Report 2015

Preamble

National Bank
OF BELGIUM
Eurosystem

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

1. Constantly changing global situation

1. Following the deep wounds inflicted by the economic and financial crisis, the recovery continued to make hesitant progress in the advanced economies in 2015. Growth reached 1.9 %, compared to 1.8 % in 2014. Conversely, in the emerging economies, economic activity slowed for the fifth consecutive year, recording only 4 % growth, which was 0.6 of a percentage point below the 2014 figure. Owing to the scale of this slowdown and the emerging countries' weight in the international economy – they now account for almost 60 % of the world's economic activity –, growth decelerated worldwide, dropping from 3.4 % in 2014 to 3.1 % in 2015. This triggered a steep fall in commodity prices – a movement which had already begun at the end of 2014 – and led to slower expansion of world trade. At just 2.6 %, the growth of world trade actually lagged behind the expansion of global activity, whereas trade flows generally grow faster than GDP.

2. The slowdown in the emerging countries sapped the strength of the recovery in the advanced economies, particularly during the second half of the year when the financial markets also suffered from heightened uncertainty and volatility. Nonetheless, domestic growth remained fairly robust, partly because the various decision-makers modified their policies to take account of the new headwinds coming from the emerging countries. In addition, numerous advanced economies are net commodity importers so that the purchasing power gained from the fall in commodity prices substantially offset the less favourable export figures.

3. The recovery was more vigorous in the United Kingdom and in the United States where, in December, the Federal Reserve raised the key interest rates for the first time since the crisis. In that respect, it announced that the subsequent monetary policy normalisation process would probably be very gradual. The recovery was also maintained in Japan and in the euro area, albeit at a more modest pace. However, the under-utilisation of production capacity and the resulting downward pressure on prices in the euro area remain considerable, so that the monetary policy stance was eased again in 2015, as will be explained in more detail below. These monetary policy divergences in the leading advanced economies were reflected in the continued decoupling of their long-term interest rates and by significant exchange rate movements between their respective currencies. In a context of great intrinsic uncertainty over the state of the economy, central banks

* Two Regents were not able to endorse the Report in its entirety.

must duly continue to communicate their intentions and avoid being a source of uncertainty themselves. Such communication will inevitably be conditional and must clearly indicate the extent to which the intentions depend on the materialisation of certain macroeconomic scenarios.

4. The slackening pace of growth in the emerging economies is due to a combination of mutually reinforcing factors. However, the principal reason is the reversal of the credit and investment boom of preceding years. In China, where that investment boom was mainly financed internally, the authorities opted for a centralised transition from an economy focusing on investment and exports to a growth model geared more to consumption and services. Although that transition is vital to achieve a more balanced, sustainable and environment-friendly growth model, it implies the risk of an excessively abrupt growth slowdown in the short term and could exacerbate the vulnerabilities that have built up in the Chinese financial system. To contain those risks, the Chinese authorities decided to ease their fiscal, monetary and exchange rate policies in 2015. However, the great uncertainty surrounding current economic developments persisted, and the financial markets were very jittery in the early weeks of 2016. China is now in fact the world's largest economy.

5. Conversely, in many other emerging economies which traditionally maintain very close trading relations with China, the boom was financed externally. In some cases, the expansion was also heavily concentrated on the extraction of raw materials destined mainly for China, since the production process there has hitherto been highly commodity-intensive. Owing to the reappraisal of the outlook for growth and the prospect of a normalisation of monetary policy in the United States, some of those countries experienced a sudden reversal of their capital flows, leading to tighter financial conditions and sharp currency depreciations. These movements were most apparent in Russia – which also had to contend with the trade embargo decreed by the EU – and Brazil, two countries which saw the value of their currency drop by almost half between mid-2014 and the end of 2015, while their economies contracted by almost 4 % in 2015. In such circumstances, the currency depreciation will in principle have a corrective effect by supporting net exports, but in countries where a large proportion of loans are denominated in foreign currency, it also exacerbates the fragility of the financial system. If, in addition, the monetary policy is insufficiently credible, that can cause a self-sustaining depreciation spiral owing to the expectation of further price increases. A number of Latin American countries, including Argentina and Brazil, recorded high inflation in 2015.

6. The implications of the end of the investment boom are not just cyclical. Insofar as the boom led to structural excess investment in certain sectors, it also has an impact on production potential. That applies primarily to the commodity-exporting countries, as some production facilities can no longer be run profitably owing to the slump in prices. For their part, economies with better fundamentals continued to record robust growth rates. For example, India achieved growth of 7.3 %, equalling the 2014 figure. This shows that the permanent integration of less advanced countries into the global economy continues to offer huge potential in the long term. The opening up of markets where both needs and potential for catching up are massive generates numerous investment opportunities for the excess savings built up in certain advanced economies with an ageing population.

7. The slackening pace and changing composition of growth in China imply that pressure on finite resources as well as greenhouse gas emissions could diminish, although there is a risk that the steep fall in prices might lead to higher consumption elsewhere. At the December 2015 climate conference in Paris, the United Nations countries concluded an agreement aimed at limiting global warming. Ultimately, that should help to protect not only the ecosystem but also the whole economic fabric against the effects of climate change. As the corollary to this long-term gain, the transition to an economy with lower greenhouse gas emissions implies various costs in the short term. The efficient accomplishment of that transition is a huge challenge and will entail a major reallocation of resources. On the other hand, this reordering also offers opportunities

in that intensified research and investment in technologies protecting the environment may be a source of growth and could help to resolve the current investment deficit. Moreover, the consequences will not be confined to the real economy; they also require attention from the financial stability angle. Thus, an abrupt revision of the prices of – frequently debt-financed – assets associated with high emission rates could put stress on the financial system. The risks for both the real economy and the financial system will be easier to control if the transition begins early enough so that it can be as gradual and predictable as possible.

8. The year 2015 also brought the steadily widening repercussions of geopolitical tensions and conflicts, not only in the form of terrorist attacks – the impact of which has so far been fairly small in both Belgium and the euro area –, but also in the increasing flow of refugees. These refugee movements are primarily within the actual conflict regions but, since the summer, have also been increasingly towards the EU countries. Apart from the logistical, social and societal problems associated with such an influx of refugees, there is the question of its economic consequences. According to an initial analysis by the European Commission – inevitably subject to much uncertainty – the number of asylum-seekers came to more than a million in 2015, and that could rise to three million by 2017. That being the case, the economic impact – and more particularly the effect on public finances – is likely to be limited overall, especially considering that the total population of the EU will probably grow by no more than 0.4 %, bearing in mind that not all asylum applications will be accepted. Over a somewhat longer term, the effect on public finances could actually be slightly positive, although that depends very much on how successful the newcomers are in finding work, and hence on their contribution to economic growth. The speed of the recognition procedures, the aptitudes and skills of the asylum-seekers on arrival, and the efforts of the host countries to encourage their integration into the labour market are key determinants in that respect. The challenges are considerable, and will require lengthy efforts, but this investment is vital to transform the current flow of migrants into a positive supply shock for the European economy. In the longer term, the consequences will be greatest for the three main countries of destination, namely Germany, Austria and Sweden, whereas, in the shorter term, the reception costs will also be concentrated in the transit countries.

9. In the light of a constantly changing global situation, it is necessary to be sufficiently adaptable while remaining aware of the impact of globalisation on social cohesion. In that respect, national economies need to resist the instinctive response of insularity and guard against protectionism. Openness and international trade also – and above all – imply greater prosperity: trade boosts productivity, facilitates the spread of new technologies, opens up new markets, strengthens competition and gives consumers access to new products and greater variety. For the EU countries, and especially for those in the European Economic and Monetary Union (EMU), the events of 2015 also showed that the process of European integration requires a qualitative adjustment. The approach to the refugee question, the debate on Greece's participation in the euro during the summer, and the United Kingdom's request for revision of its EU membership conditions all point in that direction. This adjustment has to result in a more effective approach to mutual challenges, safeguard the integrity of the Monetary Union via the necessary deepening of EMU, and culminate in a new balance between EU membership and participation in the Monetary Union. That is not an end in itself but a necessary step in order to provide maximum support for growth dynamics in Europe, take full advantage of the introduction of the euro, and ensure an appropriate presence on the international stage.

2. Euro area: redirecting the recovery towards sustainable growth and strengthening the fundamentals for a stable Monetary Union

10. Growth in the euro area accelerated from 0.9 % in 2014 to 1.6 % in 2015, although it weakened slightly in the second half of the year owing to flagging demand from the emerging

economies. Furthermore, the revival was evident in almost all the euro area countries. Lower oil prices, favourable financing conditions associated with an accommodative monetary policy, and the transition from a restrictive fiscal policy to a neutral stance were all factors supporting domestic demand – which has since become the engine of growth. The euro's depreciation tempered the impact on exports of the slowdown in world trade. Nonetheless, the recovery remained modest considering both the scale of the favourable factors at work in 2015 and the upturn now apparent in other advanced economies such as the United States and the United Kingdom. Within the euro area, economic activity has yet to regain its pre-crisis level and, despite the approximately 1 % rise in employment, unemployment still stood at 10.5 % at the end of the year.

11. These various factors are holding down domestic costs, particularly unit labour costs. Leaving aside energy and food, inflation therefore reached no more than 0.8 %. On top of that came the effect of substantial falls in prices of commodities – especially crude oil – so that the overall consumer price index did not increase at all in 2015. What is more, this had some impact on inflation expectations, even in the longer term. If this dynamic persists without an appropriate policy response, there is a danger that the economy could become stuck in a low inflation environment, or could even slide towards deflation, because the lower expectations influence pricing and wage-setting, and therefore also have an impact on actual inflation. Moreover, real interest rates rise if the fall in inflation expectations is not countered by an easing of monetary policy ; that curbs the revival in activity, and hence inflation itself. From then on, low inflation is no longer a mere symptom of the economic malaise – which is already worrying in itself – but also becomes a factor hampering the recovery, notably by impeding the debt reduction process.

12. In 2015, in view of these risks and their seriousness, the ECB Governing Council opted for a further easing of monetary policy. Since there was little scope available for another cut in the key interest rates, the easing primarily took the form of a substantial securities purchase programme announced in January 2015 and implemented from March onwards. It was modelled on the 2014 programme for the purchase of asset-backed securities (ABS) and covered bank bonds. The programme, which consists in purchasing not only the assets mentioned above but also euro area public sector bonds on the secondary market for a total of € 60 billion per month, was initially scheduled up to September 2016, and was in any case to continue as long as necessary to secure a sustained adjustment in the inflation profile compatible with the target of inflation below but close to 2 % over the medium term. After the summer, when it became clear that it would take longer to achieve that sustained adjustment in the inflation profile, the Governing Council further heightened the accommodative character of monetary policy in December. To that end, it extended the purchase programme by six months – to March 2017 – and decided that it would now also acquire regional and local authority bonds. That six-month extension is simply the logical application of the criteria set out at the start of the programme. Moreover, those criteria are being upheld in full so that the purchase programme can continue beyond March 2017 if that becomes necessary for price stability. In addition, a reinvestment policy was announced for securities maturing, the deposit facility interest rate was cut by 10 basis points to –0.3 %, and it was announced that the fixed-rate tenders with full allotment would continue until at least the end of 2017 for all refinancing operations. This not only extended the asset purchase programme but reinforced it with additional measures.

13. The easing had a favourable impact on financing conditions in the economy. Despite periods of heightened volatility, the nominal interest rate on government bonds dropped to an unprecedentedly low level, not only in Germany but also in the more vulnerable euro area countries. In addition, the decline in inflation expectations was halted so that real long-term interest rates – relevant for decisions on expenditure – also subsided. Furthermore, the space created in the portfolios of investors and financial institutions by the sale of government securities to the Eurosystem encouraged the search for other investment opportunities, including outside the euro area. That underpinned the value of riskier assets such as corporate bonds

and equities, while the euro exchange rate declined. In 2015, the monetary stimulus steadily gained traction in the case of households and businesses, which depend heavily on the banks for their funding. The interest rates on new bank loans thus declined significantly, especially in the more vulnerable euro area countries where the transmission of key interest rate cuts had previously been incomplete. Combined with less restrictive credit conditions and rising demand, this restored the growth of lending to positive territory in 2015, thus supporting the recovery.

14. But, it must be remembered that the accommodative monetary policy has side effects and is not without risks to financial stability. Those risks concern the possibility of an overvaluation of asset prices, an excessive search for yield – particularly on the part of financial institutions experiencing a slump in profitability in a low interest rate environment – and a distortion of resource allocation within the economy, which ultimately undermines growth potential. So long as these risks are only present in certain segments of the financial system, prudential policy – and particularly macroprudential policy – is the best way of containing them. Monetary policy can thus concentrate on its primary objective – the maintenance of price stability – which also has positive spillover effects on financial stability via a beneficial impact on debt reduction, the economic recovery, and hence the quality of outstanding credit. Conversely, if financial stability is threatened by widespread risks – which sooner or later could, if they materialised, have implications for macroeconomic stability – monetary policy needs to take them into account as well, in a medium-term perspective.

15. At this stage, the euro area shows few signs of a general overvaluation of asset prices. Nor does it appear to be on the verge of a new credit boom. On the contrary, over-restrictive credit conditions remain a source of concern as they hamper the funding of new projects. On the other hand, the profitability of banks and insurers appears to have come under pressure owing to both the slow nominal growth and the low interest rate environment. For the rest, the trend in commercial property prices is dynamic. In regard to residential property, following the sharp corrections in some countries, there does not appear to be any overvaluation in the European Monetary Union taken as a whole, although there are still wide variations between countries. Taking account of the sectoral – and often also national – nature of these vulnerabilities, the current low interest rate environment calls for an important role within the Monetary Union not only for macroprudential policy but also, and above all, for the national component of that policy. The implementation of macroprudential policy in Belgium, which is the Bank's responsibility, is described in detail later.

16. But is monetary policy holding interest rates at a level which is artificially low – or even too low? In a historical perspective, the current low interest rate environment is indeed highly unusual: at the end of 2015, the yield on Belgian government bonds was negative for all maturities up to four years, and that applied even up to five years in Germany. From a more normative point of view, taking account of the imbalance between saving and investment, and the accompanying economic malaise and disinflation – two factors which have also reached an exceptional scale in the euro area – the current level of interest rates is not surprising. For the time being, the underlying economic determinants justify very low interest rates. What is happening here is that more secular forces, such as the low growth potential of the euro area, are operating along with cyclical factors linked to dealing with the legacy of the financial and debt crisis – a process which has been hampered by the incompleteness of the institutional architecture of the EMU and the resulting financial fragmentation during the crisis. The interaction between the muted future prospects and the legacy of the past influences current decisions on expenditure and is clearly impeding business investment. Since 2012, that investment has been less dynamic than might have been expected in the light of its usual cyclical profile, and that in turn has implications for future output potential. The accommodative monetary policy is not enough in itself to escape this impasse, but is nonetheless absolutely essential because it stimulates demand and prevents the persistence of disinflation, thus also helping to hold the inflation component of nominal interest rates up. However, in order to improve the efficiency of monetary policy and provide

a structural stimulus for growth – and hence for interest rates –, it is also necessary to apply a whole range of other levers. It is a question of improving the flow of funding for the economy, conducting a growth-friendly fiscal policy geared to stability, strengthening potential growth and completing the institutional architecture of the euro area. The success achieved in activating these levers will determine the degree to which interest rates return to normal, and the timing of that normalisation.

17. One of the factors holding back the momentum of the recovery is that the non-financial private sector is still feeling the effects of a high debt level. In the United States, deleveraging is more advanced, not only because it has benefited from stronger nominal growth, but also because it was encouraged by debt write-down. The crisis also had a serious impact on the balance sheets of the banks – the main source of finance in the euro area. In the meantime, significant progress has been achieved here, notably via recapitalisation as a result of the comprehensive assessment which preceded the November 2014 transition to the single supervisory mechanism (SSM) and the phasing in, for European banks, of the more stringent Basel III framework as defined by EU legislation. Together with the accommodative monetary policy, these factors helped to restore the smooth functioning of the bank credit channel. However, the banks' balance sheets still include non-performing loans, especially in the countries hardest hit by the crisis. Obstacles to their efficient resolution, such as factors relating to bankruptcy law, must be removed. That will bring the debt ratio down faster without causing excessive levels of saving, and will create scope for new lending to investment projects likely to support growth potential. In September 2015, the European Commission launched a large-scale project in the EU for the purpose of unifying the capital markets with the aim of diversifying the financing of the economy and thus tapping new sources of funding. Although the Capital Markets Union is a medium-term project, efforts are already being made in the short term to relaunch high-quality securitisation and facilitate long-term infrastructure investment. Rapid progress is vital here to foster the recovery. In that respect, however, it is necessary to ensure that the transition to more market financing does not increase the risks to financial stability.

18. In the euro area, the impact of deleveraging in the private sector largely coincided with the substantial fiscal consolidation prompted by the sovereign debt crisis, while other advanced economies had greater scope for a sequential reduction of leverage in the private and public sectors. That hampered the recovery, even though fiscal policy ceased to be restrictive in 2015. The reduction in the euro area public deficit, from 2.6 % in 2014 to 2 % in 2015, is in fact entirely attributable to a cyclical improvement and the fall in interest charges. As a result, the public debt also declined for the first time from 94.5 % to 94 % of GDP. That said, there is little scope for supporting demand by using fiscal policy. Although most countries no longer have an excessive deficit of more than 3 % of GDP, many of them are still a long way from their medium-term objective under the preventive arm of the Stability and Growth Pact. Safeguarding the sustainability of public finances remains crucial in order to cope with the budgetary cost of population ageing and create financial buffers for the future. Greater confidence in public finances is in turn favourable to private sector consumption and investment. Since the Pact is geared very much to the medium term, its implementation offers some scope for flexibility. In January 2015, the European Commission explained how it intended to make optimum use of that flexibility to pursue a fiscal policy conducive to growth, encouraging structural reforms – which promote the sustainability of public finances in the long term – and boosting investment, particularly in the context of the new European Fund for Strategic Investments. In the autumn, during the review of the draft budgets for 2016, the European Commission also stated that it considered the additional costs of the refugee crisis to be an exceptional factor. Fiscal policy can also encourage growth by steering expenditure towards investment or by reducing the charges on labour and transferring them to sources of taxation less damaging to employment.

19. To ensure that the recovery is sustainable, reforms are likewise needed to strengthen the supply side of the economy. In the first place, these reforms support growth potential by encouraging

more intensive and efficient use of the production factors. That is essential since the euro area's growth potential is barely 1 %, whereas that of the United States is 2 %. At the same time, these reforms promote more effective support for demand, as the improvement in the outlook shortens the laborious debt reduction process, increases the scope for expenditure and stimulates investment. The catalyst is a confidence boost. It is therefore absolutely vital for the reforms to be credible. They also enhance the economy's adaptability so that, as the reallocation of resources becomes easier, demand is steered towards the appropriate sectors and employment can respond faster to rising demand. That reduces the risk that the current unacceptably high unemployment – which was initially cyclical – could become structural. In the Monetary Union, where the economies no longer pursue their own monetary or exchange rate policy, it is also vital to augment adaptability in order to absorb asymmetric shocks. The reforms are proving beneficial. Some countries which were very severely affected by the crisis and have carried out reforms – such as Ireland and Spain – are now recording strong growth rates once again.

20. Work is also needed on the completion of EMU, a process which was outlined in June 2015 in a report by the President of the European Commission drawn up in close collaboration with the Presidents of the European Council, the Eurogroup, the European Central Bank and the European Parliament. The Monetary Union needs a stronger foundation so that, via the enhanced efficiency of its constituent economies, it becomes more effective and stable itself, and therefore capable of meeting the high expectations. To that end, following the adjustments already made to its architecture since the outbreak of the crisis, particularly in the sphere of economic governance and the banking union, further qualitative progress is needed to ensure that participating countries are permanently better off within the union rather than outside, despite having renounced their own monetary policy as an adjustment tool. That will entail increased responsibility combined with greater solidarity. All monetary unions that operate satisfactorily have mechanisms for both risk control and risk-sharing, mechanisms that are not sufficiently developed in EMU. Reinforcement of EMU's institutional architecture is the only way to end once and for all the doubts over the irreversibility of the euro. So long as doubts persist, as was clearly the case at the height of the crisis in the summer of 2012, or following the problems in Greece in 2015, there is a danger of the single currency being reduced to an exchange rate system of fixed parities which may nonetheless be adjusted sooner or later. The incomplete architecture of the Monetary Union is one of the reasons why the crisis left such deep scars on the euro area.

21. First, EMU does not have sufficient characteristics of an economic union. Its economic governance needs to be better coordinated and democratically legitimised in order to encourage and assist the countries in conducting an appropriate macroeconomic policy which aims to increase prosperity, prevent crises and acquire, at national level, adjustment mechanisms and sufficient buffers to absorb shocks. It is also necessary to pay closer attention to the interdependence between Member States. To that end, in October 2015, the European Commission proposed adjusting the European Semester to take greater account of developments at the level of the Monetary Union as a whole, and of employment and the social implications of the policies pursued. It also recommended establishing a system of National Competitiveness Boards, and an independent European Fiscal Board is in the process of being set up. The latter will play an advisory role not only in regard to the application of the EU fiscal governance framework but also in the formulation of an appropriate fiscal policy at the level of the euro area as a whole.

22. However good the economic governance, sooner or later the EMU countries will suffer asymmetric shocks, which cannot be absorbed by the buffers – particularly budgetary ones – built up at national level. It is therefore necessary to establish more risk-sharing mechanisms. With appropriate financial integration, that can be done by recourse to the private sector, but going forward, it would be preferable to back those mechanisms up with mutual last resort safety net arrangements for the financial system, and at a later stage, with the development of a fiscal stabilisation function. Together with the economic union, the financial union and the fiscal

union are in fact two vital pillars of the efficient operation of the Monetary Union. In addition, the ambitious aim of completing EMU can be achieved only if it has sufficient democratic support and is backed by a genuine political union which will have to be the keystone of the reform programme.

23. In the first place, a financial union is of direct importance for the integrity of the single currency. Thus, the events in Greece made it abundantly clear that if a banking sector which is still far too national encounters problems, that may lead to an exit dynamic. A financial union can also contribute to risk-sharing in the private sector. During the run-up to the crisis, financial integration mainly took the form of short-term interbank lending, whereas the retail banks' activities were still very much geared to the national economies themselves. That situation certainly did not give rise to risk-sharing during the crisis; on the contrary, when the interbank market dried up, the financial system fragmented along national borders because the banks had to turn to their respective public authorities, and a negative spiral developed between the two sectors. That is why the launch of the Capital Markets Union project is equally crucial from this angle, too, since it can help to ensure that the financing of the euro area economies takes place less via bank intermediation, and instead takes the form of financial products better suited to effective risk-sharing in the private sector. It is also necessary to proceed with completion of the banking union – a project which was launched at the end of 2012 and started in November 2014 with the changeover to the SSM.

24. While the regulation and supervision of credit institutions are now largely standardised, two components have yet to be completed in order to finalise the banking union. In regard to the first element, namely the introduction of a single resolution mechanism, that has already been more or less accomplished since the entry into operation of the Single Resolution Board for the euro area and, in Belgium, the Resolution College, which is legally established within the Bank. In parallel with the development of the first resolution plans, the European Banking Authority (EBA) set the course for imposing a minimum requirement in terms of own funds and other liabilities which might be eligible for a bail-in if an individual bank got into serious difficulties. In accordance with the Bank Recovery and Resolution Directive (BRRD), the approach is first to opt for a model of risk-sharing within the private sector. But to effectively limit the costs to the taxpayer, it is also necessary to prevent that resolution model from generating new risks to financial stability. The resources available internally can, if necessary, be increased by the intervention of a Single Resolution Fund to be formed by gradually merging the national resolution funds in order to achieve the target of at least 1 % of total deposits by 2024. This Single Resolution Fund came into effect on 1 January 2016 and – up to 2024 – if all other financial resources are exhausted, it can resort to a system of bridge finance provided by the Member States. A common backstop will also be needed once the Fund is fully operational in 2024.

25. On the other hand, the second missing component of the banking union is a more distant prospect. This concerns the creation of a joint deposit guarantee system. At the end of 2015, the European Commission proposed establishing a European Deposit Insurance Scheme based on a European deposit guarantee fund created by risk-weighted contributions from the banks and managed by the Single Resolution Board. The transition from national systems to a European scheme would take place in stages, starting with a reinsurance mechanism and proceeding via co-insurance, culminating in the full assumption of the deposit guarantee by the European system. However, this risk-sharing must be accompanied by better risk control. That is why it is also necessary to devise mechanisms which keep the stability of the financial system separate from national public finances. In that regard, a reflection has started at both European and international level concerning the prudential treatment of credit institutions' claims on sovereign authorities.

26. The deepening of EMU faces numerous obstacles and progress is sometimes hard, as is evident from the hesitancy over the finalisation of the banking union. A political and fiscal union is, by

nature, even more complicated to achieve, and at present there is insufficient support for it in society. EMU must therefore inevitably be completed step by step. But if the Monetary Union is to become more robust and efficient, then there can be no doubt – from a purely economic point of view – that sooner or later it will have to go down the road indicated in the Five Presidents' Report.

3. The Belgian financial system in the low interest rate environment

27. The restructuring measures implemented after the financial crisis brought profound changes in the appearance of the Belgian financial sector. Balance sheets were slimmed down and the main excesses of the past were corrected, leading to a refocusing on the domestic market. Credit institutions were thus able to restore their solvency and achieve good profitability in 2015. The decline in interest rates bolstered demand for bank loans, improved the debtor situation – reducing the credit risk –, strengthened market liquidity, thus lowering financing costs, and pushed up the value of bonds, a source of capital gains for banks and insurance companies.

28. This last effect which has greatly benefited financial intermediaries in recent years is now tending to fade away as interest rates approach their floor. The first sign of that is the stress on intermediation margins, which are still the main income source for financial institutions. Legal or commercial requirements put a floor on interest rates for sight deposits and savings deposits, whereas competition continues to drive down interest rates for borrowers. It is probably on the mortgage market that this constraint has been most acute, as many borrowers repaid their loans early and took out new loans on more favourable terms. The imposition of an early repayment indemnity on these refinancing operations generated income for the banks which, while considerable, was non-recurring, whereas the drop in interest rates will weigh on profitability throughout the full term of these new loans.

29. Insurance companies also face an interest rate risk, especially in the life insurance segment, as market interest rates have dropped well below the guaranteed yields on many contracts dating from earlier years. Up to now, the difference has been offset by gains on portfolio securities or by the yields still being received on older bonds. Insurers need to impose strict limits on the distribution of profits to their policy-holders or shareholders so as not to exhaust a source of income which is vital for continuing fulfilment of their contractual obligations. It is also imperative to align the interest rates on new contracts with current market conditions. In that connection, the Bank proposed cutting the maximum benchmark rate on individual life insurance contracts from 3.75 % to 1.5 %. In January 2016, the Minister of the Economy decided to bring this rate back up to 2 %. The draft Law on the status and supervision of insurance and reinsurance companies also incorporates a legal framework for a regular procedure for setting that benchmark interest rate. The Bank likewise welcomes the agreement between the social partners on the review of the minimum interest rates that employers must guarantee under their pension plans.

30. To overcome their liability management problems, Belgian banks and insurers are trying to maximise the return on their assets, either by widening the maturity gap between their assets and their liabilities, or by taking on more credit risk. The lessons of the past are still recent, and financial intermediaries remain very cautious in their lending to foreign borrowers. It is more on the domestic market, and particularly on the residential property market, that lending has continued to expand. In contrast to many European countries, Belgium did not experience any property crisis, but it is only very recently that the steady price rises came to a halt. While the market is not easy to assess from indicators that sometimes give contradictory signals, attention should focus on the banks' lending policies, especially as the overall debt ratio of Belgian households, traditionally lower than elsewhere in the euro area, has risen sharply in recent years to approach the European average. Some mortgage loans are for amounts almost equivalent to the total value of the mortgaged property, or entail repayments representing a worrying percentage of the borrowers' income. The Bank therefore proposed a one-year extension of its

macroprudential policy measure imposing a 5 percentage point surcharge on the risk-weighting coefficients applied to Belgian mortgage loans by institutions using internal models. It is also continuing to keep a close eye on the property market situation in order to determine whether additional measures should be considered.

31. A targeted, individual measure was deemed preferable to the imposition of a uniform minimum capital requirement which would have penalised the most prudent banks, or the general introduction of a countercyclical capital buffer applicable to all loans ; that is not currently justified in view of the weak growth of corporate lending. The Bank nonetheless set up the reference framework enabling such an instrument to be introduced in the future. It thus complied with the European rules requesting every Member State to equip itself with macroprudential tools providing protection against the emergence of systemic risks which could threaten the stability of the entire financial system. Those instruments are not designed solely to achieve a cyclical aim, by preventing a credit boom which could lead to excessive debt levels followed by an abrupt asset price correction. They can also be used for more structural purposes, in order to limit the risks of contagion that could result if financial transactions are concentrated too heavily on a limited number of large institutions. With that in mind, at the beginning of 2016, the Bank introduced a capital buffer for systemic institutions, in accordance with the EBA guidelines. In line with this methodology, the Bank considers eight Belgian banks to be domestic systemically important institutions. Four of them – BNP Paribas Fortis, KBC Group, ING Belgium and Belfius Bank – are subject to a capital surcharge of 1.5 % of the risk-weighted assets, while the other four – AXA Bank Europe, Argenta, Euroclear and The Bank of New York Mellon – will have to create an additional 0.75 % buffer. Those buffers will be phased in over three years. These various measures were implemented in close consultation with the ECB which, since the entry into force of the SSM, shares macroprudential powers with the national authorities, the ECB having the right to strengthen but not to weaken the national provisions.

32. In contrast, in the microprudential sphere, the ECB has acquired a dominant role : since the entry into force of the SSM in November 2014, it has become directly responsible for the supervision of the main credit institutions of the euro area. During the first year of operation of the new system, the ECB set out to standardise the arrangements for exercising bank supervision between the various euro area countries. That involved two main aspects. The first concerned the application of the second pillar of the Basel III accords organising a structured dialogue between the bank supervisory authorities and the financial institutions subject to their supervision. The ECB revised the individual banks' estimates of their capital needs and compared them with its own risk analyses, arriving at supplementary requirements that those banks must respect in 2016 in addition to the minimum regulatory capital. The second aspect concerns the treatment of discretionary assessment options and margins available to the national authorities in the application of European legislation on the activities, supervision and prudential obligations of credit institutions. As that national latitude can sometimes create substantial variations in capital requirements between different banks, the ECB endeavoured to harmonise the use of that margin of manoeuvre while keeping certain options open. For instance, for banking groups in the insurance business, the ECB retained the option of not deducting from the capital the stakes that those banks hold in insurance companies, while in the case of banking subsidiaries of large foreign groups, it left some latitude over the criteria to be complied with by those subsidiaries in order to respect the liquidity ratios in the short term and the risk concentration limits for intra-group exposures.

33. Adjustments to the regulations also continued in the other segments of financial activity. In the insurance sector, the draft Law on the status and supervision of insurance and reinsurance companies aims to transpose into Belgian law the important Solvency II Directive which came into force at the start of the year. This change to the reference system will have radical implications for the sector, since the capital requirements will now have to be calculated on the basis of all the risks concerning both assets and liabilities, particularly for provisions which

will have to be valued with reference to market interest rates. In 2015, in preparation for the entry into force of the new Directive, the Bank examined adherence to the qualitative corporate governance standards and the reliability of the financial and accounting data that insurance companies have to submit in order to enable the prudential authorities to verify compliance with the new requirements. The Bank also processed the applications from companies wishing to use an internal model to determine their capital requirement under Solvency II, and examined the adequacy of the technical reserves applicable under the new regime, enlisting the assistance of external actuaries in the case of some large companies. These various analyses showed that the sector is generally ready for the entry into force of Solvency II, although the degree of preparedness and the safety margins in relation to the minimum requirements vary greatly from one company to another.

34. In regard to financial infrastructures, there was a continuing gradual transition from a supervisory system based on compliance with general principles and the exertion of moral suasion to a stricter framework involving binding rules. That is true, in particular, for the application of the new EU Regulation on central securities depositories, which gives the European prudential authorities the task of drawing up technical standards for submission to the EC. A matter of particular importance to financial infrastructures – though not confined to that sector – is cyber security. The digital age and growing use of service platforms available on the internet render financial institutions extremely vulnerable to external intrusion, particularly in the case of networked financial activities. In December, the Bank published a circular specifying the additional prudential expectations concerning the operational continuity and security of systemic financial institutions. That circular was in line with the work being done by international organisations on the development of measures to protect against cyber risks. In a related sphere, in 2015, the European Parliament and the European Council adopted the Directive on the prevention of the use of the financial system for the purpose of money-laundering and terrorist financing. These new rules will be transposed into Belgian law in the coming months, helping to bring Belgium into line with the recommendations which the Financial Action Task Force (FATF) made in 2015 in its fourth report assessing the measures introduced by Belgium to combat money-laundering and terrorist financing.

35. The numerous measures implemented in recent years bear witness to the desire to reform the prudential regulation and supervision framework to take account of the lessons of the crisis. However, the supervisory authorities are not the only ones needing to reorganise their activities. Financial intermediaries also need to reconsider their business model, particularly owing to the pressure of technological developments which are changing methods of access to financial services. They should begin by cutting their operating costs in line with the smaller scope of business, adjusting their tariffs and the hierarchy of debit and credit interest rates to tailor them more closely to the costs of the various services, and changing the way they design their products. The substantial efforts that financial intermediaries have already made in these areas must continue. All the same, in an economic environment featuring a slower growth rate and very low yields, those measures do not obviate the need for a more radical reflection on the potential impact of regulatory changes and technological progress on the future development of the financial sector.

36. In promoting financial integration within the euro area, the SSM will have a major influence on the Belgian market. The harmonisation of supervision procedures could favour the development of cross-border groups, the requirements imposed respectively on parent companies and subsidiaries could be reconsidered, while the strategic choices of the leading Belgian banks will from now on be examined by the ECB. Those institutions will have to clearly explain the advantages of their main strategic choices, especially where they differ from the structures usual elsewhere in the euro area, as is the case for the Belgian *bancassurance* model.

37. Another initiative which has already been mentioned and which may influence competition conditions between financial intermediaries is the Capital Markets Union Action Plan, launched by the EC in September 2015. The aim is to encourage the development of other funding sources,

complementary to bank financing, notably by relaunching high-quality securitisation, facilitating long-term investment in infrastructure by insurers and pension funds, and initiating consultations on venture capital funds and covered bonds. These alternative funding sources – notably via the new European long-term investment funds (ELTIFs) set up in May 2015 by an EU Regulation – could enable Belgian financial intermediaries to offer their customers investment opportunities generating a higher return than traditional banking products. The banks have for some years been exploiting the synergies with investment funds arising from asset management consultancy activities in order to generate fee income to supplement interest income. Those links with businesses outside the sphere of credit institutions are tending to proliferate, creating a shadow banking sector. This diversification of the financial circuits is a good thing because it means that Belgian and European firms need no longer depend solely on bank financing, but it is necessary to ensure that the use of these parallel entities is not a means of circumventing prudential supervision and market transparency obligations.

38. In the years ahead, the major challenge that financial intermediaries are likely to face will concern the spread of IT innovations. New players specialising in the development and application of digital technologies will try to penetrate the financial market, particularly in the sphere of payment services or credit platforms and crowdfunding. Traditional financial intermediaries will need to revise their business models, using integrated data platforms in order to provide the speedy, flexible services that customers now expect. Financial institutions might have to abandon the separation of their various activities – blurring the distinction between services for business and private customers – and concentrate instead on an integrated approach. New business models are being developed which offer traditional banking activities in new ways, e.g. by exploiting massive databases or by totally revamping the transaction process. The degree to which traditional financial institutions will themselves be able to direct and adopt the radical changes expected in the IT sphere will determine whether they themselves or new players will dominate the supply of financial services in the future. In this regard, traditional intermediaries will also have to pay attention to presenting their services in modular form, optimising their costs and ensuring that IT innovations in financial services are customer-friendly.

39. The authorities are aware that they have a supporting role to play during the sector's transformation, and in 2015 the Minister of Finance set up a group of leading experts to consider the future of the financial system in Belgium. Seeing that the most attractive financial centres are the ones operating within a stable and predictable legal, fiscal and regulatory framework, thriving in conditions that foster expertise and skills, the experts issued a number of recommendations aimed at strengthening the resilience of the Belgian financial market and making it more competitive. The Bank is prepared to work with the Minister of Finance in following up this report in areas which fall within its competence. It welcomes the experts' decision to refrain from proposing measures and tax incentives which would be unrealistic in the current fiscal conditions and would merely introduce distortions in the collection and allocation of financial savings. Similarly, it also supports the idea of simplifying taxation of investment income to enhance its neutrality. The government's main contribution to the smooth operation of the financial system must be to maintain a general environment conducive to the development of a flexible and competitive economy, in which the financial system can benefit from the expansion of activity and contribute towards support for growth.

4. The Belgian economy: obstacles to growth removed

40. In the wake of the euro area's recovery, the gradual revival of the Belgian economy has continued. The efforts to promote competitiveness and employment are already having some effect, but should continue to produce results in the years ahead. There have also been significant measures to ensure the long-term sustainability of public finances, but in 2015 only very modest progress was achieved in fiscal consolidation.

41. The Belgian economy still faces considerable challenges. They pre-date the crisis and concern progressive globalisation, climate change, the impact of rapid technological development and the costs of population ageing. The crisis has also left scars, so that the environment in which these challenges must be addressed has deteriorated. For instance, the public debt has risen by almost 20 percentage points of GDP in the space of eight years, swelling from 86.9 % in 2007 to 106.5 % in 2015, although the switchover to the new European System of Accounts (ESA 2010) also played a role here. The crisis also had an impact on employment, albeit to a lesser degree than in the euro area. Between 2007 and 2015, the employment rate dropped from 67.7 % to 67.2 % so that, instead of approaching the target of 73.2 % set for 2020, it has widened the gap. Over that same period, the unemployment rate increased from 7.5 % to 8.4 %. The crisis years were particularly tough for newcomers to the labour market and workers with low skills, and that is detrimental to social cohesion. The reason underlying these various factors is that, during that period, economic activity was almost 10 % below the level that might have been expected on the basis of trends prevailing before the crisis. The longer the effects of the crisis persist, the greater the risk that this loss will become permanent. Thus, high unemployment and low investment, though initially cyclical, could ultimately depress output potential because of the risk of the permanent loss of talent on the labour market and the failure to build up an adequate capital stock. What is true for the euro area as a whole also applies to the Belgian economy: the solution cannot come solely from an accommodative monetary policy, though that has supported growth in Belgium, too. Other levers must also be used for that purpose.

42. Since 2011, various measures have already been taken, both to contain the repercussions of the crisis and to remedy the structural weaknesses of the Belgian economy. That reform policy is spearheaded by labour market reforms, the extension of working life, the restoration of competitiveness, the reduction in charges applicable to labour and the consolidation of public finances, without hampering growth. Some important new steps were taken in 2015. Their main objective is job creation, particularly in the private sector, since job creation had until then been heavily concentrated on the public sector and branches subsidised by the government. The aim is to lay a solid foundation not only for economic activity but also for sound public finances and the financial sustainability of the Belgian social model. Aided by the revival in economic activity in the euro area, some measures had a significant impact on a number of economic developments in 2015. That was less true of others, either because they take longer to produce their effects – as in the case of the pension reform – or because they will only be phased in gradually, such as the tax shift.

The policy pursued had an impact on various economic developments in 2015

43. Economic activity expanded by 1.4 %, or 0.1 of a percentage point more than in 2014. As in the euro area, it was bolstered by the beneficial effect of monetary policy easing on financing conditions, by the euro's depreciation and by the fall in commodity prices. This last factor reduced firms' expenses and provided considerable support for household purchasing power. In addition, the recovery in the euro area also contributed in itself to the Belgian revival. The impetus from domestic sources was more diffuse. In the short term, both the control of public expenditure and the continuing wage moderation could conceivably have depressed domestic demand somewhat before stimulating growth via gains in competitiveness and job creation. Perhaps that is why growth in Belgium was slightly weaker than in the euro area, for the first time since the crisis. Nevertheless, there are signs that the policy adopted is beginning to produce results.

44. In 2015, primary public expenditure – i.e. public spending excluding interest charges on the public debt – dipped slightly in real terms, after its growth had already slowed down between 2012 and 2014. The main reason for this fall in 2015 is the index jump together with

the job cuts in the public sector and the reduction in certain operating expenses and subsidies. The index jump slowed the increase in civil servants' pay and the growth of social benefits. Overall, the share of primary expenditure in GDP declined for the second consecutive year, from 52 % in 2014 to 51.2 %.

45. The revenue ratio is expected to show an identical fall, i.e. from 52 % to 51.2 %. This decline is due partly to the impact of wage moderation on levies on earned incomes and to the first tranche of the tax shift which has already been implemented. In regard to the latter, in 2015, the total measures to support purchasing power – and in particular the rise in the flat-rate allowance for professional expenses – exceeded the revenue derived from increases in indirect taxation during the final quarter, namely the higher rate of VAT on electricity and the increases in excise duty on diesel, tobacco and alcoholic beverages. But at the same time, corporation tax revenues were also lower than expected, despite the measures aimed at enlarging the tax base, perhaps owing to a shift away from advance payments in favour of collection via the assessments. VAT revenues also fell short of expectations, as a result of higher refunds. The latter two developments on the revenue side need to be closely monitored. They largely explain why the public deficit has only improved by 0.3 % overall; that is in line with the improvement resulting from the continued reduction in interest charges. The budget deficit therefore came to 2.8 % of GDP, whereas when the stability programme was presented in April, the target was a deficit of 2.5 %, and when the draft budget was being prepared in October, a 2.6 % deficit still appeared to be feasible. The fact that the public debt nevertheless declined slightly is due solely to exogenous factors, the main one being KBC's repayment of the aid from the Flemish government.

46. In addition, wage moderation was further reinforced in 2015. Apart from the new ban on awarding real collectively negotiated pay rises in the private sector, the indexation mechanism was temporarily suspended from April 2015. In consequence, the rise in hourly labour costs slowed again, dropping from 0.7 % in 2014 to 0.4 %, whereas it had reached 3.1 % and 2.5 % respectively in 2012 and 2013. Taking account of productivity gains, unit labour costs in the private sector actually fell for the second consecutive year, declining by as much as 0.5 % in 2015.

47. Despite falling labour costs and commodity prices – the latter having had a particularly large impact on energy prices – inflation speeded up, rising from –0.4 % at the end of 2014 to 1.4 % at the end of 2015. That was due partly to increases in indirect taxation connected with the tax shift, and to price rises resulting directly or indirectly from the fiscal consolidation efforts of the various public authorities. Together, these factors drove up inflation by an estimated 0.5 of a percentage point on an annualised basis. Even taking account of that, there are signs that high inflation is persisting, especially in services, perhaps because of insufficient productivity gains, the practice of price indexation, or increased margins. Price rises of that type accelerate the loss of purchasing power caused by the index jump, as well as bringing forward the time when indexation can resume, and therefore reduce its effectiveness. If these price rises persist, they will also exert more permanent pressure on competitiveness, not only because the services provided are intermediate inputs for branches exposed to competition, but also because the movement in their prices affects wage-setting.

48. Wage moderation has greatly narrowed the hourly labour cost gap which had built up since 1996 in relation to the three neighbouring countries. According to the technical report of the Central Economic Council, the gap diminished from 4.1 % in 2013 to 2.9 % in 2014 and then 1.5 % in 2015. In 2016, the hourly labour cost gap should actually become slightly negative. Although hourly labour costs had moved at a more moderate pace in Belgium than in the Netherlands and France throughout that period, a considerable wage handicap had developed in relation to Germany. That has also narrowed, not only as a result of Belgium's wage moderation but also because of the return to larger wage increases in Germany. The unit wage gap accumulated since 1996 has also diminished considerably. While it still stood at almost 10 % in 2013, it dropped to 5.3 % in the first three quarters of 2015. That handicap is

attributable to market services, where productivity growth in Belgium lags significantly behind that in neighbouring countries, while the rise in hourly wages is roughly the same. For 2016, the law makes provision for the possibility of granting new real negotiated wage increases provided they keep within the total margin of 0.5 % of the gross wage bill – corresponding to the total employer cost including all charges – plus 0.3 % of the wage bill in net terms – at no extra cost for the employer. Combined with the index suspension, this should lead to a faster improvement of firms' costs competitiveness.

49. It is also clear from the figures for economic activity and employment that the policy pursued is beginning to produce results, although the cyclical upturn due mainly to external factors has also been a key determinant. Thus, while exports of goods and services were hit by the slowdown in world trade, gains in market share were made, as in 2014. That is attributable both to the euro's depreciation and to cost control in Belgium. The labour market situation also improved considerably, even during the second half of the year when growth faltered somewhat. Domestic employment was up by 37 500 units; the improvement was also evident for employees in sectors sensitive to the business cycle. In that respect, contrary to what was seen for a number of years, job creation connected with service vouchers was limited and public sector employment actually declined slightly. The unemployment rate began to fall from May onwards. The number of long-term unemployed was also down slightly, although that is to some extent because a portion of the unemployed who had lost their entitlement to an integration allowance ceased to register as job-seekers. Since 1 January 2012, that entitlement has been restricted to a maximum of three years, and the implications of that measure were apparent for the first time in January 2015. In addition, there are ever-increasing signs that age is seen less and less as a factor for working or not. Not only are older unemployed persons now required – following successive reforms – to remain available for the labour market up to the age of 65 years, but since mid-2014, the number of unemployed people between the ages of 50 and 55 has fallen. Finally, the employment rate of persons over 55 years of age has continued to rise, reaching 43.8 % in 2015, or almost 10 percentage points higher than in 2007 on the eve of the crisis.

50. In 2015, besides the fall in commodity prices, the growth of employment totalling 0.8 % was therefore the main factor supporting disposable incomes. Despite wage moderation, disposable income was up by 1.2 % in real terms, and private consumption grew to the same extent. That is the strongest rise since 2010. Conversely, investment in housing slowed down in 2015, mainly because the prospect of a change in the housing bonus in Flanders had caused many investment plans to be brought forward to 2014. Nevertheless, other determinants such as the fall in mortgage interest rates and the improvement in the outlook for jobs provided support. Business investment also slowed down, mainly owing to temporary factors, whereas it benefited from the strengthening support of rising demand, increased capacity utilisation, the restoration of profitability and highly favourable financing conditions. It therefore seems that investment is poised to become one of the engines of the recovery in the future.

Further strengthening the Belgian economy and the sustainability of public finances

51. For the coming years, the tax shift and the pension reform are already two key projects under construction; moreover, a budgetary path has been set which, in regard to fiscal consolidation, aims at a structural balance in 2018. That all requires rigorous implementation, while in some areas additional measures are needed to provide maximum support for growth potential and job creation in the Belgian economy.

52. The tax shift is intended to reduce the wedge between labour costs and net pay, which in Belgium is the biggest in the EU. By driving up costs, the heavy charges on labour curb demand for labour and by their impact on net wages they depress both the supply of labour and

purchasing power. To remedy that situation, the federal government intends to implement new structural measures in relation to purchasing power and competitiveness amounting to a total of € 11.4 billion spread over the period 2015-2020, which is equivalent to 2.2 % of the GDP expected in 2020. The gross purchasing power stimulus amounts to € 7.3 billion and consists mainly of personal income tax reductions. Since this measure has a significant impact on lower incomes, these tax cuts also contribute towards combating the unemployment or inactivity traps. The amount allocated to the adjustment of social welfare benefits has also been increased, while corrections are planned to offset the negative effect on the lowest incomes due to funding of the tax shift. To improve competitiveness, reductions are scheduled amounting to € 4.1 billion and mainly concerning employers' contributions. These are predominantly linear reductions; the others concern lower incomes or specific problem areas relating in particular to start-ups and initial recruitment by firms. These reductions in charges also include the cuts which had already been decided on by the previous federal government under the Competitiveness Pact. The extra purchasing power primarily generates additional jobs by boosting domestic demand. Alongside the rise in net exports, an important effect of the measures concerning competitiveness is that the price of labour as a factor of production is made more attractive in relation to the cost of capital. Since that renders the production process more labour-intensive, this type of measure boosts the growth of employment.

53. To fund the tax shift, measures amounting to € 4.8 billion have been defined sufficiently clearly to be taken into account in a simulation. They include € 2.6 billion in indirect tax increases, while the taxes on property incomes are also being raised and the corporate tax base is being enlarged. Simulations using the Bank's quarterly model show that, viewed overall, the tax shift – which comprises a gross injection of € 11.4 billion and funding for that amounting to € 4.8 billion, implying a fiscal stimulus of € 6.6 billion in addition to the favourable effect of the actual shift in charges – will generate 1.5 % extra growth between now and 2021 and help to create around 64 500 additional jobs. Even if the feedback effects are taken into account, it is evident that the tax shift as currently envisaged is not fiscally neutral over the period in question. In order to meet the fiscal targets, it is therefore necessary to continue to focus on the funding, first of all by ensuring that all the funding channels already specified but not yet defined in detail are fully utilised. That will reduce the impact on growth and employment.

54. To maximise the benefits of the tax shift and the other measures aimed at restoring competitiveness, it is desirable to proceed with reforms aimed at strengthening competitive pricing and promoting appropriate wage-setting. More competitive product markets – the need for which is still evident particularly in the network industries and in certain services sectors – will permit efficiency gains and price reductions which will benefit purchasing power and cost competitiveness. That will also enhance the transmission of both wage moderation and the tax shift to selling prices by avoiding an increase in margins, so that growth and employment will be fully supported. The simulations using the Bank's model also incorporate this impact of cost reductions on prices, and that is one of the decisive factors in the scale of job creation. It is likewise necessary to ensure that the margins created by the reductions in charges benefit employment to the maximum degree and are not used to steer wage-setting in a different direction. One of the assumptions underlying the Bank's model simulations is that the tax shift has no impact on the movement in real wages. It is also necessary to ascertain how wage-setting can be brought more effectively into line with productivity growth. The government's forthcoming revision of the Law of 26 July 1996 on the Promotion of Employment and the Preventive Safeguarding of Competitiveness offers an opportunity in that respect. It is necessary to act jointly with the social partners to seek a new balance between the advantages of coordination at the macro level and the need for increased modulation according to developments specific to sectors or firms or the business cycle.

55. The federal government has also devoted much attention to a pension reform which was largely implemented in 2015. Thus, it was decided to raise the statutory pensionable age to

66 and 67 years in 2025 and 2030 respectively. The conditions governing early retirement have been tightened up, as have the criteria governing entitlement to unemployment benefits with employer top-up – previously known as the "pre-pension" scheme – while the pension bonus has been abolished. In addition, in the case of the public sector pension scheme, the rule whereby years spent studying count towards the calculation of years of service will be phased out between 2016 and 2030. On the other hand, the wider reform of public sector pensions announced when the federal government took office and which aims to bring that scheme more closely into line with that in the private sector has yet to be carried out. In 2015, a National Pension Committee was also set up to advise the government.

56. The Study Committee on Ageing has calculated that, taking account of the reforms already in place, ageing costs will decline between now and 2040, dropping from 5.8 % to 3.1 % of GDP, and from 4.2 % to 2.1 % by 2060. That gain is the combined result of the reduction in the number of benefits paid to pensioners and unemployed people entitled to an employer top-up, together with the positive impact on growth potential of the fact that most of those people will remain in work for longer, which should ultimately boost employment, and hence GDP, by 5.6 %. As a result of these reforms, the employment rate among those in the 55-66 age group is forecast to rise by 16.4 percentage points to reach 68.2 % in 2060. The extension of working life and the resulting higher pensions should reduce the risk of poverty among pensioners, thus improving not only the fiscal sustainability of the pension system but also its social sustainability. It is specifically the reduction in ageing costs in the longer term, resulting from the pension reform, that will create some scope for fiscal policy in the shorter term. The heavy burden on the budget associated with population ageing is one of the reasons why Belgium still needs to pursue an ambitious medium-term objective within the European fiscal framework – in this case a structural surplus of 0.75 % of GDP ; however, that objective could conceivably be adjusted downwards once the effect of the pension reform is taken into account. It is also possible that, following these reforms, households may feel less need to save in order to fund their own retirement, and that could already provide support for demand in the short term.

57. But, to maximise the effect of the pension reform, it is also necessary to consider the question of remuneration, and firms must ensure that appropriate adjustments are made to cater for the longer working life. In fact, it is common for pay to rise with seniority, without reflecting any proportionate increase in productivity, even if older workers have a favourable influence on the productivity of young people by passing on their experience. Career development is not sufficiently successful at retaining older staff in work. It is therefore crucial to attend to the productivity, employability and career characteristics of workers at each stage of their career, and especially those of older workers, if the reform is to succeed. In that respect, the social partners have a key role to play, as their practical knowledge places them in a good position to design the qualitative content of the necessary extension of working life.

58. The restoration of competitiveness and the tax shift will obviously favour the required expansion of employment, as will the pension reform. Nonetheless, the labour market needs additional measures on top of the efforts already made in regard to the responsibility and activation of the unemployed. Now that the economy is picking up and the number of vacancies is rising, labour supply must not trail behind. Special attention should focus on risk groups which have difficulty in entering the labour market, particularly people from non-EU countries and low-skilled workers. Furthermore, every effort must be made to ensure that the new refugees are integrated into the labour market as quickly as possible. In an economy with an ageing population, the influx of young workers is not only a challenge, it primarily presents opportunities. That is why an inclusive approach is vital ; it is also necessary to combat all forms of discrimination. The policies pursued must take sufficient account of characteristics specific to the various target groups, because the factors which may impede the integration of new refugees into the labour market are not the same as those applicable to second- or third-generation immigrants.

59. The paradigm of the modern labour market is based on developing talent rather than on selection. The primary focus must be on training, support and easing the transition between the various forms of education and the labour market. Targeted reductions in the wage burden, responsibility for which rests with the Communities and Regions since the sixth State reform, may also be an appropriate instrument here. Obstacles to the geographical mobility of workers must be removed. Finally, it is also vital to ensure that workers remain employable. Life-long learning must enable them to keep up with rapid technological innovations and changes to the work process.

60. To support growth potential and boost productivity, it is also necessary to encourage entrepreneurship and innovation and remove the factors hampering business start-ups and market access. The economy in fact involves a dynamic process. In the short term, its development is determined mainly by the success of existing firms, where cost control is often a decisive factor. However, in the longer term, the predominant factor and primary source of income is rotation, whereby new businesses, new products or new production processes take over from existing ones. This dynamic can operate smoothly if, in particular, administrative, legal and fiscal obstacles are eliminated, an effective, transparent regulatory framework is established, the public administration works properly and financial intermediation is efficient. At macroeconomic level, growth occurs not only if the frontiers of technology are pushed forward but also and above all if technological innovations – especially in the field of information and communications (ICT) – become widespread throughout the economy. The Belgian economy features a number of firms that are particularly productive and innovative at international level, but the country also has many firms which fall short of the highest productivity standards. There is therefore considerable ground that could be made up. Moreover, the development of an adequate infrastructure could stimulate growth via the associated investment and by the support functions that the infrastructure offers for the rest of the economy. Here, too, the challenges are formidable, as is evident from the scale of everyday traffic problems. In regard to mobility, what is needed is a vision geared to the future which, by establishing the right incentives, changes attitudes to the organisation of work and housing, and the use of leisure time, so that demand for transport is first reduced and then channelled towards modes of travel that generate the least pollution. Here, too, the government has a major role to perform in steering developments.

61. Finally, fiscal consolidation conducive to growth is vital to achieve the structural balance planned for 2018. That balance is necessary to provide the means to meet the budgetary costs of ageing and, via a substantial reduction in the public debt, to rebuild the financial buffers to absorb negative shocks and create the scope for addressing the new challenges facing society. Owing to the deviation from the planned budget path in 2015, there is a need to adjust the efforts to be made in the coming years. On the revenue side, this concerns the funding of the tax shift and close monitoring of the revenue figures which, in 2015, failed to keep up with the tax base. Work is also needed to ensure that taxes are duly collected and to maintain resolute efforts to combat both tax evasion and tax and social security fraud. All the same, the budgetary adjustment will have to come largely from judicious control over expenditure. Despite the progress made, primary public expenditure is still high, not only in comparison with the pre-crisis situation but also in relation to most other advanced economies. Moreover, there is also some scope available on the expenditure side for adjustments more favourable to growth. Investment in infrastructure, training and sustainable development can boost economic growth, but so can a reduction in social inequality. Now that the economy is picking up, it is time to implement fiscal consolidation without fear of serious negative feedback effects.

62. All levels of government must contribute to fiscal consolidation. To that end, it is necessary to set binding, verifiable targets for each entity in accordance with the cooperation agreement of 13 December 2013 between the federal government and the Communities and Regions, which assigned monitoring powers in that respect to the High Council of Finance.

63. Since 2011, significant steps have been taken towards eliminating the structural weaknesses of the Belgian economy. Labour market reforms, the extension of working life, the restoration

of competitiveness, the reduction of charges on labour and the preservation of sustainable public finances are all priority aims of the reform policy. Together with the favourable effect of the upturn in economic activity, the reforms are also beginning to produce results, notably as far as improving competitiveness is concerned, creating private sector jobs and controlling public expenditure. It is important to continue with the reform efforts in order to reinforce the economic basis, as well as the sustainability of public finances, and to find a balanced and forward-looking response to the socio-economic challenges. For this, a multipolar strategy is required. First, the growth potential of the Belgian economy must be given maximum support. That is vital mainly for the development of a high standard of living. That will also foster the sustainability of public finances while creating scope to meet the costs of ageing and the new challenges facing society. Next, sound public finances require continuing fiscal consolidation so as to achieve the structural balance in 2018. All available levers must be deployed. They are not substitutes but complement one another. Both pricing and wage-setting and labour market policies must be geared even more to maximum support for job creation, implementing the longer working life arrangements and raising the particularly low employment rate of certain risk groups. Substantial efforts must also be devoted to promoting entrepreneurship, innovation and productivity which, in the long term, will be the main source of income creation while at the same time being the key to greater environmental sustainability. Consistency between the various policy areas and – in a federal state like Belgium – between the various levels of power is crucial in that respect. There is much at stake. It is a matter of laying solid foundations not only for economic activity and sound public finances but also for the financial sustainability of the Belgian social model. Such a comprehensive, forward-looking project must be able to count on the support of all elements of society and all levels of power.

Brussels, 27 January 2016

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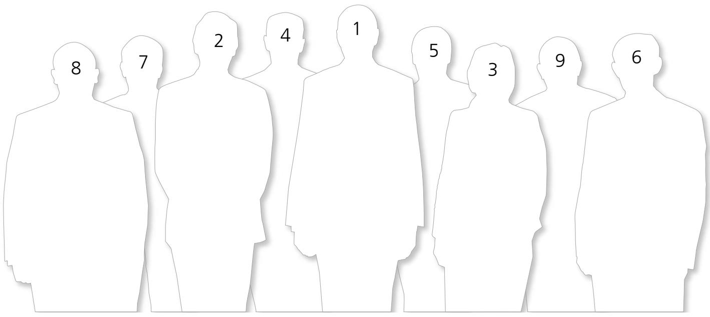
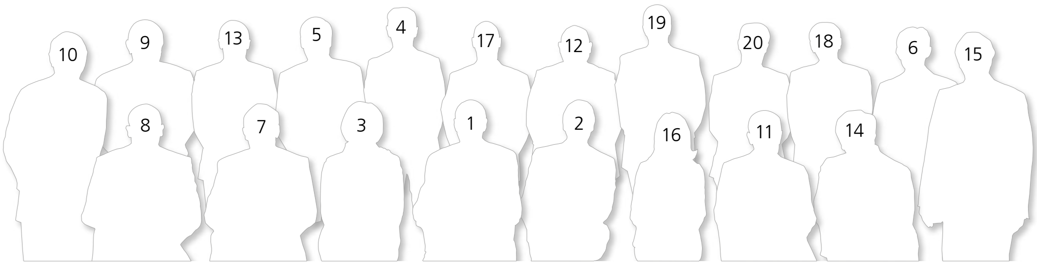
6 Vincent Magnée, DIRECTOR
7 Tom Dechaene, DIRECTOR
8 Tim Hermans, DIRECTOR
9 Luc Dufresne, SECRETARY



Council of Regency



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