1. Global economy and euro area

1.1 Robust growth widespread in the main economic regions

In line with the trend that had begun in mid-2016, economic activity continued to gain momentum in 2017. At 3.7 %, global GDP growth reached its highest level since 2011. Moreover, its geographical basis became broader in both the advanced and the emerging economies. In the advanced economies, the vigour of activity was supported by continuing accommodative monetary policies combined with a fiscal policy stance that remained neutral overall and a revival of consumer and business confidence. It was very clearly based on the dynamism of domestic demand – particularly the investment revival – and employment. In the emerging economies, the growth acceleration was less marked, but there was a more noticeable decline in the divergences between countries. The improvement

TABLE 1 GDP OF THE MAIN ECONOMIES

(percentage changes in volume compared to the previous year, unless otherwise stated)

	2015	2016	2017	*p.m. Contribution to global GDP growth* 2017	*p.m. Share of global GDP*(1) 2017
Advanced economies	2.2	1.7	2.3	*1.0*	*41.3*
of which:					
United States	2.9	1.5	2.3	*0.4*	*15.3*
Japan	1.1	0.9	1.8	*0.1*	*4.3*
Euro area	2.1	1.8	2.2	*0.3*	*11.6*
United Kingdom	2.3	1.9	1.5	*0.0*	*2.3*
Emerging economies	4.0	4.4	4.7	*2.7*	*58.7*
of which:					
China	6.9	6.7	6.8	*1.2*	*18.3*
India	8.0	7.1	6.7	*0.5*	*7.5*
Russia	–2.8	–0.2	1.8	*0.1*	*3.2*
Brazil	–3.8	–3.5	1.1	*0.0*	*2.5*
World	3.4	3.2	3.7	*3.7*	*100.0*
p.m. World trade(2)	*2.8*	*2.5*	*4.7*		

Sources: EC, IMF.
(1) According to the IMF definitions and calculated on the basis of purchasing power parities.
(2) Average of exports and imports of goods and services.

in the general economic climate was accompanied by strengthening world trade and a strong rise in financial asset prices. Conversely, commodity prices presented a more mixed picture.

The economic situation improved slightly in the emerging economies

In China, economic growth maintained a strong pace at 6.8 %. In contrast with the previous rebalancing in favour of private consumption and services, activity in 2017 benefited from a steep rise in exports, offsetting the slowing of domestic demand. It was mainly investment in businesses and housing that decelerated, with substantial capacity left unused. Fiscal policy remained slightly expansionary, the main factor being a high level of public investment. While the monetary policy stance was neutral overall, the People's Bank of China embarked on selective easing in order to facilitate access to credit for small firms and for the agricultural sector. But on the other hand, in the context of a high debt level and increased risks to financial stability, the Chinese authorities took new measures to curb the rapid and persistent expansion of credit. Moves to contain the activities of the shadow banking sector are ongoing, while access to mortgage loans has been tightened and interbank financing is to be more strictly regulated. In addition, certain measures have contributed to the deleveraging of the business sector, though progress has been limited so far. But there has been no change as yet in the implicit guarantees provided for State enterprises.

In India, the repercussions of the measures to curb the shadow economy, such as the demonetisation of the 500 and 1 000 rupee notes implemented in November 2016 and the effects of the harmonisation of the tax on goods and services introduced in July 2017, temporarily weighed on the dynamism of activity. GDP growth dropped to just below 7 % in 2017. However, these measures should help to reinforce economic potential in the longer term. In addition, the adoption of a national code governing corporate bankruptcies and the plan to recapitalise the public banks (amounting to around 1.3 % of GDP) announced in October should enable the banks to grant new loans and thus support investment and the dynamism of the economy.

Economic activity in the commodity-exporting countries – and more particularly those exporting fossil fuels – continued to suffer from the still relatively low prices of these products on the international markets, although prices did pick up in 2017. All the same, after two years of severe recession, Brazil and Russia managed to stage a comeback. In Brazil, the recovery was initially driven by agriculture, before strengthening and extending to other sectors of the economy. Lower inflation underpinned household consumption demand, while investment – though still down – nevertheless benefited from the easing of monetary policy. In Russia, the economy gradually strengthened from the end of 2016, following the rise in oil prices, stabilisation of the rouble, and the decline in inflation. Consumption and private investment both contributed to the recovery on the back of renewed confidence and an improvement in financing conditions. The higher revenue from fossil fuels helped to bring about a considerable reduction in the public deficit.

The cyclical upturn continued in the main advanced economies

In the United States, economic activity gained momentum in 2017. Supported by an investment revival, GDP growth increased steadily, reaching more than 3 % year-on-year in the third quarter. As a result of job creation, the unemployment rate reverted to the level prevailing in the early 2000s, falling to 4.1 % in December. At the same time, the labour market participation rate of the population of working age remained largely unchanged, at just under 63 %. Private consumption remained robust, bolstered equally by the wealth effects associated with the flourishing asset market and by the – albeit still modest – rise in wages. Despite these favourable developments, inflation languished below its target level of 2 % and inflation expectations were still relatively weak. Nonetheless, taking account of the strengthening economy, the Federal Reserve widened the range for its three key interest rates on three occasions – in March, June and December – raising it to 1.25-1.50 %. In October 2017, it also launched a plan for gradually scaling down its investment in securities reaching maturity. Fiscal policy remained neutral overall in 2017. The public deficit was steady at just over 4 % while the public debt edged upwards to 108 % of GDP. The end of the year saw the adoption of a major tax reform comprising tax cuts on both personal incomes and corporate profits. The implementation of this programme during the course of 2018 and 2019 means that the gradual monetary normalisation should be accompanied by a fiscal stimulus.

In Japan, the economic expansion gathered pace in the context of highly accommodative financing conditions and massive government measures to support the economy. Export growth in the wake of the international trade revival led to stronger investment, while consumption benefited from a further improvement in employment. Nevertheless, excluding prices of energy and food, inflation remained close to zero; the main factor seems to be the very cautious approach to setting wages and prices among Japanese firms, after years of low inflation or even slight deflation. Despite a growing shortage of labour, with unemployment at less than 3 %, and a sharp rise in business profits, wages hardly changed in real terms.

In these circumstances, the Bank of Japan made no adjustments to its accommodative monetary policy, aimed at raising inflation towards its 2 % target. It continued to apply a negative interest rate of –0.1 % on the current account deposits of financial institutions. In addition, to keep the ten-year interest rate close to 0 %, it retained its programme of purchases of Japanese Treasury bills in the region of 80 000 billion yen (or around € 590 billion) on an annual basis. Finally, it continued purchasing other types of assets such as exchange-traded funds and property investment funds. The fiscal stance remained expansionary in 2017, with the deficit above 4 % of GDP. The gross public debt came to around 240 % of GDP.

In contrast to the general trend, growth slowed down in the United Kingdom

In the United Kingdom, after having displayed some resilience following the vote in favour of Britain's exit from the EU on 23 June 2016, the economy slowed considerably in 2017, the main reason being a weakening of private consumption, which suffered particularly from a decline in purchasing power as a result of the surge in inflation that followed the sharp depreciation of the pound sterling during 2016. Conversely, the fall in the pound bolstered exports which, unlike imports, recorded strong growth. On the other hand, the uncertainties surrounding the arrangements for leaving the EU curbed business investment. Despite the less favourable economic dynamic, job creation remained robust. The unemployment rate dropped below 4.5 %, while the labour market participation rate remained stable at around 78.5 %.

As inflation had reached a high point of 3.1 % in November 2017, well above its 2 % target, the Bank of England decided to raise its key interest rate to 0.5 % in November. The government did little to ease the restrictive fiscal policy implemented to bring down the deficit, which had verged on 10 % of GDP at the height of the crisis. In November 2017, it announced a new plan to stimulate the economy in the form of higher investment, lower taxes – notably to make access to home ownership easier for households – and moderation of the planned cuts to current expenditure.

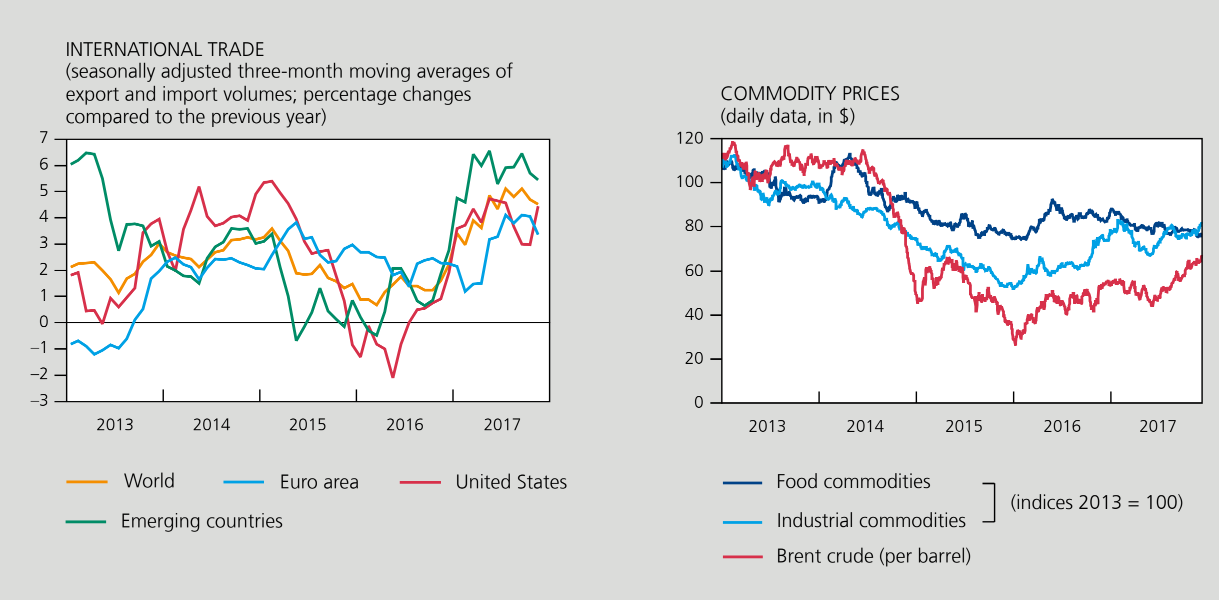
On 29 March 2017, the British government officially informed the President of the European Council that the United Kingdom wished to leave the EU. Since then, negotiations with the European Commission have begun; initially they concerned questions relating to the separation, and more particularly the full financial settlement, the rights of British citizens in the EU and of European citizens in the United Kingdom, and the border between Northern Ireland and the Irish Republic. These discussions were made more difficult by the fact that the Conservatives lost their absolute majority in the parliamentary elections that they called in June 2017. At the European Council on 14 and 15 December, the Heads of State and Government of the EU Member States found that sufficient progress had been made on the questions relating to the divorce. That opened the way to negotiations on the future economic relationship between the EU and the United Kingdom, and on the transitional phase that the British government wants once the United Kingdom officially leaves the EU on 29 March 2019.

International trade picked up, and non-food commodity prices followed suit during the year

After having weakened considerably in 2016, global trade flows staged a strong recovery in 2017, with expansion once again significantly outpacing GDP growth, in contrast to the picture in the two preceding years. The strengthening of trade was evident both in the advanced economies and in the emerging economies. It was driven by the rise in global demand, and more specifically the increased investment in equipment, which tends to have a higher import content than other demand categories. Apart from the revival in activity in the euro area, where trade is particularly intense, the stronger growth in China and the United States was a dominant factor here. Higher Chinese imports stimulated trade within Asia, while across the Atlantic, the rise in oil prices supported the investment revival in the energy sector.

After having virtually doubled in 2016, oil prices subsided for a time in the first half of 2017. That was due to the increased production in the United States and the faster-than-expected recovery of production in Libya and Nigeria. During the second half of the year, however, oil prices began rising again, as a result of both the strong demand from Europe and the United States, and the uncertainty surrounding the (geo)political and social situation in a number of producer countries in the Middle East and Venezuela. Finally, the expectation of extension of the agreement between OPEC members and some other countries on cutting production by 1.8 million barrels per day drove prices still higher as the year drew to a close. At the end of November, it was finally decided to renew the agreement until the end of 2018.

CHART 1 WORLD TRADE ACCELERATED STRONGLY AND COMMODITY PRICES PICKED UP IN 2017



Sources: CPB, Thomson Reuters.

Industrial commodity prices followed a similar pattern; after beginning to strengthen in 2016, they dropped back from February in view of the prospect of weaker demand from China, following the Chinese government's measures to avoid a property market bubble. Most of the lost ground was made up in the second half of the year, as metal prices were then supported by the improvement in the economic climate, and in particular by the increased dynamism of the Chinese economy. Only food commodity prices continued to fall throughout the year, as a succession of record harvests in recent years had led to the formation of substantial stocks.

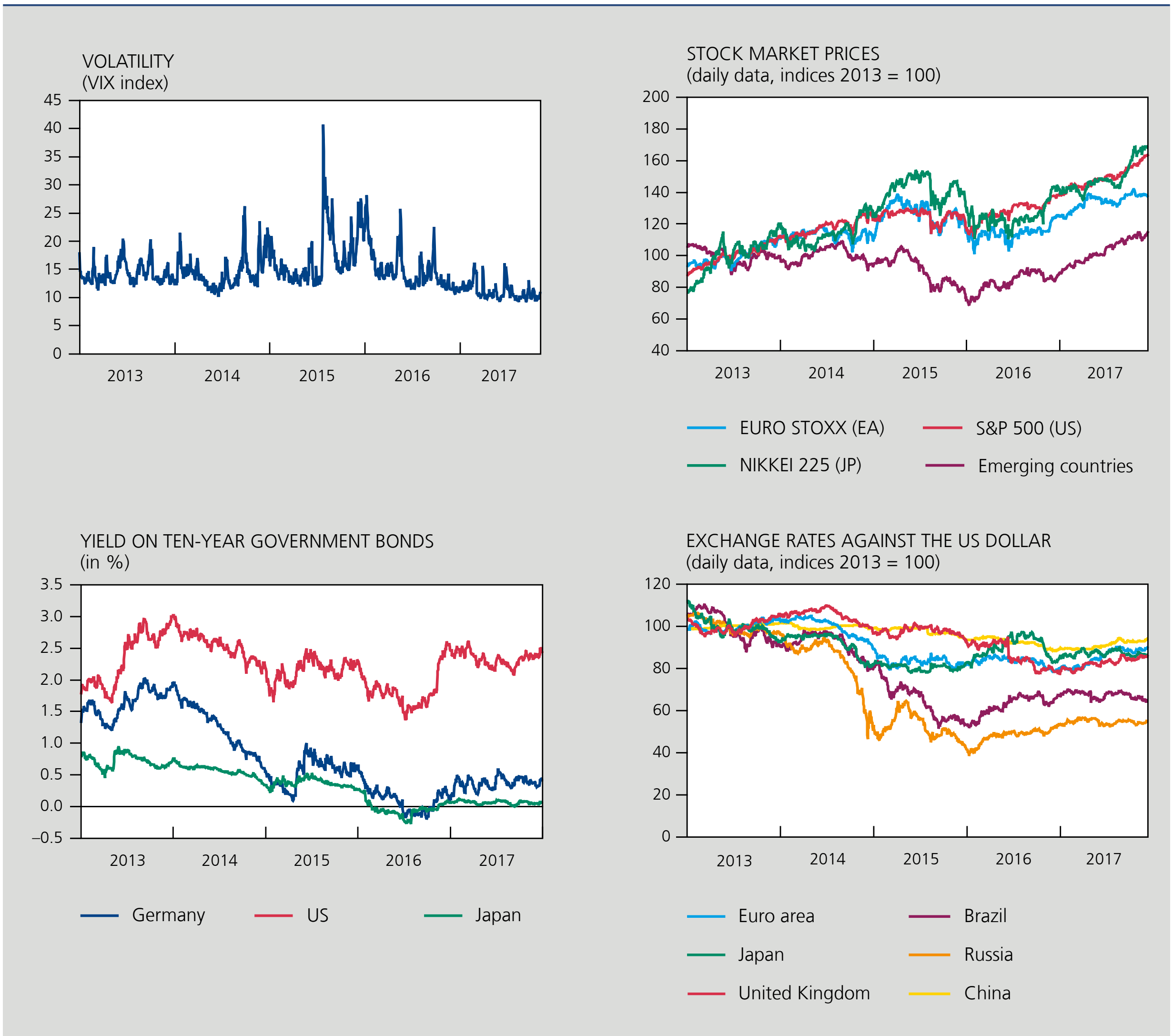
Financial market conditions remained favourable

On the financial markets, conditions remained particularly favourable in 2017, against the backdrop of the revival of the global economy, anticipation of a continuing accommodative monetary policy in the main advanced economies, and the search for yield in an environment of still exceptionally low interest rates. Although political uncertainty remained high owing to the Brexit negotiations, the lack of clarity over the future fiscal policy in the United States, and the persistent geopolitical tensions, volatility remained very low. The VIX index reverted to its pre-crisis level – except for some spikes in the spring and summer – due mainly to the renewed tensions between the United States and North Korea.

Stock markets soared worldwide as a result of the improved outlook for corporate profits in a favourable economic climate. In the United States, they actually rose to new record levels. In the emerging countries, the Chinese and Indian stock markets performed particularly well. There were just a few isolated corrections. For instance, share prices in the euro area dipped slightly from May to August, potentially as a result of the appreciation of the euro which may have depressed the profit outlook for export firms. The temporary price falls in Japan were due mainly to reactions to developments in North Korea and the appreciation of the yen.

Like last year, bond yields remained very low. The interest rate rise in the wake of the US presidential elections in November 2016, which mainly reflected higher inflation forecasts in expectation of a more expansionary fiscal policy in the United States, did not continue in 2017. The yield on US government bonds actually declined further in the first nine months of the year, as market forecasts concerning the future fiscal policy were gradually revised downwards. The possibility of a tightening of monetary policy and the announcement of the tax reform plans reversed the trend in the autumn. In the euro area and in Japan, interest rates remained close to their historical floor. European bond yields maintained a gradual upward trend on account of favourable economic prospects for the euro area and stronger expectations of the phased withdrawal of the monetary stimulus by the ECB.

CHART 2 HIGHLY FAVOURABLE FUNDING CONDITIONS AND LOW FINANCIAL MARKET VOLATILITY



Source: Thomson Reuters.

At the same time, spreads in relation to the German Bund also narrowed in most of the euro area countries, primarily following the waning of the political uncertainty seen in the run-up to the French presidential elections. That contraction was supported by the improvement in economic conditions and the increase in the rating of certain countries. Portugal and Greece saw the biggest reduction in spreads, amounting to over 200 basis points. The restoration of confidence in the Greek economy was conveyed by the fact that the country's government returned to the capital markets during the summer, issuing bonds with a 5-year maturity for a total of € 3 billion.

While financial market conditions thus remained very positive overall, a number of international financial institutions nevertheless warn about the possibility of risks to financial stability, as there are some signs suggesting that current financial market prices are out of line with their fundamental values. For example, in the United States, the price-earnings ratios are higher than their historical averages. Such high valuations combined with the persistently low volatility create the risk of sharp corrections on the markets in the event of a sudden reversal in investor sentiment.

On the foreign exchange markets, the uncertainty surrounding US monetary and fiscal policies depressed the US dollar. In the first nine months of the year, it depreciated against the currencies of most of the advanced and emerging economies. It weakened particularly in relation to the euro, which was itself actually supported by stronger growth rates in the euro area and renewed confidence in the European economy following the French presidential elections. Against the backdrop of the Brexit negotiations, the euro also continued to rise against the pound sterling, before subsiding slightly in September, as there were increasing expectations that the Bank of England would tighten its monetary policy. The dollar regained a little ground from September as the prospect of a corporation tax reform became more likely and market forecasts for the future US monetary policy path were revised. The Russian rouble and the Brazilian real, which had appreciated considerably in 2016 following the rise in commodity prices, did not strengthen any further against the dollar in 2017.

Box 1 – The advent of digital currencies from a central bank's point of view (1)

Digital currencies issued by the private sector, such as bitcoin and ether, aroused keen interest in the press last year. Some of them recorded a significant increase in value. These currencies generally make use of distributed ledger technology (DLT), which – like cash (or in other words, coins and banknotes) – enables the participants to effect direct transactions between themselves. Unlike traditional electronic money systems which are based on secure intermediaries – such as central banks or credit card issuers – for making transactions and maintaining an up-to-date central register, the settlement system is therefore direct in the case of digital electronic currency. As these types of decentralised systems are anonymous and promise to be more efficient, less expensive, and speedier, digital currency could compete strongly with traditional monetary instruments and have potentially significant consequences for central banks, the financial system and the economy in general. Apart from financial services, distributed ledger technology could have applications in many branches of activity, such as the transport sector (for listing logistical transactions), notaries (for recording house purchases), public administration (for collecting taxes, granting subsidies, and electronic voting), and health care (for digitising patient records). This box will simply confine itself to examining digital currencies and their underlying technology from the central bank's point of view.

Money traditionally performs three functions: it can be used to make transactions (means of exchange), to keep wealth safe (store of value) and to express the value of goods and services (unit of account).

The new technology could make the private sector's digital currencies into an attractive means of exchange. But its large-scale application still seems to imply some disadvantages. For instance, the number of transactions that can be processed simultaneously is currently rather small and the system is still highly energy-intensive.

At the moment, private digital currencies, and especially bitcoin, are therefore a speculative asset rather than a means of exchange. As there is no advantage in simply holding these currencies – for example, they do not generate any interest – they are bought solely for subsequent resale at a higher price. This lack of fundamental value – they in fact consist only of a digital code – makes these currencies different not only from certain commodities but also from central bank money, which derives its value from its status as legal tender and its predictable purchasing power. The price of private sector digital currency is therefore volatile by nature, so that it cannot be used as a secure store of value for transferring purchasing power to the future. However, that volatility and the risk of bubbles imply that private sector digital currencies may disrupt financial stability, and hence the transmission of monetary policy. Similarly, the practice whereby companies acquire capital by issuing a digital currency themselves (initial coin offering – ICO) may be detrimental to financial stability or result in unexpected losses for consumers. At this stage, there is in fact little if any control over ICOs, so that there is a serious danger of risky or fraudulent investment. Moreover, unlike electronic bank accounts, investment in private digital currencies does not qualify for the € 100 000 cover provided by the deposit guarantee system. At present, the total value of all private sector digital currencies seems too small to threaten the system, though that does not rule out occasional minor disruption.

(1) For more information, see Stevens A. (2017), "Digital currencies: threats and opportunities for monetary policy", NBB *Economic Review*, June, 79-92.

At the moment, private sector digital currencies play no role at all as a unit of account in the economy – thus, stores that offer to accept payment for purchases in euros or bitcoins base the bitcoin price on the prevailing exchange rate – and that situation seems likely to persist in the future. Once again, the fact that these currencies are not legal tender, making them intrinsically volatile, is a major obstacle. If private sector digital currencies were nevertheless to gain wide acceptance and ultimately served as a unit of account, they could take the place of traditional money, including central bank money. That scenario embodies a serious risk in that it would prevent the central bank from fulfilling its role. Since it would no longer be able to steer financing conditions in the economy, it would also be unable to absorb macroeconomic shocks and could no longer take on the function of lender of last resort in the event of a shortage of market liquidity.

Private sector digital currencies thus do not perform the three functions of money and cannot be regarded as a monetary instrument. That limits their large-scale adoption, so that they seem to present only a minor potential threat to financial and monetary stability. Nevertheless, central banks and competent authorities are keeping a close watch on developments in digital currencies and will take any necessary action.

All the same, central banks are taking an interest in digital currencies. Some are examining whether it is appropriate to issue banknotes in digital form – central bank digital currency (CBDC). A digital currency of that type raises a whole lot of questions, including as regards its universal accessibility, whether or not it bears interest, the possibility of holding it in unlimited amounts, and whether its advantages outweigh its drawbacks.

For example, in an appropriate configuration, this digital currency could remove the obstacles preventing monetary policy from imposing strongly negative nominal interest rates when the economic circumstances so require. In that respect, a CBDC could promote macroeconomic stability. Similarly, it could guarantee citizens' access to secure assets, even if cash became less widely used. However, the consequences of introducing a CBDC are uncertain for the banking sector and for financial stability. Substantial conversion into digital banknotes of bank deposits by households and firms could have serious repercussions on the financial sector. Even if it might reduce the liquidity risk that commercial banks incur in using short-term deposits to fund long-term loans, which would make the financial system more secure and limit the risk of disruption in the transmission of monetary policy, that scenario does have its dangers. In order to protect lending and economic activity against adverse effects, the commercial banks might need to attract alternative longer-term finance. Furthermore, there is a risk that a readily accessible claim on the central bank could amplify the intensity and frequency of bank runs. Thus, central banks are seriously considering the advantages and disadvantages of CBDCs and their various modalities before taking a decision.

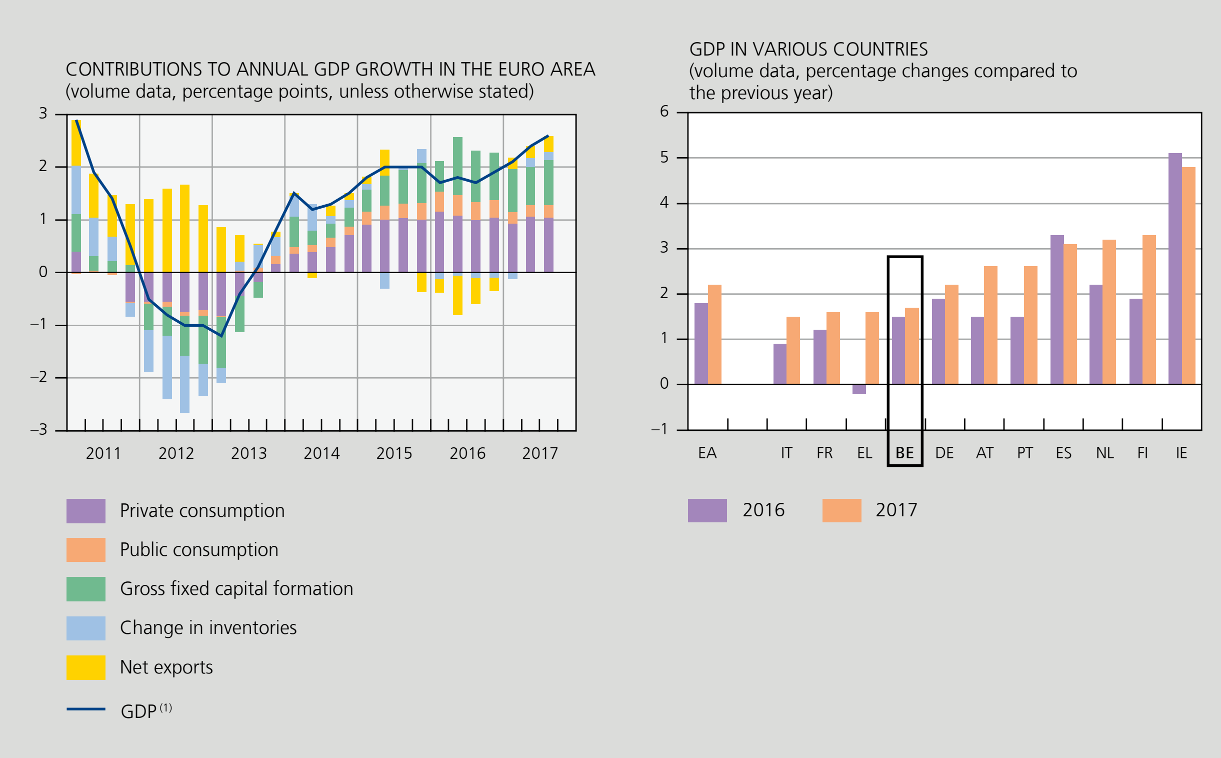
1.2 Even though economic activity has picked up in the euro area, inflation has remained below target so the accommodative monetary policy has continued

The expansion of activity strengthened in the euro area

As was the case in other leading advanced economies, activity in the euro area clearly became more dynamic in 2017. The recovery which had begun in 2013 and gained further momentum in mid-2016 thus drove up the average rate of GDP growth to 2.2 %, following 1.8 % growth in 2016. The expansion continued to generate a particularly large number of new jobs. It also became widespread across countries. Although there are still differences between countries, with growth rates ranging from 1.5 % to 5.6 %, the divergences have diminished in the euro area, with no country recording a fall in GDP.

With the support of monetary and fiscal policies in particular, there was a marked improvement during 2017. As in the two preceding years, private consumption remained the principal engine of growth. Despite the weak wage growth, labour incomes were in fact boosted by significant new job creation ; in some cases, this job creation was reinforced by the reforms of previous years. Public consumption also continued to rise in 2017. But it was investment – though somewhat volatile – that tended to record the biggest expansion in 2017, with a GDP growth contribution almost equalling that of private consumption.

CHART 3 GROWTH EXTENDED TO THE VARIOUS FACTORS OF DEMAND AND SPREAD TO ALL COUNTRIES



Sources: EC, Eurostat, NBB.
(1) Percentage changes compared to the corresponding quarter of the previous year.

In this regard, firms exhibited greater dynamism than in 2016. While an increased need to renew and extend the means of production led to a steady rise in the capacity utilisation rate, taking it above the long-term average, firms continued to enjoy favourable external financing conditions, rising profitability and robust demand prospects on both the domestic market and the export market. Business confidence thus reached levels not seen since the early 2000s, and was hardly affected at all by the uncertainties associated with such issues as the laborious negotiations on the United Kingdom's exit from the EU or political divisions in certain countries such as Spain, or by those originating elsewhere in the world.

The recovery also concerned other types of investment. More particularly, investment in housing which had fallen to a low point in 2015, ultimately began to pick up a bit later than business investment. The recovery was strongest in the countries which had suffered the sharpest corrections when their property bubble burst, namely Ireland, the Netherlands and Spain. Pockets of vulnerability could appear in the first two of those countries, where prices are rising in a context of persistent market rigidity and continuing high household debt levels. In Germany, too, residential investment continued to increase at a steady pace in 2017, in line with the general expansion of the property market ongoing since 2010. Germany is one of the few countries where the market has reached its highest levels in ten years, thanks to the recent dynamism but also in the light of the weakness that preceded the crisis.

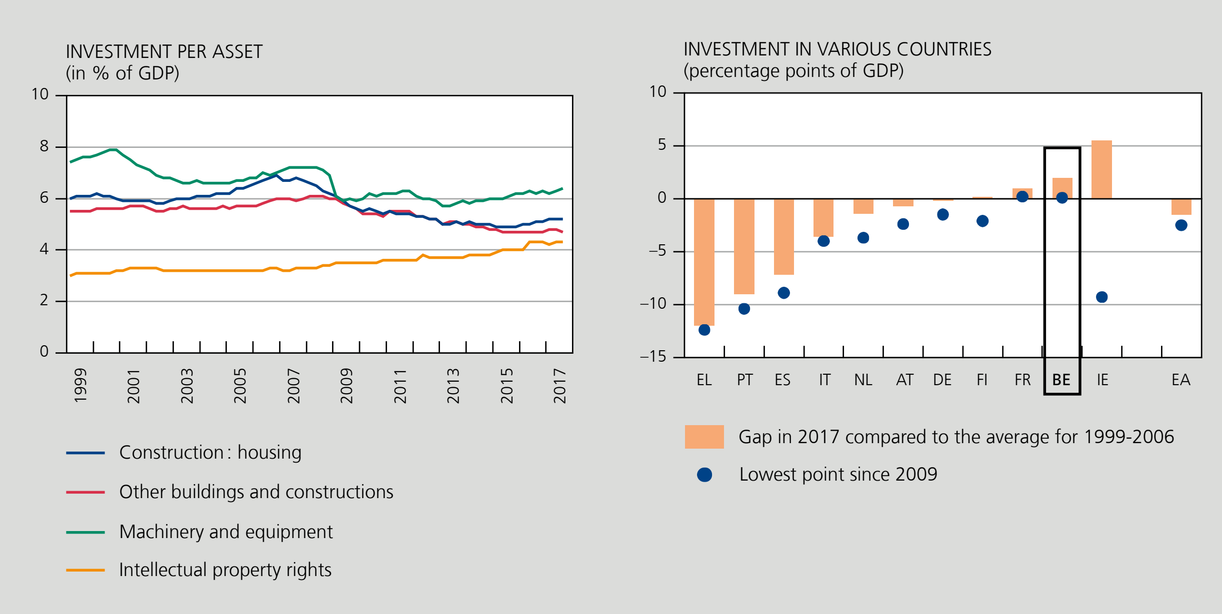
By continuing in 2017, the strengthening of world trade that had begun in the previous year boosted exports from the euro area, despite the euro's appreciation. The export growth also outpaced the expansion of imports, so that foreign trade made a direct contribution to GDP growth in 2017, as well as having knock-on effects on investment and employment.

Yet the recovery is still partly incomplete

Despite this clear improvement in economic activity, the euro area's recovery remains incomplete. In most euro area countries, the general investment revival has not yet been sufficient to restore the average investment levels prevailing before the crisis. In some of those countries, investment – notably in housing – had been excessively bloated at that time.

On the labour market, the under-utilisation that had built up over the past ten years has not yet been entirely

CHART 4 DESPITE THE INVESTMENT REVIVAL, THE DEFICITS HAVE NOT YET BEEN FULLY ABSORBED



Sources : EC, Eurostat, NBB.

absorbed, even though the consolidation of the economic recovery became increasingly apparent via improvements in the conditions on that market. Job gains gradually became widespread in more countries and sectors. Thus, in the first quarter of 2017, employment eventually exceeded its pre-crisis level. Moreover, there was a general decline in unemployment rates which was all the more remarkable in that it occurred in a context of rising labour market participation rates, mainly in the case of women and older workers. In some euro area countries, there were actually signs of a labour shortage in particular sectors or concerning specific skills.

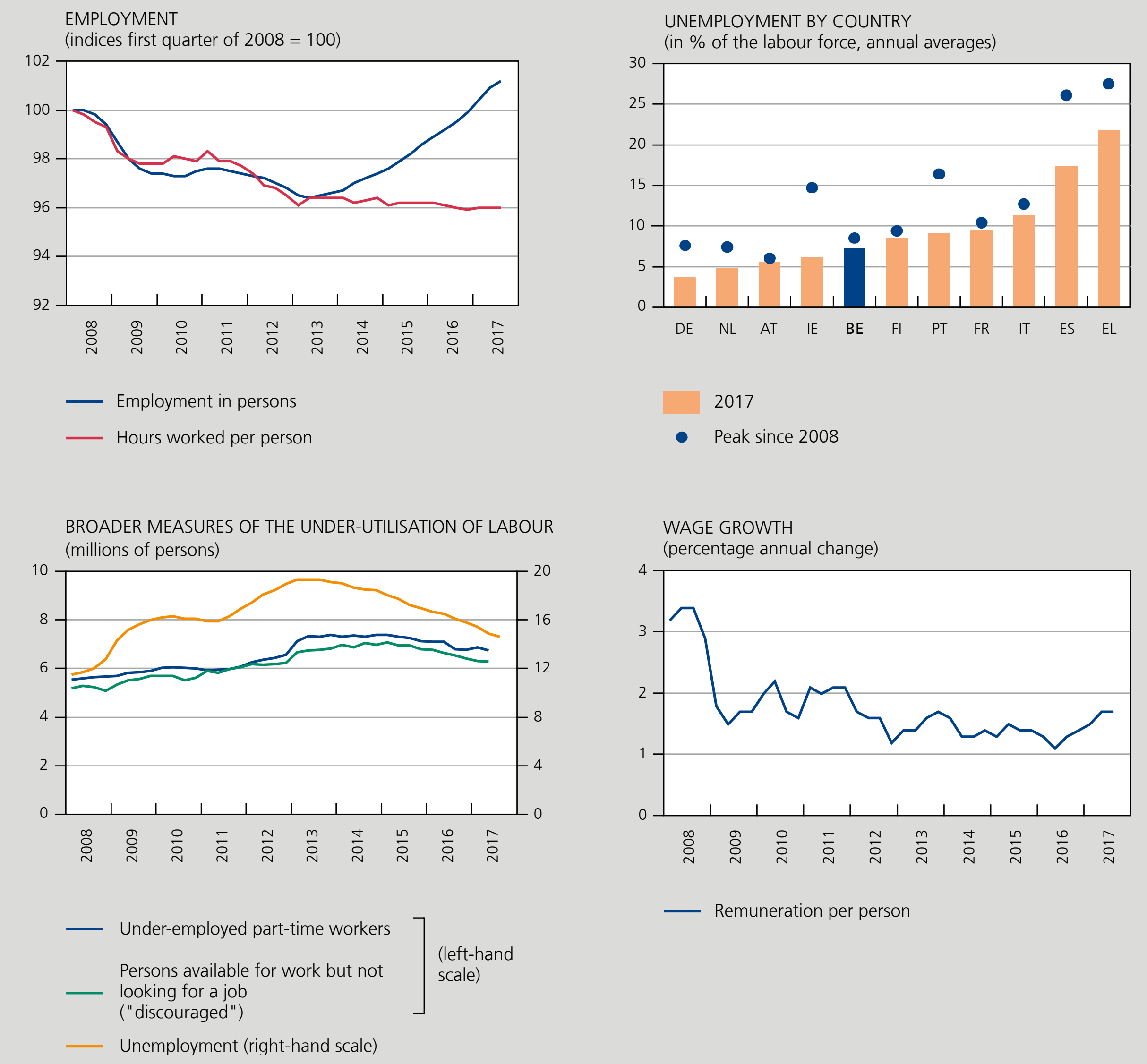
Other indicators modify this picture. For instance, after having fallen until 2013, like the number of people in work, the number of hours worked per person has not increased since then, owing to the growing proportion of part-time workers. In addition, the unemployment rate is still very high in certain countries or for certain groups, such as the young, and the number of long-term unemployed remains very substantial. Furthermore, for the euro area as a whole, other broader measures of the underutilisation of labour – such as the number of involuntary part-timers or the numbers discouraged from looking for work – revealed a much slower reduction than in the case of the unemployed.

Combined with other aspects such as low productivity gains, low inflation, employment composition effects in terms of sectoral allocation, and the impact of the labour market reforms introduced in some countries following the economic and financial crisis, these factors helped to hold down wages. Although remuneration per person began to pick up from mid-2016, the increase remained generally weak in the euro area in 2017. Here, too, there were significant variations between countries depending on the state of the domestic labour market.

Inflation is still too low

The weak wage growth in the euro area kept core inflation down to a low level, in the region of 1 % in 2017. While headline inflation rose from 0.2 % in 2016 to 1.5 % in 2017, it remained lower than a level compatible with the ECB's definition of price stability, namely below but close to 2 %. Furthermore, the sharp rise in inflation at the beginning of the year was driven mainly by the volatile components, namely energy and food, so that it is unlikely to be sustained. According to the Eurosystem estimates, inflation is set to remain below the target in the years ahead. The forecasts were actually revised downwards during the year. Despite a slightly higher projection for 2018 released in December, the forecast for 2019 does not exceed 1.5 %. Long-term expectations are also not yet anchored at around the higher level dating from before the crisis. However, inflation expectations based on survey data have constantly picked up, though the respondents still report downside risks.

CHART 5 PERSISTENT UNDER-UTILISATION ON THE LABOUR MARKET CONTINUED TO RESTRAIN WAGE GROWTH



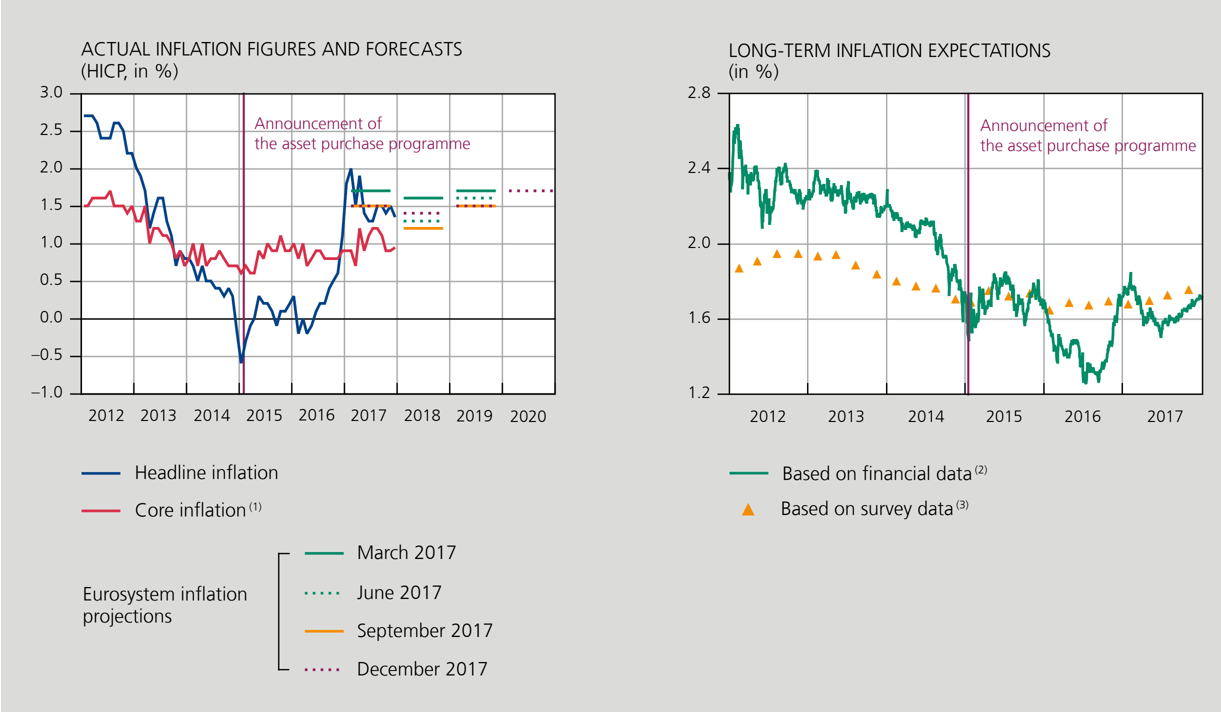
Sources: ECB, EC, Eurostat.

Numerous factors may explain the persistently low inflation

The inflationary process is complex, and subject to the influence of numerous factors which may also have a changing impact over time. For instance, as already stated, the extent to which the revival in economic activity resulted in a shortage of production factors in the euro area remains uncertain. It is also possible that certain structural reforms may have increased the labour and production potential so that it takes longer before a strengthening of aggregate demand exerts upward pressure on prices.

The prolonged period of low inflation in recent times may also affect price movements. For instance, persistently low inflation could exert downward pressure on the wages negotiated between employers and workers, and on the prices set by firms, and that would delay progress towards the inflation target. In addition, long-term inflation expectations are still below the Eurosystem target. In principle, the effect of shocks currently influencing prices should disappear in the medium term, and inflation should therefore conform to the target once again. The fact that inflation expectations are still lower than targeted could therefore indicate that the protracted period of low inflation has led economic agents to revise the inflation trend

CHART 6 INFLATION DYNAMICS HAVE NOT RECOVERED SUFFICIENTLY



Sources: ECB, Bloomberg.
(1) Headline inflation excluding energy and food.
(2) Implicit inflation rate derived from swap contracts hedging the inflation risk in the euro area during a five-year period starting five years after conclusion of the contract.
(3) Average of the aggregate probability distribution of five-year inflation expectations. The data were obtained from the ECB's quarterly survey of professional forecasters.

downwards: one would therefore expect price increases to stabilise at a lower level, rather than regaining the average prevailing before the crisis.

Finally, exogenous shocks may also have curbed inflation. Thus, the decline in oil prices in 2014 and 2015 was a major factor in the slowing of price increases. While such shocks normally have only a temporary impact on inflation, their influence may persist if inflation expectations are not firmly anchored.

As in the case of deflation, it is undesirable for inflation to remain too low for an excessively long period

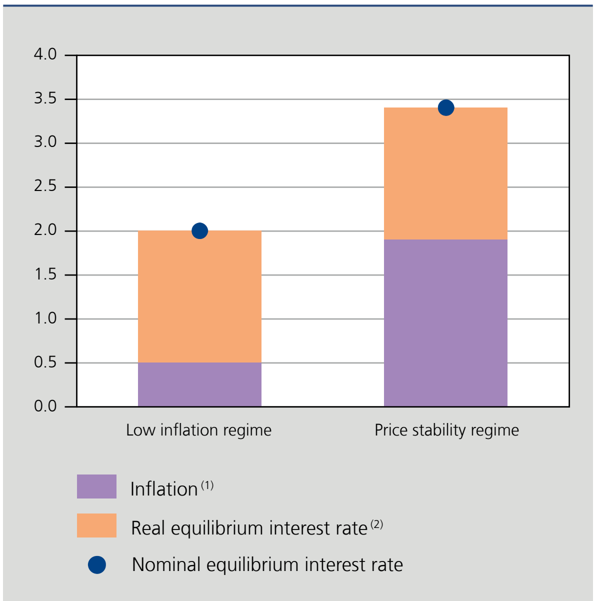
In response to the steep fall in inflation and the associated risk of deflation, the ECB Governing Council has adopted various stimulus measures in recent years. Thus, in January 2015, it decided to purchase public and private sector assets on a large scale (expanded asset purchase programme – APP). From the start, the Governing Council announced that it would continue with the monthly purchases until prices were rising in line with the target in a sustained manner. That decision explicitly linked the execution of the purchase programme to the inflation target. From March 2016, the Governing Council also announced that it would maintain the key interest rates at or below their current levels well past the horizon of the net asset purchases. It thereby gave clear indications of the future monetary policy (forward guidance) relating to both the period of the asset purchases and the period for maintaining low key interest rates. Since March 2016, the deposit facility rate has stood at –0.40 %, with the rate on the main refinancing operations at 0 % and the marginal lending facility rate at 0.25 %.

The measures proved effective in supporting the real economy and averting the risk of deflation. Consequently, in December 2016, it was decided to cut the monthly net asset purchases from € 80 billion to € 60 billion with effect from April 2017. Then, in June, the wording of the forward guidance was altered slightly: the Governing Council confirmed that the key interest rates would be held at their (low) current levels, but no longer mentioned the possibility of lowering them further.

However, a substantial monetary stimulus was still required in order to avoid a long period of excessively low inflation. Inflation which falls short of the central bank target for too long is in fact harmful, just like deflation. In the current circumstances, if price rises reverted to 2 %, that would attenuate the impact of the crisis. Since debts are generally contracted in nominal terms, lower-than-expected inflation hampers the still necessary process of debt reduction in the euro area. Since the desire to avoid any nominal fall in wages and prices if at all possible is deeply embedded in society, low inflation also impedes the absorption of macroeconomic imbalances in various Member States.

In addition, a monetary policy geared to price stability attacks the fundamental causes of low inflation. If the latter is due solely to a shortage of demand in the economy, maintenance of the monetary stimulus will also help to eliminate the residual under-utilisation of the production factors. Moreover, if the protracted period of weak price rises has affected the price- and wage-setting behaviour of firms and workers, then – in order to restore the firm anchoring of inflation (or inflation expectations) at around 2 % – the monetary stimulus must be maintained until price stability is re-established, and hence possibly after the output gap has been filled. The costs of an overheated economy will in fact be offset by longer-lasting benefits in the future. The nominal interest rate effectively corresponds to the sum of expected inflation and the real interest rate. Firmly anchored inflation expectations give the central bank more scope to tackle future recessions. It can then make adequate cuts in the key interest rates without taking them down to their floor level [1], and that reduces the likelihood of the Eurosystem having to resort to non-standard measures once again.

CHART 7 PRICE STABILITY GIVES MONETARY POLICY MORE SCOPE TO ABSORB SHOCKS



Sources: EC, NBB.

(1) In the low inflation regime, inflation is calculated as the average figure for the euro area since 2014. In the other regime, price stability is interpreted by way of illustration as an inflation rate of 1.9 %.

(1) The real equilibrium interest rate is the rate at which saving and investment are in balance, or the rate at which the output gap is filled and inflation is stable. The real equilibrium interest rate is a theoretical concept which cannot be observed. It is therefore approximated in the two regimes on the basis of the EC's autumn forecasts for potential growth in the euro area in 2018.

It was therefore decided to prolong the monetary stimulus

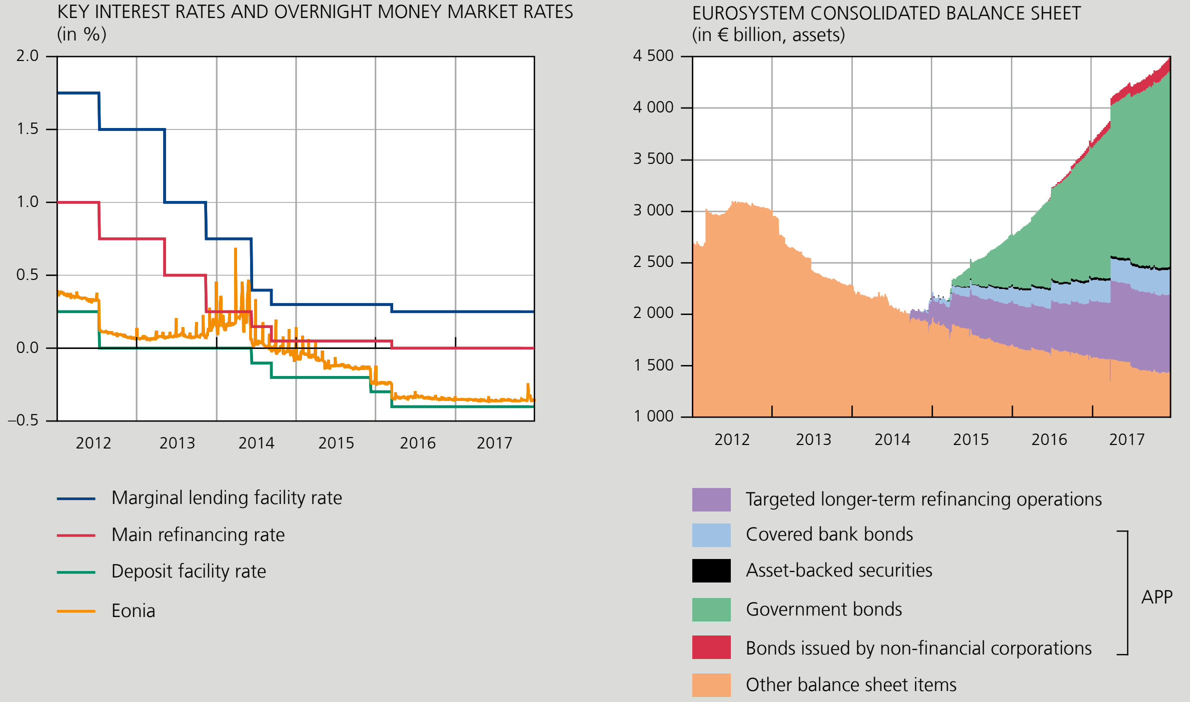
As the level of inflation (and inflation expectations) was too low, the Governing Council maintained its flexible monetary policy stance in 2017. The various monetary stimulus measures – low key interest rates, asset purchases, and forward guidance – therefore continued to apply. In October, the Governing Council also decided to maintain the flexible stance after December 2017. That decision is consistent with its commitment to continue the asset purchases until there are signs of a sustained adjustment in the path of inflation.

In practice, the Governing Council decided to extend the asset purchases for nine months, i.e. until the end of September 2018. In any case, it repeated that the net purchases would continue until inflation shows sustained progress towards its target. Since the Governing Council is increasingly convinced that convergence on the inflation target will come about gradually, the amount of the net monthly purchases was cut from € 60 billion to € 30 billion from January 2018 ("lower for longer"). Debt instruments maturing will still be reinvested well after the end of the net asset purchases, and in any case for as long as necessary, so that the total amount of assets held on the Eurosystem's balance sheet will remain steady. The key interest rates remained unchanged and the Governing Council confirmed that they would remain at their current level for an extended period, and in any case well past the horizon of the net asset purchases.

By purchasing a smaller amount over a longer period – rather than a larger amount over a shorter period – the Eurosystem maintains a presence on the market for longer, so that the stimulus measures can be transmitted over a longer period. In the more favourable financial and economic environment, investors can immediately take better account of future central bank purchases in the valuation of financial assets. Moreover, the forward guidance on the key interest rates implies that extension of the

(1) Section 1.3 of the Report 2016 contains more information on the floor level of the key interest rates.

CHART 8 ASSET PURCHASES, LOW INTEREST RATES, FORWARD GUIDANCE AND REINVESTMENT AIM TO RESTORE INFLATION TO A LEVEL CLOSE TO 2 %



Sources: ECB, Thomson Reuters.

purchase programme postpones the expected date for the first interest rate rise. If the outlook becomes less favourable or if the financial conditions no longer permit further progress towards a sustained adjustment of the inflation path, the Governing Council is also prepared to increase the volume and/or extend the duration of the APP.

Practical implementation of monetary policy measures

Purchases under the APP are made in accordance with certain guidelines. Thus, the Eurosystem decided not to hold more than 33 % of each issue and 33 % of a country's total debt. Government bond purchases are also broken down between euro area countries in accordance with the ECB's capital key. Since that reflects a country's size in terms of its economy and its population, and is unconnected with the country's debt level, the Eurosystem may become a key player in debt markets which are relatively small if measured according to the outstanding stock or new issues, as is the case in Germany. German government bonds are also very much in demand: owing to their high solvency and the depth of the market, they are a secure investment instrument and are highly prized as collateral. As a result, considerable tensions appeared between demand and supply regarding these instruments.

As a result, for several months in 2017, monthly purchases of German government bonds were slightly below the percentage indicated by the capital key. However, minor and/or temporary divergences are permitted, since the key is a guideline and not a strict objective. Such divergences are also inevitable, as purchases depend on the availability of the assets. The proportion of German securities in the total public debt purchased by the Eurosystem is actually a little higher than the figure indicated by the capital key. Consequently, smaller monthly purchases can also be absorbed in the future. Nonetheless, a number of smaller euro area countries have greater difficulty in achieving their target for government bond purchases. That is due to the very small scale of the markets concerned or the fact that the stated purchase limits have been reached. In that case, to attain the target volumes of government securities, bonds of European institutions, for example, are purchased instead.

In addition, the growing imbalance between demand and supply led to a marked compression of the yields on government bonds with the highest credit rating. Thus, in 2016, the short- and medium-term yields on German bonds were generally lower than the deposit facility rate, which constitutes a floor for overnight money market rates. In 2017, short-term German yields were pushed down even further. That fall also resulted from the Governing Council's decision, in December 2016, to purchase if necessary government securities offering yields below the deposit facility rate. However, that decision made it easier for the Eurosystem to reach its targets for purchases of German securities and other prized instruments.

In order to ensure that the shortage of good-quality instruments did not hamper the smooth operation of the market, most Eurosystem central banks devised arrangements for lending securities. In that way, bonds purchased under the APP were loaned again to market players. In fact, it is mainly government bonds that are much in demand, notably because they serve as collateral for repo transactions. Securities lending thus helped to curb serious disruption on the markets in good-quality securities. Nonetheless, the Eurosystem is still maintaining a close watch on developments on the securities markets concerned, in order to guarantee both the efficient transmission of monetary policy and financial stability.

The October 2017 "lower for longer" decision will have a positive influence on the implementation of the APP, since a scarcity of securities will take longer to arise and the downward pressure on interest rates will be more measured. The Governing Council also intends to continue purchasing substantial amounts of private assets. It has therefore once again demonstrated the necessary flexibility, which should also facilitate the implementation of the APP.

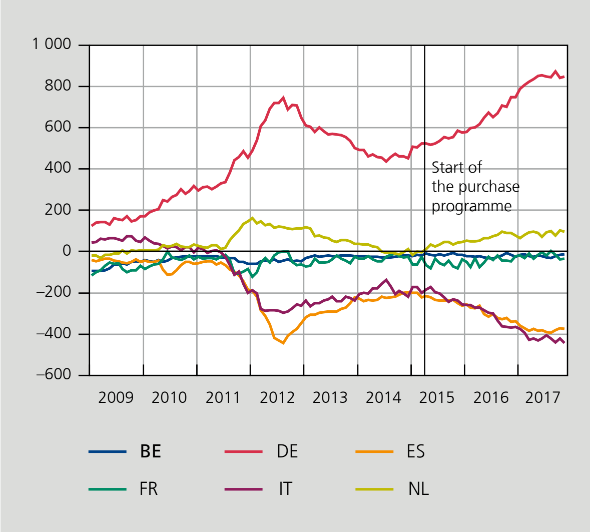
Thanks to the APP's flexibility, the purchase volume targets were again achieved and market disruption was kept to a minimum. At the end of 2017, the securities purchased under the APP came to almost € 2 300 billion, or around 50 % of the Eurosystem's balance sheet total. Government bonds made up the bulk of that at € 1 889 billion. The Eurosystem also held € 241 billion in covered bank bonds, € 132 billion in bonds issued by non-financial corporations, and € 25 billion in asset-backed securities.

In addition, in March 2017, the Eurosystem provided cheap, stable financing for the banks via a fourth and final targeted longer-term refinancing operation (TLTRO II)[1]. After deduction of the repayment of the old TLTROs, that operation injected € 217 billion into the banking system to support lending to the private sector. At the end of 2017, the total outstanding volume of TLTROs came to € 754 billion, or around 17 % of the Eurosystem's balance sheet total.

As a result of the APP and the TLTROs, the Eurosystem's consolidated balance sheet continued to expand considerably. In parallel with the growth of the central bank's balance sheet, the liquidity that euro area credit institutions hold with the Eurosystem also increased. In this surplus liquidity situation, the overnight money market rate – Eonia – stabilised at several basis points above the deposit facility rate. Throughout 2017, the overnight money market rate therefore remained negative so that interbank financing costs were at the lowest levels ever recorded.

The extra liquidity injected into the banking system via the APP likewise drove up the claims and liabilities that national central banks of the euro area hold in relation to the ECB, known as the TARGET balances. As a result of the decentralised implementation of monetary policy in the euro area, cross-border interbank payments in euro create open positions between national central banks: a net inflow of payments into a Member State increases the TARGET claim (or reduces the TARGET debt) of the national central bank concerned, and vice versa for a net outflow. Since, under the APP, around 80 % of the securities are purchased from non-residents, that generates considerable

CHART 9 INCREASE IN TARGET BALANCES FOLLOWING IMPLEMENTATION OF THE APP
(in € billion)



Source: ECB.

(1) For more information, see the 2016 Report.

cross-border payment flows and, consequently, an increase in the TARGET balances. For example, if the Banco de España purchases securities of a commercial bank based in Germany, or makes the purchase via such a bank, there is then a flow of payments from Spain to Germany which increases both the TARGET debt of the Banco de España and the TARGET claim of the Bundesbank. In addition, a significant proportion of counterparties are established outside the euro area. Settlement of APP transactions with those counterparties generally takes place in large financial centres such as Germany, and to a lesser extent the Netherlands. The associated inflow of liquidity is reflected in an increase in the TARGET claims of the central banks of those two countries. Since the launch of the APP, however, the TARGET balance of the National Bank of Belgium has remained small and fairly stable.

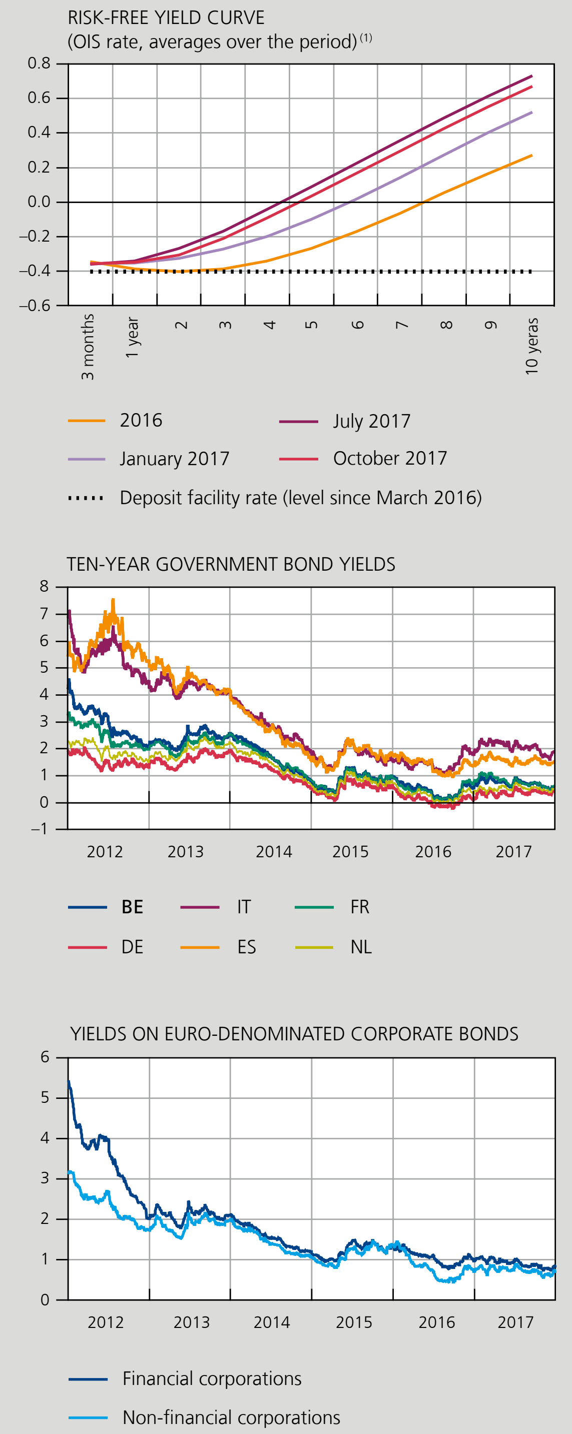
Financial conditions have remained favourable

The monetary policy measures helped to ensure that the nominal interest rates on the various asset classes remain low. The forward guidance thus anchored short-term risk-free interest rates at a low level, close to the deposit facility rate. The APP drove down longer-term risk-free interest rates, and particularly the term premium that they include. That premium reflects the compensation that investors demand for the duration risk, i.e. the fact that longer-term financial assets are exposed to volatile prices owing to unforeseen future fluctuations in interest rates. In purchasing longer-term assets and replacing them with secure short-term assets (i.e. central bank reserves), the Eurosystem in fact reduces the overall duration risk in the hands of the private sector. In that context, it is the total amount purchased (i.e. both existing and future purchases) that matters, and not the monthly purchases, which may justify a slower pace of purchases from January 2018. During 2017, however, the yield curve steepened slightly, probably as a result of the euro area's improved macroeconomic performance and the associated expectations concerning revision of the monetary stimuli. Moreover, a higher long-term nominal interest rate due to better prospects for growth and inflation is proof of the success of the purchase programme (for more information, see box 2).

In all euro area countries, ten-year government bond yields in 2017 were slightly higher than in the previous year, while remaining low and remarkably stable. Spreads between yields on government bonds of euro area countries and German securities were generally stable. That could be evidence of the active functioning of the APP portfolio rebalancing channel. In that connection, investors reduce their portfolios of euro area government securities purchased on a massive scale by the Eurosystem

CHART 10 NOMINAL INTEREST RATES ARE ANCHORED AT A LOW LEVEL

(in %)



Source: Thomson Reuters.
(1) Eonia swap interest rates for various maturities.

and buy more higher-yielding securities so that the interest rates on the latter are also driven down.

Firms likewise enjoyed favourable funding costs. Since June 2016, the Eurosystem has also purchased bonds of non-financial corporations with a very high credit rating, and that has been a factor holding down the yields on those bonds. Yields on corporate bonds not eligible for the programme also remained low or even declined, which is a further sign of the portfolio adjustments that followed the Eurosystem's purchases.

In contrast to the rather flat nominal interest rates, the euro appreciated strongly from the spring of 2017, both against the dollar and against a broader basket of currencies. As that appreciation was largely due to the improvement in the situation within the euro area, its impact – in principle downward – on inflation needs to be qualified to some degree.

Lending to the private sector continued to expand

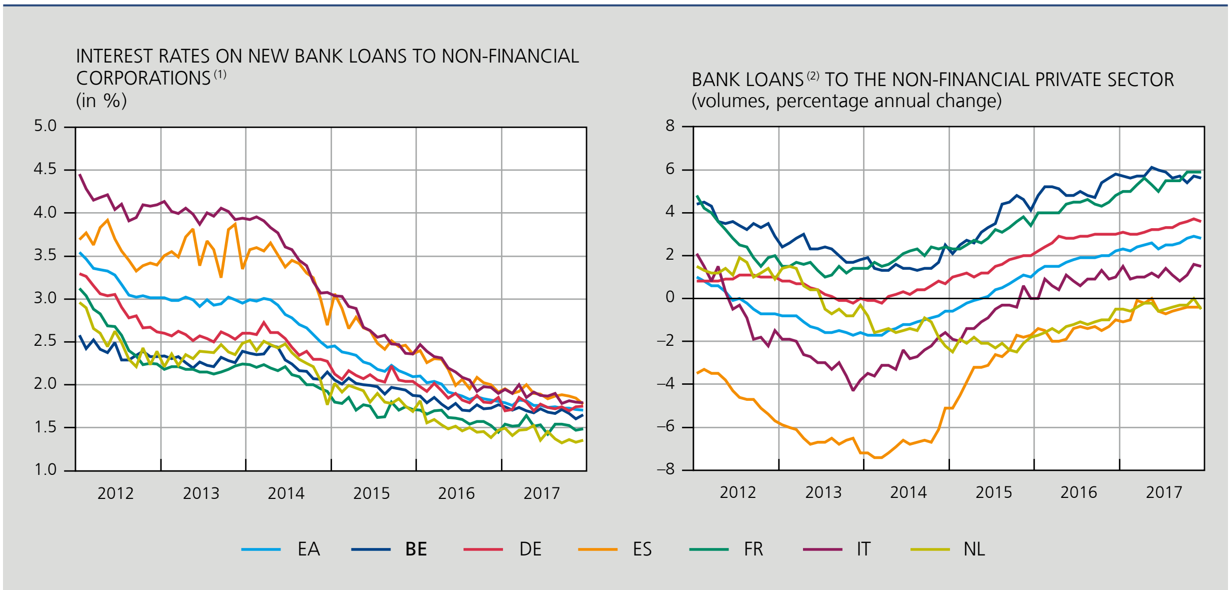
The banking sector – which plays a fundamental role in financing the euro area's economy – continued to transmit the monetary policy stimuli to the real economy. On the one hand, borrowing costs for households and businesses continued to fall. Moreover, there was some further convergence in debit interest rates on bank loans to firms in the various euro area countries, reflecting a further attenuation of the financial fragmentation. Also, the positive dynamic of the growth of bank lending to the private sector persisted. But in the vulnerable Member States and in the Netherlands, credit expansion generally remained negative.

The bank lending survey (BLS) shows that the credit supply and demand for loans both contributed to the vigorous expansion of lending in the euro area. Thus, the criteria for lending to businesses and households were eased, usually as a result of the fiercer competition and a reduction in risk perception on the part of the banks. The banks also announced that they had given priority to allocating the liquidity generated by the APP to the expansion of their lending. Furthermore, they stated that the negative interest rate on the deposit facility had a positive impact on the volume of lending even though it simultaneously depressed their interest margin. That said, demand for loans on the part of businesses and households continued to rise, thanks to low interest rates, higher fixed capital formation, stronger consumer confidence and the improved outlook on the housing market.

The low interest rates, expanding volumes and easier access to credit thus put a different perspective on the concerns of some observers who fear that the monetary policy measures may have an inappropriate effect on the banks' intermediation capacity and on the supply of bank credit in the euro area (1).

(1) For more information, see de Sola Perea M. and M. Kasongo Kashama (2017), "The negative interest rate policy in the euro area and the supply of bank loans", NBB, *Economic Review*, December, 43-61.

CHART 11 THE EURO AREA'S PRIVATE SECTOR ENJOYS EASY ACCESS TO CHEAP LOANS



Source: ECB.
(1) Taking all maturities together.
(2) Taking all maturities together. The data are adjusted for securitisation.

The road to price stability presents risks and opportunities

By maintaining favourable financing conditions, monetary policy supported the cyclical upturn in the euro area. In this way, the Governing Council aims to fulfil its price stability mandate. It will thus be possible to normalise monetary policy in order to create conditions enabling the central bank to perform its stabilising role at all times, including during future recessions. However, it is also essential to mobilise other policy spheres.

The low interest rate policy in fact does not only offer advantages at macroeconomic level, but is also liable to create risks for financial stability. The Eurosystem is keeping a close eye on any negative effects of its accommodative policy, but so far there has been little sign of widespread risks in the euro area. Nonetheless, specific vulnerabilities may become apparent in some countries, e.g. on the housing market. Prudential policy has the best instruments for being the first to ward off those risks. That enables monetary policy to concentrate fully on price stability, and hence to create conditions which will ultimately facilitate the normalisation of nominal interest rates, which will foster financial stability.

Although monetary policy helps to stabilise economic activity at around its potential level, it has few if any means of guaranteeing sustained economic growth in the long term. Structural and institutional reforms, and a fiscal policy which encourages growth and inspires confidence, are key factors in that respect.

Box 2 – What are the factors underlying the change in financial conditions in the euro area since the end of 2016 ?

In the autumn of 2016, nominal yields on government and corporate bonds increased in the euro area, and that rise continued in early 2017. Thereafter, yields remained more or less stable. The effective euro exchange rate also made fairly steady progress during the spring and summer of 2017 before stabilising at a slightly higher level than at the beginning of 2015, when the Eurosystem announced the purchase programme. These two findings seem to indicate a tightening of financial conditions. However, the rise in stock market values in the euro area over the same period casts a different light on those findings. This box proposes an interpretation of recent developments on the basis of an econometric model.

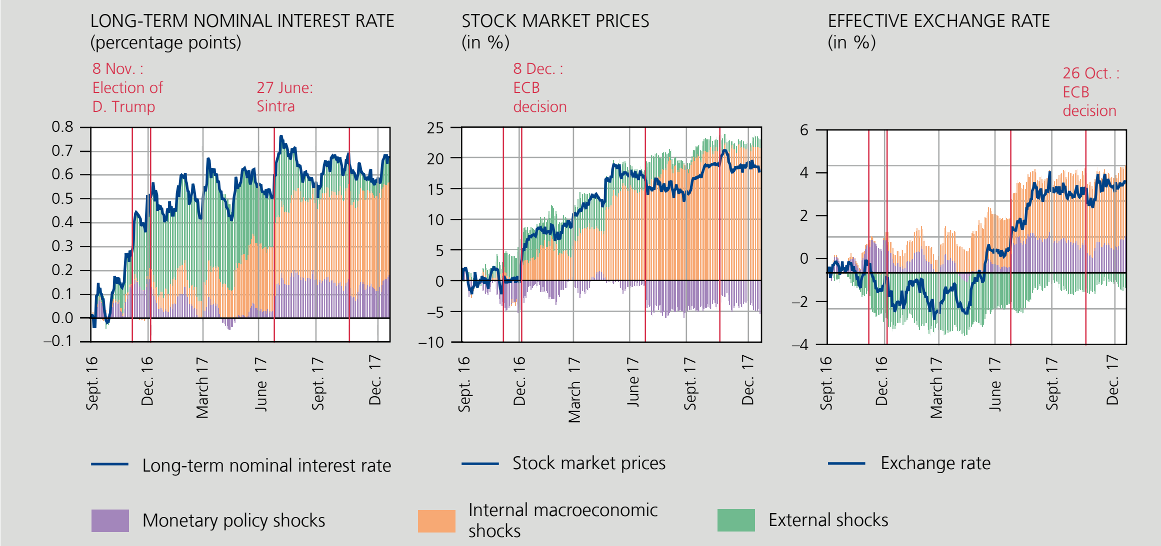
The increase in long-term interest rates and strengthening of the euro seem to thwart the Eurosystem, which is trying to create highly accommodative financial conditions to nudge inflation back towards its target in the euro area. Yet, a tightening of financial conditions does not always imply an excessive and undesirable tightening of monetary policy ; the nature of the underlying shock plays a leading role in that regard. For instance, the more favourable outlook for growth and inflation in the euro area may justify an increase in the exchange rate or a higher long-term interest rate. That said, when external shocks cause an unwelcome tightening of financial conditions, or when financial market players over-react to new information, it is possible for the central bank to have to intervene in order to guarantee an appropriate monetary policy course. That is why it is important for the Eurosystem to know the shocks which caused the tougher financial conditions.

The vector autoregression model (1) used to this end explains how these three factors – internal macroeconomic shocks, external shocks and monetary policy shocks – contributed towards the change in financial conditions in the euro area. The model uses three variables, namely the ten-year risk-free nominal interest rate in the euro area, the stock market index for the euro area, and the euro exchange rate in relation to 38 trading partners. On the basis of theoretical assumptions, sign restrictions are then applied which enable the three shocks to be identified. Thus it is postulated that, all other things being equal, restrictive monetary policy shocks drive up interest rates, depress stock markets and strengthen the euro. Positive internal macroeconomic shocks are assumed to exert upward pressure on these three variables, while external shocks will drive interest rates in the opposite direction from exchange rates. Incidentally, the shocks in the

(1) The method is based on that used in Matheson T. and E. Stavrev (2014), *News and monetary shocks at a high frequency : A simple approach*, in two ECB speeches given in 2017, namely *Calibrating unconventional monetary policy* and *Dissecting the yield curve : a central bank perspective*, and in Budrys and Saint-Guilhem (mimeo).

model only present a picture of the interpretation that financial market players put upon the flow of economic data. The analysis cannot determine the degree to which the various shocks influence uncertainty, risk aversion, or risk assessment. Furthermore, the analysis only captures the degree to which the respective shocks have contributed to the change in financial conditions since the autumn of 2016, and does not measure their overall contribution to their levels. Over a longer period, the contribution of monetary policy shocks is much greater: the accommodative monetary policy pursued since the financial crisis has in fact played a significant role in easing financial conditions.

FACTORS EXPLAINING THE EVOLUTION OF FINANCIAL VARIABLES IN THE EURO AREA
(cumulative change since 1 September 2016)



Sources: ECB, Thomson Reuters, own calculations.

The model's results show that external shocks played a dominant role in the change in financial conditions in the euro area at the beginning of the period in question. The election of Donald Trump as President of the United States and the associated expectations of a new fiscal stimulus – which would result in speedier tightening of US monetary policy – therefore drove up long-term interest rates not only across the Atlantic but also visibly in the euro area. At the same time, external shocks also led to some easing: they depressed the euro exchange rate and caused European stock markets to rise. During 2017, however, the impact of external shocks on the financial variables moderated considerably, probably reflecting the slackening pace of American economic growth and the downward adjustment of expectations concerning a fiscal stimulus in the United States.

From the spring of 2017, it was mainly the combination of an improved performance and better growth prospects in the euro area that underpinned the continuing rise in long-term interest rates and strengthening of stock market sentiment. It was also a major factor in the euro's appreciation during the summer. The effect on inflation occurred via two channels. First, by lowering import prices, the euro's appreciation prevented inflation from reverting to 2 %. Next, in principle, an economy in an upswing also exerts internal upward pressure on prices.

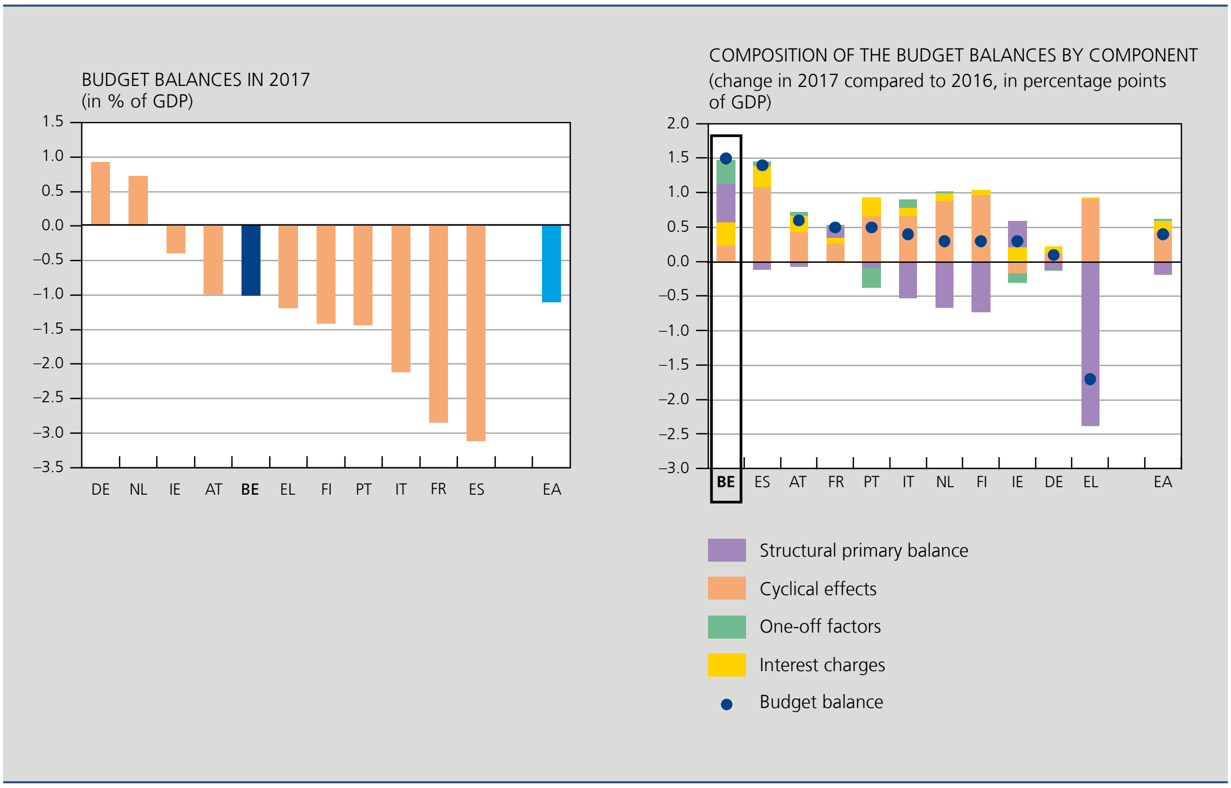
The contribution of monetary policy shocks was smaller, and up to mid-2017 it was neutral overall. The Eurosystem therefore succeeded in preserving favourable financial conditions without even causing volatility. Nevertheless, since the summer, a monetary policy shock has also led to some tightening. The markets seem to have interpreted Mario Draghi's speech at the ECB forum in Sintra at the end of June as a tightening of monetary policy, or at least as an indication in that direction. Since it was announced, in October 2017, that the monetary stimulus measures would be maintained for some time yet, monetary policy temporarily helped to ease financial conditions once again.

In view of the leading role played by internal factors, and considering that the tightening in the form of higher interest rates and a more expensive euro was offset to some extent by the rising stock markets, financial conditions in the euro area remained favourable overall in 2017 and were conducive to the revival of economic activity and higher inflation. However, if the financial conditions were to prove incompatible with a further rise in inflation towards its target, the asset purchase programme could be extended in terms of size and duration. In 2017, that commitment was confirmed at the end of each Governing Council meeting.

1.3 Taking advantage of the favourable economic climate to strengthen EMU

The robust and balanced economic growth and the financial conditions prevailing in 2017 create a buoyant environment for strengthening the basis of the euro area and its constituent economies. Although this environment has permitted some progress in reducing the imbalances that have accumulated since the crisis, that progress has been limited so far. Reforms are essential to boost the euro area's development potential and resilience, as regards both the governance of the Economic and Monetary Union (EMU) and the functioning of the economies.

CHART 12 PUBLIC FINANCES ARE SUPPORTED BY THE STRONGER ECONOMY AND LOWER INTEREST CHARGES



Sources: EC, NBB.

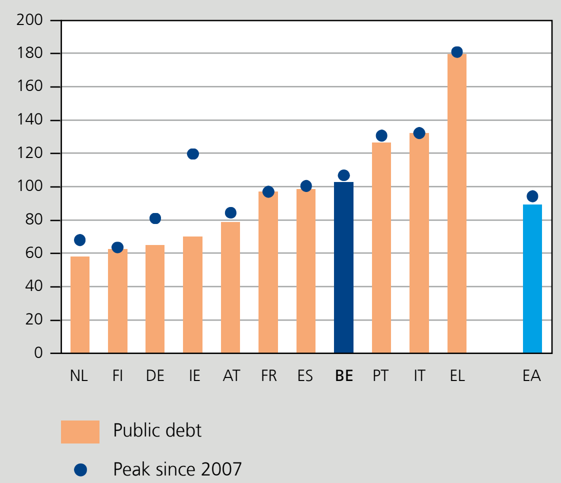
Public finances are gradually improving in the euro area, although many countries still need to make an effort

In the euro area as a whole, the public deficit continued to fall, declining from 1.5 % of GDP in 2016 to 1.1 % of GDP in 2017. That improvement is due mainly to the continuing economic recovery and, in a very low interest rate environment, to the reduction in interest charges. Fiscal policy was slightly expansionary overall.

The budget balance improved in most euro area Member States. Despite stronger-than-expected growth, Greece again recorded a budget deficit, but the figure was well below the reference value of 3 % of GDP. This picture is due to the fiscal policy pursued by the Greek government: in 2016, in the context of stabilisation of the economy, the restriction on public expenditure, including public investment, and a number of one-off factors had resulted in a primary balance considerably above the target set in the adjustment programme. However, a decline ensued in 2017. Nonetheless, in its autumn forecasts, the EC expected Greece to achieve its primary surplus target for 2017. Most euro area countries pursued an expansionary fiscal policy, leading to a deterioration in their structural primary balance. That was particularly true in Finland, the Netherlands and Italy; conversely, Belgium, Ireland and France tightened their fiscal policy. The business cycle had a favourable influence in almost all countries, and interest charges were down slightly more or less everywhere.

CHART 13 THE PUBLIC DEBT WAS DOWN IN MOST EURO AREA COUNTRIES, ALTHOUGH IT STILL REACHED ALMOST 90 % OF GDP ON AVERAGE

(in % of GDP, 2017)



Sources: EC, NBB.

The public debt diminished in most euro area countries; nonetheless, the debt ratio remained more or less steady in France and Italy. In general, the public debt of the euro area as a whole therefore subsided, coming down to 89.3 % of GDP.

Although Spain's budget deficit diminished, it still exceeded the reference value of 3 % of GDP. Among the euro area countries, France also remained subject to an excessive deficit procedure under the corrective arm of the Stability and Growth Pact (SGP). In the case of Portugal, the EU Council decided in June 2017 that the excessive public deficit had been eliminated, and the procedure was therefore terminated. The excessive deficit procedure concerning Greece was cancelled in September 2017, in view of the fiscal measures adopted by the Greek government in recent years. Nonetheless, Greek public finances remain subject to close scrutiny under the current macroeconomic adjustment programme. In all, only two euro area countries were therefore still subject to an excessive deficit procedure at the end of 2017, in sharp contrast to the situation during the crisis years of 2010 and 2011 when only three of the current 19 euro area countries were spared that procedure.

For 16 euro area Member States – namely the 19 countries excluding Spain, France (both subject to an excessive deficit procedure) and Greece (subject to an adjustment programme) – the supervision of public finances takes place under the preventive arm of the SGP. In that connection, the EU Member States are required to pursue a medium-term objective (MTO). This is a reference value for the structural budget balance specific to each country and consistent with sound public finances. Factors taken into account in setting the MTOs included the need to reduce the public debt to a sustainable level. In 2017, the efforts that Member States needed to make to achieve their respective MTO still differed considerably from one country to another. Thus, a few countries such as Germany and the Netherlands had some scope in their budgets, since their structural budget balance exceeded their MTO. Conversely, many euro area countries, including Italy and Belgium, still needed to make an effort to achieve their objective. In that regard, in November 2017, in its overall assessment of the draft budgetary plans of the euro area countries, the EC stated that some Member States, including Belgium, risked deviating significantly from the adjustment path required to achieve their MTO.

In the private sector, too, the vulnerabilities which have built up since the crisis are slowly being resolved

The fragilities left over from the crisis continued to depress growth in the euro area. They are due to the excessive private debt levels and non-performing loans remaining on the balance sheets of some banking sector institutions. These vulnerabilities continued to recede, albeit at a slow pace.

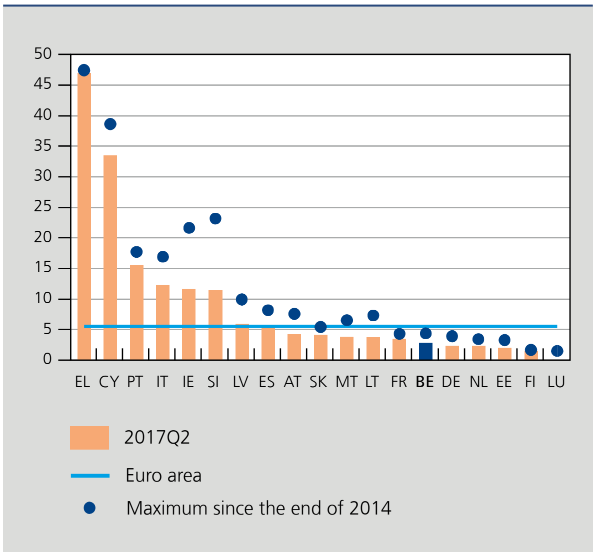
The debts of the non-financial private sector had reached a high level in the euro area in general, and in certain countries in particular. Depending on the case, it was mainly due to non-financial corporations, notably in countries such as Ireland, the Netherlands and Belgium that recorded cross-border financial flows inflated by the presence of multinational financial entities in their territory. In other cases, it was households that bore a heavy debt burden.

The downward trend in the debt as a ratio of GDP which has been evident in the euro area since 2015 continued in the first half of 2017. It was very marked in Ireland, mainly owing to the decline in the outstanding debt of non-financial corporations (active deleveraging). Significant reductions were also seen in Portugal, the Netherlands, Spain and Greece for both households and non-financial corporations, mainly as a result of GDP growth (passive deleveraging). In Belgium, too, the ratio dipped slightly during the first half of 2017. But in this case, apart from the effect of higher GDP, the decline is due entirely to non-financial corporations as a result of a reduction in intra-group debt. Conversely, as will be explained in more detail in chapter 3, households continued to add to their debt. In contrast to other countries, firms in Finland and France continued actively taking on debt, causing the ratios to rise. Germany is an atypical case: while the private sector debt ratio had fallen steadily since 1999, it stabilised at a low level from 2015 and actually edged up very slightly in the first half of 2017.

The euro area's banking sector also faced the need to resolve problems inherited from the past in order to fully restore its capacity to allocate funding efficiently in all countries. The profitability of some financial institutions is still hampered by excess capacity and cost inefficiencies, exacerbated by the low interest rate environment. In some countries, this concerns the scale of the non-performing loans in the portfolios of loans and advances. While that ratio continued falling up to the second quarter of 2017 throughout the euro area, dropping to its lowest level since the end of 2014, broad geographical divergences persisted, with ratios ranging between less than 1 % and more than 40 %. In all, total unproductive claims remain high at around € 800 billion despite having fallen from the peak of almost € 1 100 billion reached at the beginning of 2015.

CHART 15 STOCKS OF NON-PERFORMING LOANS [(1)] ARE STILL VERY HIGH IN SOME COUNTRIES

(percentages of total loans and advances)

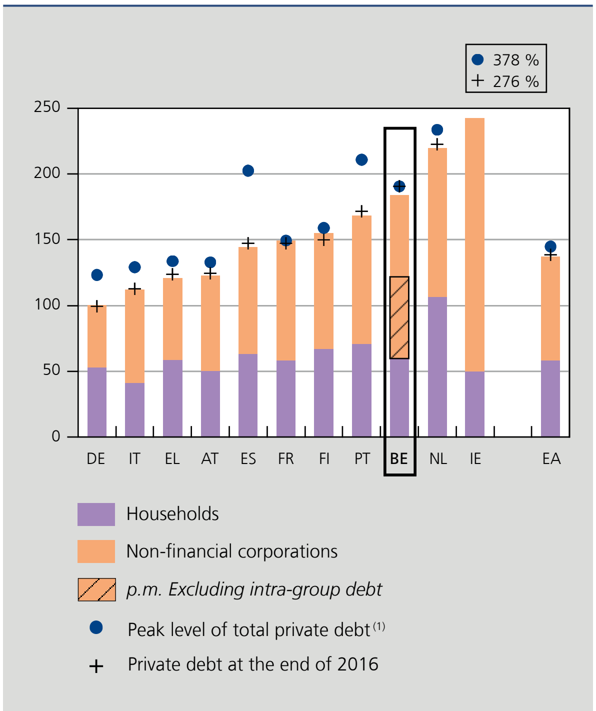


Source: ECB.

(1) Non-performing loan ratios vary according to the sources considered owing to divergences in the definition of non-performing loans and in the demarcation of the banking sectors.

CHART 14 THE REDUCTIONS IN NON-FINANCIAL PRIVATE SECTOR DEBT ARE SMALL

(consolidated data in % of GDP; 30 June 2017, unless otherwise stated)



Sources: ECB, NBB.

(1) Since 1999 or first available data, depending on the country.

In July 2017, the Ecofin Council adopted an action plan to tackle non-performing loans. The ECB likewise lent its support to that initiative. In fulfilling its mission of banking supervision, it noted that banks adopted very different approaches to the identification, assessment, management and write-off of non-performing loans. In March 2017, in order to implement a consistent prudential strategy in the euro area, the ECB sent the banks guidelines on the treatment of non-performing loans. The guidelines advocate measures, processes and good practices requiring the banks to set up methods of reducing these loans. In October 2017, these guidelines were supplemented by an addendum spelling out the expectations concerning prudential provisioning for new non-performing loans with effect from 1 January 2018.

Limited progress in implementing the agenda for deepening EMU

The economic and financial crises that Europe suffered between 2008 and 2013 revealed some flaws in the original architecture of EMU which prevented citizens from reaping all the potential benefits in terms of opportunities and economic and social protection. While significant progress has been achieved since then, consistent efforts are still needed to achieve full completion.

In June 2015, the Five Presidents' Report had relaunched the process, proposing a roadmap for the route to be followed up to 2025. In line with that report, the reflection paper on the deepening of EMU, published by the EC in May 2017, reformulated the specific options on the basis of a new sequence of steps. For some of the existing proposals, more time may be needed to complete the discussions and secure sufficient support from the Member States to permit full implementation, while others which are already well on the way to fruition will be easy to finalise. On the basis of the principle that the reduction in risks specific to each EMU member must go hand in hand with the establishment of institutions and procedures permitting risk-sharing between the various parties, the options put forward in the reflection paper aim at completion of a genuine financial union and greater integration of the economic and fiscal union. Finally, on 6 December 2017, the EC presented a series of Communications describing the new stages towards completion of EMU. These new proposals essentially concern the creation of a European Monetary Fund (EMF) anchored in the EU's legal framework, new fiscal instruments to strengthen the stability of the euro area, and finally, the definition of the possible functions of a European Minister of Economy and Finance.

Since its launch, the Banking Union has made great progress, particularly in the establishment of the single supervisory mechanism (SSM) and the single resolution mechanism (SRM). Nevertheless, two major components are yet to come; they are discussed in box 14 in this report (see the "Prudential regulation and supervision" part of the Report). First, the EU's new bank resolution framework provides for resolutions to be financed by the shareholders and creditors of the bank concerned, and if necessary by a Single Resolution Fund (SRF) pre-financed by the banking sector. However, in the event of serious problems affecting several banks simultaneously, the Fund could prove insufficient. In December 2013, it had thus already been agreed that the Member States would supplement the fund with a common backstop which would be fiscally neutral – any pay-outs would have to be reimbursed by the banking sector in the medium term – and available solely as a last resort. The European Stability Mechanism (ESM) was put forward as a natural candidate for such financial support, and in December 2017, the EC suggested that the ESM could be gradually converted into the EMF. Next, a European Deposit Insurance Scheme (EDIS) constituting the third pillar of the Banking Union would guarantee that deposit accounts had a greater level of protection, the same for all savers in the euro area.

The establishment of a Capital Markets Union (CMU) is intended to integrate the various national financial ecosystems and make the current system less dependent on the banking channel. The private sector could thus count on more diversified funding sources or investment options, better suited to its plans. That would substantially reinforce the financial sector's overall resilience and the private sector's capacity for cross-border risk-sharing. A 2015 action plan had defined the priorities for achieving the entry into force of the CMU by 2019. A number of measures have been taken since then in accordance with the planned schedule, such as the revision of the legislative framework concerning risk capital and securitisation operations, and the removal of certain national barriers connected with differences between corporate restructuring and insolvency procedures. With Brexit, the prospect of the largest European financial centre's departure from the Single Market has accentuated the need to consolidate this programme. Thus, in June 2017, the EC published a mid-term review reporting on the progress made and redefining the action plan by centring it round a number of new priority measures accompanied by a scoreboard. The aim is to strengthen the supervision framework concerning the capital markets, develop proportionate rules on small listed companies and investment firms, remove the final barriers to cross-border investment, consolidate the EU's dominant position in sustainable investment, and support the development of financial technology (FinTech).

Among the various options mentioned, the 2015 Five Presidents' Report had highlighted the fact that economic and fiscal union needed to progress towards increased convergence of economic and social structures in euro area countries. The proposal for a macroeconomic stabilisation mechanism for the euro area was put forward with that objective in mind. In view of past crises, it is impossible to guarantee that all risks can be eliminated and all economic shocks can be readily absorbed, even in economies which are already resilient, with sufficiently flexible labour markets and sound public finances. As stated in the EC's May 2017 reflection paper, a European stabilisation mechanism could thus be envisaged to supplement the stabilising role of the national budgets and monetary policy. In that connection, the EC's Communication in December 2017 proposes new budgetary instruments. They include an *ad-hoc* instrument for pooling the EU's public finances, based on the principle of a European investment protection system and triggered automatically in the event of a serious asymmetric shock, subject to compliance with strict eligibility criteria. Such support would be mixed, based on loans from the EU budget and the EMF, and a "grant" component funded by EU budget appropriations and supplemented if necessary by an insurance mechanism based on voluntary contributions from the Member States.

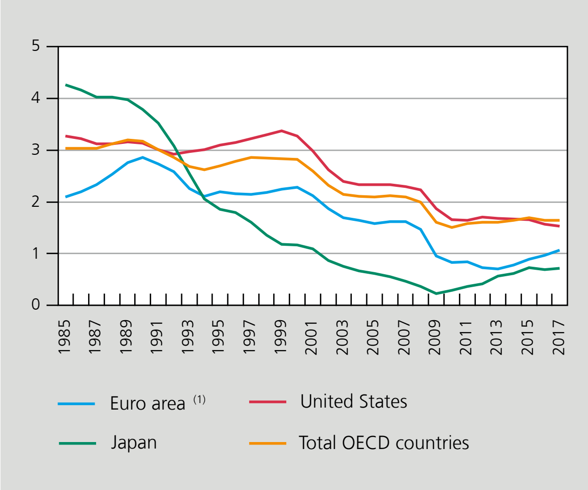
Take the necessary action to strengthen the potential of the euro area economies

Although they have a key role to play, initiatives taken at European level will be insufficient to guarantee that the economies of the euro area function satisfactorily in order to ensure the prosperity of their citizens. Responsibility for economic policies rests mainly with the Member States, and there are considerable challenges to be addressed in order to reverse the trend towards slower potential growth, to increase the resilience of the economies, and to include more people in that process. The restoration of potential growth could also help to break the self-perpetuating spiral of weaker growth and low investment, as well as supporting the reduction of public and private sector debt levels.

In recent decades, the potential growth of the euro area has maintained a downward trend, in common with other advanced economies such as the United States and Japan. While it had already fallen below the average for OECD member countries since the 1980s, it subsequently continued to decline gradually. During the 2008-2012 crisis, the impact was actually more severe and longer lasting than in other economies, so that potential growth stood at less than 1 % per annum at the beginning of this decade. In contrast, in the United States and on average in the OECD countries, growth remained considerably higher at over 1.5 %.

CHART 16 POTENTIAL GROWTH IN THE EURO AREA HAS MAINTAINED A DOWNWARD TREND IN RECENT DECADES

(volume data, annual percentage change)



Source : OECD.
(1) Average for the 16 euro area countries belonging to the OECD, i.e. the euro area excluding Cyprus, Malta and Lithuania.

While the difficulty of capturing certain types of new activities – notably those concerning digital technologies – in the statistics may heighten the uncertainty around the exact quantification of potential growth, and perhaps lead to an under-estimation bias, the general finding of a marked slowdown in potential growth in the euro area and a shortfall in relation to other advanced countries is nevertheless borne out. Potential growth is influenced by the various production factors that can be mobilised, and more specifically by the volume of labour and capital available, and by the efficiency with which those factors are used. In regard to labour, this concerns in particular the size of the labour force (which is affected by ageing, for example) but also its skills (the "human capital") and the degree to which the characteristics of the labour supply correspond to the needs of the demand for labour (mismatch). The production factor "capital", which complements the factor "labour", incorporates technological innovations and progress to a great extent. The continuous process of creating and destroying businesses and jobs is important for the efficient allocation or reallocation of the means of production between branches of activity and firms.

Thus, inefficient rules governing product, labour or financial markets may unnecessarily hamper the reallocation of resources and competition between firms, yet without better achieving the rules' original aim. The services sector seems to suffer most in that respect. Also, in some countries, the crisis impeded access to loans for young, often highly productive, businesses.

Policy must help to create a climate more favourable to investment, innovation and the spread of technology, as well as the reallocation of resources towards the most productive investment. In addition, improvements in the institutional environment can play a part, notably via more efficient resolution mechanisms for insolvent businesses, making it easier for failing firms to disappear and for the production factors that they used to be efficiently reallocated. On the product markets, it is necessary to continue breaking down the barriers preventing the entry of new businesses. Other structural reforms are likewise recommended, such as reforms aimed at improving the business climate, strengthening competition, enhancing efficiency and providing better training for human capital.

Measures are also needed to foster a labour market that functions more smoothly and to raise the labour market participation rate, particularly in the case of younger and older workers, women, the low-skilled, and migrants. The necessary action must be taken according to the specific factors hampering the participation of these groups. Thus, the employability of certain groups has to be enhanced, e.g. by updating or developing the skills of older persons and low-skilled workers, providing more child-care facilities, continuing to reduce the gap between gross and net pay, particularly for low wage earners, and combating discrimination. In addition, other reforms will be needed in various spheres such as pensions, education and training.

Consistent reform packages of complementary measures in various fields, such as labour and product markets, are a better way of supporting growth than isolated measures. It is very important to set the priorities and the sequence to be followed in implementing structural reforms, so as to optimise their short- and medium-term impact and ensure that they are distributed across income groups. In this connection, labour market reforms must be preceded – or at least accompanied – by product market reforms in order to ensure that wage adjustments are reflected in prices. Similarly, as regards the labour market, the OECD – to mention just one entity – recommends that reforms to employment protection and unemployment benefit systems should always be accompanied by measures concerning activation, retraining, and a return to work.

Various Member States have already adopted a series of measures. But this mainly applies to the countries hard hit by the crisis. Other countries have introduced few structural measures, so that the economic potential is not fully exploited. The monitoring at national level of measures designed to fulfil the recommendations addressed to them year after year in the European Semester shows that the measures are not being sufficiently implemented. In all euro area countries, additional progress will be necessary to accelerate further the restoration of potential growth.

In recent years, the EU has taken various initiatives to encourage the implementation of this type of measures. For instance, the national productivity boards, which the EU Council recommended creating in 2016, should in the future stimulate structural reforms. If national authorities and the citizens themselves are convinced of the need for the reforms, then – in accordance with the ownership principle – they will be better disposed to adopt the measures concerned. Similarly, the Communication which the EC published on 6 December 2017 on the subject of the new budgetary instruments for a stable euro area within the framework of the European Union aims in particular to encourage national structural reforms. For that purpose, a new tool to assist in establishing reforms will be devised after 2020 to support the reforms that the Member States are committed to implementing. As a test, the EC proposes already extending the options available to them of allocating part of the European structural and investment funds to the support of reforms agreed under the European Semester. There will also be provision for tailor-made technical assistance deployed at the request of the countries concerned.

Finally, it is necessary to emphasise once again the importance of completing the CMU in order to facilitate access to alternative funding for innovative projects.