Report 2017

Preamble

NationalBank
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Eurosystem

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

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1. Converting the cyclical upturn into sustainable growth: towards an adjustment of the global economic policy mix

1. It was back in 2011 that the global economy last produced such a good performance as 2017, when it grew by 3.7 %. Not only was that half a percentage point higher than in 2016, it also exceeded all expectations. Furthermore, the recovery was highly synchronised. Most economies, both advanced and emerging, had a share in it. Investment – which had been seriously affected by the crisis – also picked up, and that had a beneficial impact on international trade, given the high trade intensity of investment goods. In contrast to 2015 and 2016, world trade grew faster than global output, expanding by 4.7 %.

2. Against that backdrop, the 2016 commodity price rises were consolidated. Support for crude oil prices also came from the decision by OPEC and other oil-producing countries to extend the current output restrictions until the end of 2018. The recovery thus spread to Russia and Brazil, countries which are very dependent on commodity exports and which were still languishing in deep recession in 2015 and 2016.

3. However, there is as yet no sign of any real increase in inflationary pressure, especially as wage rises remain modest. This is due to various factors, one being the persistence of a degree of underemployment. Another factor concerns the marks that the low inflation environment of recent years may have left on the expectations process underlying wage-setting. In addition, real wages are being held down by the weak productivity growth, although in principle that factor is neutral for inflation. While these three determinants of meagre wage growth differ in character, their common thread is that they each highlight a dimension of the incompleteness of the recovery. For instance, the labour market's potential will only be fully exploited once the residual underemployment has been absorbed. For their part, the benefits of price stability will only become apparent once wage-setting ceases to bear the imprint of past years' low inflation. And prosperity and purchasing power will only succeed in producing sustainable growth once faster productivity gains are restored after the cyclical upturn.

* One Regent was unable to endorse the Report in its entirety.

4. It is precisely because the recovery is incomplete that the economy still needs a supportive policy. Thus, monetary policy has remained particularly accommodative, even though the United States has taken new steps towards normalisation. In 2017, the key interest rates were raised on three occasions, and the Federal Reserve began implementing its plan for gradually scaling down its balance sheet. However, long-term interest rates there have not risen above the level prevailing at the end of 2016, as it became apparent that expectations of a strong fiscal stimulus following the presidential election would not be entirely fulfilled. In the aftermath, the profile of the financial markets' expectations of interest rate increases was adjusted downwards. These were major factors in the depreciation of the US dollar. However, fiscal policy did not become restrictive. At the end of 2017, the United States actually launched a programme of tax cuts. Moreover, fiscal policy elsewhere in the world also bolstered growth. For instance, public investment was stepped up in China to avert an excessive growth slowdown as a result of the economy's conversion to a model based less on exports and geared more to consumption. The Chinese economy thus continued to grow by 6.8 %. In the euro area, fiscal policy reverted to being broadly neutral, after the fiscal consolidation had dampened growth during the worst years of the crisis.

5. Given the still extremely low risk-free interest rates, rising asset prices, declining risk premiums – including those for euro area governments – and the low volatility on the financial markets, global financing conditions have remained highly favourable. That has undoubtedly supported growth, but in the event of excessive risk-taking or a sudden repricing of financial assets, that could also create vulnerabilities for the future. Furthermore, the household debt ratio in many advanced economies remains high, while in the emerging economies it is businesses that have a heavy debt burden, especially in China, even though the Chinese authorities took steps to curb credit expansion during 2017. China also faces a steep rise in bad debts. Owing to the size of the Chinese economy, the accumulation of vulnerabilities there is now of global relevance. Also, the normalisation of monetary policy may entail the risk of an over-abrupt tightening of financial conditions and, for the emerging economies, could imply a reversal of capital flows or expose those economies to the vulnerabilities associated with loans in foreign currencies. Finally, there is a possibility that countries may adopt a more protectionist stance. To avert those risks, it is necessary to make use of all the levers in the various policy spheres.

6. First, we need to contain the vulnerabilities specific to the financial system. Huge progress has been made in that respect since the crisis. Financial institutions now have larger capital buffers and meet higher liquidity requirements. Furthermore, in macroprudential policy, we now have a new sphere of action aimed at stemming systemic risks. While it is useful to assess the effectiveness of this new prudential framework, the primary need is to consolidate that framework and to resist at all costs the temptation to relax it again on the basis of short-term considerations. The completion of the Basel III reform is a further important step in that regard. The final phase of that reform aims to resolve the problem of unjustified differences in risk weightings based on internal models. While banks and insurers have become more shock-resistant, some risks have shifted to less regulated segments of the financial system, and the interconnections between segments have increased – notably via portfolios of derivatives. The prudential authorities need to keep a close watch on these developments.

7. In view of the extreme fluctuations in so-called digital currencies such as bitcoin and ether, there were many questions in 2017 concerning their implications for financial stability. Those implications remain minor for now on account of the generally limited use of such currencies, which is due in turn to some of their intrinsic characteristics. First, they are not legal tender, nor do they have the other usual characteristics of money. In reality, they are a highly speculative financial asset, because – unlike money issued by central banks – their value is not safeguarded. On the contrary, since the supply is fixed, speculative trends in demand often trigger significant price fluctuations. Moreover, unlike in the case of traditional payment systems, their use for payments is not subject to any form of oversight. These various factors seem to hamper their more widespread use so that there is no likelihood of systemic risks in the immediate future,

although vigilance must be maintained. The authorities must also ensure that individual users are adequately informed of the particular – speculative – character of these currencies and the resulting risks.

8. The current growth acceleration is largely cyclical and originates from the narrowing of the output gap. Now that the gap has diminished – and has even been eliminated in some economies – the economic policy mix needs judicious adjustment to ensure that the cyclical upturn can be converted into sustainable growth. The current upturn must therefore be seized as an opportunity to implement the entire reform agenda aimed at mobilising the labour force and boosting productivity. It is a good while since the conditions have been so favourable for reform: in view of the strength of the recovery, the recurrent argument whereby structural reforms may have adverse effects in the short term is becoming less relevant. Reforms are needed not only in the advanced countries but also in the emerging economies, which now represent almost 60 % of global output. The loss of momentum in the catching-up process in those economies is the main reason why global growth is still lagging behind its usual pre-crisis level.

9. More than ever before, this reform process depends on openness. That is the only way for all parts of the world economy to progress together. Furthermore, international trade and direct investment are powerful vectors of technological progress and its diffusion, and that mechanism must be safeguarded. As populations continue to age, the productivity gains resulting from technological progress will have to become the main engine of growth. The future therefore implies not less openness but more international cooperation to manage the process of globalisation and avoid the detrimental side effects. The economic partnership agreement concluded between the EU and Japan at the end of 2017 is one example. The need for such cooperation goes beyond the sphere of trade alone. It also applies in such areas as financial regulation, the prevention of a race to the bottom in regard to the taxation of movable assets, and the transition to economies producing lower greenhouse gas emissions. The future also lies in an inclusive economic policy mix ensuring that everyone in the respective national economies can share in the benefits of globalisation and technological progress. In the past, that has not been sufficiently the case, and the result has been polarisation of the labour market. Reversing that trend will require not only an adequate social safety net but also, and above all, a policy that – via education, labour market support, training and empowerment – ensures that everyone's talents can always be put to use in a constantly changing global economy.

10. Finally, the adjustment of the policy mix must involve reducing the monetary policy stimulus by means of accurate calibration and transparency. As is evident from the example of the United States, the timing and pace of that normalisation depend primarily on the strength of the recovery. However, developments on the supply side of the economy are also significant factors. For instance, the Bank of England was obliged to start the normalisation process at a time when growth in the United Kingdom had slowed to 1.5 % owing to the process of departure from the EU (Brexit). This demonstrates that the movement in real incomes is driven mainly by the supply side of the economy, and that monetary policy can do little more than support the economy along its adjustment path. Since inflation has remained low in the euro area, that support process entails continuation of an accommodative monetary policy, even though growth has strengthened to 2.2 %.

2. The euro area: on the road to reflation, but also to increased economic strength and stability for the Monetary Union

11. The recovery that had begun in the euro area in 2013 gained further momentum in 2017. It also became more broadly based, not only because activity picked up in all the Member States, but also because, after private consumption, business investment likewise became a significant driver. The strong job creation – employment expanded by no less than 1.5 % – underpinned private

consumption. Investment gathered pace because firms wanted to ensure that their production capacity – which was already at a high utilisation rate – could keep up with demand, which has strengthened both in the euro area and elsewhere in the world, generating a sharp rise in exports. As a result, net exports again contributed to growth despite the appreciation of the euro.

12. Since that appreciation of the European currency was due largely to the improved outlook for the euro area, it will not necessarily be a serious impediment to either growth or inflation. Exchange rate fluctuations that are not in line with economic developments, on the other hand, are more damaging. Also, in the case of long-term interest rates, it is the economic fundamentals that have been the most important determinant of their slight increase. These factors therefore do not point to any tightening of financial or monetary conditions. On the contrary, the accommodative monetary policy has continued to ease those conditions and, now that the demand outlook is improving, the policy is actually gaining traction via its support for investment. In addition, bank credit interest rates remained particularly low in 2017, while the volume of lending continued to rise.

13. The effectiveness of the monetary stimulus is evident not only from the profile of economic activity and lending. Inflation is also showing signs of a turnaround. Although the increase in inflation to 1.5 % in 2017 was largely due to higher oil prices, core inflation has also bottomed out. It stood at 1 % in 2017 compared to 0.6 % at the beginning of 2015. Nevertheless, it is not moving durably enough towards the target of price stability. Since nominal pay increases have remained low, inflation is still insufficiently sustainable in nature. The rise in unit labour costs – the principal source of domestic inflation – came to no more than 0.9 %. In short, 2017 brought both greater confidence that inflation would eventually converge on the target, and awareness that monetary policy needed to be prudent, patient and persistent in order to achieve that.

14. That is why, in October, the ECB Governing Council decided to continue the net asset purchases in 2018, more specifically until the end of September 2018 or later if necessary, and in any case until the Council sees a sustained adjustment in the path of inflation consistent with the target. From the start, the termination of the net asset purchases had been subject to attainment of the inflation target. This new extension once again emphasises that conditionality. While the amount of the monthly purchases has been further reduced since January 2018 to € 30 billion, in weighing up the options, the Governing Council decided on a smaller amount spread over a slightly longer period. That exerts further downward pressure on the expectation component of long-term interest rates, in view of the reiteration of the intention to hold the key interest rates at their current low levels well beyond the horizon of the net asset purchases. It was also confirmed that, at maturity, debt instruments would be reinvested for as long as necessary. Consequently, when net purchases come to an end, the volume of assets held will remain stable for a good while, and the downward pressure on long-term interest rates will persist.

15. Is this strong monetary stimulus still necessary, now that the economy is picking up and the danger of deflation has faded ? The answer to that question is a definite yes. Restoring inflation to 2 % is not only in line with the price stability mandate conferred on the Eurosystem by the Treaty, but is also and above all a robust policy. It is advisable from various points of view.

16. First, it ensures that the euro area does not drift into a low inflation equilibrium. That risk has not yet disappeared entirely, as some indices suggest that the low inflation rate in recent years is one of the causes of the weak nominal wage growth. Inflation expectations have also not yet fully regained their previous level, but it is important that they do so, otherwise the nominal interest rate will become structurally lower, in turn reducing the available scope for future interest rate cuts without coming up against their lower bound. It was specifically in order to create an adequate inflation buffer that the Governing Council clarified the definition of price

stability in 2003, stating that inflation in the medium term should preferably be not only below 2 % but also close to that figure. That argument has lost none of its force in the meantime. On the contrary : as the real equilibrium interest rate has since declined further as a result of more secular forces which monetary policy cannot control, the problem of the lower bound for key interest rates has actually become more relevant.

17. The restoration of price stability will also have considerable positive spillover effects on financial stability. A shift towards a permanent low interest rate environment would be particularly damaging for the business model of financial intermediaries. Moreover, the fact that the key interest rates are therefore more often confronted by their lower bound represents an additional threat, both because of the resulting increased volatility of the economy and because of the need for monetary policy to resort to non-standard instruments. That is precisely the situation currently facing the financial system, where the monetary policy accommodation also entails certain risks. It is true that the monetary stimulus facilitates the deleveraging process, exerts a beneficial influence on the underlying quality of financial assets, and supports demand for credit. But at the same time, that stimulus also compresses the banks' interest rate margin and could encourage excessive risk-taking, in turn restarting the debt leverage process or leading to asset overvaluation. Although there are few signs of these risks manifesting themselves on a large scale in the euro area, it is essential to remain vigilant, because imbalances are often only built up gradually. Moreover, in some euro area Member States, there has been a steep rise in both mortgage lending and house prices. In view of the predominantly national character of those risks, recourse to macroprudential policy is the most appropriate way of containing them.

18. Finally, the excessively low inflation is a sign of persistent under-utilisation of production factors. Although the unemployment rate dropped from 12 % in 2013 to 8.7 % at the end of 2017, it remains above its pre-crisis level. Moreover, the under-utilisation of the labour potential also takes other forms. For instance, the number of involuntary part-time workers is still relatively high, and it appears that some members of the labour force have left the labour market owing to the lack of job prospects, but could return if demand for labour continues to rise. In addition, the usual production potential indicators show that the long period of low investment has had a significant downward effect on the capital stock. The fact that investment has now become a factor driving the recovery should make that restriction less of a constraint. There therefore seems to be some scope available for ensuring, by stimulating demand, that the production potential is not only fully used but that it is also supported to the maximum by preventing hysteresis effects. As a result, the structural reforms implemented here and there since the crisis can also come to full fruition. They have undeniably contributed to the strong job creation, and that process does not yet appear to have reached its limit. Accelerating pay rises and higher inflation are precisely the warning lights that indicate when that limit is being approached. From that point of view, too, it is therefore appropriate to make the normalisation of monetary policy dependent on inflation returning towards its target.

19. Now that the recovery has gained momentum and reflation is looming, the time has come to proceed with reforms in the euro area, too. If the Monetary Union is to gain economic strength while remaining stable, its architecture needs to be reinforced. That can only be done in stages, with convergence on best practices and risk reduction being the preconditions for greater risk-sharing. In that respect, the emphasis must first be placed on completing the current initiatives : the Banking Union and the Capital Markets Union, plus the European Semester and the newly-formed national productivity boards. These initiatives must also constitute opportunities for lifting potential growth and strengthening the resilience of the Member States. That process can gradually create the conditions for progressing towards increased risk-sharing via the public sector, while bearing in mind that sound public finances in the various Member States will always remain the central pillar of the Monetary Union's fiscal governance.

20. Considerable progress has already been made in developing the Banking Union, but the project is still incomplete in some crucial respects. The single supervisory mechanism (SSM) has been particularly successful in taking over the direct supervision of large banks and now carries ultimate responsibility for banking supervision in the euro area. In addition, the single resolution mechanism (SRM) in charge of the orderly resolution of systemic banks is also being implemented. With the SRM, the bail-in principle becomes the new operating mode, in which resolution costs are borne by the shareholders and certain creditors, obviating the need to use taxpayers' money to fund a bail-out.

21. However, the creation of a fully-fledged Banking Union requires further measures to reinforce stability, including in the event of financial disruption. For instance, even in the event of extreme turmoil, the SRM needs to have sufficient financial strength to provide effective support for the resolution of banks – should a bail-in prove insufficient – and thus limit the risks for financial stability. It is also necessary to set up a strong European deposit guarantee system (the European Deposit Insurance Scheme – EDIS) providing adequate protection for euro area depositors. Moreover, these essential financial safety nets become more effective and more credible if they are organised at Banking Union level and not by each Member State, as they then have larger reserves and are therefore better equipped to intervene effectively, including in the case of major shocks, and thus avert the risk of financial instability. However, the joint financial safety nets also imply far-reaching risk-sharing between the euro area countries. The geographical concentration of a large proportion of the banking risks in the euro area is impeding rapid progress in this sphere. As well as non-performing loans (NPLs), the strong home bias in the government bond portfolios exposes some banks excessively to specific country risks.

22. Increased risk-sharing must therefore be preceded by substantial risk reduction, involving not only the consolidation of certain bank balance sheets, but also efforts to strengthen the banking system's resilience. Deeper financial integration must not be at the expense of the financial stability necessary for sustainable economic growth. For these reasons, banks operating in the Banking Union must have sufficient individual resilience to absorb shocks, and adequate safeguards must be built into the framework of regulation and supervision. In that regard, it is very important that the European regulatory authorities transpose the Basel III accord consistently and on time, imposing harmonised, robust liquidity and capital requirements. In addition, the credit institutions that actually incur the risks must have sufficient buffers (in the form of capital, liquidity or bail-in capacity of the required quality) to cover unforeseen losses or shocks, or to permit smooth resolution. In this connection – as regards the home-host debate – it is necessary to take due account of the concerns of the host country, so that systemic subsidiaries of international banking groups operating in those countries have adequate buffers and therefore do not constitute an excessive risk for the financial stability of the countries concerned. Finally, increased risk-sharing at European level will be more readily accepted if the historical legacy is removed. The large volumes of NPLs in some countries and the structurally low profitability of a number of banks are still a particular cause for concern.

23. Further reduction of the stock of NPLs is regarded as an important catalyst for the completion of the Banking Union. Although that stock has already been partly reduced in recent years in the euro area – from € 1 046 billion at the end of 2014 to around € 830 billion in the second quarter of 2017 – it continues to weigh on the balance sheets of some European banks, and also indirectly on the European economy. The initiatives of the ECB and the European Commission, which focus on the accelerated reduction of the existing stock of NPLs or on the prevention of new NPL problems, therefore merit all possible support. However, the economic revival and the structural profitability of a number of banks in the countries affected are as yet still too weak to permit adequate, orderly dismantling of the stock of NPLs in the short term. The Ecofin Council's July 2017 proposals concerning better support for further moves to reduce those assets should encourage the banks to actively clean up their balance sheets. The establishment of an efficient secondary market in that type of assets, possibly including an asset

management company, accessible to specialist investors and based on an efficient, transparent legal framework for recovery and bankruptcy, is important not only for the speedier liquidation of the current stock of NPLs but also for that market's potential future role as a safety valve for removing the excess pressure that non-performing loans place on bank balance sheets.

24. Although the European banking sector has become much more solvent since the financial crisis, it still faces the challenge of achieving an adequate level of profitability in a sustainable way. As regards the profitability of their business, a large proportion of European banks fall well short of the capital costs demanded by the financial markets. That profitability shortfall is not only reflected in low valuations for the banking sector on the financial markets, but in the long run it also risks leading to funding problems and under-utilisation of the sector's intermediation capacity, which would hamper economic growth. Apart from cyclical factors associated with the low interest rate environment, such as the low levels of interest rates, the flatness of yield curves, and the downward pressure on interest incomes, more structural factors are also at work. The sector's excess capacity and the resulting fierce competition, some persistent operational inefficiencies and the long list of challenges relating to technological innovation are squeezing bank profits. At the same time, despite the improved solvency within the European banking sector, the financial markets are still demanding high risk premiums, resulting in relatively heavy capital costs. The structural uncertainties concerning the eventual regulatory framework, the normalisation of monetary policy and the remedies for the legacies from the past have in fact continued to determine risk assessments. Numerous simulations show that a cyclical economic upturn is liable to be insufficient, in the relatively short term, to restore the European banking sector to sustainable profitability in line with market expectations. To safeguard the banking sector's health in the long term, there is a need for more structural measures aimed at substantial efficiency gains. It is worth considering a number of strategies, such as the achievement of potential economies of scale via acquisitions or the implementation of cost-cutting measures based on digitisation, and a more diversified and flexible business model. In addition, the conclusion of the Basel III accord brings to an end, for the time being, the regulatory framework reforms and the resulting uncertainties. The banking sector can put the final touches to the adjustment of its business models, while the financial markets can continue to pass on the reduced uncertainty in the form of lower risk premiums and capital costs for the sector.

25. Even with the necessary prior reduction of risks in the regulatory framework and the strengthening of bank balance sheets, completion of the Banking Union remains an ambitious project. To achieve that, it is necessary to reinforce the SRM and implement the EDIS. To complete the SRM, it is important to finalise the European negotiations on the transposition and application of the resolution tools and principles, including the total loss-absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL). In that connection, to ensure orderly bank resolution, it is necessary to stipulate that the bail-inable liabilities must be sufficient in quality and quantity. The SRM also lacks the broad, mutual financial safety net required for the Single Resolution Fund (SRF) in order to ensure orderly bank resolution even in extreme situations. However, the introduction of the EDIS remains the major stumbling block in the process of completing the Banking Union. The latest proposals by the European Commission provide for a phased transition from the national guarantee systems to the European guarantee system. In the first phase – the reinsurance phase – the EDIS will only provide liquidity assistance; later, during the coinsurance phase, it could increasingly contribute towards covering losses.

26. Finally, a Capital Markets Union (CMU) is an important and necessary complement to the Banking Union, which will further reinforce the economy's growth potential and financial stability. In the Capital Markets Union, risk-sharing (via further financial integration) goes hand in hand with risk reduction (via financial diversification). Direct, diversified funding obtained via the capital markets, such as venture capital and growth capital, is an essential addition to

the bank finance predominant in Europe, and could support economic growth and innovation. Furthermore, integrated capital markets are an effective instrument for spreading risks and reducing excessive exposures to local risks. Since the 2015 announcement of the creation of the CMU, various projects have been launched which, by the end of 2019, should result in a framework in which the private sector itself can pursue the development of the European Capital Markets Union. In that context, the European Commission discussed some specific initiatives in its CMU mid-term review. The emphasis here is on such matters as mobilising European risk capital by encouraging European venture capital and growth capital funds and long-term investment, and by simplifying and facilitating SME access to the financial markets. In addition, further harmonisation of national legislative procedures – such as those related to resolution and bankruptcy – and improvement of the transparency of national financial markets should encourage cross-border investment within the EU.

27. An efficient and stable system of financial intermediation could be of significant help in supporting growth potential in the euro area. However, the availability of finance is not sufficient in itself. It is also necessary to have a dynamic economic environment that stimulates the implementation of growth-generating projects. The European Semester and the newly-created national productivity boards should become a catalyst for the structural reforms needed for that purpose. These productivity boards may also improve ownership of the reform agenda at national level. That process could lead to greater convergence between the Member States and better shock resistance. It should also pave the way to more inclusive growth. As well as potentially boosting the economic vigour of the Monetary Union, those reforms should generate significant positive externalities, because increased growth potential makes it easier to shed the debt burden, creates greater scope for fiscal policy and – by exerting upward pressure on the equilibrium real interest rate – facilitates the implementation of monetary policy. Furthermore, the establishment of a deeper Economic Union reduces the country-specific risks and strengthens the mutual trust necessary for proceeding later on towards the final stages of Economic and Monetary Union. Apart from the possible reform of the European Stability Mechanism, it will still be some time before views on new deepening initiatives converge. This concerns the idea of creating a post for a Minister of Economic and Financial Affairs for the euro area, or establishing a budgetary stabilisation mechanism aimed at absorbing asymmetric shocks.

28. In the meantime, it is only possible to use the margins in the national budgets, and even if the step towards increased fiscal solidarity is taken, the national budgets will still form the first line of defence against asymmetric shocks. Given the relatively high level of public expenditure in Europe and the existence of a well-developed social safety net, these national automatic stabilisers are in principle powerful. But if public finances are to be fully used, they must be structurally sound, which implies the creation of adequate buffers when the economy is doing well. The fact that these buffers were too small when the crisis erupted is among the reasons why fiscal policy failed to achieve macroeconomic stabilisation during the period 2012-2014. Sound public finances are also vital to financial stability, not least as regards halting the contamination of the banking sector. That is why it is so important for the Member States to adhere strictly to the Stability and Growth Pact rules. The Pact translates the structural determinants of the sustainability of public finances into a medium-term objective and, as regards the adjustment paths towards that objective, takes account of the position in the economic cycle. While the number of countries facing an excessive deficit of more than 3 % of GDP has declined sharply, and the deficit of the euro area as a whole fell to 1.1 % of GDP in 2017, in its assessment of the draft 2018 budgets for five countries, including Belgium, the European Commission nevertheless drew attention to a danger of insufficient progress towards the medium-term objective. Those countries need to take advantage of the recovery to build up reserves for the future.

29. The importance of sound public finances is beyond dispute. All the same, it cannot be denied that, over time, the Pact has become particularly complex, and that may impair its effective implementation. It is therefore necessary to examine whether any of its provisions can be simplified,

but without abandoning the principles behind them. Moreover, there is a need for good incentives to provide maximum support for investment. Of course, the fiscal authorities already have the option of redirecting their expenditure in favour of public investment. In addition, the European Fund for Strategic Investments and the clarification that Eurostat has provided on the statistical treatment of public-private partnerships also create a stimulus. Nonetheless, it is advisable to examine whether further encouragement to make up the shortfall in public investment could be offered if the preventive arm of the Pact were to take account only of amortisation rather than total investment expenditure, provided that does not threaten the debt's sustainability, and the investment in question actually strengthens the economic growth potential.

30. Paradoxically, the Monetary Union needs to be strengthened just at the time when the United Kingdom has opted to leave the EU. Brexit is a complex process because integration has now become so firmly entrenched. Nonetheless, in December 2017, the European Council was able to state that sufficient progress had been made to launch the second negotiation phase, as progress had been achieved in all three spheres that had to be clarified in the first phase, namely the legal status of EU citizens in the United Kingdom, the UK's obligations to the EU budget, and the arrangements for avoiding a hard border between Northern Ireland and the Irish Republic. That has increased the chances of averting a hard Brexit. In any case, such a scenario is not in the interests of either the United Kingdom or the other 27 EU countries. Yet many risks persist, since there is still much to be done in the second phase before the United Kingdom leaves the EU in 2019, and even then, the negotiations on a new trade agreement, in particular, will not have been finalised. For the remaining EU Member States, it is a question of preserving unity, just as in the first phase. While Brexit undeniably had an adverse impact on the British economy in 2017, the effect on the other EU countries, and the euro area in particular, was far smaller. The fact that the divorce process is taking place in an upward phase of the economic cycle has something to do with that.

3. A stable financial system in Belgium

31. Ten years after the crisis, the financial sector in Belgium has undergone a real transformation. The thorough revision of the regulatory and supervisory framework has restored the emphasis on financial stability, and the structural changes in the sector's business models – particularly in the case of banks and insurers – have clearly boosted the sector's resilience. The robust financial position of the Belgian financial sector provides a sound basis for tackling major challenges in the future, such as a persistently low interest rate environment, the digital transformation, and the deepening of the Banking Union and the Capital Markets Union.

32. That transformation was particularly apparent in the Belgian banking sector which – partly as a mandatory requirement – abandoned its previous business models and cut its balance sheet total by a third. The banking sector has largely digested these essential structural reforms and is now in a sounder financial situation, as the legacy of the past has been eliminated, giving way to a business model that focuses more on core banking activities such as lending and is aimed primarily at the domestic market. In addition, the banking sector's solvency has steadily improved so that it now has buffers which have restored the sector's resilience ; moreover, partly thanks to the ECB's asset purchase programme, there is now abundant liquidity. Finally, the transformation did not cause lasting detriment to the sector's profitability. On the contrary, after the initial impact profitability quite quickly regained a level in line with the financial markets' expectations, partly thanks to widening interest margins. Taking account of the specific funding structure of the Belgian banks, based largely on deposits, the decline in market interest rates was in fact reflected sooner in the banks' funding costs than in the returns on their assets. This widening of the total interest margin helped to underpin the banks' interest income and profitability during the crisis. On average, the sector's return on equity comes to around 10 %, which corresponds to the estimated capital costs.

33. The reorientation of the sector was not only important for restoring financial stability, it also protected the Belgian economy from an extreme credit drought which typically accompanies a radical balance sheet restructuring in a financial crisis. The Belgian banks continued to finance the real economy – even during the financial crisis. Partly as a result of the dynamic lending and the presence of increased liquidity, bank balance sheets have already been expanding again for several years, after a long period of balance sheet reduction. In entering additional credit risks on the balance sheet, the banking sector fulfils one of its essential financial intermediation functions, namely the selection, financing, monitoring and management of investment projects with ample value added. In this sphere, too, the Belgian banking sector has a good service record. Despite the abundant, dynamic lending to the private sector, the level of NPLs remains quite low in the balance sheets of Belgian banks, and in any case well below the euro area average. However, additional provisioning cannot be entirely ruled out, e.g. following the introduction of the new international accounting standard, IFRS 9, in January 2018.

34. Nonetheless, there are still serious challenges to be addressed which will put stress on the Belgian banks' standard business model in the longer term. Apart from the more structural challenges associated with the digital transformation in the financial sector and the increasing competition from FinTech companies, the low interest rate environment is slowly beginning to depress profitability. Apart from some other factors, such as the levies banks have to pay, the profitability of Belgian banks is primarily determined by the net interest margin. Yet, this has steadily come under pressure now that the low interest rates are increasingly reflected in the returns on assets – partly as a result of the refinancing of mortgage loans – while deposit interest rates reached their lower limit some time ago. In addition, the fierce competition in the Belgian banking landscape has led to individual banks applying narrow margins. Belgium is "lagging behind" other countries in seeing narrower interest margins because the balance sheets of Belgian banks, to a greater extent than those of other European banks, are composed of assets with a fairly long repricing period, while the refinancing of mortgage loans began relatively late. In the light of these challenges, the banks need to consider the various ways of maintaining profitability. On the one hand, in their search for yield, the banks are gradually opting to take on more interest rate and credit risks, using higher risk premiums to compensate for the fall in interest income. The latest stress tests show that the Belgian banks do indeed have an above-average exposure to interest rate risks. On the other hand, in a low interest rate environment, business models are being adjusted and geared more specifically to non-interest income, particularly commission and fees for financial services. Nevertheless, additional cost-cutting and/or efficiency gains seem inevitable, particularly in view of the digital transformation in financial intermediation and the increasing competition from FinTech companies.

35. Mortgage lending and property market developments also need to be analysed with due regard for that context. As the macroprudential authority responsible for financial stability, the Bank keeps a close watch on what is happening in those markets. The current risk analyses in fact suggest that the systemic risks are gradually accumulating. The sustained price increases on the property market which, in Belgium – in contrast to most other European countries – were not accompanied by significant corrections during the crisis, and the strong rise in the household debt ratio indicate that the financial cycle is picking up and the accumulation of macrofinancial risks is continuing. These risks are also reflected in bank balance sheets, which record a substantial volume of mortgage loans for which the banks need only constitute modest reserves on the basis of internal models. In 2013, the Bank had already taken a macroprudential measure in the form of a linear 5 percentage point increase in the risk weighting resulting from the models. In view of the continuing accumulation of systemic risks, the Bank announced that it would reinforce that measure by imposing additional capital buffers in proportion to the risk profile of the mortgage loan portfolio. In so doing, the Bank aims primarily to make credit institutions resilient to property market shocks, and hence to preserve their future lending capability.

36. Insurance companies have also undergone a structural transformation. The financial crisis had in fact revealed significant exposure to the interest rate risk (duration gap) accompanied by a less solvent sector owing to the steep decline in interest rates. In recent years, the insurance sector has therefore invested heavily to bring the duration gap down to a more manageable level. The big companies have been particularly active in reducing the duration gap, partly by repurchasing a number of large loss-making portfolios and partly by using derivatives and long-term investment to cover the interest rate risks. Although these measures have reduced the interest rate risk exposure of the insurance sector as a whole, some – generally smaller – companies are still significantly exposed to interest rate risks. However, the stress tests conducted in 2017 by the Bank as the insurance sector supervisory authority confirm that the sector's financial situation is generally sufficiently robust at this stage to withstand a prolonged period of low interest rates.

37. This reduction in the interest rate risk exposure has removed a heavy burden on the insurance sector's stability. Nevertheless, in the long run, there are still a number of challenges – especially for life insurers – concerning the larger liquidity risks and long-term profitability. To reduce the duration gap, insurers made greater use of derivatives and invested more in long-term but less liquid assets, thus converting part of the interest rate risk into liquidity risk. Moreover, a prolonged low interest rate environment generates a potential reinvestment risk, because high-yield assets are replaced at maturity by assets at lower yields. But this risk is less relevant in the short term, as the sector's current investment portfolio guarantees sufficiently high returns and a relatively stable interest margin for a certain period of time. Conversely, the problem is more acute in the case of new guaranteed-yield contracts because the low market interest rates and high entry costs and charges render this type of assets unattractive and impair their profitability. A number of insurers have already stated that they are scaling down their activities in this segment and concentrating more on products on which the financial risks are borne at least in part by the policy-holder and which offer the prospect of potentially higher returns (such as class 23 products).

38. In a low interest rate environment, it is therefore vital, in the interests of financial stability, to maintain the financial equilibrium in the insurance sector. As the authority responsible for both macroprudential and microprudential supervision of the insurance sector, the Bank has repeatedly published recommendations urging the sector to be cautious in regard to profit-sharing and dividends. If the existing commitments are to be fulfilled in the future, the stock of assets needs to be managed prudently, and there must be a limit on the realisation of capital gains and on profit-sharing and dividend payments for policy-holders and shareholders respectively. As the microprudential supervisor, the Bank can restrict these payments in the event of a threat to the financial balance of a given company. In addition, the Bank intends to see that the contractual conditions of new individual life insurance policies remain in line with market conditions.

39. The digital transformation will bring profound and irreversible changes for the financial sector. Ready access to digital networks and the rapid assimilation of digital technology in society combined with the exponential growth of computing and storage capacity are the driving forces behind the rapid and far-reaching digital transformation process. That process is also taking place in the Belgian financial sector and is gradually being incorporated in the business models of financial institutions. In the banking sector in particular, the digitisation of customer relations is already far advanced, as consumers increasingly expect financial services to be accessible at all times, regardless of location, time, or the medium used. In addition, digitisation of more operational tasks in the back offices and front offices of financial institutions can generate substantial economies of scale and sharp reductions in costs. However, this type of transformation requires careful preparation to maximise the reduction of operational risks, in view of the complexity of these operations and the need to ensure the business continuity of the institutions, which sometimes have a less flexible IT infrastructure.

40. The new FinTech companies could play a key role in this digital transformation, because these innovative operators enrich the financial landscape by offering additional services in specific segments of the financial intermediation chain. Thus, FinTech developments – such as crowd-funding, automated investment advice, alternative payment services or peer-to-peer loans – can have a positive impact in that they improve the level of customer satisfaction, reduce transaction costs, and expand the product range. At the same time, FinTech companies can offer financial institutions new types of support services that enhance the efficiency of certain business processes and – via the establishment of appropriate risk management measures – make them run more securely and smoothly. Examples include big data analysis, cloud computing, and the use of distributed ledger systems to protect certain financial transactions. The Bank has a contact point offering active guidance for FinTech companies on compliance with the applicable regulations and supervision requirements. Furthermore, the potentially disruptive effect of FinTech on the financial sector and the resulting new challenges for supervisory authorities must not be underestimated. In the long run, FinTech companies could in fact take over certain lucrative segments of the financial intermediation chain and thus erode the profitability of established operators. Also, the operational risks are increasing because of the heavy dependence on IT systems, and it is not always easy for new FinTech businesses – which are generally small companies – to keep strictly to all the regulations. Finally, the natural environment for these businesses lies much more in the shadow banking sector, or even beyond the supervisory scope of the financial regulators, and that further reinforces the need for cooperation with other competent supervisory authorities in non-financial spheres, such as cyber security.

41. In this context, the second European Payment Services Directive is a significant step forward in the further integration of FinTech – and BigTech – into European payments. Under this Directive, and subject to the account-holders' approval, a number of new service providers (offering payment initiation or information aggregation services) can now gain access to information on accounts and payment transactions, which means that banks could *de facto* lose their monopoly over that information and the associated competitive advantage. Ultimately, this Directive could therefore bring about a structural change in the European payment systems landscape.

42. As a result of the digital transformation, a number of risks are becoming increasingly correlated. Digitisation and FinTech developments are not only making the financial sector more complex, notably by accentuating the interconnections, but they are also intensifying the interaction between the financial sector and other sectors, such as those comprising technology firms and telecommunications. A clear view of developments in these areas is crucial, particularly for the supervisory authorities responsible for monitoring these risks. Apart from the cyber risks, it is necessary to monitor the risks concerning invasions of privacy and those relating to money-laundering or terrorist financing. Owing to the heavy digital dependence and the interconnections within the financial sector, cyber risk is becoming one of the main risks to the maintenance of financial stability, and a top priority for the supervisory authorities. Cyber attacks are becoming increasingly frequent and may also originate from various quarters, such as financial theft, terrorism or activism. The rapidly evolving cyber threats mean that the sector's defence capability needs to be sufficiently flexible, and it is vital to ensure that all parties involved in the intermediation process – from the financial market infrastructures to the end users – take the required precautions. In this context, the Bank announced its expectations in a prudential Circular in force since 2016. It is important that the management of the institutions in question guarantees a sound culture in regard to IT risks, and that the regulatory framework conforms to the guidelines issued by international bodies and is sufficiently holistic and flexible to respond promptly and appropriately to new developments in this sphere.

43. The monitoring of cyber risks is also one of the top priorities for the Bank's supervision of the financial market infrastructures and the systemic service providers concerned, such as SWIFT, owing to the stringent requirements governing the availability and integrity of these players, as they perform a pivotal, international role in the processing of payments and securities

transactions and in the exchange of financial information, and they are of crucial importance for the security of financial transactions. In that context, the Bank – as the lead overseer in an international arrangement with the G10 central banks – keeps a close watch on SWIFT. Not only the roll-out of the Customer Security Programme (CSP), aimed at improving cyber security and the management of cyber risks among direct users, but also SWIFT's internal resilience are subject to close monitoring and careful assessment on the basis of the relevant international standards. Apart from the emphasis on cyber risks, there is also much attention to the approval of central securities depositories (CSDs) under the new European Regulation on the subject. Other systemic institutions specialising in the custody of securities will be monitored from this year onwards on the basis of a new prudential status specifically geared to this type of institution. This will provide a better legal framework for the specific supervisory activity which the Bank has long since applied to this type of business.

44. Finally, the Bank took note of the conclusions and recommendations of the parliamentary commissions concerning Optima and the Panama Papers, and is cooperating fully in the implementation of those recommendations. In carrying out some of those recommendations – especially those relating to bank supervision – it is certainly necessary to take account of the new supervisory framework under the SSM. In regard to regulation, the Bank has already taken some initiatives concerning money-laundering practices, terrorist financing, fit & proper requirements, and the "special schemes" liable to favour tax fraud. Some of them have already been implemented or will shortly be acted upon. Other recommendations involving other authorities, such as those concerning the special tax fraud schemes, will take longer. In this area too, the Bank is committed to playing an active part in implementing these recommendations.

4. A resilient economy and sound public finances are the key levers to a high standard of living and greater social inclusion in Belgium

45. In 2017, Belgium's economy grew by 1.7 %, which was respectively 0.2 and 0.3 percentage points higher than in the two preceding years. As a small, open economy, Belgium naturally benefited from the world trade revival and the recovery in the euro area. Exports of goods and services were up by 0.8 percentage point, although the movement in market shares was less favourable than in the preceding years, as cost competitiveness showed no further improvement following its recovery and the euro's appreciation. Business investment also displayed a clear upward trend. In order to continue meeting demand, firms decide to invest increasingly in expansion. Household consumption grew by 1.1 %, which was less than in 2016. Following the fall in the savings ratio in that year, the growth of consumption dropped back into line with the rise in disposable income, which came to 1.3 % in real terms. This income increased, on the one hand, because real wages were rising again, while on the other hand, employment was expanding strongly. The volume of hours worked rose by 1.5 %, and 66 000 jobs were created. That was the biggest expansion in employment since 2008.

Growth remains moderate, but job creation is particularly robust

46. In this connection, two striking developments call for clarification. To start with, since 2015, Belgium's growth has been slightly below the average for the euro area and for the three main neighbouring countries, yet at the same time job creation in Belgium has been particularly robust. What is the meaning of these divergent developments ?

47. First, it is necessary to assess Belgium's growth performance over a longer period. In the past ten years – i.e. since the start of the crisis – Belgium has significantly outperformed the euro area as a whole, and has also done better than neighbouring countries other than Germany. During

the two downward phases in the cycle, Belgium proved more resilient, which also implies that there was less ground to make up during the recovery phase – but also less need in that respect. Conversely, the catching-up process was very apparent in countries such as Spain, which had been seriously affected by the crisis. Closer to home, the Netherlands displays a similar profile. It suffered more from the decline in the housing market and the fall in financial asset prices, but is gaining more benefit today from the recovery in those areas. In addition, the fiscal consolidation was initially more vigorous in the Netherlands, and that depressed growth at first, though it subsequently created some room for manoeuvre. In contrast, in recent years, Belgium's economic policies have exerted some downward pressure on growth, though in principle the impact was temporary. Control over public expenditure meant that public consumption grew more slowly than in neighbouring countries. In addition, although the wage moderation policy had a positive impact on employment and exports, it depressed the growth of disposable income and hence household consumption. Now that disposable income is picking up, private consumption will increasingly become an engine of growth, and that will lessen the divergence in relation to neighbouring countries.

48. Apart from this short-term downward effect on growth, however, this same policy undoubtedly achieved its main objective of creating jobs in an economy suffering from an atypically low employment rate. The increase in this rate was still lagging behind rates observed in the euro area. Nevertheless, the job intensity of growth was particularly high in Belgium. In the past two years, it has been more than 50 % greater than it was before the crisis. For instance, in 2007, it took growth of 3.4 % to create roughly the same number of jobs as in 2017. The job intensity was also higher than elsewhere in the euro area and in each of the three neighbouring countries. And in contrast to what happened previously, the jobs were created mainly in the business sector, and to a lesser degree in the public sector or in branches of activity receiving substantial government subsidies.

49. Two policy avenues in this area contributed to this strong job creation. First, major efforts were made to reduce labour costs, partly by introducing wage moderation and partly by cutting employers' social security contributions. That benefits demand for labour, not only because of the resulting gains in competitiveness but also because the production factor labour becomes more attractive in relation to the production factor capital. However, higher demand for labour cannot boost employment unless the labour supply is sufficient. That is why support for the labour supply formed the second pillar of the policy, especially as that supply is increasingly feeling the effects of population ageing. In that context, the statutory retirement age was increased and the opportunities for early departure from the labour market were reduced. Also, there was emphasis on job-seekers' activation, training and accountability. Finally, tax cuts via the tax shift serve to make work more remunerative and, in particular, help to reduce what are commonly known as unemployment and inactivity traps. Together, these factors led to an increase in the labour force amounting to around 38 000 units – partly as a result of greater participation among the older age groups – while the number of job-seekers fell by 28 000 units. The unemployment rate thus declined to 7.3 %.

50. Despite this progress, unemployment remains unacceptably high, and the employment rate is still too low, particularly for certain "risk" groups and in the Brussels and Walloon Regions. The fact that a growing labour shortage nevertheless became apparent in certain labour market segments in 2017 also indicates the presence of a significant qualitative dimension. There is not just a lack of geographical mobility; it is also likely that the job-seekers' skills do not sufficiently coincide with the skills in demand on the labour market. Owing to the structural shifts in the economy – due in particular to digitisation – the desired skills are also constantly changing and there are signs of polarisation on the labour market, which is at the expense of jobs requiring medium skills but which above all limits the job opportunities for workers with a low level of education. Further effort is therefore needed in many spheres to mobilise the unused labour potential. That is one of the first factors which could significantly enhance the Belgian

economy's growth potential. An effort is also needed to boost labour productivity, because once the labour potential is fully exploited, productivity gains become the sole sustainable source of wealth creation.

Making maximum use of the untapped labour potential

51. In order to make optimum use of the labour potential, it is of primary importance to consolidate the progress on cost competitiveness and ensure that wage-setting makes the maximum contribution to job creation. The amendments to the Law on the Promotion of Employment and the Preventive Safeguarding of Competitiveness, revised in 2017, aim to ensure that the reductions in charges under the tax shift benefit employment to the maximum, and strengthen the preventive character of the framework by fixing a safety margin of at least 0.5 of a percentage point in each negotiation round. Because of the initial moderating effect that this has, in principle, it limits the need for subsequent intervention, but at the same time the amended Law provides for a correction term so that rectification of any slippage compared to the 1996 reference year becomes more automatic. In recent years, it has in fact become apparent that the elimination of any larger handicap is a lengthy and difficult process.

52. Due regard for competitiveness constraints does not necessarily rule out any increase in purchasing power. For instance, within the limits of this new framework, the social partners agreed on a maximum margin of 1.1 % for real pay rises over the period 2017-2018 as a whole. Most of the margin will be used in 2018 and will help to support private consumption. For that boost to be sustainable, it is necessary to continue to safeguard competitiveness. Preferably, within the negotiating framework, account should also be taken of productivity trends which may vary between sectors, regions and individual firms. As well as promoting employment, that will contribute to labour mobility.

53. In regard to safeguarding competitiveness, it is not only the movement in wages that matters: price-setting and the trend in other incomes also play a significant role. It is therefore very worrying that inflation has been systematically higher in Belgium than in the neighbouring countries over recent years. Driven by the rise in energy prices, inflation climbed even higher in 2017, from 1.8 to 2.2 %. Moreover, inflation in Belgium is more sensitive to crude oil price fluctuations than in neighbouring countries, mainly on account of lower excise duties on heating oil. Nevertheless, in relation to neighbouring countries, the inflation gap narrowed, declining from almost 2 percentage points in the spring of 2016 to 0.6 percentage point at the end of 2017. This gap had in fact widened temporarily as a result of a number of increases in indirect taxes and public tariffs. Furthermore, the report on that issue produced by the Federal Planning Bureau, FPS Economy and the Bank at the request of the Minister of the Economy found that the movement in prices in the hotels and restaurants sector and in telecommunications was the principal source of the adverse inflation gap in services. Meanwhile, in order to stimulate competition in the telecommunications market, it has been made easier for consumers to switch between operators. It remains important to boost competition on the various product markets. This will lead to more competitive pricing and bigger productivity gains. Furthermore, it will benefit competitiveness. The services provided are not only intermediate inputs for sectors competing with other countries, their pricing also has an impact on wage-setting.

54. Necessary as it is to control prices and costs, it is equally important to ensure the employability of the labour potential. Not only will that bolster the strength of the economy, it will also foster social inclusion, because a job is the key to emancipation. Everyone therefore needs to be adequately equipped to find a place on the labour market and remain employable throughout their working life in a fast-changing economic environment. The empowerment of people and talents are therefore key words for the labour market policy.

55. That empowerment starts with the training that young people receive in education. Reforms that reinforce and extend the benefits of training are therefore necessary. Preventing young people from dropping out must remain an important point for attention, even though significant progress has already been achieved in that respect. Language skills – including mastery of both national languages – are crucial, as is early initiation into the latest developments in ICT, or the teaching of ways of thinking aimed at devising creative solutions. Scientific and technological subjects merit particular attention and offer good job prospects. For young people, the transition to working life is facilitated by day-release apprenticeships. But training does not cease on leaving school. Nowadays, lifelong learning is equally vital for keeping up with developments in technology, working methods and forms of organisation. That is not just a matter for firms and their workers, but also for job-seekers, employment agencies and vocational training services. By matching vacancies promptly to job-seekers, it is possible to establish job security in a dynamic economy where jobs with no future disappear, while new jobs are created.

56. So far, there are few signs that, in Belgium, the changes affecting the labour market have resulted in any sharp rise in income inequality, an increased risk of poverty for persons in work, or a significant deterioration in job quality. Thus, nine out of ten workers still have a permanent employment contract, although temporary contracts are becoming more common. Also, involuntary part-time working is much less prevalent in Belgium than elsewhere in Europe. Many other qualitative labour market indicators differ little from those in countries such as Sweden, Finland and Denmark, which generally score highly in that respect. However, like those countries, Belgium has a very low employment rate for the low-skilled and residents from non-EU countries. These groups must continue to receive special attention, and all forms of discrimination must be excluded. Nevertheless, one characteristic of Belgium is that the gender pay gap is considerably wider than in the Nordic countries. This is because women are proportionately more likely to be in less well-paid occupations, and in particular because, in Belgium, they more frequently work part time. This suggests that it is more often the women who take on the child care, while the men focus more on their career development. That makes it harder for women to progress to more senior positions. This is not only an ethical question, it also has economic implications, as nowadays it is advantageous to be able to call on a wide range of skills via greater diversity at all levels.

Towards a more productive and dynamic economy

57. While the changes which are transforming the economy call for adaptation of working conditions, they also create opportunities. For instance, digitisation redefines the concept of distance by eliminating its purely geographical aspect. That applies to the distance between consumers and suppliers, but also the distance between workers and their employer, and is associated not only with e-commerce but also teleworking. Both create new scope in an economy which has to contend with both the congestion of its transport infrastructure and the need to reduce greenhouse gas emissions, while looking for ways to increase productivity gains. Those gains have in fact been seriously eroded in recent years. This is not a typically Belgian phenomenon, although the pace of productivity growth has slackened considerably in Belgium. That is partly just the corollary to the strong job creation, which exerts normal, temporary downward pressure on productivity growth, but ensures that future productivity gains will have a stronger impact since a greater number of workers will have a share in them. For economic growth, it is crucial to create an environment that stimulates productivity gains. That will strengthen income growth and free up additional margins for public finances.

58. Productivity gains originate from many sources. Innovation and technological progress are key factors, but so are their wide diffusion throughout the economy and an efficient reallocation process whereby labour and capital can be readily redeployed. From that point of view, productivity and innovation are multidimensional concepts which require a transversal approach. Where innovation

itself is concerned, Belgium performs well, especially as regards partnerships between businesses, universities and government. Nonetheless, the spread of innovation is still unsatisfactory. In that respect, a more competitive market could provide incentives for modernisation and greater organisational efficiency. By simplifying the time-consuming administrative, legal or fiscal procedures and removing unnecessary barriers, resource allocation can be facilitated. Also, a smoothly functioning public administration and an efficient and transparent regulatory framework will contribute to this. In Belgium, many fast-growing businesses are appearing on the scene, and lately more people have been switching to self-employed activity. At the same time, the dynamic process whereby the most productive activities take over from less productive ones is still underdeveloped. In comparison with other European countries, few new businesses are being established, their growth is limited and also the rate at which existing companies disappear is low. That could be a sign of inefficiency. The number of "zombie" companies – i.e. those whose operating profits are insufficient to cover their financial costs over an extended period – is also fairly high in Belgium. This concerns about 10% of the population of firms, and they generally record slow productivity growth. A dynamic economy needs companies that, thanks to their adaptability, successfully boost their own chances of survival. Besides, resources for new initiatives can be freed up from scrapping activities with no future. Not only does that substitution have an immediate impact on productivity at macroeconomic level, it also promotes the employability and remuneration of workers by giving them the opportunity to develop in a more productive environment.

59. Furthermore, potential growth and productivity will benefit from an efficient infrastructure. In Belgium, the infrastructure has suffered from the low level of public investment. Mobility and energy supplies are two crucial areas where the need is very great in that regard. A forward-looking perspective is necessary to reconcile economic efficiency and ecological sustainability. As well as carefully considered infrastructure investment, there is also a need to create incentives to reduce demand for mobility and energy before channelling that demand towards the least polluting options. While the government has a notable steering role to play here, the private sector's contribution may also be important. In order to mobilise private investment for projects requiring a substantial capital injection and extending over a very long period, it is essential to have a stable and predictable framework.

For public finances, the time has come to build up buffers for the future

60. The budget deficit declined sharply in 2017, from 2.5% to 1% of GDP. The improvement was due to a further reduction in interest charges, the buoyant economy (especially the strong jobs growth), the maintenance of control over primary expenditure, the substantial rise in corporation tax revenues, particularly the advance payments, and a reduction in the contribution to the EU budget. Excluding the impact of the business cycle and one-off factors, the structural deficit dropped from 2.1% of GDP in 2016 to 1.2%. This improvement is close to the target set in the stability programme, namely a full one percentage point reduction. For the first time in years, the public debt diminished significantly, by almost 3 percentage points, to 102.8% of GDP. While no progress had been made in 2016, 2017 proved to be a particularly good year for public finances.

61. However, there can be no resting on laurels. The good economic situation must be used to build up buffers for the future, because the public debt is still particularly high while, despite the pension reform, population ageing will generate additional budgetary costs. Moreover, it is becoming increasingly necessary to find solutions to other challenges, such as mobility and the energy transition. And in today's rapidly changing economic constellation it is important for the government to be able to continue providing an adequate social safety net. That is why continued progress towards structural equilibrium – the medium-term objective for Belgium's budget balance – remains desirable. The adjustment path towards that objective plays a key role in the Stability and Growth Pact, and must remain the guiding principle of fiscal policy in Belgium.

62. The need for further fiscal consolidation is undeniable, but it remains complex to achieve as there are many interactions between the government and the economy which need to be taken into account in devising the budget strategy. First, a resilient economy will facilitate fiscal consolidation. That is an important reason for pursuing the structural reforms which support the economy's growth potential. The fact that, following implementation of the pension reform in particular, it was possible to reduce Belgium's medium-term objective from a surplus of 0.75 % of GDP to a structural balance is a telling example. The composition of revenue and expenditure also influences the functioning of the economy, and hence ultimately the budget balance itself. On both the revenue and the expenditure side, there is scope for adjustments to make public finances more conducive to growth.

63. On the revenue side, the tax shift was an important step in that direction. The heavy burden of charges on labour in fact holds back growth and employment. Reducing those charges has already generated additional jobs. The current tax shift will continue until 2020, and the planned reductions are to be implemented in a way which does not compromise further reductions in the public deficit. Corporation tax was also reformed in 2017 : the result is that, once the new regime becomes fully effective in 2020, the basic tax rate will be cut to 25 % but the tax base will be enlarged. That will bring the taxation of businesses more into line with the format in other European countries ; the reform is a follow-up to the new European rules to combat tax evasion. The lowering of the tax rate – which prevents any widening of the gap in relation to other countries – is important for attracting foreign direct investment. That investment is significant in facilitating the spread of innovation and technology. In view of the need for further fiscal consolidation, it is good that the corporation tax rate cut is kept fiscally neutral, and the fact that any payback effects are disregarded demonstrates prudence. In implementing the reform, it is advisable to keep a close eye on the associated risks and effects. It is also necessary to maintain the efforts aimed at the proper collection of revenue, and to examine the degree to which new tax reforms could support growth, steer the abundant savings in Belgium towards financing investment, and create incentives to help reduce greenhouse gas emissions.

64. On the expenditure side, there is also scope for growth-friendly adjustments, particularly as regards investment which supports the economy and the social fabric. In addition, there must be judicious control over public expenditure, and effort must be devoted to enhancing the efficiency and quality of government action. Primary public expenditure is still high, not only in relation to the pre-crisis situation, but also compared to most advanced economies, without necessarily producing a correspondingly better service. In parallel with the efforts to achieve administrative simplification and efficient management, the government must seize the progressive digitisation as an opportunity for securing productivity gains in the many spheres in which it operates. Determining the spheres designated for government action is an intrinsically political choice that reflects society's preferences. Conversely, striving for cost effectiveness in those spheres is a universally accepted economic principle.

65. All Belgian government entities have a responsibility to ensure the sustainability of public finances, and mutual coordination is indispensable. That is why the federal government and the governments of the Communities and Regions must conclude an agreement which contains binding budget targets, as specified by the cooperation agreement of 13 December 2013. That clarifies each entity's responsibility and permits independent monitoring of the adjustment path by the High Council of Finance. It is also advisable for the country's various government entities to coordinate their policy initiatives so that they can be efficiently tailored to local needs, in line with the aim of the sixth State reform.

5. Conclusion

66. Now that the global economy is doing well, it is time to adjust the economic policy mix. The powerful monetary incentives need to be gradually scaled down, even though the various economies still diverge in terms of the strength of the recovery and the underlying inflationary pressures. Thus, the Federal Reserve has been able to take further normalisation steps, while in the euro area it has proved necessary to prolong the accommodative monetary policy. Nevertheless, a policy of reforms favourable to growth must become a priority everywhere. That will convert the cyclical upturn into sustainable growth. In the euro area, there is an urgent need to complete the Banking Union while remaining aware of the specific challenges that the current asymmetric architecture presents during the transitional phase. The Capital Markets Union needs to be deepened further, and the Member States must make their economic fabric more resilient while also ensuring sound public finances conducive to growth. These reforms will not only boost economic strength, they will also benefit the stability of the Monetary Union.

67. In 2017, the financial conditions remained highly favourable throughout the world, and financial market volatility was particularly low. While that undoubtedly benefited growth, we must not lose sight of the risks which could accumulate. That is also the environment in which Belgian financial institutions operate. The radical restructuring in the wake of the crisis has made the Belgian financial system fundamentally sounder. All the same, new challenges are emerging. The current low interest rate environment is one of them. While it is necessary from a macroeconomic angle, and it has positive repercussions on financial stability, it nevertheless generates increases in financial market valuations and compresses the banks' intermediation margin, which may encourage increased risk-taking. This situation is also liable to have a more serious impact on life insurers, even though most of the companies concerned have succeeded in considerably reducing their interest rate risk exposure. Those risks are being closely monitored, and that is the context in which the Bank proposed, in 2017, an additional macroprudential measure concerning mortgage loans. Financial intermediaries also face major structural changes, such as the trend towards more market financing, excess capacity in the European banking world, and last but not least, digitisation and the emergence of the FinTech operators. This combination of factors certainly has implications for current business models, but it also gives rise to opportunities for improving user-friendliness, expanding the range of services, and ensuring effective cost control. The supervisory authorities must ensure that these transitions do not compromise financial stability, and they must remain sufficiently attentive to the new vulnerabilities that are emerging, e.g. as regards the increase in cyber risks.

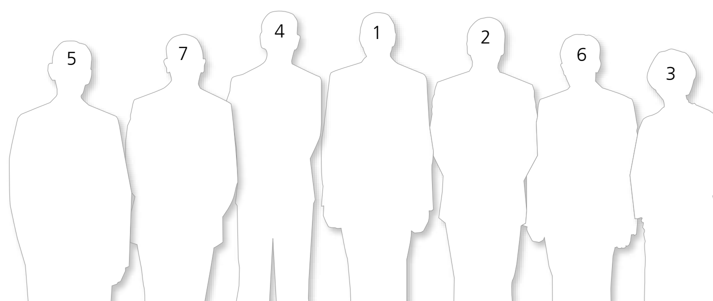
68. In parallel with the recovery in the euro area, economic activity also picked up in Belgium. Although Belgium's growth remained a little lower at 1.7 %, job creation was particularly robust, with 66 000 additional jobs. The job creation was facilitated by wage moderation and the reduction in employers' social security contributions. It also benefited from the ever-increasing support for the labour supply resulting from the extension of working life, the activation and guidance concerning job-seekers, and the support for purchasing power via the tax shift. The reforms which have been implemented are therefore clearly bearing fruit. While the economic upturn, with the increasing tension on the labour market, presages other problems that will have to be addressed, it primarily creates a favourable climate for dealing with those issues. Apart from the consolidation of competitiveness via appropriate wage-setting and pricing, there is still much to be done to take advantage of Belgium's untapped labour potential. Education, labour market support and lifelong learning must ensure that talent can be used to the full in a constantly changing economic structure. That empowerment of people and talent will bear more fruit if every form of discrimination is outlawed – whether it concerns the workers' origin, religion, gender or age. That could also encourage the reallocation of resources from less productive to more productive activities and – in conjunction with innovation efforts, well thought-out infrastructure investments and more competitive product markets – lead to the

necessary increase in productivity growth in Belgium. That is the way to establish a sustainable basis for a high standard of living, and create the necessary scope for the government to handle the budgetary impact of ageing, to deal with other challenges such as mobility and the energy transition, and to continue to guarantee an adequate social safety net. Nonetheless, following the clear progress achieved in 2017, that same government must maintain its efforts to achieve a structural balance and – without compromising that path – it must continue to adjust both revenue and expenditure in order to make the government's action both more efficient and more conducive to growth.

69. The strength of the Belgian economy is not only evident in the high standard of living that it has already generated, or in the fact that it withstood the crisis fairly well. That strength may also be latent in aspects which, at this stage, are still a source of fragility but which, for the future, offer the prospect of considerable scope for progress. The continuing mobilisation of the labour potential, increased productivity gains, adequate funding for the economy, and more efficient public service are all levers which, via the continuation of the reform policy, can both enhance the economy's resilience and strengthen social inclusion.

Brussels, 31 January 2018

Board of Directors



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