. At the end of the year, it was actually negative. That situation is due to the movement in prices of food and particularly energy – taking account of the slump in crude oil prices and the reduction in VAT on electricity – whereas core inflation, at 1.5 %, remained almost as high as in 2013. In fact, the wage increases during the period 2012-2013 take some time to be reflected in prices, and for a range of services it is still common practice to index link prices on the basis of past (high) inflation. In 2014, however, the rise in hourly labour costs in the private sector slowed down sharply, declining to 0.7 % after successive increases of 3.2 and 2.4 % in 2012 and 2013. The lower inflation caused a significant reduction in the indexation component, while as a result of the wage freeze there were no negotiated pay increases in excess of the index, and the wage drift remained very modest on a rather sluggish labour market.

32. The low interest rate environment had a major influence on the consumption and saving patterns of the various economic agents and on their financial transactions and their wealth. The effect nevertheless varies according to whether they have net financial assets or net liabilities. Moreover, the composition of the assets and liabilities also plays a role. At the end of September 2014, the Belgian economy as a whole had net financial assets equivalent to 35 % of GDP. That reflects substantial net assets for households – amounting to 225 % of GDP – whereas businesses and the government have net liabilities.

33. In recent years, the decline in interest rates has therefore eroded households' capital income. However, since much of that income is traditionally saved, the impact on private consumption has been smaller. In fact, in parallel with the reduction in income from property, the overall savings ratio has fallen. The fact that lower interest rates discourage savings and generate a

positive wealth effect may also have favoured that decline. In the past five years, the increase in the net wealth of households may in fact be partly attributable to higher valuations of both financial assets and property, driven partly by the fall in interest rates. During 2014, households put some of their new investment into riskier assets in order to maintain their yield. In view of the persistently high uncertainty, however, they still hold a large proportion of their savings in short-term liquid assets, despite the very low level of short-term interest rates, particularly for savings deposits. The fall in mortgage interest rates has enabled some households to refinance their existing mortgage loans on more attractive terms. This was also one of the factors behind the albeit hesitant revival of investment in housing.

34. In contrast to households, non-financial corporations have substantial net financial liabilities, so that the lower interest rates reduce their borrowing costs and thus bolster the economy. In 2014, it was mainly long-term bank credit interest rates and corporate bond yields that continued to decline. For large Belgian companies with a good credit rating, the issuance of corporate bonds and listed shares was once again an attractive alternative to bank finance in 2014; at the same time, the availability of credit from the banks also improved, even for SMEs. The low interest rate environment poses significant challenges for financial institutions and for the stability of the financial system, challenges that will be examined below.

35. Faced with a gross debt ratio of more than 106 % of GDP in 2014, the government saw its interest charges diminish as a result of the fall in interest rates. During 2014, interest rates on short-term securities issued by the Belgian Treasury actually became slightly negative, while the ten-year rate dropped to around 0.6 % in January 2015. Compared to 2008, interest charges on the public debt were thus already down by 0.7 % of GDP, and a further fall is in the offing for the coming years. The full impact is in fact not expected until the whole of the debt financed at higher interest rates has reached maturity. This will bring into play a key stabilising factor for the sustainability of public finances, helping to buffer the impact on the debt ratio of both a cyclical deterioration and any possible disinflation. This last factor could be felt even more keenly in Belgium in the years ahead owing to wage moderation.

36. Despite the further decline in interest charges, the public deficit continued to grow, rising from 2.9 % of GDP in 2013 to 3.2 %. The process of fiscal consolidation which began at the end of 2011 and improved the structural balance by almost 1 percentage point during 2012-2013 was interrupted in 2014, an election year. In addition, the fiscal effort for the whole period 2011-2014 remained very modest compared to that of the euro area. In fact, under the Stability and Growth Pact, Belgium opted for a gradual process of fiscal consolidation which, except for the second half of 2011, has so far continued to benefit from the financial markets' confidence. Conversely, many other euro area countries have been obliged to frontload the effort, making their fiscal policy highly pro-cyclical, just at a time when financial fragmentation also excluded them from the easing of monetary policy. The fact that this has enabled Belgium to introduce a less restrictive macroeconomic policy mix is part of the reason why the Belgian economy has withstood the crisis better up to now.

37. All the same, the Belgian economy faces some major challenges, particularly in relation to progressive globalisation and population ageing. For example, by reducing the labour supply, this latter factor has significant implications for future growth potential as well as entailing substantial budgetary costs. The Study Committee on Ageing estimates the costs at almost 6 % of GDP by 2040, and the European Ageing Working Group whose projections are based on different assumptions predicts an even bigger rise in expenditure. Such challenges require strategic responses. Safeguarding the sustainability of public finances is part of that, and the gradual approach in recent years implies that much of the effort has yet to be made. In addition, the particularly low employment rate – only two in three people of working age have a job – needs to be addressed urgently. Finally, a third priority lies in raising the growth potential and productivity of the Belgian economy via innovation and competitiveness. There

are close interactions between these various spheres. The high level of public spending which, leaving aside interest charges, amounted to over 51 % of GDP in 2014, is accompanied by severe fiscal and parafiscal pressure that, besides, has a disproportionate impact on the factor labour, hampering the economy's capacity to generate employment. Moreover, some of that expenditure discourages participation in the labour market, or even rewards early departure. The inability to create sufficient jobs and growth – primarily in the private sector – undermines the economic basis necessary for maintaining a high degree of social protection and a wide range of public services, though both these factors are among society's choices. If nothing is done, that interdependence could lead to an untenable situation. Conversely, resolute action in each of the spheres mentioned could trigger a self-perpetuating positive spiral giving rise to sustainable growth, job creation in the private sector, and sound public finances, thus opening the way to a high standard of living and safeguarding the Belgian social model.

4. Sustainable growth, job creation and sound public finances lay the basis for a high standard of living and safeguard the Belgian social model

38. In the previous legislature, the government had already tackled the structural weaknesses of the Belgian economy. It embarked on fiscal consolidation, implemented reforms of pensions and the labour market, and adopted measures to boost competition in the network industries and to make firms more competitive. The new federal government – which won the confidence of Parliament in October 2014 – and the governments of the Communities and Regions are planning further steps in that direction.

39. Pension reform again holds a central position. The statutory retirement age will be raised to 66 years in 2025 and to 67 years in 2030. The rules on early retirement are also being further tightened, as is necessary to continue rapidly narrowing the gap between the statutory pensionable age and the actual retirement age. In addition, a points system will be introduced for calculating pensions, greater account will be taken of the proportion of periods worked, and civil service pensions will be brought into line with the system in the private sector. The specific implementing provisions have yet to be determined, following consultation in the forthcoming National Pensions Advisory Committee. Here, it is a question of ensuring that an adequate pension package and access to health care can be guaranteed. Extending working life is a structural reform that has a favourable impact not only in the long term but also in the short term.

40. In the long term, it helps to maintain the labour supply, supporting potential growth. However, for this reform to be as effective as possible, attention must also focus on remuneration, and firms must attend to the conditions for extending working life. In fact, in some cases remuneration increases with seniority, but without reflecting a proportionate increase in productivity. Working arrangements are not adequately geared to retaining older workers. If the reform is to succeed, it is therefore crucial to give some thought to the productivity, employability and specific job characteristics of older workers. In this respect, the social partners have a vital role to play because, thanks to their practical knowledge, they are well placed to define the qualitative content for the necessary extension of working life and to enhance its efficiency from both the economic and the social point of view.

41. Since it also reduces the budgetary costs of ageing, a longer working life can also offer some breathing space for fiscal policy in the short term. The high level of ageing costs is in fact the reason why, according to the European budget framework, Belgium needs to aim at an ambitious medium-term objective – namely a structural surplus of 0.75 % of GDP. Although it is still too soon to calculate precisely the impact of the pension reform on the budgetary costs of ageing, and hence to examine its implications for the medium-term objective, it will

nevertheless have a beneficial influence on the sustainability of public finances. Moreover, greater clarity over the exact content of the reform will eliminate a factor of uncertainty for households, which could therefore reduce their savings for old age.

42. Jobs and competitiveness are a second weakness of the Belgian economy. There is an urgent need to create more jobs in the market sector because, since 2000, much of the net job creation has been outside that sector and has been funded mainly by the government. In this area, too, there have been new moves in the right direction, but the challenge is so great that every lever must be used.

43. In a small, open economy like Belgium, in order to stimulate demand for labour, it would be appropriate to continue the policy of wage restraint. To that end, wage indexation has been temporarily suspended via the "index jump", and pay rises in excess of indexation will continue to be moderated during the period 2015-2016, unless competitiveness in relation to the three neighbouring countries is restored in the meantime. According to estimates based on the Bank's macroeconomic models, which assume a proportionate impact on prices, the index jump could boost employment in the private sector from 2016 onwards and benefit economic growth from 2017. That effect would be further reinforced in subsequent years since the initial negative impact on domestic demand will be increasingly offset by the favourable effects of competitiveness gains and job creation. However, in this respect it is assumed that the wage moderation resulting from the index jump will not be counterbalanced by higher pay rises excluding indexation. Moreover, the reductions in charges under the Competitiveness and Employment Pact for 2015 and 2017 respectively will be implemented in 2016. While the one planned for 2017 will be brought in early, the 2015 reduction will be postponed for a year, as the government has opted to raise the allowance for flat-rate professional expenses straightaway in 2015 and to allocate a budget to lessen the impact of the index jump on the purchasing power of the lowest incomes. It has also been announced that employers' contributions are to be cut to 25 % by the end of the legislature.

44. According to the Central Economic Council's technical report, the hourly labour cost gap which has developed since 1996 in relation to the average in the three neighbouring countries stood at 4.2 % in 2013, excluding the impact of wage subsidies and the movement in productivity. This situation is due to a serious wage handicap in relation to Germany, whereas the movement in hourly labour costs in Belgium has been more moderate than in the Netherlands and France. In 2014, the gap narrowed for the first time since 2010, contracting to 2.9 %. That was the result of wage moderation in Belgium and the return to bigger pay rises in Germany. Nonetheless, the problem of labour costs as a barrier to job creation has not been resolved, as the level of labour costs in Belgium is still among the highest in the EU, mainly but not solely on account of the heavy burden of labour charges. Undoubtedly, the high labour costs correspond largely to the remuneration of a high level of productivity. However, the fact that hourly labour costs in Belgium have risen faster than in the three neighbouring countries since 1996 is certainly not attributable to stronger productivity growth. Quite the contrary : the cumulative wage gap per unit of output since 1996 is even larger, around 10 %, once again owing to a wide discrepancy in relation to Germany. High labour costs force less productive workers out of the market, primarily penalising low-skilled workers and that is one of the reasons for the extremely low employment rate of certain risk groups.

45. By the end of the wage freeze, it is necessary to ascertain how wage-setting can best be aligned with productivity, to maximise the benefits for job creation. The revision of the Law of 26 July 1996 on the Promotion of Employment and the Preventive Safeguarding of Competitiveness, announced by the government, offers the opportunity for that. Together with the social partners, a new balance must be achieved between the advantages of coordinating wage-setting at macroeconomic level and the need for greater differentiation according to

developments specific to the various sectors and firms. Furthermore, the productivity of the Belgian economy can be reinforced by putting more emphasis on training and innovation.

46. Since the level of labour costs is also determined to a large extent by the heavy charges on labour, appropriate wage-setting – important though it is – cannot resolve all the problems. There is therefore a need to reduce labour charges by turning to other revenue sources that are less detrimental to job creation, i.e. to implement what is known as a "tax shift". The government agreement already makes provision for such a shift, up to a certain point. The reductions in charges in 2015 and 2016 have in fact already been partly funded by an increase in certain indirect taxes and certain capital levies. However, there is still some available scope for proceeding further down this route. Excise duties and environmental taxes – especially energy taxes – are quite clearly lower in Belgium than in other European countries. The standard rate of VAT is close to the European average, but the application of reduced rates for a significant part of the consumption basket needs to be reviewed. These levies can be used not only to reduce the burden on labour but also to steer consumption patterns towards greater sustainability. Attention should also focus on a shift in levies towards property incomes, capital gains or wealth itself, and on how to increase the standardisation of taxes on the various wealth components. The tax shift is justified from the economic perspective, as is also borne out by the recommendations of national and international organisations alike.

47. A shift in charges could also push up net wages, thus stimulating not only demand for labour but also the labour supply. That is precisely the effect intended by the higher allowance for flat-rate professional expenses. It is proportionately larger for low-income earners who are precisely the ones most affected by the problem of unemployment/inactivity traps. In addition, making unemployment benefits more degressive and encouraging mobility further reinforces the incentives to work. Effective assistance for the unemployed in their search for a job is another way of encouraging activation. The government has decided to develop a community service scheme for the long-term unemployed. Care must be taken to ensure that reforms to the unemployment system do not lead to any less assistance to job-seekers.

48. Certain risk groups merit particular attention, as they evidently have great difficulty in gaining access to the labour market. Not only does under-employment of the most vulnerable section of the population entail considerable economic costs, it is also a cause of poverty and social exclusion. There is a need for an inclusive approach and measures to combat all forms of negative discrimination. Above all, the focus must be on training, guidance and easing the transition from school to work. Greater availability of traineeships in firms could make a contribution here. In this respect, targeted reductions in labour costs could also be an appropriate policy instrument. The sixth State reform transferred many of the political levers in this sphere to the Regions, enabling them to conduct a consistent policy and respond to the specific needs of their own area. At the same time, those bodies need to work closely with one another to remove the barriers to labour mobility between the Regions. In Belgium, there are actually wider variations in unemployment between the three Regions than within each Region. The Brussels Capital Region, where over 19 % of the labour force is unemployed, has the most to gain from that. Finally, it is also necessary to ensure that those in work maintain their employability. Life-long learning must enable workers to adapt to rapid technological innovations and adjustments to the work process.

49. Restoration of Belgium's competitiveness will also boost growth potential, since it will enable firms to slot readily into global value added chains. Not only will these firms thus be able to tap fast-growing markets, even if they are not directly active there, but they will also gain access to the most efficient and innovative production techniques. This could be a valuable catalyst for accelerating the growth of total factor productivity (TFP). That growth is weak in Belgium, and has slowed further in recent years, whereas in the long term it is the main source of wealth

creation. In view of the importance of TFP, the Bank devoted a conference to the subject in the autumn of 2014.

50. TFP growth benefits first of all from innovation, hence the importance of investing in R&D, especially for industry. Such investment is low in Belgium, particularly on the part of the government, and is also heavily concentrated on a few branches of activity. But innovation is a broader concept which is also linked to the organisation of businesses, management, marketing and the rapid integration of new techniques – primarily concerning ICT – into existing processes so as to create spillover and multiplier effects. Moreover, at macroeconomic level, TFP growth benefits from the ease of reallocating resources from less productive to more productive firms. This means that new companies can be established quickly, but it also means that activities which perform less well and lack future potential can be readily closed down. This reallocation process can be supported both by the elimination of administrative, legal and fiscal hurdles and by a smoothly operating labour market and efficient financial intermediation. Finally, the quality of the production factors – both labour and capital – is a vital engine of TFP growth. Labour skills and life-long learning are therefore crucial factors here, too. For their part, investment maintains the quality of the capital stock in facilitating the integration of the most innovative technologies. Furthermore, it is in Belgium's interests to attract foreign investment, as that is a powerful vehicle for disseminating technical and organisational innovations and can strengthen entrepreneurship.

51. More competitive market structures also stimulate TFP growth by encouraging efficiency gains. Consequently, there is a need for new product market reforms, particularly in the network industries and in the service sectors which are still protected. These reforms will boost cost competitiveness, not only by their impact on productivity but also by reducing prices. In addition, competitive markets encourage the transmission of wage moderation to sales prices and prevent the expansion of margins, thus accentuating the effect on growth and employment. Potential growth and TFP also benefit from an efficient infrastructure. Both the risk of a black-out which became apparent in 2014 and the extent of the country's transport problems similarly illustrate the scale of the challenges here. Economic efficiency must be reconciled with ecological considerations in the search for solutions. There is also a need to consider the relative contributions of the private and public sectors. In order to mobilise private investment in projects requiring large amounts of capital and extending over a very long period, it is essential to have a stable and predictable legal framework.

52. Fiscal consolidation conducive to growth must be the final piece in the strategy for meeting the challenges that face the Belgian economy. To that end, in its draft budget plan, the federal government mapped out a path towards structural balance in 2018, which is two years later than under the plan defined by the previous administration in April 2014, though that plan was only tentative. Since Belgium is strongly committed to structural reforms and the restoration of competitiveness, and since each of those factors also benefits the sustainability of public finances in the medium term, there is in principle some scope for a more gradual approach which may also support the economy's recovery. All the same, it is necessary to ensure that the structural efforts conform to the European framework and that they are then implemented in full. In its assessment of the draft budget plan, the European Commission warned that the path might not correspond to the requirements of the Stability and Growth Pact. It will review the situation in March 2015, in the light of the actual implementation of the budget and the structural reforms which have been announced. Any necessary adjustments will have to be made.

53. The restoration of a sound budget must be based primarily on judicious control of expenditure, as new taxes need to be used as a priority to permit a reduction in the levies on labour. Nonetheless, it is necessary to strive for the proper collection of taxes and to combat tax avoidance, tax evasion and social security fraud. Close international collaboration and an

assiduous exchange of data are recommended in that regard, as well as coordination on a European scale. The draft budget plan places the emphasis on pruning expenditure, and this also applies to the contribution of the Communities and Regions towards consolidation. That course must be maintained. However, on the expenditure side, there is also scope for shifts and greater prioritisation, in order to provide better support for growth. From that perspective, the first thing to be done is to invest in infrastructure, training and sustainable development, but the attenuation of extreme social inequalities could also help to boost economic growth. An OECD survey in fact shows that marked inequality – particularly at the lower end of the income scale – is detrimental to growth because it compromises investment in training for the most vulnerable section of the population. Efforts to enhance the efficiency of public services and to steer the consumption of those services more effectively by using price signals more frequently can create the scope necessary for such shifts without further increasing the already particularly large size of the public sector.

5. The stability of the Belgian financial system

54. Taking stock of the state of affairs in the European banking sector under the comprehensive assessment (CA) was seen as vital for the successful launch of the SSM, but that assessment based on an asset quality review and stress tests can also serve as a guide for the future action plans of both individual firms and the prudential authorities. In Belgium, six banks were directly involved in the CA, namely Argenta, AXA Bank Europe, Bank of New York Mellon, Belfius, Dexia and KBC Group, while a number of subsidiaries of foreign groups, including in particular BNP Paribas Fortis and ING Belgium, were assessed via their parent company.

55. The asset quality review confirmed that the accounting practices of the Belgian banks were generally prudent and in line with international standards, as was evident in particular from the adequate credit risk provisions. An initial stress test showed that these banks could withstand a baseline scenario combining the very weak growth expected in Europe in the coming years with the gradual introduction of the stricter solvency rules laid down by the Basel Committee, as the banks remain well above the minimum 8 % core capital (common equity Tier 1) set by the CA methodology. The second test, based on a much tougher scenario involving a downturn in growth, rising unemployment, a widespread increase in interest rates and a sudden slump in property prices, produced more variable results. Four of the banks were still well above the required minimum of 5.5 % of CET1, but AXA Bank Europe and Dexia failed to meet that requirement. However, a capital contribution from the parent company enabled AXA Bank Europe to fulfil the stipulations, while Dexia is a special case since the bank is being dismantled and is backed by a State guarantee. The ECB took these characteristics into account, and concluded that the results for that institution did not cast doubt on the plan approved by the EC, so that it did not stipulate additional measures.

56. Of course, for a prospective analysis, it is necessary to go beyond these global data and refer to the more detailed CA results, while avoiding the traps of aggregation and shortcuts in comparisons between banks, especially as, for these tests, each participating country continued to apply national waivers still permitted by the European prudential rules. In the case of Belgium, one of the first lessons of the tests is that the burdens of the past, whether they are due to risky strategic choices or the acquisition of overvalued assets, are still denting the banks' profitability and are probably the main reason for the variations between individual outcomes. However, despite these divergent positions, most Belgian banks are adopting fairly similar approaches, trying to focus on their traditional activities and their domestic market which they understand the best, by exploiting the structural characteristics of the national economy.

57. These characteristics include the substantial investments that Belgian households have accumulated. Since financial intermediaries compete fiercely to attract these savings, the market

is very sensitive to the smallest differences in yields, including those due to distortions resulting from the system of taxes on income from movable property. That differentiation factor is one of the key determinants of the recent trend in the two main categories of financial assets held by households : savings deposits and insurance products. Not only are savings deposits covered up to € 100 000 by the deposit guarantee system, the income on them is exempt from the withholding tax with full discharge up to a maximum limit the constraining effect of which declines as interest rates fall. Conversely, even though premium payments for life insurance contracts are tax deductible under certain conditions, the increase in the tax on these premiums to 2 % in 2013 is all the more disadvantageous for that type of product because the current low level of interest rates increases the penalising effect of this tax on payment of the premium. This tax wedge interferes with the business models of Belgian financial intermediaries. On the one hand, it encourages banks to concentrate their liabilities on a single product which can, furthermore, be readily marketed by foreign banks taking advantage of the preferential tax status of savings deposits to collect resources in Belgium for the purpose of funding activities on other markets. It also impedes expansion of the "life" business of insurance companies, whose profitability is therefore based increasingly on the development of non-life business. Harmonisation of the tax on movable assets could neutralise these effects on the structure of the markets.

58. To some extent, Belgian financial institutions have internalised the competition between banking and life insurance products by creating bancassurance groups which make optimum use of the retail networks. However, this model is not used very much in the new SSM, and the CA stress tests showed that the ECB is keeping a close eye on compliance with the solvency standards applicable to these conglomerates. Moreover, this combination of activities does not prevent competition either from foreign players or from direct intermediation via the issuance of securities, a strategy adopted by a growing number of Belgian firms under current market conditions.

59. For Belgian financial institutions, the way in which household deposits are used is a key issue, especially as these funds exceed the borrowing needs of resident firms. Belgian banks have long used this surplus primarily for subscribing to Belgian government loans, which has enabled them to constitute a large buffer of liquid assets. During the years preceding the crisis, they also used these resources to fund the development of foreign activities. At the time, that expansion ultimately created financing needs far in excess of the surpluses collected in Belgium, so that the Belgian banks had become very dependent on the international interbank markets.

60. When the banks refocused on their domestic market, that did remedy the problem but it also raises the question of finding a use for these funds which offers an attractive return for an appropriate risk, in a context in which low interest rates mean fiercer rivalry on all financial markets. The quality of the banks' assets was examined in depth during the CA, not only in terms of asset valuation but also in the stress tests for credit risks and market risks. These analyses confirmed that the main vulnerabilities were connected with portfolios of loans and securities abroad, particularly in certain countries where the debtors' position deteriorated, such as Ireland and Hungary.

61. Conversely, the more traditional loans to Belgian firms and households currently feature modest default rates, reflecting the banks' good knowledge of this market plus the provision of sound collateral in many cases. However, the low level of past losses is no guarantee for the future, as is evident from the example of a number of euro area countries which have suffered a property crisis in recent years. In conducting the stress tests, the ECB wanted to take account of such an eventuality by supposing a 25 % cumulative fall in house prices over three years in Belgium, which would trigger a sharp rise in default rates. The Belgian banks stood up well to that scenario, one of the toughest applied to the various countries taking part in the tests, and totally out of scale with anything that has happened in the past, even in the periods of severe

tension on the property market. This extreme assumption has not been borne out by the latest developments, which show prices stabilising. Nonetheless, the Bank continues to monitor the consequences of a possible property price correction, and that has prompted it to increase the risk weighting coefficients of the internal models that the banks use to manage their mortgage loan portfolios.

62. The banks have adjusted their new lending conditions to take account of these stricter regulatory requirements, but those conditions also reflect the decline in interest rates which, over recent months, has led a very large number of borrowers to apply for refinancing. This last factor will diminish the profitability of mortgage loans, especially as expansion of the loan volume has slowed considerably, despite a very short-lived surge at the end of the year when many prospective buyers tried to pre-empt the Flemish government's decision to cut the maximum tax relief under the housing bonus from the beginning of 2015.

63. Up to now, the adverse effect of the level of rates on the banks' interest income has been offset by the positive impact of the interest rate movement, as the continuing decline has generated capital gains. But this source of income is set to dry up as rates have fallen to a historical low. From now on, banks will feel the full force of the loss of the advantage offered by the availability of unremunerated sight deposits, with no offsetting effect. Insurance companies will also come under pressure, because market rates have dropped well below the guaranteed yields on many life insurance contracts dating from previous years. True, in the short term, they may escape that constraint thanks to capital gains made on portfolio securities and to yields still being received on the oldest bonds acquired in years when interest rates were much higher. But it is vital that they take advantage of this breathing space to adopt a preventive strategy, by allocating most of their capital gains to covering their contractual obligations, preferably for the payment of dividends or profit shares, and by adjusting the guaranteed rates to the new market conditions from now on. The prudential authorities could make a contribution here by lowering the legal maximums currently in force for these guaranteed yields.

64. In view of the severe constraints on intermediation activities, financial institutions need to explore various ways of developing a model which can ensure their lasting profitability. The first option is to reduce operating expenses, if appropriate via consolidation, because the cost structure still bears the hallmarks of the arrangements set up for the purpose of the previous expansion strategies. A second approach is to adapt the characteristics of existing products, by maintaining realistic margins between debit and credit interest rates, by more systematic charges for the services offered, more in line with the true cost of the business, or – in the case of insurance companies – by transferring certain risks to the policy-holders by using contracts under which the returns are linked to investment fund yields. In the more specific case of financial market infrastructures, it would be better for the activities to be remunerated directly via fee payments, rather than indirectly in the form of interest income obtained by investing the deposits of users of these infrastructures.

65. The banks also generate non-interest income in addition to the intermediation margin. Its proportion of banking income has contracted recently, down from more than 50 % in 2006 to around 30 % in 2014. That income has two very different components, namely the results of trading activities and fee income. The crisis revealed that the additional income from own account market transactions was highly volatile and that it could rapidly turn into heavy losses. That danger led the Belgian authorities to introduce a structural measure to prohibit the principle of own-account trading by banks, while – subject to certain conditions and, if appropriate, additional capital requirements – they authorised that type of activity if it was intended to cover risks or to offer products and services directly to customers.

66. The fees that banks charge come from a very wide range of activities which, apart from asset management relating, for example, to offering alternative investment options for customers, include payment or settlement services in connection with securities transactions. These are often specific services provided by specialist institutions, market infrastructures that have a leading position in the Belgian financial landscape. These settlement and clearing institutions perform a vital role as a channel for ensuring the successful completion of financial transactions, but owing to their central position they can also heighten the risk of contagion. That prompted the authorities to impose appropriate regulation on these infrastructures. Thus, the European Market Infrastructure Regulation (EMIR) specifies central clearing obligations, risk attenuation techniques and disclosure requirements for transactions. The EU Regulation on central securities depositories (the CSD Regulation) which came into force in September 2014 standardises the prudential rules applicable to the licensing, supervision and organisation of these institutions and the settlement deadlines for transactions on regulated markets. These various measures are meant to ensure close supervision of these infrastructures in order to avoid concentration risks in the event of the failure of institutions in this category.

67. These provisions form part of the long-term project for progressive harmonisation of the European financial rules, in which the next major step will be the introduction of the Solvency II Directive in the insurance sector, scheduled for 1 January 2016. Under these new rules, the capital requirements will have to be calculated with due regard for all the risks facing both the assets and the liabilities. In addition, it should be noted that the technical provisions will from now on be valued by reference to market rates. Since this abandonment of valuation at historical prices will greatly increase the sensitivity of the capital to fluctuations in interest rates and prices, provision has been made for adjustment and correction mechanisms, called the Long-Term Guarantee measures, in order to attenuate this excess volatility.

68. The potential impact of the new Solvency II regime on the capital requirements of insurance companies was assessed during the second stress test exercise conducted by the European Insurance and Occupational Pensions Authority (EIOPA) in 2014. In all, 19 Belgian firms were involved in whole or in part. Before the shock scenarios were applied, the coverage rate of the new solvency capital requirement (SCR ratio) based on the standard formula averaged 204 % for these companies, which is well above the statutory minimum. The scenarios covered three main aspects. First, they tested two series of market shocks concerning interest rate risks, credit risks, and risks relating to fluctuations in stock market prices and property prices. Next, they checked the sensitivity to specific insurance risks, particularly the mortality risk, the risk of longer life expectancy, disaster risk, the inflation risk confronting claims reserves, and contract cancellation risk. Finally, they subjected the firms to a low interest rate scenario, sub-divided into two modules : one corresponded to a very long period of very low rates, like that in Japan, and the other reflected the inversion of the yield curve. While all firms withstood the specific insurance risks, the most severe market risk scenario brought the average SCR ratio very slightly below the 100 % threshold. Finally, while the sector was able to withstand the low interest rate scenario without too much trouble, there were wide variations between companies, with about 20 % of them failing to meet the future regulatory requirements.

69. The introduction of new rules for both financial infrastructures and insurance companies will demand special attention, both from these sectors and from the Bank. The Bank still retains full responsibility for supervising insurance companies, and will continue to play a dominant role in the supervision of the large financial market infrastructures based in Belgium ; that is no longer the case for credit institutions, for which supervision is now partly centralised at the ECB. But even in the latter case the Bank will retain important functions. Apart from supervising smaller institutions for which the national authorities remain primarily responsible, it will have to play an active part in the multinational teams set up by the ECB to supervise the main Belgian credit institutions as well as subsidiaries based in Belgium belonging to large euro area banking groups.

6. Conclusion

70. The global economy is struggling to overcome the crisis, and the euro area faces the threat of stagnation. Nonetheless, an appropriate policy mix could improve the situation, actually more so in the euro area than elsewhere. Demand needs to be stimulated, and that is primarily a task for monetary policy which has to ensure that an excessively protracted period of low inflation does not hamper the recovery. The size and composition of the central bank balance sheet and its rate of expansion are monetary policy parameters which are still available for that purpose, even after the key interest rates have reached their floor. At its first monetary policy meeting in January 2015, the ECB Governing Council chose this path by launching a € 60-billion-a-month expanded asset purchase programme. Under the Stability and Growth Pact, which offers a degree of flexibility, fiscal consolidation must continue in the countries where the sustainability of public finances is compromised. However, where scope exists, the fiscal stance should likewise be more expansionary. At the same time, there must be structural reforms in two areas. First, it is necessary to boost productivity and growth potential. Also, the economy must be financed more efficiently, on the one hand by facilitating market financing and on the other by reaping the benefits of the substantial progress achieved in 2014 with the creation of the banking union. By thus increasing the return on investment and cutting funding costs, it will be possible to give significant impetus to the expenditure component which, up to now, has been the main factor behind the shortfall in demand in the euro area.

71. That is also in broad terms the policy mix that the Belgian economy needs. On the demand side, Belgium is benefiting from the ECB's accommodative monetary policy, the pass-through of that policy to interest rates relevant to the economy being less distorted in Belgium than in some other euro area countries. There is also a need for gradual but resolute fiscal consolidation conducive to growth. After the budget deficit was cut to 2.9 % in 2013, under the previous administration, the new government has opted for a path leading to a structural balance by 2018. In that respect, it is necessary to ensure that the structural budgetary efforts conform to the Stability and Growth Pact, and that they are actually implemented. If adjustments are needed, they will have to be made at the time of the March 2015 budget review.

72. On the subject of structural reforms, new measures are being taken to support growth potential. They thus also help to consolidate the economic basis for the high degree of social protection and the wide range of public services, both factors that form part of Belgian society's choices. Efforts are being made to extend working life, to restore competitiveness and to create jobs by improving the functioning of the labour market. These action points also spearheaded the reforms initiated at the end of 2011. They will help to improve the labour supply, reduce the budgetary costs of ageing and gradually reduce the wage handicap. All the same, there is still work to be done. Between now and the end of the wage freeze, it is necessary to examine with the social partners how wage setting can best be linked to the movement in productivity so as to promote job creation. The charges on labour also need to be reduced by switching to levies on consumption, pollution, wealth, capital gains or property incomes. Such a tax shift is essential to reduce the level of labour costs in Belgium – which is among the highest in Europe – and to make work financially attractive. In addition, an effort must be made to reform product markets, to encourage innovation, to attract foreign investment and to facilitate a reallocation of resources, in order to boost productivity growth which, in the long term, is the main source of income creation. Any delay will only increase the effort to be made subsequently. Along this route to a better future, the various governments, the social partners and all other stakeholders have to play their part. The measures undeniably require efforts in the short term, but cooperation can only benefit their effectiveness.

Brussels, 28 January 2015