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

1. Policy uncertainty has increased worldwide, whereas everything possible should be done to strengthen growth and make it more inclusive

1. Global economic growth was modest again in 2016, at 3.1 %. As in 2015, activity was held back by the process of radical transformation in emerging economies. The catalyst is the rebalancing in China, as the country is in transition from an economy geared to investment and exports to a growth model based more on consumption and services. Yet it was the advanced economies that – in the wake of often unexpected political developments – experienced the greatest uncertainty over strategic options for the future, at a time when those countries were still struggling with the legacy of the economic and financial crisis. Despite the heightened uncertainty and the accompanying waves of volatility on the financial markets, activity in the advanced economies was resilient in 2016, and growth actually gained momentum in the second half of the year. But the rising uncertainty implies risks for the future. If those risks materialise, the advanced economies could become trapped in slow growth, putting further strain on social cohesion. For that reason, everything possible must be done in the future to strengthen growth while making it more inclusive.

2. The transition in China is necessary to achieve a more sustainable growth model and must also help to reduce the current account surplus. That nevertheless entails the risk of an overly abrupt slowdown in growth, and threatens to exacerbate the vulnerabilities associated with the strong credit expansion and rising property prices. Furthermore, it reinforced the decline in commodity prices – the price per barrel of crude oil had dropped below $ 30 in January 2016 – which in turn brought deep recessions in the countries heavily dependent on commodity exports. However, signs of stabilisation emerged in 2016, especially in Brazil and Russia which benefited from the depreciation of their currency and the partial recovery of commodity prices. At the end of the year, oil prices gained further support from the OPEC countries' decision to limit production, while industrial commodity prices also rose. In China itself, the delicate rebalancing process was accompanied by fiscal stimulus to prevent an excessive growth slowdown. The monetary authority maintained its accommodative policy and used its foreign currency reserves to support the renminbi exchange rate. At the beginning of 2016, concern over the emerging economies sparked increased nervousness

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

on the financial markets, but that subsequently subsided. Nonetheless, the real economy and the financial sector in China still require substantial adjustments, and the countries dependent on commodity exports, lacking a more diversified growth model, continue to struggle with significant excess capacity.

3. The headwinds from the emerging economies were among the factors causing growth in the advanced economies to slow by half a percentage point to 1.6 %. That slackening was particularly evident in the United States, especially in the first half of the year. Against that backdrop, the Federal Reserve did not raise its key interest rate until December, exactly a year after putting it up for the first time since the outbreak of the crisis. In Japan and the euro area, where growth was only modest and there was no sustained rise in inflation, monetary policy was further eased. The same applied in the United Kingdom, where in August the Bank of England launched a range of stimulus measures to soften the economic impact of the result of the 23 June referendum in which the British people opted to leave the EU (Brexit).

4. This unexpected referendum result sent strong shock waves through the financial markets, but they were short-lived. Furthermore, economic activity in the United Kingdom remained more robust than expected in the second half of 2016. Immediately after the referendum, the pound sterling depreciated. A second wave of depreciation followed in October when it became clearer that future trading relations between the United Kingdom and the EU might be less open than originally assumed. In the aftermath, inflation forecasts began rising while expected real interest rates declined. The erosion of purchasing power due to the deterioration in the terms of trade, the uncertainty about the new relationship with the EU and the rest of the world, and the adjustments which will ensue sooner or later, are all factors which will depress the outlook for growth in the United Kingdom for a considerable time.

5. While Brexit had surprisingly little impact on economic activity in 2016, the long-term economic repercussions are potentially significant, including outside the United Kingdom. That obviously applies primarily to the other EU countries, and the euro area in particular, considering the close trading relationship with the United Kingdom, the predominance of London as a financial centre in the EU, and the flow of migrants to and from Britain. The Belgian economy's exposure is also considerable, not least because the United Kingdom is Belgium's fourth largest export market. The Bank is therefore keeping a close eye on the risks associated with Brexit as regards both the real economy and the implications for the financial system. With this expertise, the Governor is assisting the government, in particular in a High-Level Group set up specifically for that purpose.

6. Brexit obliges the EU not only to address the complex task of clarifying its future relationship with the United Kingdom but also to seek a new dynamic. That presents challenges but also creates new opportunities. Compared to the period immediately following the financial crisis, the pursuit of deeper Economic and Monetary Union is now receiving less attention. With the refugee crisis, the changing geopolitical relationships and the terrorist attacks, the focus has shifted to other subjects. Europe has to produce a convincing response on all fronts. Greater economic clout resulting from more complete monetary union could make it easier to respond adequately to the many other concerns of European citizens. Moreover, it could provide a solution to the growing sense of socio-economic insecurity fuelled not only by the repercussions of the crisis but also by the uncertainties associated with globalisation, digitalisation and increased income inequality. Giving new impetus to European integration is not an end in itself, but is nevertheless necessary to provide maximum support for growth dynamics, to enjoy the full benefits of the single currency, to foster socio-economic inclusion and – at global level – to maximise Europe's influence in the interests of each of its Member States.

7. Yet there is clearly greater uncertainty now over the continued momentum towards European integration. Not only is 2017 an election year in many Member States, a more important factor

is that in continental Europe, too, the idea is gaining ground that self-reliance and taking back national sovereignty can solve the complex problems confronting the economy and society in general. Much the same considerations dominated both the Brexit debate and the presidential election campaign in the United States. In both cases, migration was a key issue defining points of view. In the United States, it also gave rise to calls for a protectionist trade policy.

8. This aversion to openness and the tendency towards protectionism are emerging at a time when the growth of world trade is already particularly weak. In 2016, it reached only 1.9 %, falling well short of global GDP growth. That is due partly to cyclical factors such as weak investment – a result of the transition in China itself and the repercussions on commodity-exporting countries. But structural factors are also at work, such as the reversion to shorter global value chains, the lack of progress in opening up international trade, and in some cases the adoption of protectionist measures.

9. These developments, and any resulting reversal of policy, stem from the fact that greater openness has brought not only economic benefits at macro level but also side effects which have had a serious impact on large sections of the population. Although trade raises productivity, facilitates the spread of technological innovations, creates new markets and brings down prices, globalisation has been accompanied in recent decades by increased income inequality in most of the advanced economies. The reason is polarisation in favour of highly-skilled workers for whom the specialisation resulting from the progress of trade and technology is an advantage. Moreover, the economic and financial crisis had a greater impact on lower-income earners. Migration also brings costs as well as benefits. The net economic effect for the host countries depends very much on the extent to which the incomers are able to integrate into the labour market. Migration can in fact bring the labour supply more into line with demand for labour. That is why the free movement of people, like the free movement of goods and capital, is an essential component of European integration. Besides, in the monetary union, the mobility of labour between Member States is a natural adjustment mechanism in the face of asymmetric shocks. But not all forms of migration originate from motives equally beneficial for the economy – however legitimate they may be in other respects, e.g. on humanitarian grounds. That is particularly true of the influx of refugees from conflict zones in 2015 and 2016. Major efforts are therefore needed to enable asylum-seekers to enter the labour market and thus reduce the economic costs, or even convert them into advantages. The speed of recognition procedures, the knowledge and skills that asylum-seekers possess on arrival, and the efforts that the host countries make to foster their integration into the labour market are key determinants in this respect. In the case of migration, too, the consequences are not the same for all population groups. Both trade and migration therefore require support measures not only designed to achieve the most favourable possible effect at macro level but also sufficiently geared to a fair distribution of the costs and benefits.

10. The strain that this places on social cohesion could – by rejection of a policy intrinsically capable of stimulating growth – trigger a vicious circle leading to lower growth combined with weaker social protection. It is therefore vital to make growth more inclusive. In regard to education, training and support on the jobs market, that presupposes additional efforts to enable everyone to cope with the economic changes and find their place on the labour market. At the same time, everyone must be able to reap the benefits of globalisation and economic progress. Greater attention must focus on inclusive growth, not only to ensure that society is sufficiently supportive of a policy aimed at increasing growth potential via structural reforms and openness to trade, but also because that may prove more efficient from a purely economic point of view. Since the lower income groups tend to spend a larger share of their disposable income, a more inclusive policy gives a bigger boost to demand. The supply side of the economy would also benefit from improved support for all potential labour market participants, while excessive income inequality damages growth, as the lowest income groups often cease to invest in training. More inclusive growth could lead to a positive interaction

between higher growth and better social protection, potentially laying the foundations for a new social contract.

11. In 2016, the mounting uncertainty triggered successive waves of volatility on the financial markets, but they were generally short-lived. The financial system coped comfortably with these movements, and that suggests increased resilience. However, the outcome of the election in the United States brought a sharper correction on the financial markets. In anticipation of an expansionary fiscal policy, long-term interest rates climbed by more than 50 basis points. Not only could this rise become more permanent, it also had some impact on bond markets in Europe, and even more so in the emerging economies. Some of the latter are particularly vulnerable if the United States were to opt for a more protectionist trade policy, or in a scenario where the Federal Reserve was obliged to tighten its monetary policy more rapidly. In view of the high level of uncertainty and the continuing vulnerabilities in the emerging economies, a further repricing of risk cannot be ruled out. That could put a strain on the stability of the financial system and lead to a tightening of financial conditions, impeding economic growth.

12. It is therefore necessary to apply all the policy levers to support growth, otherwise there is the risk of a low-growth trap. Today's weak growth is in fact detrimental to tomorrow's growth potential, with the threat of cyclical unemployment turning into structural unemployment, and low investment having an adverse effect on the capital stock. The prospect of weak growth potential in turn inhibits demand via a permanent income effect on consumption and reduced investment. The accommodative monetary policy, important though it is, cannot be the only lever. A vital role must therefore be assigned both to a fiscal policy conducive to growth and confidence, and to the kind of structural reforms that not only support longer-term growth potential but can also stimulate demand straightaway in the short term.

13. That approach also avoids the need to give monetary policy too big a role in the adjustment. Monetary policy cannot in fact provide a solution to many challenges extending beyond the purely monetary sphere, and therefore requiring a structural remedy. The inability to find those solutions could exacerbate the pressure on central banks, or even cast doubt on their independence, especially now that attention is increasingly focusing on the distributive effects of monetary policy and the implications for savers. In the long run, the loss of that independence would be detrimental to price stability so that, rather than providing an answer, it would create an additional source of uncertainty.

2. Low interest rates in the euro area : a symptom of insufficient growth

14. The modest revival in economic activity evident in the euro area from mid-2013 continued in 2016, although growth dipped to 1.7 %, compared to 2 % in 2015. Despite the rather unfavourable external environment, the heightened uncertainty and the waves of volatility on the financial markets – caused partly by concerns about the euro area's banks and their ability to finance the economy – the recovery remained intact. That was due to the favourable financing conditions following the further easing of monetary policy plus a degree of fiscal stimulus. Furthermore, domestic demand – and particularly private consumption – benefited not only from low oil prices but also from surprisingly strong job creation. Partly as a result of earlier labour market reforms, growth was in fact highly labour-intensive. The fact that domestic demand has now become the engine of growth, and remained so under the tough conditions of 2016, contrasts with the first phase of the recovery experienced by the euro area immediately after the great recession.

15. Nonetheless, the euro area still faces a serious imbalance between savings and investment. The share of investment in GDP remains more than 2 percentage points below the pre-crisis average,

and the current account surplus – i.e. the difference between savings and investment – has now risen to 3.7 % of GDP. These various factors reflect deficient demand and underemployment. According to the European Commission, the output gap was 1 % negative in 2016, and unemployment still stood at 9.8 % at the end of 2016. While headline inflation increased to 1.1 % at the end of the year owing to the upturn in energy prices, under-utilisation of production capacity continued to hold down domestic costs. As a result, inflation excluding energy and food came to no more than 0.9 % for the third consecutive year.

16. As inflation remained persistently below the price stability level defined by the ECB Governing Council – inflation below, but close to, 2 % over the medium term – and as there were insufficient indications that this gap would be closed on a lasting basis, the already highly accommodative monetary policy stance was eased further on two occasions in 2016. There was only limited recourse to the key interest rates for that purpose, although in March 2016 the rate on the main refinancing operations was cut by 5 basis points to 0 % and the deposit facility rate was reduced by 10 basis points to –0.40 %.

17. The more negative the key interest rates, the more difficult it becomes to transmit further easing via the banks, a very important channel for financing the euro area's economy. The fundamental reason is that there is always a financial asset on which the interest rate is zero : namely banknotes. That makes it difficult for banks to apply negative interest rates to their retail deposits. In the case of private savings deposits in particular, that could mean the risk of a large-scale withdrawal of banknotes. If the cost of this major source of finance cannot fall further, that will put pressure on the banks' profitability and hence on their ability to pass on the interest rate cut in their lending rates, or to continue granting credit. This demonstrates that there is a lower bound for the key interest rates, and explains why central banks resort to other instruments once that limit is approached. The use of these non-standard instruments essentially amounts to holding the key interest rates at their lower bound for a longer period instead of lowering them further, and depressing risk premiums by means of asset purchases in order to flatten the yield curve. That creates a low interest rate environment over a generally longer period, rather than a decidedly negative interest rate environment.

18. The Eurosystem had already taken that route before, first indicating from July 2013 that the key interest rates should be expected to remain at or below their existing level for a prolonged period, and then in 2015 launching a large-scale asset purchase programme. Under that programme, from March 2015 onwards it purchased fixed-income assets amounting to € 60 billion per month – mainly in the form of government bonds, but also covered bank bonds and asset-backed securities – initially with the intention of continuing the purchases until September 2016. In December 2015, the programme was extended to March 2017, and in any case until the Governing Council saw a sustained adjustment of the inflation path consistent with the price stability objective. From the start, the duration of the programme was linked to the results achieved in terms of inflation.

19. The monthly volume of asset purchases was subsequently increased from € 60 billion to € 80 billion in March 2016, and it was announced that bonds issued by non-financial corporations would also be bought. In addition, the forward guidance on the key interest rates was reinforced by linking it to the guidance on asset purchases. It was in fact specified that the period for which the key interest rates would remain at or below their current level would extend well beyond the horizon for the net asset purchases. The interest rate signal was further reinforced by applying a fixed interest rate to the new series of four targeted refinancing operations with a term of four years announced at the same time. Together with the cut in the deposit facility interest rate to –0.40 %, this was a response to the further decline in inflation expectations in the initial months of 2016. That decline was due in turn to the deteriorating outlook for the growth of the world economy and the resulting increased pressure on oil prices. Lower inflation expectations are quickly reflected in actual inflation because they

influence pricing and wage-setting. In addition, the real interest rate rises if the fall in inflation expectations is not offset by an easing of monetary policy; that impedes the revival of economic activity, and hence any rise in inflation. In such circumstances, the risk of a deflationary spiral was not far off.

20. In December 2016, the ECB Governing Council decided to extend its asset purchases beyond March 2017 because there were no sufficiently clear signs of a sustained adjustment of the inflation path towards the objective. It therefore extended the programme on this occasion to December 2017, or later if necessary, in line with its previous statements. But since the threat of deflation had diminished considerably compared to the start of the year, the monthly amount of these additional purchases was cut to the original figure of € 60 billion. In the meantime, it had actually become apparent that the economic recovery was continuing, while commodity prices and inflation expectations were rising. However, the Governing Council also stated that the scale and/or duration of the programme would be increased if the outlook deteriorated or if the movement in financial conditions hampered any sustained adjustment of the inflation path. At the end of the year, long-term interest rates had in fact risen in the euro area too, and that rise was more pronounced in the most vulnerable countries.

21. This set of measures created particularly easy financing conditions. In the third quarter of 2016, yields on government bonds of most euro area countries declined to unprecedentedly low levels, and corporate bond yields also fell as a result of the Eurosystem's purchases. Although long-term interest rates subsequently climbed back, that mainly reflected rising inflation expectations, so that the impact on real interest rates was small. During this correction, it also emerged that the short end of the yield curve was rather insensitive to the upward movement in the United States, indicating that the forward guidance on key interest rates is working. In addition, the growth of bank lending to households and non-financial corporations gathered pace, and interest rates on those loans continued to fall. That decline was more marked in the countries hard hit by the financial fragmentation in 2011-2012, and credit conditions for small firms moved back in line with the criteria applicable to major borrowers. In a climate of uncertainty, all these factors supported the recovery.

22. All the same, there are signs that transmission through the banks is reaching saturation point, as the reduction in deposit interest rates is approaching its limit and the banks' interest rate margin is coming under pressure. But the effect of low interest rates on banks' profitability is complex, and there are also compensating factors, at least in the short term. For instance, the higher valuation of financial assets generates capital gains on the banks' securities portfolios, and the economic recovery bolsters demand for new loans and prevents defaults. As the lower interest rate environment persists, some of these positive effects fade away while the pressure on the interest rate margin persists owing to the rigidity of retail deposit rates.

23. Apart from the secondary effects on the profitability of financial institutions, the accommodative monetary policy may also imply other risks for financial stability. That is due to a potential overvaluation of asset prices, an exaggerated search for yield and strong growth of the shadow banking sector, a new credit boom or a distortion of the allocation of resources, which ultimately undermines growth potential. If these risks are confined to specific segments of the financial system, they can best be contained by prudential policy – and macroprudential policy in particular. That is certainly true for the euro area where the scale of these vulnerabilities generally varies from one country to another, and macroprudential policy has a national component whereas monetary policy operates solely at the level of the monetary union. By imposing reserve requirements, macroprudential policy can reinforce systemic resilience and limit any new excesses. Monetary policy can therefore focus on its primary objective – the maintenance of price stability – which also produces favourable effects for financial stability. By supporting nominal growth, it has a beneficial impact on deleveraging and on the credit quality of outstanding loans. In addition, price stability prevents uncertainty over the value of financial

contracts, which are often concluded in nominal terms. More particularly, unexpectedly low inflation causes an arbitrary shift in resources from debtors to creditors, and therefore puts stress on the borrowers' repayment capability. The interactions between macroprudential and monetary policy are therefore important, but this is a relatively new subject and knowledge of the transmission channels is still rather limited. The Bank therefore devoted a conference to that subject in the autumn of 2016.

24. There are as yet few signs that financial assets are generally overvalued in the euro area. However, those valuations need continued monitoring, as imbalances often build up gradually. Nor do there appear to be any preliminary signs of a new credit boom. Despite the improvement in borrowing conditions, the availability of credit for non-financial corporations is a factor that continues to hamper the funding of new projects, especially in countries where the banks still hold a large volume of non-performing loans on their balance sheet. Conversely, some euro area countries are seeing stronger growth of mortgages, and the same applies to the increase in property market prices. In that connection, the European Systemic Risk Board (ESRB) recently drew attention to the vulnerabilities on the residential property market in five euro area countries, including Belgium. The way in which the Bank took account of these and other risk factors in the implementation of macroprudential policy in Belgium is described later.

25. Monetary policy has seldom been more the subject of public debate than in 2016. There are two central topics here. One is the question whether, by driving up asset prices, monetary policy has primarily benefited the wealthiest, thus causing greater social inequality. Also, it is claimed that it has created an artificially low interest rate environment that penalises savers, a phenomenon often referred to as financial repression.

26. The impact of monetary policy on the distribution of incomes and assets is a complicated subject because it operates via two channels: one macroeconomic and the other financial. The distribution effects via the macroeconomic channel – felt mainly in the medium term – are in most cases socially progressive, as it is mainly low incomes that benefit from attenuation of the recession and hence lower unemployment. Efforts to curb the fall in inflation can prevent an arbitrary redistribution of wealth between debtors – often younger households – and creditors – who tend to belong to the older age groups. It is therefore fairer from an intergenerational viewpoint. Conversely, regressive redistribution effects may operate in the short term via the financial channel. However, analysis of the composition and distribution of the net assets of Belgian households on the basis of the 2014 Household Finance and Consumption Survey indicates that the overall distribution effect of the low interest rate environment via the financial channel is hard to estimate. While the wealthiest households benefit the most from capital gains on both financial assets and their own home or other real estate, they also suffer a loss of earnings as a result of the low interest rates. Households in the centre of the distribution lose interest income on their deposits, but on the other hand they see the value of their home increase, and they are the ones who benefit the most from advantageous mortgage loan conditions. The poorest households have a heavier debt burden, including in the form of consumer credit. In their case, a decline in interest rates tends to be beneficial. It is therefore difficult to determine whether monetary policy has had significant redistribution effects in favour of the wealthiest people, especially if account is taken of the impact of macroeconomic stabilisation on unemployment.

27. As regards the determinants of the low interest rate environment, it is not so much monetary policy itself – still less any form of financial repression – that is driving down interest rates, but the substantial imbalance between savings and investment. This cyclical component – which is still clearly apparent in the euro area owing to the deep scars left by the crisis – is combined with a range of more structural factors which have depressed real interest rates in recent decades, such as the weaker productivity growth, the increased propensity to save at global level that accompanies population ageing and greater income inequality, and the

absorption by the financial markets of surplus savings in the emerging economies. In addition, the downward pressure on the risk-free interest rate was further intensified during the crisis by greatly heightened risk aversion and the reduced supply of secure assets. In the euro area, more specifically, a number of governments had their credit rating downgraded. These factors depress the equilibrium interest rate – a theoretical rate which, given full capacity utilisation and stable inflation, brings savings and investment into balance with one another. Monetary policy has to track this movement so that the actual interest rate reflects the equilibrium rate, otherwise the interest rate is too high compared to the return on investment, so that investment declines, production capacity is not fully used, and inflation falls. That is essentially the situation today, now that – as the key interest rates approach their lower bound – non-standard instruments are also being used to influence the broader range of interest rates in the economy. Action to combat the under-utilisation of production factors and disinflation creates the conditions for ultimately restoring interest rates to the level determined by more structural factors. Furthermore, by also influencing those structural determinants – a task for fiscal and structural policies –, it is possible to bring about a more permanent rise in the equilibrium interest rate, e.g. via an increase in productivity. Since savers ultimately always have a claim on the real economy, the health of the economy is the decisive factor for their return.

28. In principle, in view of the scale of the demand deficit in the euro area, the stimulation of demand via monetary policy should preferably be reinforced by a fiscal stimulus. That is what happened to some extent in 2016. The reduction in the euro area's public deficit from 2.1 % in 2015 to 1.8 % was in fact smaller than the fall in interest charges and the impact of the cyclical improvement. In several Member States, the fiscal stimulus took the form of tax cuts. Yet it is vital to safeguard the sustainability of public finances as well, in order to cover the budgetary costs of population ageing and to build up financial reserves for the future. Boosting confidence in the sustainability of public finances also favours private sector consumption and investment. The need to pursue a stabilising fiscal policy in the euro area must therefore be reconciled with the requirement that Member States have to respect the rules of the Stability and Growth Pact. That implies that, except in a few countries, there is hardly any scope for a more expansionary stance. Most countries – including Belgium – are in fact a long way from achieving their medium-term objective under the preventive arm of the Pact. They therefore have to stick to the path required to meet that objective. Those paths are modulated according to the cyclical situation in the countries concerned and on the basis of their efforts as regards structural reforms or the European Fund for Strategic Investments. The costs relating to the refugee crisis and the security measures adopted after the terrorist attacks are also considered as exceptional factors. Since the Pact is geared to the medium term, it offers the necessary flexibility in that regard. Even with no leeway in the budget, Member States can make their fiscal policy more favourable to growth by adopting qualitative shifts in their revenue and expenditure, and by striving for efficiency gains. As well as providing a cyclical boost, it is thus also possible to support long-term growth potential. Public investment – primarily in infrastructure useful to the economy – can play a key role here. In that regard, Eurostat's clarification of the statistical treatment of public-private partnerships is welcome. It is worth ascertaining whether such public investment could be further encouraged if the preventive arm of the Pact were to take account solely of the depreciation rather than the whole of the investment expenditure, provided that does not compromise the debt's sustainability. That would permit maximum use of the low interest rate environment.

29. Structural reforms conducive to growth are another crucial component of the policy mix that the euro area needs. They can foster the process of convergence so vital to a well-functioning monetary union, and strengthen the Member States' resilience to shocks. Besides, they promote potential growth, which has currently dropped to around 1 % in the euro area, as opposed to 2 % in the United States. To speed up the deleveraging process and maintain the financial sustainability of the European social model, it is therefore essential to increase potential growth. However, the reform momentum faltered in 2016 after the implementation

of several reforms earlier, particularly in the countries most affected by the crisis. The emphasis here was on labour market reforms and the restoration of competitiveness, but in the future productivity and employment must be the key issues: productivity, because in the long term that is the prime source of income creation, and employment because participation in active life is the best route to more social inclusion. The creation of national productivity boards, recommended by the Ecofin Council in September 2016, could prove to be important in facilitating reforms in the future. Reforms encouraging increased productivity and the creation of an environment favourable to entrepreneurship can do much to help eliminate the investment deficit in the euro area. While monetary policy reduces the cost of funding investment, the adoption of reforms would increase the resulting returns. The complementarity of these two aspects of policy will give an additional stimulus to investment. Moreover, reforms encourage confidence by attenuating uncertainty regarding the long term and offering the prospect of greater growth. It is not only efficient product and labour markets that are needed but also the appropriate allocation of capital, as sufficient funding must be available for new projects geared to the future.

30. The financial sector is an important lever for achieving a sustained economic recovery in the euro area. Significant steps have been taken in recent years to restore confidence in this sector – notably with the initial phases of the banking union and, at the start of the single supervisory mechanism, a comprehensive assessment involving a review of asset quality and a stress test conducted by the ECB. Nevertheless, those measures are insufficient, as is clear from the heightened market volatility during 2016. Although the financial sector proved to be sounder and more resilient following the regulatory reforms introduced in the wake of the financial crisis, if the economic recovery is to be sustained then the euro area's financial sector requires more fundamental and decisive improvement in order to reduce the uncertainty surrounding the sector, which in June was exacerbated by the vote in favour of Brexit.

31. The problem of non-performing loans in some euro area countries – reflecting the legacy of the prolonged recession in certain Member States – must be tackled without delay. Those loans amount to over € 1 000 billion in the EU. History has shown that the presence of non-performing loans on banks' balance sheets puts a strain on the banks' financial position. These non-performing loans erode the institutions' credit supply, as the management of the portfolios in question ties up substantial resources in terms of both funds – notably additional reserves – and staff. That leaves the banks fewer resources for granting new loans. Those factors significantly hamper the recovery of economic activity in Europe, and can disrupt the transmission of monetary policy.

32. The only answer is a consistent strategy aimed at consolidation of the banks' balance sheets and based on various levers. The level of economic growth is currently too low to achieve that consolidation. And any delay on that front could kill off the already fragile growth revival and jeopardise the credibility of the European institutions set up in connection with the banking union. First, to ensure that the claims in question are identified sufficiently early and covered by provisions appropriate to the risks, the supervision has to be intrusive. In that context, the ECB has set up a working group to develop guidelines aimed at improving the management of impaired assets and defining quantitative targets for reducing the volume of those loans. In some countries, this last aim is nevertheless hampered by the low solvency of the banks. Next, more fundamental reforms of the judicial system are necessary in some Member States, particularly to enhance the efficiency of recovery and bankruptcy procedures. These reforms are essential to increase the value of non-performing loans on the secondary market and thus encourage the sale of those assets.

33. In view of the scale and diversity of non-performing loans in Europe, solving this problem also implies developing a secondary market in these assets. The establishment of 'bad banks' can make a contribution here, as can regular, substantial sales of those assets. The new European

legal framework created by the Directive on bank recovery and resolution nevertheless makes it more complex to implement such measures. It specifies that state aid, generally necessary in that connection, must be preceded by the resolution of the institution concerned and by a bail-in requirement corresponding to 8 % of the institution's liabilities. The Directive also stipulates that, under certain conditions, a credit institution can receive state aid without having to go into resolution. In order to safeguard financial stability, that option was used to enable the Italian government to arrange the precautionary recapitalisation of the Monte dei Paschi di Siena bank ; without the bail-in requirement, subordinate creditors are treated as shareholders, except for subordinate retail creditors who will be compensated for their losses by the bank itself. The resources that the Italian government has made available to consolidate the banking sector make it possible to extend that approach to other banks which cannot turn to their own shareholders or cannot raise capital on the market. But this recapitalisation must still be accompanied by substantial restructuring measures to ensure the long-term viability of the institutions concerned.

34. The European banking sector is battling profitability problems in the broad sense. The interest rate level is not the only source of pressure on the European sector : excess capacity and certain inefficiencies are also contributory factors. Rigid management and cost structures often prevent the sector from adapting quickly to new realities and new developments, such as the digital revolution. Although bank balance sheets have been slimmed down since the financial crisis, measures to improve efficiency gains and simplify the management and organisational structures have not always been implemented. Moreover, certain risks stemming from past practices are only now emerging with the imposition of heavy fines, and pose a potential threat to the financial position of the banks. In general, banks which have already been restructured are more profitable and can adapt more easily to the new developments. The current environment, with its many uncertainties at both macroeconomic and regulatory level and its increased volatility and complexity, requires greater adaptability on the part of the banking sector.

35. It is therefore advisable to complete the Basel 3.5 reform without delay. That would clarify the situation and enable the banks to adapt their business model to this new framework. The conversion of the Basel 3.5 accord into European legal texts will undoubtedly take some time, but in that regard it is crucial that the European authorities faithfully transpose the accord while abiding by the time limits set for its implementation at international level. The main aim of these new proposals is to resolve the problem of unjustified differences in the use of internal models to calculate the capital requirements. Such an accord would also halt the wave of regulatory reforms that followed the financial crisis with the aim of making the sector healthier and more resilient. The coming years will be important for standing back and considering the implications of all these reforms for the diversity of the banks' business models and for the real economy. It will also be vital to analyse whether the complexity of the new prudential framework leads to undesirable consequences and regulatory arbitrage.

36. After several years of progress in the governance of the Economic and Monetary Union, there was often a lack of momentum in 2016. As regards the banking union, the proposals submitted by the European Commission in 2015 for establishing a common deposit guarantee system – the third pillar of the banking union – have yet to be implemented. That system would be based on a European Deposit Insurance Fund consisting of contributions from the banks geared to their risk profile, and would be managed by the Single Resolution Board. The deposit guarantee system would not be entirely taken over by the European system until after an eight-year transitional period. This risk-sharing must still be accompanied by better control over the sector's risks. There is also a need to devise mechanisms to achieve the further decoupling of the financial system from national public finances. On that subject, the prudential treatment of the risks that banks carry on sovereign States is currently being considered at European and international level, but at this stage that has not resulted in any specific proposals. It is differences of opinion over the balance between risk-sharing and risk reduction measures for

the sector that are impeding the finalisation of the banking union. Yet it is essential to complete this union and solve the structural problems facing the sector in order to ensure the coherence of the European project.

3. Challenges for the Belgian financial system in a low interest rate environment

37. In 2016, the persistence of the very low or even negative interest rate environment began to affect the fundamentals of financial intermediation. The current interest rate situation is putting structural pressure on the profitability of financial institutions, and could also endanger financial stability as a whole.

38. Insurance companies, especially in the life insurance sector, are particularly affected by that environment in their class 21 activities. The life insurance sector must continue to meet commitments entered into in the past offering high guaranteed interest rates. However, as the period of low interest rates persists, the return on the life insurers' asset portfolios declines, threatening their financial position and possibly their ability to honour their contracts. That trend has already prompted a number of institutions to revise their business model. Some have made announcements on the subject, usually indicating the partial dismantling or cessation of certain life insurance activities. It is mainly companies offering only life insurance products that potentially face the greatest need to revise their business model, as other insurance activities have performed much better in recent years. But all companies will have to think about how to integrate the low interest rate environment into their business model.

39. The results of the stress tests conducted by EIOPA jointly with the Bank also highlighted these challenges. In the current low interest rate environment, it is important for insurers to strengthen their financial position, in particular by limiting the realisation of capital gains and the payment of profits to their policy-holders or dividends to their shareholders, so as not to mortgage their future results. In that context, the Bank submitted a draft Royal Decree to the Minister of the Economy, designed to lay down rules on profit distribution. That draft, which has since been approved by the Minister, allows the Bank – as the microprudential authority – to prohibit such payments to policy-holders if they pose a threat to the institution's financial equilibrium. For several years, the Bank has also recommended that market interest rates be taken into account when fixing the interest rates on new contracts. That principle was enshrined in the Law of 13 March 2016 which provides for a mechanism whereby the interest rate is fixed on the basis of the average 10-year OLO yield over the past 24 months, subject to a maximum of 3.75 % and a minimum of 0.75 %. On that basis, the maximum interest rate on individual life insurance contracts must be cut from 2 % to 0.75 %. However, the Minister of the Economy – who has a right of veto – decided to keep the rate unchanged at 2 % in 2017 in order to protect consumers and maintain a link with the minimum interest rate currently set at 1.75 % by the legislation on supplementary pensions.

40. More fundamentally, the stress test results and the latest financial results of some companies raise questions over the viability of a life insurance business offering contracts at guaranteed interest rates. During their strategic review, some companies have already opted to drop certain life insurance segments and/or to offer their customers *en masse* a buy-back option on existing contracts with high guaranteed interest rates, in return for payment of a redemption premium. In those circumstances, the Bank drew up proposals which it submitted to the authorities and to the various players to revive the insurance business in some respects. In particular, those measures aim to ensure the creation of new opportunities to support the sustainable growth of the economy, and more especially the financing of infrastructure projects, for which there has long been a significant shortfall in Belgium.

41. Together with a few other factors influencing profitability, for instance bank sector taxation, the current environment of persistently low or even negative interest rates presents major challenges for the banking sector, too. In recent years, declining interest rates had nevertheless bolstered the sector's intermediation margin. Given their financing structure based very largely on savings deposits, the banks were able to adjust their financing costs almost immediately in line with market conditions, whereas the assets were adjusted only gradually as loans reached maturity. The fall in interest rates had also supported demand for credit and permitted the realisation of any capital gains on the banks' bond portfolios. That positive support from lower interest rates was combined with the effect of numerous restructuring measures implemented by the sector in the aftermath of the financial crisis. Those measures changed the face of the Belgian banking sector. For instance, by refocusing their activities on their domestic markets and core business – namely the collection of funds from the public to finance lending to firms and households – the banks were able to consolidate their portfolios and reduce the credit risk. In contrast to many banking sectors – particularly in southern Europe – non-performing loans have only a limited impact, on average, on the performance of Belgian banks. The simplification of their organisational structure, the reduction of their operating expenses and the adjustment of interest margins and charges in line with the new regulatory framework and market conditions are additional factors which have helped to restore the profitability and solvency of the banking sector.

42. However, in 2016, the fall in interest rates ceased to have a direct, favourable impact on the banks' profitability, as is evident from the decline in their net interest income from the first half of the year. While the banks are unable to make further reductions in the interest rates on households' sight accounts and savings accounts, the spate of mortgage loan refinancing accelerated the revision of the assets at lower interest rates. In view of that challenge, the banks are pursuing their restructuring and exploring other ways of safeguarding their profitability.

43. First, the banks are trying to further diversify their income sources, in particular by focusing on income from the sale of investment funds. The many periods of turbulence on the markets in 2016 nevertheless diminished somewhat the risk appetite of households and firms, while competition intensified in this market segment. In those circumstances, financial institutions were unable to achieve all their goals in that area. More generally, that strategy is in line with the gradual implementation of the Capital Markets Union, aimed at developing alternative sources of finance for the economy, alongside bank financing. In recent years, the investment fund sector has made great strides in Belgium, mirroring developments in the EU and also reflecting a search for yield on the part of investors. But the beneficial effects of that type of business must not conceal the risks that could arise. It is therefore necessary to ensure that those potential risks – which include the risk of potential withdrawals by customers in periods of high market volatility – are properly managed. The current interest rate environment also prompts the managers of these funds to take more risks in order to achieve their target yields. The increasing correlation between the investment strategies of these funds at global level could give rise to systemic risks, especially as the current regulations governing these activities have no prudential dimension. The Bank keeps a very close eye on these developments, and will submit a detailed report on its analysis to the Minister of Finance in 2017.

44. As well as diversifying their income sources, credit institutions might be inclined to take more risks. For the moment, there are no widespread signs of that happening. The banks have probably learnt the lessons of the past, and the regulatory framework has become stricter. Nonetheless, certain developments merit particular attention. The Belgian housing market, in particular, requires increased vigilance. In contrast to the markets of other European countries, the Belgian market has not yet experienced a property crisis. But the Bank still considers that close monitoring is vital. For several years now, it has therefore been watching and analysing developments on this market and the quality of the financial institutions' portfolios. Although an initial macroprudential measure was implemented at the end of 2013, imposing

a 5 percentage point surcharge on the risk-weighting coefficients applied to Belgian mortgage loans, and despite the Bank's numerous recommendations on the subject, it must be said that some relaxation of the loan criteria was evident again in 2016. Moreover, these developments are accompanied by strong growth of mortgage lending, driving up household debt. For the first time, that debt level now exceeds the figure for the euro area. The Bank therefore decided to introduce a new macroprudential measure in 2017, which will supplement the previous measure and target riskier loans. That measure also responds to the ESRB's Recommendation calling on the Belgian authorities to take additional steps to alleviate the persistence of certain vulnerabilities on the residential property market. It is vital that the banks set commercial margins sufficient to cover all the costs to which the institutions are exposed, including the options that their contracts contain and the cost associated with regulatory reforms. The important thing now – particularly in the low interest rate environment – is therefore to ensure that neither the competitive environment nor the pressure on profitability leads to any further deterioration in the standards for granting mortgage loans. As is evident from recent property crises in other countries, such developments generally give rise to significant loan losses if the property market situation is reversed, with potentially very harmful consequences for both economic activity and social cohesion. It should be noted that if the said measure fails to produce the desired result, or if the banks do not modify their behaviour in 2017, the Bank will be obliged to propose more stringent measures to the Minister of Finance.

45. Apart from the potential imbalances on the housing market, other forms of risk-taking are becoming apparent. For instance, the level of stock market valuations and the low risk premiums on certain bonds are initial signs that merit close analysis in order to ensure that the sector has sufficient capital and liquidity for its risk profile. Also, in managing their assets and liabilities, credit institutions may be tempted – owing to the increasing pressure on their intermediation margin – to widen the spread duration between assets and liabilities; hence the importance of appropriate interest rate risk management, particularly in case of a sudden rise in interest rates. Since the banks generally hedge that risk by means of interest rate swaps, the situation needs to be monitored because it could give rise to new risks for the counterparties of those swaps, owing to interconnections or concentration.

46. These challenges and risks facing the financial sector arise at a time when the digital revolution is accelerating very rapidly and becoming crucial to the mode of operation of financial institutions – and of society in general. It is true that the banks had already introduced digitalisation some years ago, particularly in their customer relations, whereas some insurers appear to be lagging behind slightly in that regard. But the pressure on profitability, fiercer competition and the increasingly rapid changes in the way that customers live and work are obliging institutions to review the organisation of their business and their distribution channels. Customers want service continuity, with financial services that are easier to access and use. Some institutions, for example, are moving towards an "all channels" strategy based on a permanent relationship with the customer, regardless of the channel and where or when it is used. The new technologies present a huge opportunity for the financial sector, which has extensive databases and specific data systems for responding to the new developments and creating new services for customers. However, the institutions need to rethink all their activities and transactions, particularly their front and back office. That last point is tricky in that financial institutions rely on complex IT infrastructure with a relatively old basis which is no longer geared to current requirements. Success will be the preserve of institutions that manage to implement a proactive digital strategy and create a more flexible organisation and IT infrastructure.

47. Nonetheless, these developments are accompanied by serious challenges that the financial sector needs to address fairly promptly. First, institutions will have to arm themselves against future cyber attacks. It is therefore necessary for financial institutions to ensure that their systems are sufficiently secure and resilient to maintain customer confidence, otherwise they could face major reputational – and ultimately financial – risks. In this context, it is vital to

implement action and emergency plans to enable financial institutions to respond quickly to any attack. As incidents are often attributable to human error, sound governance – including an IT risk culture at all levels – is also very important. For their part, the supervisory authorities must also ensure that the regulatory framework is sufficiently holistic and flexible in the light of the constant technological progress in this field. The mentoring of new players must also be considered. In that context, it is essential to act quickly and define a regulatory framework to determine the appropriate prudential status for these FinTech companies engaging in activities or services comparable to those of supervised institutions. International cooperation is vital here, owing to the possibility of regulatory arbitrage and unfair competition. The development and integration of all these new technologies likewise raise essential questions of a more general nature: how to ensure that these technologies, based on highly complex models, do not increase the model risk and interconnection between all systems within the financial sector? How to ensure that the automation resulting from this new technology does not lead to a loss of control over risk management? In the years ahead, all these questions require proper answers and appropriate action if financial stability is to be guaranteed. It is therefore important for the authorities and institutions to devote due attention and additional resources to mastering these new types of risk.

48. Although these developments are in line with historical progress, they may initially engender a feeling of insecurity in society, particularly in view of the implications for jobs in the financial sector. Digitalisation is causing financial institutions to speed up the review of their operating methods and their economic model. It inevitably modifies the sector's job content and way of doing business. The profile of new employees is therefore bound to change. Unfortunately, some profiles will disappear as the new technologies lead to automation of various jobs, while relationships with customers imply fundamental changes in the role of the branches. Nevertheless, other profiles will emerge, such as jobs specialising in cyber security or in the development and use of 'big data'. Today, the financial sector is therefore in transition. Part of the adjustment can certainly be absorbed by the demographic structure in the sector. Even if the decline in employment in the traditional financial sector – a process which began in the early 2000s in Belgium – seems inevitable, it is crucial for financial institutions to ensure the proper management of the operational risks associated with restructuring, particularly in view of the technological developments and regulatory requirements. Apart from the operational risks, it is important for the sector to provide proper staff support during these changes.

49. The ongoing restructuring in the sector has triggered widespread debate over the appropriateness of the sometimes ambitious internal targets set by financial institutions for the return on capital in the light of the requirements imposed by the market (the 'cost of capital'). Quite clearly, both the financial and the regulatory environment is putting downward pressure on the return on capital. Pre-crisis levels of profitability are no longer feasible or desirable. They were based on overblown leverage effects and excessive risk-taking. Today, the sector has more capital and liquidity, making it healthier and more resilient. Although it is necessary to ensure that the institutions' return on capital does not exhibit a structural, negative deviation from the cost of capital, in order to maintain affordable access to the capital market, the main point is that high yield targets must not reflect excessive risk-taking, as a substitute for the essential, more fundamental strategic review of the business model.

50. With that in mind, the authorities became aware of the role they had to play in supporting the sector's transformation. Following the report by the group of experts published early in 2016, the Minister of Finance set up a permanent working group comprising players from the financial sector and the prudential authorities. Initially, this group is intended to formulate specific proposals on the basis of the experts' recommendations with the aim of enhancing the resilience and competitiveness of the Belgian financial sector. The focus is on three points. First, following the spate of regulatory reforms designed to reinforce the sector's financial soundness, the group considered it crucial to pursue governance reforms. Both the

financial crisis and the recent incidents in the sector demonstrate the degree to which sound, appropriate governance – supported by all players in the sector – is vital to financial stability. Next, in view of the scale and extent of the digital revolution, the group of experts formulated specific proposals for rendering Belgium more attractive in that sphere. They propose setting up a platform to promote the development of innovative financial start-ups, plus a National Cyber Security Centre. The Bank and the FSMA will jointly establish a contact point for FinTech enterprises to provide them with appropriate guidance concerning the regulatory and supervisory framework. The desire of some firms to transfer their decision-making centre to the EU following Brexit could help to speed up the development of a financial ecosystem in Belgium, though that requires a proactive approach on the part of all the authorities concerned. Finally, the last point concerns the financing of the economy. The proposals involve changes to the taxation of savings income, and measures to support the funding of infrastructure projects. The establishment of a centre of expertise for financing these projects, or targeted measures to enable insurers and pension funds to take part in that development, could clearly contribute to the gradual elimination of the substantial shortfall in public investment that Belgium has experienced for many years.

4. The Belgian economy heading for stronger growth

51. The trend in economic activity in Belgium has been largely determined by the same factors as those which have curbed the growth dynamics in the euro area, namely the sharp slowdown in global trade which depressed exports, the geopolitical uncertainties, and the waves of volatility on financial markets. For their part, the favourable financial conditions that accompanied the accommodative monetary policy alleviated the situation to some extent. In addition, growth was tested by the repercussions of the terrorist attacks in Paris in November 2015, and in Belgium itself on 22 March 2016. During that period, the number of foreign tourists declined sharply, and residents' consumption also suffered as a result of the heightened sense of insecurity. In the autumn, a spate of bad economic news from businesses eroded consumer confidence, even though the situation afterwards improved rapidly. In this climate of great uncertainty, growth proved resilient overall. It came to 1.2 %, or 0.3 percentage point lower than in 2015. It was mainly at the beginning of the year that economic expansion was rather weak.

52. Except for the impact of external shocks, economic developments in Belgium increasingly bear the hallmarks of the reforms undertaken since 2011. Those reforms aim to limit the impact of the crisis and remedy the structural weaknesses of the Belgian economy, thus preparing it for the challenges of the future. Those challenges are considerable: in an economic environment which is rapidly changing as a result of globalisation and technological progress, it is necessary to cater for the consequences of population ageing and ensure the transition to greater ecological sustainability. Tackling these challenges means laying the foundations for tomorrow's standard of living and social cohesion. In recent years, great progress has been made in implementing labour market reforms, extending working life, restoring competitiveness and reducing the burdens on labour; also, budget paths have been designed to ensure the sustainability of public finances. These efforts have been further intensified in the past two years with the temporary suspension of indexation, the tax shift and the pension reform. The reform policy is already beginning to bear fruit in some areas, particularly as regards elimination of the wage handicap, job creation and the extension of working life. However, other developments such as the relatively high level of inflation in Belgium call for vigilance, and the consolidation of public finances still falls short of the set targets. For the future, it is necessary to make every effort to consolidate Belgium's restored competitiveness. At the same time, to foster potential growth, the economic fabric needs to be made more productive, more dynamic and more inclusive. And finally, progress must be achieved in fiscal consolidation. Although the pension reform will significantly reduce the

budgetary costs of ageing in the long term, that is not enough to guarantee the sustainability of public finances.

Restoration of competitiveness and strong job creation

53. Restoring competitiveness was one of the federal government's key goals. To that end, the government implemented a wage moderation policy and reduced employers' social security contributions. In 2016, hourly labour costs in the private sector, which had already stabilised during the previous year, actually declined slightly. That was due mainly to the cut in employers' contributions resulting from the tax shift. Given inflation developments in Belgium, the temporary suspension of the indexation mechanism from April 2015 reached the targeted effect of 2 % for the four-monthly average of the health index in 2016 and so it was stopped. It nevertheless remained an important factor in wage moderation. Conversely, the social partners had some scope for real negotiated pay increases for the first time since the wage freeze of the past few years. That scope was fixed by law at 0.5 % of the gross wage bill including all charges, plus 0.3 % of the net wage bill.

54. According to the Central Economic Council's calculations, the wage gap that had accumulated since 1996 compared to the average in the three main neighbouring countries was closed completely in 2016. Back in 2008, that gap had been 4.8 %. The gap in terms of unit labour costs which had accumulated since 1996 also narrowed considerably to 4.6 % in 2015, compared with 9.3 % in 2013. The persistence of a slightly positive gap in terms of unit labour costs, while the gap in hourly labour costs has been closed completely, indicates that productivity has increased by less in Belgium than in the three main neighbouring countries. That is primarily true of the services sector.

55. Moderation of the trend in labour costs and the restoration of competitiveness reinforced the job creation that accompanied the upturn in business activity. In 2016, the number of wage-earners was actually up by 45 000 units and total employment – including the self-employed – rose by 59 000 units. That is not only 17 000 more jobs than in 2015, but increasingly often these are new jobs in sectors sensitive to the business cycle or in the market services sector. Previously, economic growth was less labour-intensive, and furthermore, job creation was heavily concentrated on the public sector or branches subsidised by the government. It is primarily large firms that have created jobs, as they still account for the bulk of employment in the business sector. The restoration of competitiveness in relation to the three main neighbouring economies is another factor behind the relatively strong export growth, although the euro's depreciation also played a significant part in that regard. The year 2016 again brought gains in market shares, thus tempering somewhat the impact of the slowdown in world trade. In addition, the improvement in corporate profitability, together with the revived outlook for demand and the particularly favourable financing conditions, constituted one of the factors driving up business investment, which displayed a fundamentally upward trend in 2016.

56. Job creation was in turn the main driver of the rise in household disposable incomes. Further support for those incomes came from measures to strengthen purchasing power, incorporated in the tax shift which aims to narrow the gap between gross and net incomes in order to expand the labour supply. Accelerating inflation, due partly to the rise in indirect taxes intended to fund the tax shift, curbed the increase in purchasing power. As the savings ratio increased in an environment of heightened uncertainty (partly due to the terrorist threat), private consumption grew by only 0.7 %, which was 0.4 percentage point below the 2015 figure.

57. Job creation outpaced the growth of the labour force so that unemployment declined by 26 000 units. For the first time since 2000, unemployment also fell in the over-50 age group.

This indicates that the successive reforms intended to keep older unemployed people available for the labour market are beginning to have an effect. In addition, the employment rate among those in the 55+ age group continued to rise. Nonetheless, the level of unemployment remains unacceptable: in 2016, the number of job-seekers still averaged 553 000, putting the unemployment rate at 8 %.

Consolidating the restored competitiveness

58. In a small open economy like Belgium, it is crucial to maintain competitiveness. In recent years, it has also emerged that eliminating the wage handicap may prove a long and difficult process in an environment where indexation forms a lower limit for pay rises. It is therefore necessary to prevent any new divergences in wage levels from emerging vis-à-vis the three main neighbouring countries, and to ensure that wage-setting makes the maximum contribution to job creation. That is why the federal government prepared a draft law aimed at amending the Law of 26 July 1996 on the Promotion of Employment and the Preventive Safeguarding of Competitiveness. According to that draft, the available margin for real pay increases cannot take account of any wage subsidies or reductions in charges granted under the tax shift in excess of those under the Competitiveness Pact. The scope created by these reductions in charges can therefore benefit employment to the maximum. A safety margin of at least 0.5 of a percentage point must also be respected in each negotiation period. That margin is intended to absorb any unexpected developments, such as a slower rise in labour costs in the neighbouring countries, or higher indexation in Belgium. Moreover, the explicit introduction of a correction term should permit more automatic elimination of any handicap compared with 1996. The application of the indexation mechanisms is guaranteed in all circumstances. However, if the wage handicap were to become so large that it could not be corrected in a single negotiation cycle, the government would have the power to take measures after consultation with the social partners. The Central Economic Council took those principles as the basis when calculating the margin for real wage increases for the period 2017-2018. In January 2017, the social partners concluded a draft interprofessional agreement in line with that. The parties agreed that the maximum margin for real wage increases beyond indexation is 1.1 % for 2017 and 2018 combined. It is to be hoped that this new framework will help to ensure a forward-looking wage-setting process, so as to avoid painful corrections at a later date.

59. Although appropriate wage-setting is very important for safeguarding competitiveness, it is not sufficient. Pricing and the movement in other incomes also play a key role. In that regard, it is noticeable that inflation has risen from 0.6 % to 1.8 %, despite the moderation of labour costs. That is due in part to the increase in indirect taxes under the tax shift, and to price rises resulting from the fiscal consolidation efforts of the various governments. Together those factors drove up inflation by around 1 percentage point. Furthermore, inflation in services has reached around 2 % in each of the past five years; fluctuations in the economic environment have had little or no effect on it, and neither has wage moderation. Since 2008, it has also systematically outpaced services inflation in the three neighbouring countries. That may be due to inadequate productivity growth in the services sector, but it could also indicate insufficiently competitive pricing, leading to the expansion of margins when costs decline. Price indexation – which is fairly common in Belgium – is an example of that. Although these price increases apply in sectors shielded from competition, they may nevertheless damage competitiveness. Services are not only intermediate inputs for the other sectors; the movement in services prices also affects wage-setting. The strong inflation in services is one reason why the temporary suspension of indexation was ended sooner than originally planned. In mid-2016, in view of concerns on this subject, the Minister of the Economy set up a working group to determine the causes of the high inflation in services in Belgium; the group is to produce its report in 2017. Particularly now that oil

prices are going up again, energy costs must be well monitored. Sufficient competition on the product markets can have a favourable influence on cost competitiveness, not only via its impact on productivity but also via price reductions. Moreover, competitive pricing fosters the transmission of more appropriate wage-setting to selling prices, thus amplifying the effect on growth and employment. Wage-setting and pricing therefore not only have their own roles to play in safeguarding competitiveness, they also complement one another to a very considerable degree.

Boost growth potential : towards a more productive, dynamic and inclusive economy

60. The safeguarding of competitiveness will make a substantial contribution to preserving the growth potential of the Belgian economy. As that potential has fallen to around 1 % since the crisis, other levers also need to be applied. That is absolutely essential in the light of population ageing, which is reducing the population of working age as a percentage of the total population, and thus threatens to depress per capita incomes. To counteract that, the first requirement is to strengthen productivity growth. That entails not only more innovation, but also better dissemination of innovations and a more fluid allocation of labour and capital. The dynamism that enables the most efficient firms to overtake the less efficient is an important source of productivity gains at macroeconomic level, especially in an environment marked by globalisation and technological change. It is therefore crucial for everyone to have enough of the necessary skills to share successfully in that process of permanent change. That will result in an adequate labour supply and more inclusion. The extension of working life and its successful implementation must also help to cushion the pressure of ageing on the growth of per capita incomes. Supporting incomes by strengthening potential growth will in turn benefit public finances and could place the government in a better position to take redistributive measures where needed.

61. As regards innovation, investment in R&D in Belgium is heavily concentrated on a small number of branches of activity, and the government's contribution is rather limited. Not only does Belgium need to boost investment, but it also has to remain attractive for foreign investment, as that is often a powerful factor in the spread of technical and organisational innovations. The process of reallocating resources can also stimulate productivity growth in Belgium. In view of the wide variations in productivity between firms – something that is not specific to Belgium –, there is considerable scope for catching up. Compared to other European countries, however, Belgium has a low rate of both creation of new businesses and destruction of existing ones, and the reallocation of resources here has appeared to be less a source of productivity gains in recent years. In that regard, the low level of entrepreneurship is an impediment. But the tide seems to have turned recently. More new businesses are starting up, and more workers are adopting self-employed status. The fluidity of the reallocation process would benefit from the elimination of unnecessary administrative, legal and fiscal barriers, an effective and transparent regulatory framework, and efficient public administration. Potential growth and productivity could also benefit from an efficient infrastructure. Mobility and energy supply are two crucial areas where the need is greatest. They are also spheres where it is particularly important to reconcile economic efficiency with ecological sustainability. Apart from judicious investment in infrastructure, there is also a need for incentives to reduce demand for mobility and energy, and channel it towards the least polluting options.

62. Despite the creation of 550 000 jobs since the beginning of the century, the employment rate has barely risen. During that period, the population of working age has continued to expand. Thus, in 2016, 67.4 % of people between 20 and 64 years of age were gainfully employed ; in 2000 the figure was 65.8 %. Women and people aged between 55 and 64 years are the only groups to record a significant increase in their employment rate. Those improvements are due mainly to the rise in the statutory retirement age for women and the reforms concerning

the end of working life, particularly the rules on early departure from the labour market. Some people, particularly the less skilled, the young, and residents from non-EU countries, face greater difficulty in gaining or maintaining a foothold in the labour market. In this last group, under-employment is particularly persistent although the number of low-skilled workers and pupils dropping out of school prematurely has fallen since the year 2000. The proportion of young people not in employment, education or training needs to be further reduced. The educational reforms, aimed among other things at increasing pre-school attendance among certain vulnerable groups, enhancing social and cultural diversity throughout education, and providing improved technical and vocational education, could make a contribution here. With the development of apprenticeships, and day release schemes in general, these reforms should ensure that young people are better prepared for the labour market and business life.

63. In a constantly changing world where everyone could face the need to switch careers during working life, and digitalisation is fundamentally altering the content of jobs, the government and the social partners need to bring about the transition to a new labour market paradigm, where job security becomes work security. Therefore, it should be based on a policy of empowerment enabling everyone to adapt to the rapid changes. That is a way of avoiding the polarisation of the labour market. Further improvements are also needed in matching the labour supply to demand for labour, e.g. by the efficient transmission of information on vacancies and job-seekers' skills, as well as guidance for job-seekers. Effective collaboration between the various employment services is particularly important in the context of the sixth State reform, which transferred many of the political levers in that area to the Regions. The changes made to the unemployment insurance system in recent years are tending to place more responsibility on job-seekers. Although that encourages activation, it is still necessary to limit the risks of financial insecurity for the most vulnerable. In the context of the extension of working life, it is vital that people in the 50+ age group are retained in employment, and that unemployed people in that same age group are reintegrated to a greater degree in the labour market. It is absolutely essential to invest in lifelong training. Making maximum use of all the diverse talents on the labour market could not only stimulate potential growth but could also make growth more inclusive.

After the deterioration in 2016, safeguard the sustainability of public finances

64. Despite the need for progress in the consolidation of Belgian public finances, the position deteriorated in 2016. The budget deficit increased from 2.5 % of GDP in 2015 to 2.8 %, and the structural deficit also expanded slightly. Yet public finances benefited from a further decline in interest charges. As a percentage of GDP, primary expenditure was virtually unchanged, halting the downward trend of recent years. Continued control over expenditure was in fact thwarted by a number of temporary factors and by the exceptional efforts made to combat terrorism and to accommodate asylum-seekers. Together, these last two factors represented 0.2 % of GDP. Revenues declined because of the reductions in charges on labour which were only partly offset by an increase in other taxes, and because they lagged behind the movement in the tax base. These developments on the revenue front require close monitoring. They caused the primary balance to become negative again. The debt ratio rose to 106.6 % of GDP.

65. To create and maintain a sound budgetary position, it is crucial to achieve the medium-term objective. The government defined that objective as the attainment of a structural balance. That is the only way to bring down the public debt sufficiently quickly and provide the necessary buffers and scope to address the challenges ahead, particularly in order to absorb the costs of ageing and safeguard social protection in the long term. The consolidation effort still required to achieve that amounts to just over 2 % of GDP. It is therefore important to resolutely reduce the budget deficit and adhere strictly to the adjustment path towards the medium-term objective

stipulated by the Stability and Growth Pact. Responsibility for sustainable public finances rests with all the government entities in Belgium. Fiscal policy must be properly coordinated, and it is therefore important for the federal government and the governments of the Communities and Regions to conclude an agreement comprising binding budget targets, as specified by the 13 December 2013 cooperation agreement. The adoption of an ambitious yet realistic and credible path will remove a significant source of uncertainty.

66. The restoration of sound public finances must be based primarily on strenuous efforts to increase efficiency in public spending. Government expenditure is currently higher not only in relation to the pre-crisis position but also in comparison with most advanced economies, even without providing a better service. Enhancing the quality and efficiency of government services is therefore a key task that requires constant efforts to control costs and improve performance. Where choices have to be made, the criterion should be the actual contribution of the various types of expenditure to the promotion of growth potential, the sustainable development of the economy and society, and the achievement of better social inclusion. However, prioritising crucial spheres must not imply any lack of attention to efficiency and cost control.

67. Measures to reduce the charges on labour – which in Belgium are among the highest in Europe – have already been implemented via the tax shift. That reduction in charges is absolutely essential. Implementation of these measures must continue under conditions which, at the same time, ensure the necessary lowering of the deficit. Apart from the expenditure control already mentioned, the provision of sufficient funding and the efficient collection of revenues must also contribute to bringing down the budget deficit. As regards reforms in other areas, too, such as corporation tax or the tax rules on direct and portfolio investment, the legitimate aims of simplification through an adequate tax rate structure, encouragement of growth-friendly investment, and creation of greater reciprocal neutrality between their various forms must be reconciled with the need to restore sound public finances.

5. Conclusion

68. In view of the hesitancy of the economic recovery in the euro area, the persistent, substantial demand deficit and excessively low inflation, monetary policy accommodation was increased still further in the euro area in 2016. That created a decidedly low interest rate environment which reflects the sluggish economic climate and is at the same time intended to foster the economy's recovery. That recovery could also be speeded up by implementing structural reforms favourable to growth and by completing the reorganisation of the euro area's banking sector. It must also be accompanied by a fiscal policy that inspires confidence. While monetary stimulus is essential from the macroeconomic point of view, and – by supporting nominal growth – generates positive spillover effects for financial stability, the low interest rate environment also creates risks for the financial sector. Belgium is no exception to that. Thus, in 2016, the banks saw their intermediation margin hit by the persistently low interest rate environment, after having benefited from declining interest rates over a number of years. That environment presents considerable challenges for the banks in the coming years, particularly as it is accompanied by the increasing digitalisation of financial activities and keener competition, including from non-traditional financial players offering financial services (FinTech companies). The banking sector needs to turn these challenges into opportunities for adapting business models, including adjustment to the new regulatory environment that aims at cost efficiency combined with sound and prudent business management. In the insurance sector, where the life insurance business was even harder hit by the persistently low interest rate environment, a number of players have already initiated the trend towards refocusing the business model in 2016. It would be desirable for all players in the life insurance market to incorporate the low interest rate environment in their business model.

69. 2016 was also the year which brought rapidly mounting uncertainty over the policy options for the future throughout the world. For a small, open economy like Belgium, which is furthermore located at the heart of the monetary union, both the possible tendency towards protectionism in the global economy and the difficulties currently facing the European project pose a risk which should not be under-estimated. But Belgian policy-makers have little influence over these developments, except via their participation in international decision-making. In an environment featuring increased uncertainty originating from outside, it is vital for economic policy in Belgium to adopt a clear approach that inspires confidence in order to provide solutions to the challenges ahead.

70. In recent years, work has been done on labour market reforms, the reduction of charges on labour, the improvement in competitiveness and the control of public expenditure. Those efforts are beginning to bear fruit, particularly in terms of job creation. However, in the light of population ageing, new reforms are necessary so that, via the increase in growth potential and the consolidation of public finances, it is possible to create the conditions for both a high standard of living and the safeguarding of the Belgian social model. That requires a consistent approach in various areas of policy. The competitiveness which has been regained must be consolidated by appropriate wage-setting combined with more competitive pricing. Productivity growth must be stimulated by promoting research, innovation and entrepreneurship, by establishing a favourable climate for investment, and by creating the conditions for the fluid reallocation of resources from the least productive to the most productive businesses. Implementation of the extension of working life and use of all available resources to combat the underemployment of certain groups, particularly young people, low-skilled workers, and residents from non-EU countries, can absorb the pressure of ageing on the labour supply. Enabling everyone to acquire the capabilities needed to find and keep their place on the labour market, in an ecosystem which is changing rapidly as a result of globalisation and technological change, creates not only economic benefits but also more social inclusion. Stronger potential growth will also facilitate the consolidation of public finances. This consolidation must be supported above all by carefully considered expenditure control and efforts to achieve efficiency gains, while all the reforms on the revenue side must respect budget neutrality. That is the way to define a credible adjustment path towards the objective of structural balance in the medium term. That path must also conform to the requirements of the Stability and Growth Pact. Applying all the economic policy levers and operating in such a way that they reinforce one another facilitates a symbiosis between more growth and more social cohesion, so that uncertainty gives way to a stable, confidence-inspiring outlook.

Brussels, 25 January 2017

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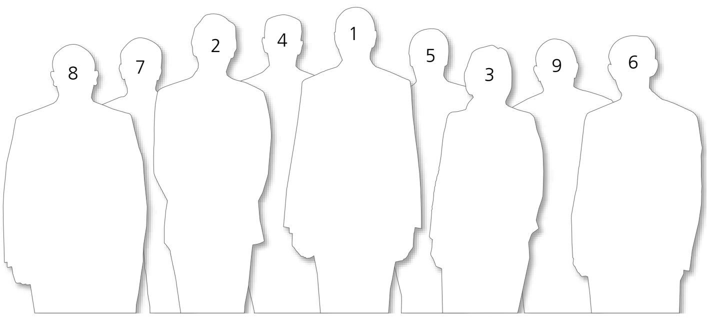

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