1. Global economy and euro area

1.1 Divergent picture in the various economic regions owing to higher risks and uncertainties

The global economy maintained its robust growth in 2018. However, mounting risks and uncertainties affected economic activity to varying degrees in several countries, so that the expansion was geographically less uniformly distributed. While growth lost momentum in most of the advanced economies, it gathered strength in the United States, supported by an expansionary fiscal policy. The emerging economies likewise experienced divergent developments. The oil-exporting countries benefited from a further rise in prices on the international markets, while growth was maintained at a steady pace in India and China. Conversely, activity slowed in some oil-importing countries with sizeable internal and external imbalances, which came under pressure from the financial markets. In that context, international

Table 1

GDP of the main economies

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

				p.m. Contribution to global GDP growth	*p.m. Share of global GDP*[1]
	2016	**2017**	**2018**	***2018***	
Advanced economies	1.7	2.4	2.3	*1.0*	*40.8*
of which:					
United States	1.6	2.2	2.9	*0.4*	*15.2*
Japan	1.0	1.9	0.9	*0.0*	*4.2*
Euro area	2.0	2.4	1.9	*0.2*	*11.4*
United Kingdom	1.8	1.8	1.4	*0.0*	*2.2*
Emerging economies	4.4	4.7	4.6	*2.7*	*59.2*
of which:					
China	6.7	6.9	6.6	*1.2*	*18.7*
India	7.1	6.7	7.3	*0.5*	*7.7*
Russia	–0.2	1.5	1.7	*0.1*	*3.1*
Brazil	–3.5	1.1	1.3	*0.0*	*2.5*
World	3.3	3.8	3.7	*3.7*	*100.0*
p.m. World trade[2]	*2.2*	*5.3*	*4.0*		

Sources: Eurostat, ECB, 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.

trade, which had been expanding strongly in 2017, slowed down during 2018.

The policy pursued in the United States left its mark on the global economy

While the American economy was running at full speed in 2018, growth was eroded in most other advanced economies. Japan's economic performance was greatly influenced by one-off factors, such as weather conditions and natural disasters. As a result, the Japanese economy displayed a highly erratic profile, with negative and positive growth alternating from one quarter to the next. In the United Kingdom, activity was bolstered by consumption but the uncertainty over the Brexit negotiations (see box 1) continued to have a detrimental impact on investment. Since 2015, GDP growth has weakened significantly so that the country is no longer among the best-performing large economies.

BOX 1

Brexit and its implications for Belgian businesses [1]

In a referendum held on 23 June 2016, a small majority of British citizens voted in favour of leaving the EU ("Brexit"). As a result, on 29 March 2017, the United Kingdom notified the European Council of its intention to leave the EU, thus triggering a procedure which, after two years, should lead to the first departure of a country from the EU.

On 25 November 2018, an agreement was concluded between the British government and the European Council concerning both a withdrawal agreement and a political declaration on the future relationship between the EU and the United Kingdom.

To avoid an abrupt and disorderly departure from the EU, the agreement needs to be ratified both by the House of Commons and by the European Parliament. Owing to the political uncertainty, there is a serious risk that the the UK will not ratify the agreement before 29 March 2019.

The withdrawal agreement is a legally-binding international treaty, setting out the terms of the separation. Key points among its many components concern:

- the rights of European citizens established in the United Kingdom and British citizens established in an EU Member State before the end of a transitional period;
- the financial settlement, the principle being that the financial commitments entered into by the 28 EU countries will be honoured by the 28, including the United Kingdom;
- a dispute settlement procedure;
- a transitional period that will begin when the United Kingdom leaves the EU and its institutions on 29 March 2019, whereby the current situation will be maintained until 31 December 2020 as regards the Single Market, the Customs Union and European policies, with the associated rights and obligations. By mutual agreement, this transition can be extended once by a maximum of two years, i.e. possibly until the end of 2022.

1 Regarding the implications of Brexit for the financial sector, see section G.7 of the "Prudential Regulation and Supervision" part of this Report.

The border between the Republic of Ireland and Northern Ireland is a particularly thorny issue: on the one hand, no-one wants to reinstate the physical frontier between the Irish Republic and Northern Ireland, but on the other hand, it is necessary to arrange for the formalities associated with crossing a border between the EU and a third country, especially as regards trade in goods. A protocol attached to the withdrawal agreement specified a "backstop" solution, namely the creation of a customs territory between the EU and the United Kingdom. This solution is to apply until such time as a final agreement has been concluded on the future relationship between the United Kingdom and the EU, including an alternative solution to avoid a hard border.

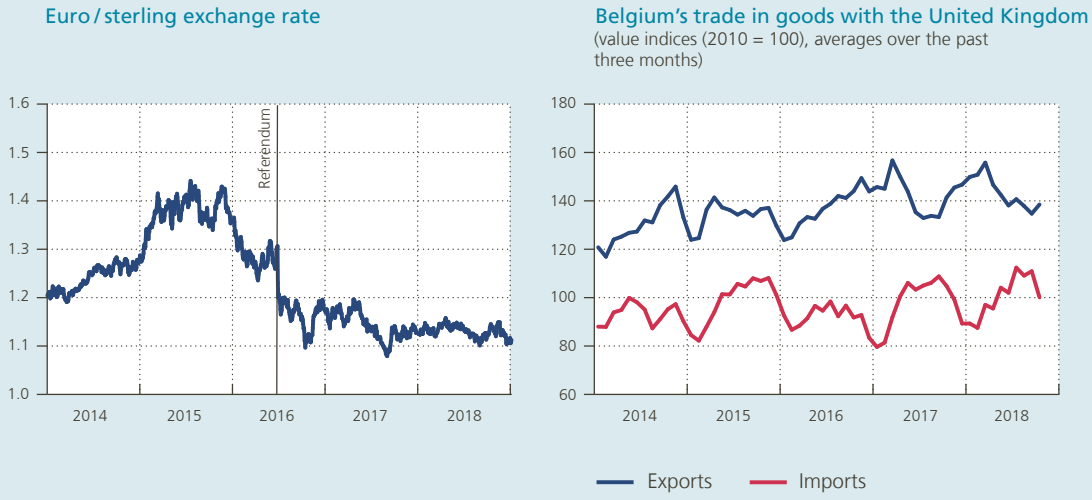
The political declaration establishes the parameters for negotiating "an ambitious, broad, deep and flexible partnership" for cooperation in various spheres. In the economic sphere, there is to be a "free trade area, combining deep regulatory and customs cooperation" for trade in goods between the EU and the United Kingdom. For financial services, the key concept concerns equivalence decisions. The parties are committed to preserving financial stability, market integrity, investor and consumer protection and fair competition. For other services, the aim is to deliver a level of liberalisation well beyond the World Trade Organisation (WTO) commitments, building on recent EU free trade agreements. While the free movement of capital and payments is maintained, that is no longer the case for the free movement of persons, but "mobility arrangements" should be established on the basis of non-discrimination between the EU Member States and full reciprocity.

Considerable potential economic consequences

Since 2016, the uncertainty caused by the Brexit referendum has been reflected primarily in fluctuations in the British currency and the slackening of domestic demand in the UK. Although this has affected

the market conditions of Belgian exporters, the foreign trade figures do not suggest at this stage any interruption in trade in goods between Belgium and the United Kingdom. Belgium's trade surplus with the United Kingdom is still substantial, totalling around € 6.7 billion in 2017 and € 4.5 billion over the first nine months of 2018.

Repercussions of Brexit on the sterling exchange rate and on Belgium's trade



Sources: NAI, Thomson Reuters.

Various studies estimate the long-term economic costs of Brexit. In the absence of any agreement on the future relationship more favourable than the basic WTO rules, those costs could be substantial. Taking just the impact of higher trading costs due to customs duties and non-tariff barriers, the impact in terms of lost GDP would exceed 3 % for the United Kingdom and Ireland. For Belgium, it would amount to 1 %, which is above the average for the EU (0.6 % of GDP). However, that impact would be greatly reduced in the event of agreement on a deeper relationship.

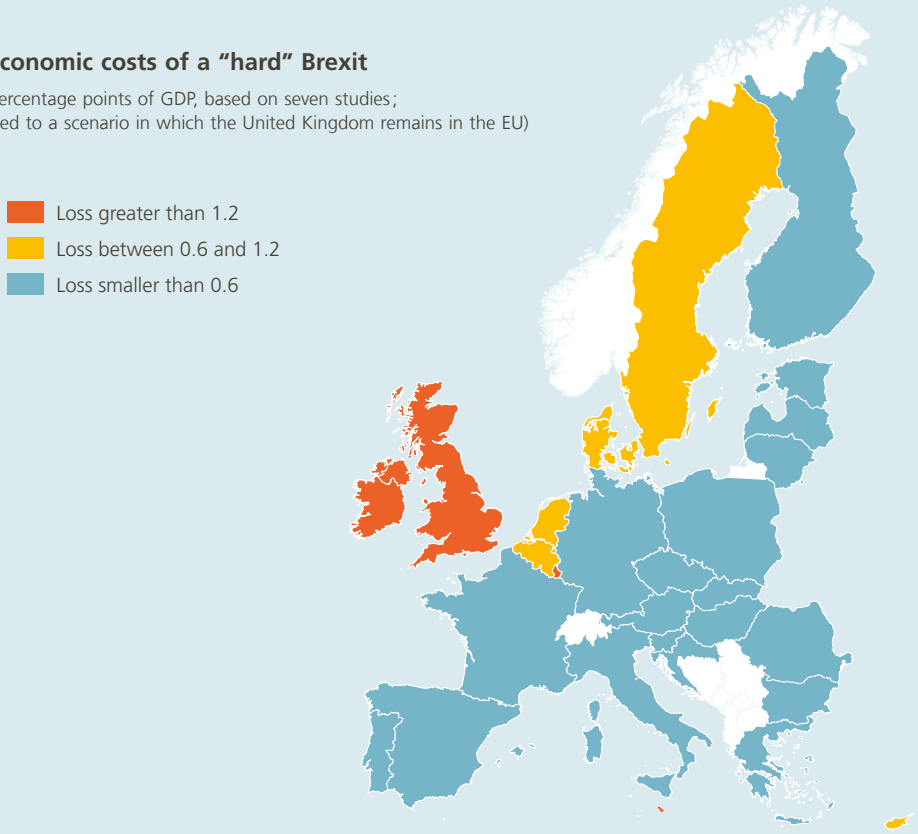
Apart from its impact on trade alone, Brexit could be bad for the entire British and European economy as well if the uncertainties were to persist. It could also make the British economy less attractive for foreign direct investment and the immigration of workers, while the reduced integration into the European economy could curb the United Kingdom's productivity growth for some time to come. Moreover, most studies estimate that the macroeconomic cost of Brexit could be much higher for the United Kingdom, sometimes as high as 10 % of GDP or even more in extreme cases.

Impact on Belgian firms

Many Belgian firms are involved in trade in goods and services with the United Kingdom. According to the 2017 VAT data, more than 41 000 firms are direct exporters and/or importers. If account is also

Long-term economic costs of a "hard" Brexit

(median loss in percentage points of GDP, based on seven studies;
deviation compared to a scenario in which the United Kingdom remains in the EU)



Source: Bisciari P. (2019), *A survey of the long-term impact of Brexit on the UK and on the EU27 economies*, NBB, Working Paper 366.

taken of the suppliers linked to the firms directly involved, almost 67 % of Belgian firms are exposed to demand from the United Kingdom. Similarly, 24 % of Belgian firms obtain supplies on the British market or direct from other importers and are thus at risk of incurring higher production costs as a result of a rise in the cost of inputs from the United Kingdom[1]. Indirect supplier relationships mean a steep rise in the number of firms potentially concerned.

Of the firms exporting to the United Kingdom, almost 8 000 SMEs will be particularly affected. For 20 % of them, the United Kingdom was the destination for more than half their exports within the EU in 2017. The lack of familiarity with the administrative procedures for exports outside the EU, as well as the tariffs that could be imposed directly on those exports, will also be detrimental to many firms, as it is estimated that almost a third of firms exporting to the United Kingdom have no previous experience of the customs formalities associated with exports outside the EU.

1 See Dhyne E. and C. Duprez (2017) "It's a small, small world… A guided tour of the Belgian production network", *International Productivity Monitor,* 32, 84-96.

Number of Belgian firms active in trade in goods and / or services with the United Kingdom

(2017)

	Exports	Imports	of which: Exports and imports
Total	18 510	28 400	5 805
of which:			
Firms employing fewer than 50 FTEs	7 963	11 214	n.
Firms for which the United Kingdom represents at least 50 % of their exports to the EU	6 105	n.	n.
Firms with no previous experience of procedures for exporting outside the EU	6 067	n.	n.

Source: NBB.

Naturally, the imposition of tariff barriers, especially non-tariff barriers (such as special conformity rules for the British market) will have an impact on trade flows. It will therefore have implications for the Belgian logistics and maritime transport sector. For example, the port of Zeebrugge is particularly exposed to cross-Channel trade, especially trade in motor vehicles. In the absence of an agreement, the fisheries sector will also be hard hit because EU fishermen would lose access to British waters.

Stepping up the preparations

In order to limit the adverse effects of Brexit, it is imperative that Belgian firms, and SMEs in particular, take the necessary measures to ensure the continuity of their business. Their exposure to Brexit is not confined just to export and import activities, but also concerns access to services, the whole logistics chain, digital data and services (privacy regulations), intellectual property, the location of production units, etc. In order to be prepared, they would do well to refer to the "Brexit Impact Scan" published on line by FPS Economy. These preparations are necessary regardless of whether the agreement is ratified, since the UK will officially cease to be a member of the EU. The European and Belgian authorities have organised safeguard arrangements to cater for potentially serious disruption if no agreement is reached.

In 2018, the global economy and financial markets were influenced mainly by the policies pursued in the United States, which generated great uncertainty. In particular, the country's protectionist attitude caused much anxiety. In January, a first raft of trade measures was adopted, with the introduction of temporary customs tariffs on solar panels and washing machines, followed in March by additional import duties on aluminium and steel. China was particularly targeted by the American government. The Trump Administration considers that some aspects of Chinese policy concerning intellectual property and technology transfers are unfair and contrary to American interests and believes that these factors explain why China accounts for almost half of the United States' deficit on international trade in goods. At the end of September, higher tariffs were imposed on Chinese products worth $ 250 billion. However, tensions were not confined to trade between the United States and China. For instance,

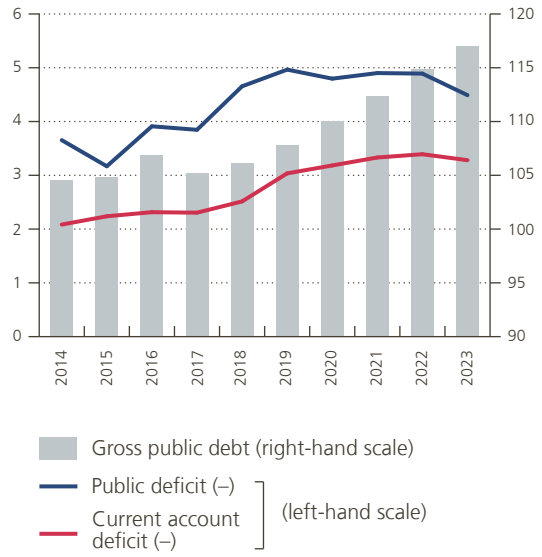
the renegotiation of the NAFTA agreement between the United States, Canada and Mexico also caused regular market disturbances.

The United States' domestic economic policy had implications for the rest of the world as well. Although US economic activity had expanded steadily in 2016 and 2017, and despite growing signs of full capacity utilisation, the Trump Administration approved a massive package of fiscal stimulus measures in late 2017 and early 2018 which provided further support for the US economy in 2018. Tax cuts boosted domestic demand, while consumption also benefited from the further improvement in the labour market situation, with unemployment down to 3.9 % in December, its lowest level for almost 50 years. Furthermore, rising oil prices stimulated investment in the energy sector. However, the expansionary fiscal policy also caused the public deficit to swell significantly, from 3.8 % of GDP in 2017 to 4.7 % in 2018, while the public debt escalated to 106.1 % of GDP. Moreover, the strength of domestic demand encouraged imports, so that the current account deficit also rose to 2.5 % of GDP.

Chart 1

The United States faces a double deficit and the public debt is growing

(in % of GDP)



Source: IMF.

In contrast to most other advanced economies, the growing labour market shortage in the United States led to wage acceleration, which in turn helped to rekindle inflation, which reached the 2 % target set by the US central bank. In those circumstances, the Federal Reserve proceeded to normalise its monetary policy. After five interest rate hikes from the end of 2015, it raised its key interest rate further in four stages in 2018, by 25 basis points at a time, to a range of between 2.25 % and 2.5 %.

Nonetheless, in the course of the year, the pursuit of a procyclical policy in an economy running at full capacity caused investors to fear that the American economy could become overheated and that the Federal Reserve might raise interest rates more rapidly than expected. In that context, the dollar – which had depreciated in 2017 – began rising from February, and this trend was further reinforced from April. The dollar's appreciation against the currencies of the other large advanced economies reflected the divergent growth prospects and the gap in key interest rates in relation to the United States. Nevertheless, the dollar appreciated particularly against the currencies of many emerging economies. The dollar's appreciation triggered a reversal in market sentiment regarding those countries, as some of them had accumulated substantial dollar-denominated debts in the preceding years. In general, the lower dollar-return on assets denominated in the currency of those countries prompted a shift in investors' positions. Although all the emerging economies proved vulnerable, to some extent, to the reversal of investor sentiment – which was reflected in capital outflows and the depreciation of their national currency – the countries most affected were those with substantial current account deficits and heavy borrowing requirements. That applied in particular to Argentina and Turkey. The situation in those countries escalated during the summer, with the sharp depreciation of the peso and the lira causing inflation to take off again. In Turkey, the situation stabilised to some degree after the central bank raised its interest rates and the government announced budget cuts, while the Argentinian government eventually had to turn to the IMF. This period of turbulence had a detrimental impact on economic activity in both

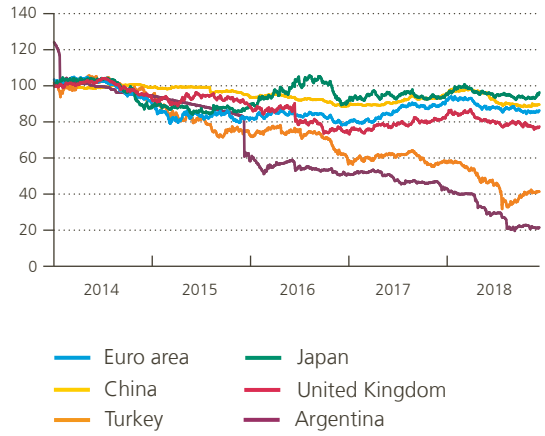
The appreciation of the dollar caused a reversal in market sentiment regarding the emerging economies

countries, resulting in growth in Turkey being halved from the 2017 figure, while in Argentina the economy went into recession.

Chart 2

The United States dollar has appreciated

(daily data, exchange rate vis-à-vis the dollar, indices 2014 = 100)



Source: Thomson Reuters.

Apart from the Argentine and Turkish currencies, the South African rand, the Indian rupee, the Brazilian real and the Russian rouble also weakened considerably. Nevertheless, these currencies stabilised or appreciated again slightly in the autumn. The Chinese renminbi also came under growing pressure from June onwards, but interventions by the Chinese authorities prevented the exchange rate from crossing the threshold of 7 renminbi per dollar.

Activity in China continued expanding steadily. In the first and second quarters, according to the official figures, growth was maintained at almost 7 %, after which it slackened pace somewhat. However, the 6.6 % expansion over the year as a whole remained within the government policy target. In line with the Chinese government's intention of rebalancing the economy, activity was driven mainly by buoyant consumption, while investment lost momentum. Infrastructure investment in particular grew more slowly, following measures to restrict the activities of the shadow banking sector, a key source of funding for such investment. In addition, structural debt reduction in public enterprises and excess capacity in a number of industrial branches also depressed investment. The share of consumption in growth thus increased from an average of 53 % in the period 2005-2017 to 76 % in 2018. Nevertheless, at just under 40 % in 2017, consumption still accounts for a much smaller share of GDP in China than in the advanced countries where the figure averages around 60 %. Despite the mounting trade tensions with the United States, Chinese exports continued expanding in 2018, albeit less strongly than in 2017. Not only did the depreciation of the renminbi bolster exports, American firms probably also brought forward some of their imports from China in anticipation of a further rise in import duties on Chinese products totalling $ 200 billion with effect from 2019. At the end of 2018, the introduction of these new import duties was nonetheless postponed from January to March 2019, depending on progress achieved in the trade talks between the two countries. However, Chinese exports fell sharply at the end of the year.

In 2018, Chinese government policy also tried to strike a balance between the desire to provide enough support for activity in order to prevent an abrupt slowdown in the economy, and the desire to limit the accumulation of financial risks. The close interdependence between the banks and the shadow banking sector, and the growing complexity of the investment instruments that the latter issues, are potential threats to financial stability. Some recent measures aim to strengthen regulation on financial institutions and investment products and to introduce a stronger macroprudential framework and greater transparency. Conversely, the People's Bank of China – which officially maintains a neutral monetary policy stance – gradually relaxed the reserve requirements for banks in order to facilitate access to credit for smaller firms. Fiscal policy remained supportive, though it was increasingly granted by means of tax cuts rather than public spending on infrastructure.

In India, the pace of economic growth quickened further, making India once again the fastest growing large economy in 2018. Investment benefited from the impact of previous structural reforms – such as the harmonisation of the goods and services tax and the new insolvency and bankruptcy code – while exports were shored up by the depreciation of the rupee. Yet the Indian economy was held back to

some extent by rising oil prices, liquidity problems facing the shadow banking sector, and less favourable financing conditions.

The oil-producing countries benefited from the higher oil prices. The recovery thus continued in Russia and Brazil. However, investment in Russia was hit by the uncertainty over the possibility of new American sanctions, while production interruptions caused by strikes in the transport sector in May weakened Brazilian growth.

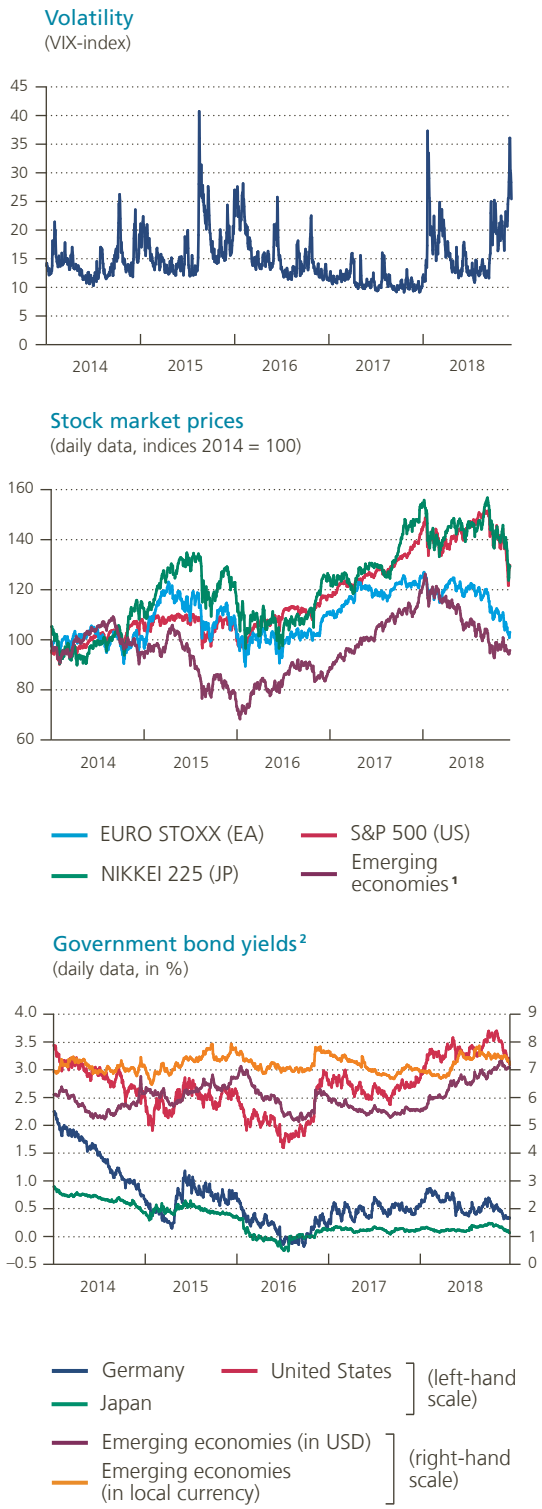
After two years of particularly robust performance, the financial market situation deteriorated considerably

Financial market volatility increased sharply in 2018. The risks and uncertainties weighing on the global economy in 2018 had an increasingly adverse impact on the financial markets as the year progressed. Thus, stock markets fell worldwide at the beginning of February, in the wake of worsening trade tensions and a rise in inflation expectations for the United States, following the publication of bigger-than-expected wage rises. In the emerging economies, stock markets subsequently continued falling, mainly as a result of the dollar's appreciation, combined with the vulnerabilities accumulated by certain countries, as well as the heightened trade tensions and weakening dynamism of the Chinese economy. Conversely, in the advanced economies, stock markets subsequently saw a temporary recovery. In the United States, after February's stock market volatility, markets began rising again strongly during the spring and summer. Thanks to sound corporate results, supported by tax cuts, stock markets actually surpassed the all-time record attained in January. In Japan and the euro area, however, share prices fluctuated without showing any clear trend. European stock markets suffered from the uncertainty over the potential impact of American trade policy on European exports and the deterioration of the situation in the emerging economies, particularly in Turkey. Developments in Italy and those concerning Brexit also played a role, in particular by driving down bank share prices.

Financial market volatility increased sharply

Chart 3

Volatile financial markets



Source: Thomson Reuters.

1 MSCI Emerging Markets index.

2 Advanced economies: ten-year government bonds; emerging economies: JPM EMBI Global index (in USD) and JPM GBI index (in local currency).

However, in the autumn, the persistent trade tensions, together with the gloomier outlook for the global economy, began to exert more widespread downward pressure on stock markets. Investors' mounting concerns over the corporate earnings outlook therefore triggered a worldwide sell-off in stock markets as from October. The impact on the American technology sector in particular – which was still enjoying a highly optimistic earnings outlook – was considerable. The situation worsened further at the end of the year, particularly in the United States, following the publication of lower growth and inflation forecasts by the Federal Reserve and in the context of the imminent shutdown of federal public services.

The bond markets also exhibited divergences between the United States and the other advanced economies in 2018. American government bond yields maintained their upward trend, widening the gap in relation to the still historically low yields on German and Japanese government bonds. This reflected the differing monetary policies and higher inflation expectations in the United States. During the final two months of the year, however, yields declined in all the advanced economies. In the euro area, the spread between Italian and German sovereign bonds widened. Thus, interest rates in Italy rose sharply in May during the negotiations on the coalition agreement between the League and the Five Star Movement. At the end of September, Italian interest rates climbed further, propelled by the fiscal stimulus proposed by the new administration. However, there was little contagion to the other euro area countries, mainly thanks to the greater resilience of the European economy compared to the financial crisis, as well as the establishment of the Banking Union which helped to strengthen the institutional structure of the euro area. In the emerging economies, sovereign bond yields began rising again in 2018, after having fallen throughout the previous year. The spread in relation to American government bonds widened especially in countries with major external imbalances.

World trade faltered while oil prices were highly volatile

Following particularly strong growth during the previous year, international trade lost momentum again in 2018. The sharpest deceleration in trade growth

occurred in the euro area. That slowdown, which affected the various Member States and branches of activity, was due partly to the new European emission tests in the automotive sector and the earlier appreciation of the euro. It is hard to ascertain the extent to which the growing tensions between the United States and China have influenced world trade up to now. On the one hand, American customs duties have mainly affected a number of specific branches of activity which make up only a small proportion of world trade. On the other hand, owing to the global interlinking of production chains, trade barriers may have a greater negative impact than just the direct effect on the countries and products concerned. Moreover, concern over the escalating trade tensions has undeniably had an adverse effect on confidence and on investment projects, as is evident from the more moderate growth in investment, which is highly trade-intensive.

BOX 2

The new American protectionism and its economic impact [1]

In accordance with his campaign speech, President Trump has resolutely opted for a more restrictive and more aggressive trade policy stance, with the aim of "serving American interests first". The unilateral measures are based on an essentially mercantilist view of international trade, whereby the massive American trade deficit ($ 552 billion in 2017) represents a loss of earnings for the country's economy. The measures accord priority to national sovereignty and centre largely on the same objective; promoting activity and employment in the United States.

Trade agreements

Soon after arriving in the White House on 20 January 2017, Donald Trump announced that the United States would withdraw from the Trans-Pacific Partnership negotiated by his predecessor, Barack Obama, with eleven other countries in the Pacific region. In August 2017, the US Administration also launched a revision of the NAFTA agreement with Canada and Mexico. At the end of September 2018, the renegotiation led to the United States-Mexico-Canada Agreement, scheduled to enter into force on 1 January 2020.

Tariffs, threats and retaliation

The Trump Administration also decided to impose new customs duties on a range of products imported into the United States. In January 2018, a safeguard measure thus applied to imports of solar panels worth $ 8.5 billion and imports of washing machines amounting to $ 1.8 billion.

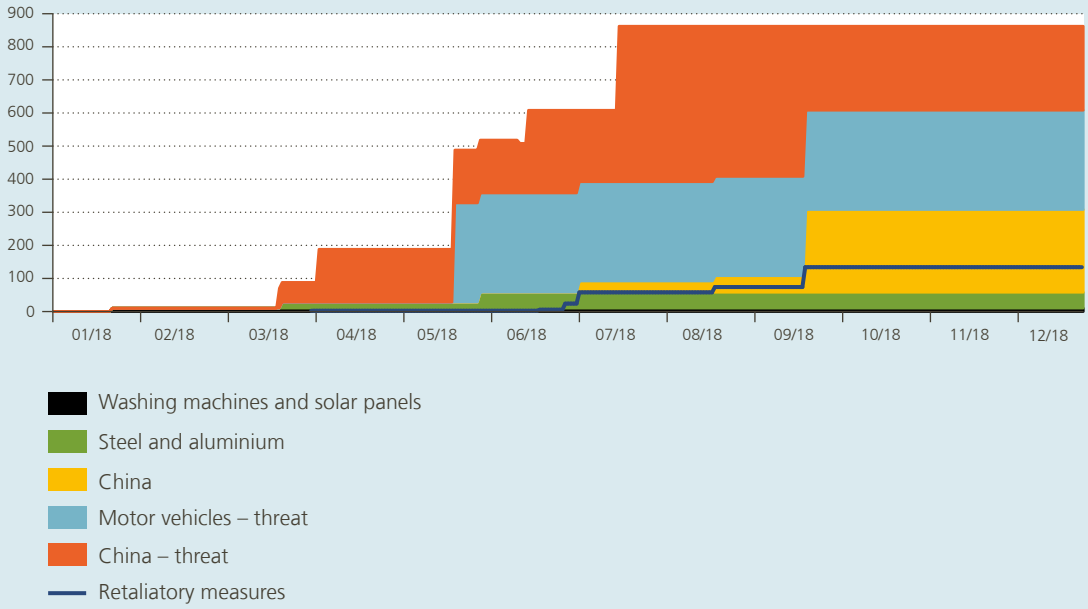
In March 2018, the United States announced that additional customs tariffs of 25 % and 10 % respectively would apply for an indefinite period to American imports of steel and aluminium, representing a total of around $ 48 billion in 2017. The measure took effect on 23 March, but

1 For more details, see Cordemans N, C. Duprez and K. Kikkawa (2018), "America's new trade policy and its impact on the Belgian economy", NBB, *Economic Review*, September, 7-33.

the EU was granted exemption until 1 June. Although the Trump Administration justified the new customs tariffs on national security grounds, they mainly affect historical allies of the United States.

American customs tariffs, threats and retaliatory measures in 2018

($ billion)



Source: Peterson Institute for International Economics.

China, accused of unfair trade practices, notably as regards intellectual property, saw an additional 25 % tariff imposed on exports to the United States worth $ 50 billion, and an additional 10 % tariff on a further $ 200 billion.

As well as imposing new customs duties, the American government threatened to tax all Chinese exports of goods to the United States (around $ 517 billion in 2017) and to raise the existing tariffs to 25 %. It also launched a survey of American imports in the motor vehicle sector. There is the possibility of a 20-25 % tariff on an amount which could be up to $ 300 billion.

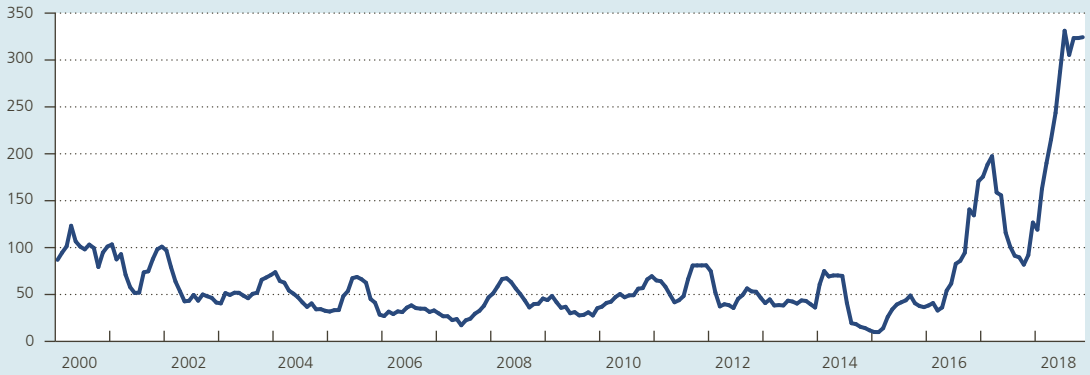
Most of the trading partners affected by the new customs duties on steel and aluminium responded with retaliatory measures against American products, amounting to a total of over $ 24 billion. China responded to the American measures by imposing customs tariffs of 5-25 % on US exports totalling $ 110 billion.

What is the impact on the global economy?

Although they surpass anything seen since the 1930s, the tariff barriers imposed so far by the United States and the reprisals by their trading partners account for only around 3 % of world trade. Their direct macroeconomic impact should therefore be small. According to the OECD[1] and the IMF[2], the tariffs imposed by China and the United States could depress the growth of production in the two countries by 0.2-0.3 of a percentage point between now and 2021. The impact on other economies would be more modest, but generally negative. In principle, the EU would mainly be affected if the threats to the motor vehicle sector are carried out.

Uncertainty of American trade policy

(six-month moving average[1])



Source: Baker S., N. Bloom and S. Davis (2016), "Measuring Economic Policy Uncertainty", *Quarterly Journal of Economics* 131(4): 1593-1636.

1 Number of articles on trade policy uncertainty in American journals.

However, it should be pointed out that the imposition of new customs tariffs inevitably leads to redistribution effects between the countries concerned and those which are exempt and can therefore take advantage of any trade opportunities. It also generates costs in terms of reorganisation of the production chains and may affect productivity in the long term. In the immediate future, the current protectionist climate is undoubtedly a factor in the continuing uncertainty over the economic outlook and financial markets. The uncertainty on the financial markets tends to be particularly detrimental to financing conditions and firms' decisions on investment and recruitment. Implementation of the American threats concerning all Chinese exports and the motor vehicle sector, and the likely escalation of trade tensions that would ensue, could cause more severe erosion of global economic growth.

1 OECD (2018), *Economic Outlook*, October.
2 IMF (2018), *World Economic Outlook,* October.

How exposed is the Belgian economy?

The Belgian value added involved in total American imports amounted to around 4.1 % of Belgian GDP over the period 2009-2011[1]. That percentage is below the figure for the United States' traditional partners, such as Canada (15.6 %) or Mexico (14.2 %), but relatively high in comparison with that of other European countries such as Germany (3.6 %) or France (2.2 %). This figure bears witness to the Belgian economy's exposure to international trade in general and to American imports in particular. It gives an indication of what the Belgian economy could lose in terms of activity if the United States simply closed the door on foreign exports.

If the recent protectionist measures are considered on their own, the macroeconomic effects should be relatively limited. For example, Belgian value added involved in American imports of base metals – including steel and aluminium – comes to 0.07 % of Belgian GDP. However, the branches concerned, including their supply chains, would suffer a quite serious negative impact.

As a supplier of China and the United States, Belgium is indirectly involved in trade between those two countries. Its contribution to Chinese exports to the United States amounted to 0.14 % of its GDP in the period 2009-2011. Conversely, Belgium's contribution to American exports to China was equivalent to 0.03 % of its GDP.

Finally, Belgium's exposure to American motor vehicle imports amounts to 0.14 % of its GDP. That exposure is essentially indirect, i.e. it reflects the Belgian production involved in the manufacture of foreign products for the American market, such as parts made in Belgium forming inputs into the assembly chains of German cars exported to the United States.

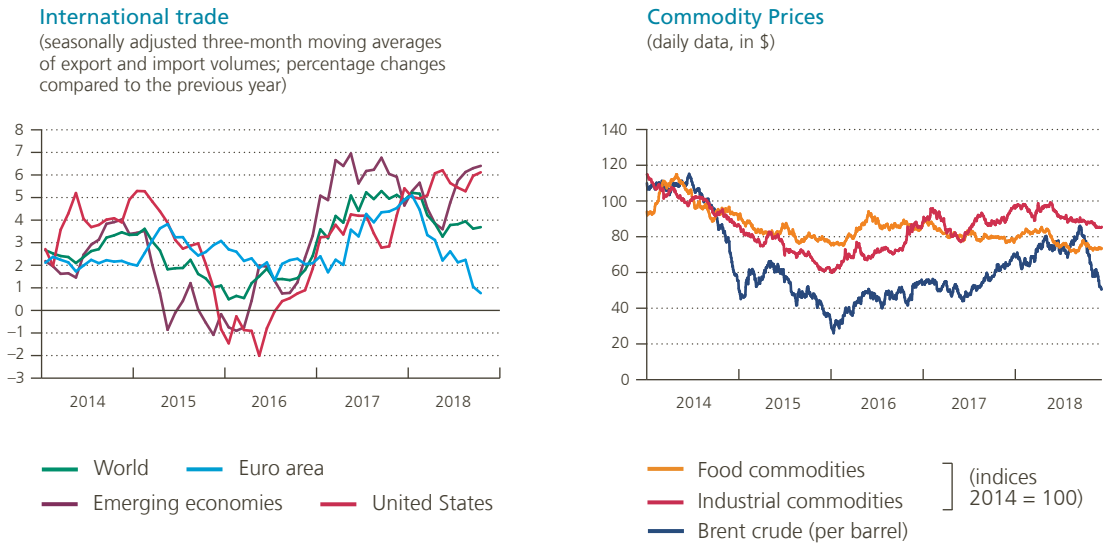
1 The data on international trade in value added are based on input-output matrices published only once every five years with a lag of three years. The estimates are obtained from the average structure of production and trade between countries for the products concerned.

Oil prices fluctuated widely in 2018. In the first half of the year, they maintained the upward trend which had begun in early 2016. The price rise was underpinned by vigorous global demand, while supplies were reduced as the OPEC members and a number of other countries adhered strictly to the agreed production limits, and output was unexpectedly interrupted in countries such as Libya and Venezuela. During the summer, however, oil prices subsided temporarily after OPEC's June decision to step up oil production in consultation with other countries, including Russia. Prices subsequently began rising again, mainly because the market expected exports from Iran – the world's fifth largest oil producer – to decline sharply following American sanctions announced for the autumn. By the beginning of October, the price per barrel of Brent had consequently climbed to around $ 85, its highest level in four years. Oil prices subsequently dropped sharply again to below the level prevailing at the beginning of the year, due to the mounting uncertainty over the outlook for the global economy. The actual implementation, in early November, of the American sanctions against Iran triggered hardly any price rise as a number of countries were still temporarily allowed to import Iranian oil and as it was clear that the decline in Iranian exports would be more than offset by higher production elsewhere.

Industrial commodity prices came under pressure from the start of 2018. They declined following a fall in demand from China, which was due partly to the imposition of stricter environmental measures. Similarly, the mounting trade tensions and uncertainty over the prospects for the global economy began to depress prices of these commodities over the year. That was also the case for food commodities, although other factors also played a role for some of them, such as more abundant than expected supplies.

Chart 4

Subdued international trade and falling commodity prices



Sources: CPB, Thomson Reuters.

1.2 Activity slowed in the euro area, but job creation and inflation continued to rise

Economic activity weakened in the euro area, due to a smaller contribution from net exports

After showing strong dynamism in 2017, with GDP up by 2.4 %, economic growth in the euro area dipped to 1.9 % in 2018. The main reason for that deterioration was a smaller contribution from net exports, as the weaker rise in imports was accompanied by significantly slower export growth, due to the deceleration of world trade and the earlier appreciation of the euro.

However, domestic demand remained vigorous and made a somewhat bigger contribution to GDP growth than in 2017. While the pace of private and public consumption growth diminished slightly, the expansion of investment gained momentum. Growth therefore remained above its potential and the absorption of the repercussions of the 2008 economic and financial crisis continued.

Private consumption remained the main contributor to domestic expenditure, thanks to the improvement in employment and the accelerating wage growth. It was also underpinned by the high level of consumer confidence, although that confidence was eroded during the year.

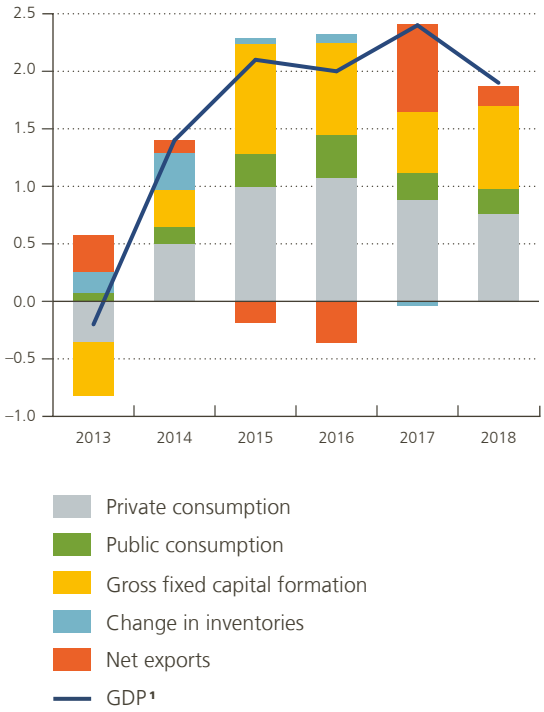
The steady investment growth is due to continuing favourable financing conditions and profitability, business confidence and – in some cases – the need to expand capacity in manufacturing industry. Productive investment in machinery and equipment recorded the strongest growth, while the increase in investment in housing and other buildings and structures slowed slightly. In 2018, the practically continuous recovery since the spring of 2013 propelled investment to its highest level for ten years in real terms.

In 2018, economic activity strengthened in all euro area Member States, so that GDP growth was widespread throughout the euro area, as it had been in the previous year. Once again, Ireland recorded the strongest growth at 7.5 %, but the country's GDP growth is volatile and is heavily influenced by

Chart 5

Domestic demand remains vigorous but the contribution of net exports has diminished

(percentage point contributions to the annual change in real GDP, unless otherwise stated)

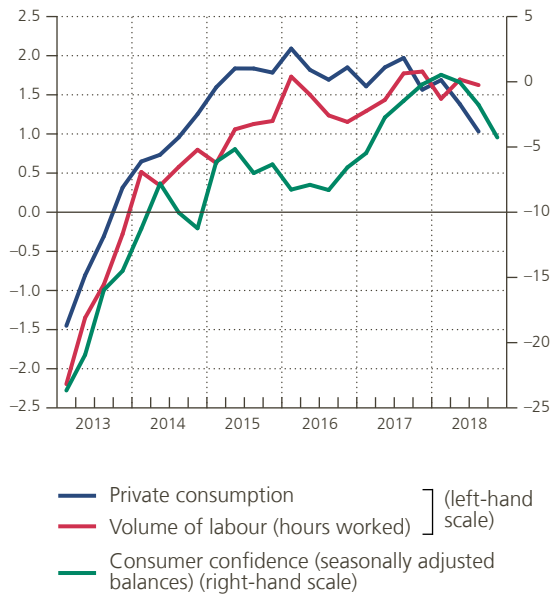


Sources: ECB, Eurostat.
1 Percentage change compared to the previous year.

Chart 6

Private consumption was supported by the favourable labour market conditions and strong consumer confidence

(percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources: EC, ECB, Eurostat.

multinationals' business. In contrast, growth came to only 1 % in Italy.

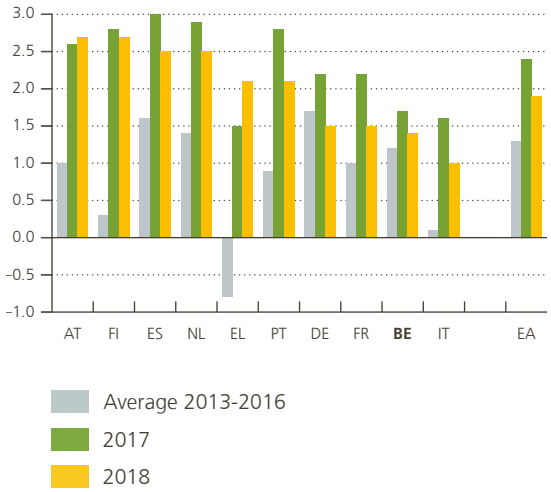
In 2018, growth in most of the euro area countries was slightly weaker than in the previous year, as it was for the euro area as a whole. This was true of the largest euro area countries, among others. The German economy with its strong export focus faced weaker foreign demand. Moreover, the country's car makers had to contend with bottlenecks in the third quarter, owing to new, more stringent emissions tests which considerably restrained vehicle production and exports. Residential investment however remained vigorous in Germany. In France, growth was hit by some one-off factors such as abnormal weather conditions, strikes and protests against fuel price increases. Both investment and exports recorded slower growth. However, imports slackened even more sharply so that the contribution of net exports to GDP growth increased. In Italy, the expansion of domestic demand decelerated, one reason being the modest private consumption. In addition, the rate of export growth slowed significantly.

In contrast, in a number of euro area Member States, including Austria and Finland, growth remained more or less steady. In Greece, the recovery which had begun in 2017 continued, and economic growth bounced back to 2.1 % in 2018. This marked the end of the deep depression, in which GDP had dropped by around a quarter. After several years of reforms which have strengthened the economy, the third adjustment programme ended in August 2018.

Chart 7

Economic activity is expanding in all euro area countries [1]

(real GDP, percentage changes compared to the previous year)



Sources: ECB, Eurostat, NBB.
1 The chart shows only a selection of euro area countries.

Continuing improvement in the labour market

The revival in economic activity was reflected in a further improvement in the labour market. The number of people in work thus rose by 1.4 %, so that the strong job intensity of growth evident in recent years has been maintained. At the end of the third quarter of 2018, the euro area thus had around 158 million people in work, roughly 3.6 % more than in 2007, on the eve of the economic and financial crisis. The repercussions of the crisis have

also been overcome as regards the total number of hours worked: after having dropped by around 7 % during the crisis and in its aftermath, in 2018, the volume of labour regained a level close to the 2007 average.

In 2018, unemployment maintained the downward trend which had begun in mid-2013, dropping to 7.9 % of the labour force in November. In that context, the unemployment rate of young people and that of long-term job-seekers, i.e. those unemployed for a year or more, also declined. In addition, various indicators measuring under-utilisation on the labour market in broader terms pointed to a further improvement in 2018. This concerns for instance the number of under-employed part-time workers and people available for work but not (or no longer) looking for a job (referred to as "discouraged"). Furthermore, the proportion of inactives – people who do not work and do not want a job – in the working age population continued to fall, the main reason being the higher labour market participation of those in the 55-64 age group.

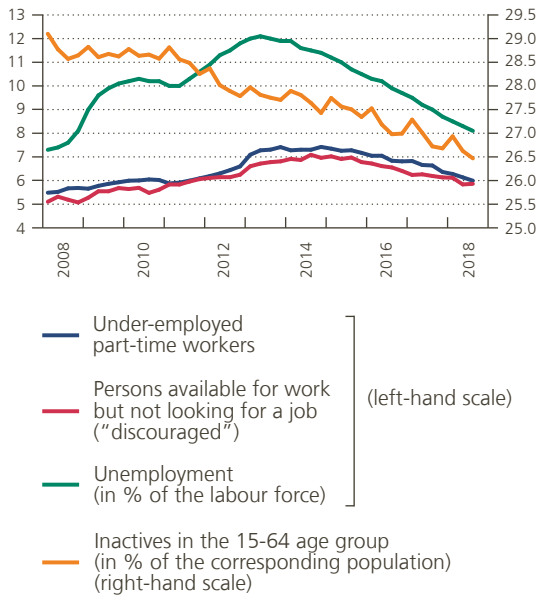
There has been a widespread improvement in the labour market throughout the euro area. In 2018, there was net job creation in almost all countries and unemployment declined everywhere. However, in some countries, including Greece, Spain and Italy, between 10 % and 20 % of the labour force were still looking for work. In contrast, the unemployment rate was below 5 % in other countries, such as Germany, the Netherlands and Austria. Thus, labour market pressures increased in various countries as a result of shortages. The rise in unfilled vacancies in 2018 thus revealed a growing scarcity of labour in some euro area Member States, in specific branches of activity or for particular job profiles. Business leaders in some countries, especially Germany, where construction is the main sector concerned, but also in the Netherlands and Belgium, among others, therefore expressed mounting concern over the availability of labour, considering that this factor could depress the growth outlook. In France, where unemployment remains relatively high, shortages of highly-skilled labour are also reported.

There has been a widespread improvement in the labour market in the euro area

Chart 8

Under-utilisation on the euro area labour market is diminishing

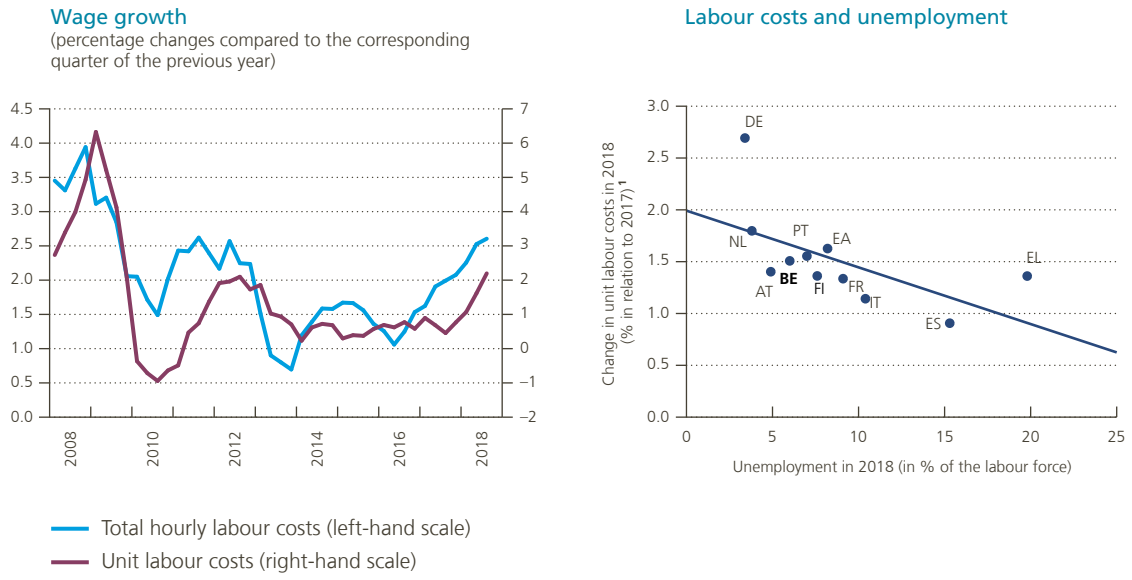
(millions of persons, unless otherwise stated)



Source: Eurostat.

Chart 9

Wage growth is accelerating but remains moderate



Sources: ECB, NBB.
1 Average of the first three quarters of 2018 compared to the corresponding period of the previous year.

Economic growth and the steady improvements in the labour market, causing shortages in certain segments, has led to accelerating labour costs in the euro area in recent years. More particularly, the rise in labour costs has tended to strengthen since employment and unemployment reached a turning point in 2013. Nonetheless, the rate of increase in labour costs per hour worked was limited to around 2.5 % year-on-year in the third quarter of 2018, representing a very small real rise in the context of inflation running at around 2 %. Moreover, the faster rise in hourly labour costs was largely offset by the improvement in productivity up to 2017, so that unit labour costs – which are a key determinant of core inflation – only began rising a little faster at the beginning of 2018. In the third quarter of 2018, those costs were around 2 % higher than a year previously.

The acceleration of the rise in unit labour costs also affected most of the euro area Member States, albeit in varying proportions. For instance, it was no more than around 1 % in some countries with high unemployment, such as Italy and Spain, while it reached 2.7 % in Germany, where unemployment has dropped to a low point and labour market shortages have become more acute.

The ECB Governing Council is more confident that inflation will steadily converge towards the aim

The steeper rise in production costs in the euro area during 2018 was not clearly reflected in the movement in consumer prices. While total inflation climbed from 1.5 % in 2017 to 1.8 % in 2018, the upward pressures originated largely from external sources. They mainly affected the most volatile components of inflation, namely energy and food. Core inflation remained at around 1 % in 2018.

Despite this weak rise in consumer prices, the ECB Governing Council became steadily more convinced that inflation was on a sustained path towards a level which it considers compatible with price stability, namely below, but close to, 2 %. This conviction is based on the fact that, as shown by various recent

studies by the ECB and the Bank [1], rather than being due to a downward revision of the trend inflation as perceived by the economic agents, the low inflation in the euro area is due mainly to real factors.

That is reassuring for two reasons.

First, it suggests that the euro area is not in a situation where a downward revision of inflation expectations would trigger a self-perpetuating low inflation process which would cause a long delay in returning to the central bank's aim. The prevalence of real factors instead implies that the likely situation is one in which increased use of the production factors will ultimately drive inflation towards the ECB's aim, which remains the anchor point for price-setting.

The cyclical upturn in the euro area has led to steady strengthening of wage dynamics

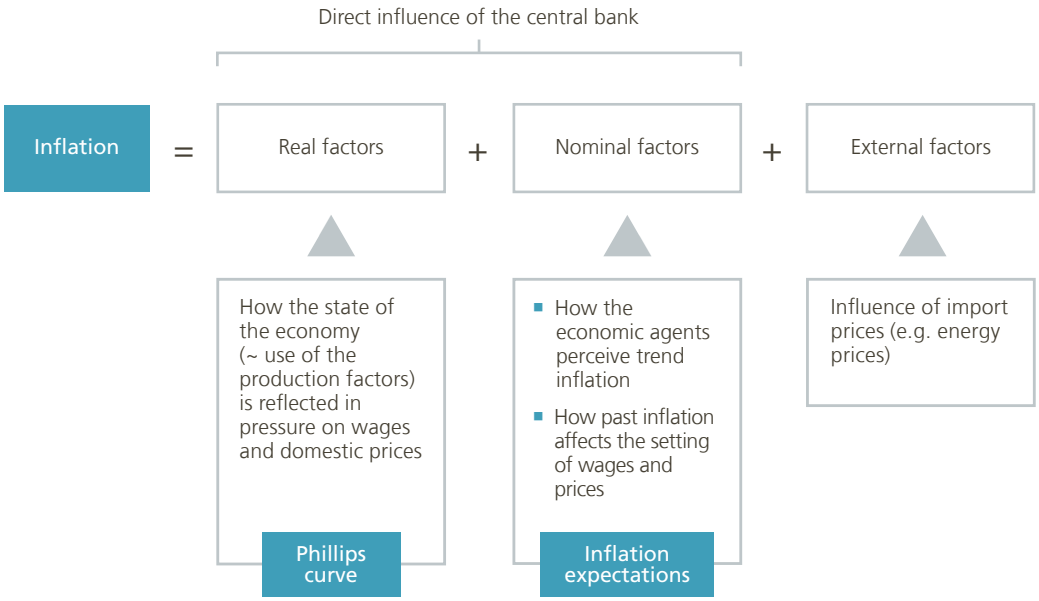
Also, the cyclical upturn in the euro area – although hesitant – has led to a gradual tightening of the labour market and steady strengthening of wage dynamics. This indicates that the ripple effects of activity on inflation – according to the Phillips curve model – are gradually getting going (again). In that context, although firms might initially cut their profit margins temporarily in the face of rising labour cost pressures, they will eventually raise their selling prices to avoid structural impairment of their profitability.

In general, this process takes time to develop. However, it has been unusually slow on this occasion, possibly because of the reforms and structural changes taking place in the euro area in recent years. They may have raised the level of potential supply in the economy, so that there is still scope for a further increase in the use of the production factors, despite the expansion of activity which has already been achieved. In addition, greater flexibility in the way that

1 For more information, see Ciccarelli M. and C. Osbat (2017), *Low inflation in the euro area: Causes and consequences*, ECB, Occasional Paper Series n° 181; Cordemans N. and J. Wauters (2018), "*Are inflation and economic activity out of sync in the euro area?*" NBB, Economic Review, June, 79-95; Stevens A. and J. Wauters (2018), *Is euro area lowflation here to stay? Insights from a time-varying parameter model with survey data*, NBB, Working Paper Research n° 355.

Chart 10

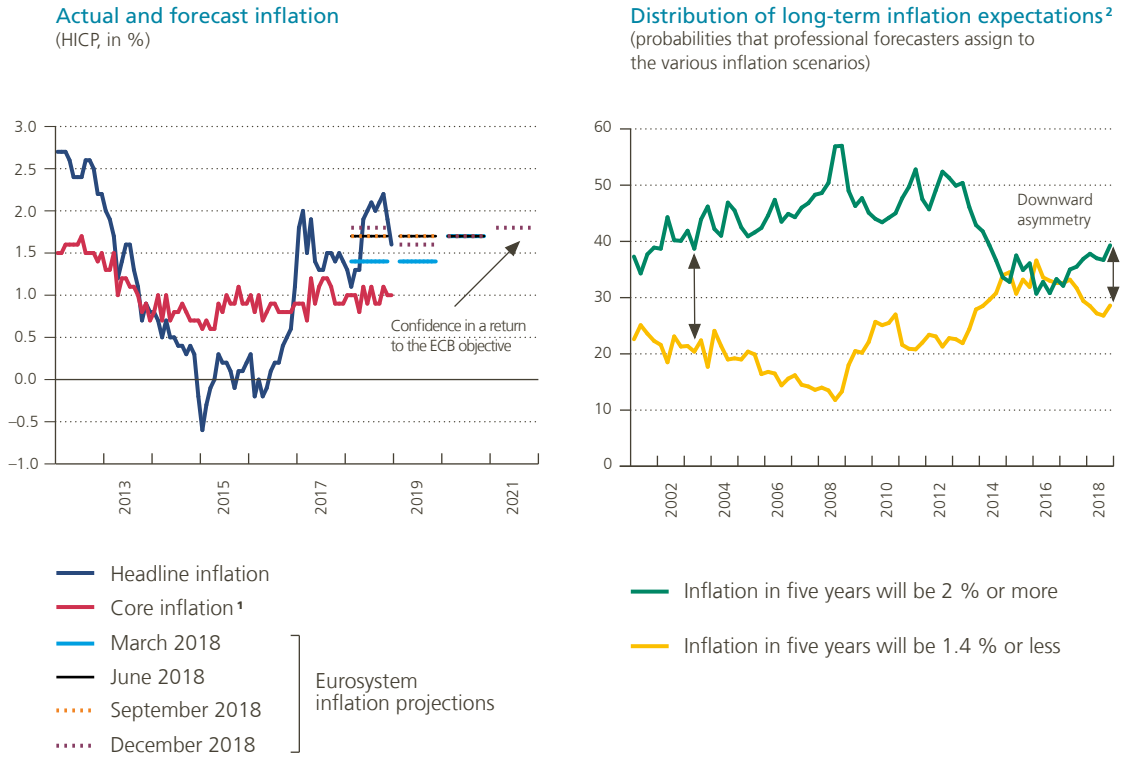
Schematic breakdown of the inflation process



Source: NBB.

Chart 11

Growing confidence in the progressive convergence of inflation towards the aim despite downward asymmetry in long-term inflation expectations



Source: ECB.
1 Headline inflation excluding energy and food.
2 Inflation expectations at five years. Data taken from the ECB's quarterly survey of professional forecasters.

markets function may mean that this residual under-utilisation of production capacity will curb inflation to a greater extent, as the downward pressures on prices and wages are more marked than previously. Finally, the long period of inflation below 2 % may have caused employers and workers to take more account of recent inflation when setting prices and negotiating wages, which could mean that it takes inflation even longer to get back on target.

Although this convergence is taking place more slowly, the conditions therefore exist for the inflation path to return to the ECB's aim in a sustainable manner. For instance, the professional forecasters' average expectations for inflation five years ahead were in the region of 1.9 %, which was comparable to the pre-crisis level. However, the uncertainty surrounding the expectations has not yet entirely returned to normal: according to the forecasters, the likelihood of a low inflation regime (i.e. of 1.4 % or less) is still relatively high in comparison with the pre-crisis period, though it has declined from the 2015-2016 peak as the risk of deflation has faded. At the same time, forecasters are also less inclined than they were before the sovereign debt crisis to bet on long-term inflation of 2 % or more. That downward asymmetry of long-term inflation expectations is unsurprising after several years of low inflation. But vigilance is still required: if that asymmetry were to persist, it could jeopardise the firm anchoring of inflation and hence its sustained approach to the objective.

More generally, the Eurosystem's quarterly projections confirm that inflation is gradually converging on levels closer to 2 %. Since the June 2018 exercise, they see headline inflation stabilising at around 1.7 % in the period from 2018 to 2020. For 2021, the estimates in the December exercise predict that inflation will rise to 1.8 %.

In this context, the previous stimulus measures were adjusted in 2018

The steep fall in inflation since 2009 and the associated deflation risk had prompted the ECB Governing Council to adopt a number of non-standard measures to ease the monetary policy stance in the euro area. The key interest rates were lowered, leading to a negative deposit facility rate. In January 2015, it was decided to embark on large-scale purchases of public and private sector securities under the expanded asset purchase programme (APP). The Council had initially stated that it would carry out monthly purchases until the rise in prices converged sustainably on the aim, thus establishing an explicit link between the execution of the programme and the movement in inflation. It had also said that it would hold the key interest rates at historically low levels until well beyond the period set for the net asset purchases. It thus gave clear indications of future monetary policy. That forward guidance concerned both the horizon of the purchases and that of the key interest rates.

These various measures, including the communication relating to them, were recalibrated on several occasions according to the progress of inflation. Given the growing confidence that the economic recovery would result in sustainable – albeit gradual – convergence of inflation towards the objective, the Council made further adjustments to its main stimulus measures during 2018.

The normalisation of monetary policy will be guided by patience, persistence and prudence

First, it phased out the net asset purchases, indications of their probable termination having been communicated at the beginning of the year and the intentions confirmed when it became apparent that the inflation prospects remained resilient. The net purchases thus declined from € 30 billion a month in January 2018 to € 15 billion a month in the period from October to December, before ceasing at the end of December 2018.

Next, more detailed information was given on the future path of the key interest rates: it is now established that they will remain at their historically low levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation towards levels below, but close to, 2 % over the medium term.

Finally, the intention to reinvest the amounts redeemed on the maturing securities acquired under the APP beyond the net purchase phase was confirmed, and the forward guidance on that reinvestment was reinforced. The reinvestment is to continue for an extended period after the date on which the Council begins raising the ECB's key interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and a high degree of monetary support.

These decisions herald a progressive and predictable "normalisation" which guarantees the persistence of a high degree of monetary support

A significant degree of monetary stimulus remains necessary, given that it is taking longer than in the past for economic activity to be reflected in inflation, there are still risks associated with the downward asymmetry of long-term inflation expectations, and widespread uncertainty has resurfaced at international level. Also, monetary policy has to be adjusted gradually and predictably, because the unwinding of the non-standard monetary easing measures which had been adopted since 2014 means venturing into unknown territory, for both policymakers and financial markets. An excessively abrupt normalisation could increase the risk of persistently higher financial volatility, already fuelled by international factors. In these circumstances, an approach guided by patience, persistence and prudence should permit the development of sound inflation dynamics.

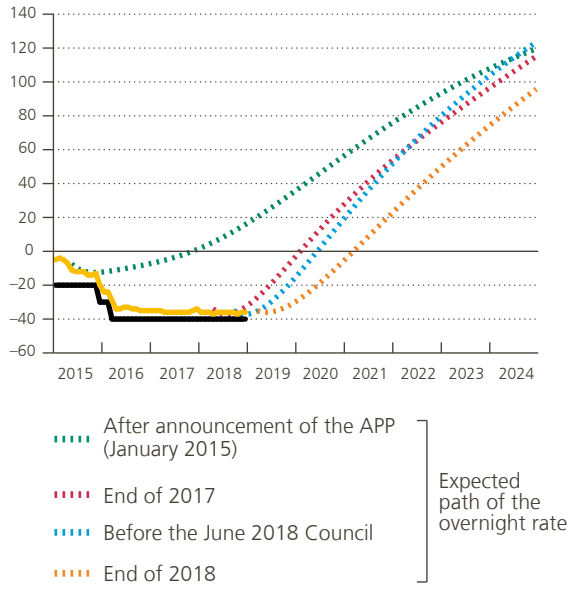
In practice, the normalisation of monetary policy implies assigning a bigger role to the key interest rates among the instruments steering the Eurosystem's monetary policy. In that context, in parallel with the phasing out of the net asset purchases in 2018, the forward guidance on interest rate policy focused directly on the future path of the key interest rates, rather than being linked to the purchase programme schedule as it was previously.

There are two aspects to this guidance. One: the schedule – the key interest rates will remain at their current levels until at least the summer of 2019 – is an anchorage point for the expected

Chart 12

The indications on the future path of the key interest rates and reinvestments guarantee the continuation of monetary support

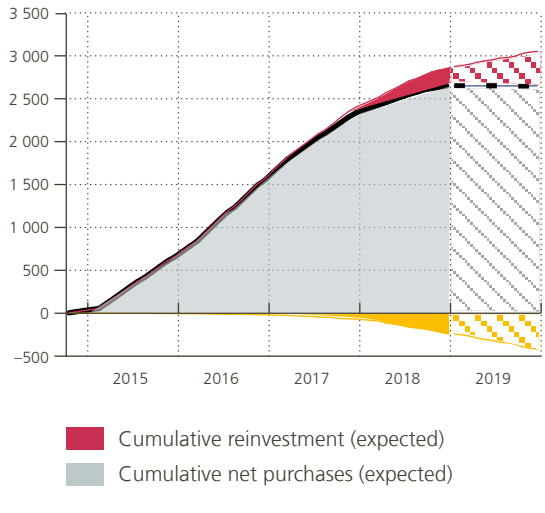
Deposit facility rate, overnight money market rate and projected path of overnight rates[1]
(basis points)



Forward guidance on the key interest rates (since 14 June 2018)

"The key ECB interest rates will remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2 % over the medium term."

Size of the portfolio of securities purchased under the APP and projection 12 months ahead[2]
(€ billion)



Forward guidance on reinvestment (since 13 December 2018)

"The reinvesting is set to continue for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation".

In any event, the Governing Council stands ready to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards its aim in a sustained manner.

Sources: ECB, own calculations.

1 On the basis of the implicit forward overnight interest rate derived from Eonia swap interest rates at varying maturities.

2 Cumulative net purchases and the outstanding amount of the portfolio are calculated on the basis of the monthly net purchases at their book value; they therefore take no account of the amortisation of securities. The cumulative reinvestments are estimated on the basis of the total redemptions each month. In practice, the Eurosystem can reinvest the maturing principal during the month when redemption takes place or in the following two months.

future path of the key interest rates. The other: the link between the key interest rates and attainment of the inflation aim – the key interest rates will remain at their current levels for as long as necessary to ensure the continued sustained convergence of inflation towards levels below, but close to, 2 % over the medium term – introduces an automatic stabilising factor.

In this way, as economic agents' expectations take account of the fact that the Governing Council adapts the path of the interest rates according to the (expected) progress of inflation in relation to the aim, a downward revision of the inflation outlook will cause them to postpone the expected timing of the rise in the key interest rates. This simple expectation that the period of low interest rates will be extended implies a monetary easing influencing economic agents' decisions on consumption and investment, which helps to neutralise the initial deterioration in the outlook.

In any event, the Governing Council stands ready to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards its aim in a sustained manner.

The acquisition of new bonds to replace maturing securities in the Eurosystem portfolio is another key element of the gradual normalisation of the monetary policy stance. This reinvestment, which began to be stepped up in 2018, ensures the prolonged presence of the Eurosystem on the markets: the stock of securities on its balance sheet will be held constant at € 2 570 billion. This means that the Eurosystem will remain a significant purchaser of long-term assets, and that will help to continue exerting sustained pressure on yields at these maturities. In other words, the purchase programme is far from over.

In addition, the fact that the duration of the reinvestment policy is linked to the timing of the rise in the key interest rates reinforces the automatic stabilisation mechanism. Any expectation of a delay in raising the key interest rates also implies that the size of the Eurosystem's asset portfolio will be maintained for longer, and thus exerts additional downward pressure on yields. That therefore results in correspondingly greater easing to address any undesirable developments concerning inflation.

Monetary and financial conditions have remained relatively favourable

In 2018, the consolidated balance sheet of the Eurosystem continued to expand as a result of additional net purchases. That growth was only very slightly curbed by the first voluntary repayments, from June onwards, of funds which euro area banks had obtained under the second series of targeted longer-term refinancing operations (TLTRO II)[1] and by the expiry in September of the first series of operations of that type (TLTRO I)[2].

The liquidity that euro area credit institutions held with the Eurosystem stabilised at a high level. In this context of excess liquidity, the overnight money market rate – Eonia – remained a few basis points above the deposit facility rate. It thus remained negative throughout 2018, keeping the cost of interbank financing at an historically low level.

In general, the forward guidance seems to have been effective in steering the markets. Expectations of the future path of the key ECB interest rates were firmly anchored. For example, they were barely affected by the tightening of financial conditions in the United States. However, during the second half of the year, as a result of the mounting uncertainty over the international environment and the situation in some parts of the euro area, economic agents expected the timing of an interest rate hike to be a little later.

Despite the higher long-term yields on American Treasury bills, medium- and long-term rates also remained low overall in the euro area in 2018, though at the end of the year, they were slightly higher than at the end of 2017. That illustrates the growing divergence between monetary policies on either side of the Atlantic.

On the riskier euro area markets, contagion effects were relatively limited despite outbreaks of uncertainty concerning specific situations. For instance, the volatility of yields on Italian sovereign bonds increased sharply, owing to the escalating political tensions in that country. However, those tensions were barely reflected in the sovereign yields of the other euro area countries,

1 For more information, see Report 2016, pp. 57-58 p. 61.
2 For more information, see Report 2014, pp. 67-69.

including those which proved more vulnerable during the euro area debt crisis. The markets thus recognise that the economies of those countries are more soundly based. In that context, investors' flight to safe-haven securities, particularly ten-year German government bonds, was on a much smaller scale than in the past, though it intensified at the end of the year.

Firms also continued to enjoy favourable financing costs on the markets in 2018, despite some widening of their yield spreads in relation to the risk-free interest rate at the end of the year. Interest rates remained low, both on the bonds of non-financial corporations with a very high credit rating and on those of other corporate bond categories. While the sizeable purchases made by the Eurosystem since June 2016 under the programme for purchasing securities of the non-financial corporation sector exerted direct pressure on yields in the case of the former, that effect continued to be transmitted to the latter via the ongoing adjustments to private investors' portfolios.

The euro has fallen steeply against the United States dollar since the spring of 2018, mainly on account of rising yields across the Atlantic. However, against a broader basket of currencies, the euro was under upward pressure, due primarily to the turbulence in some emerging countries.

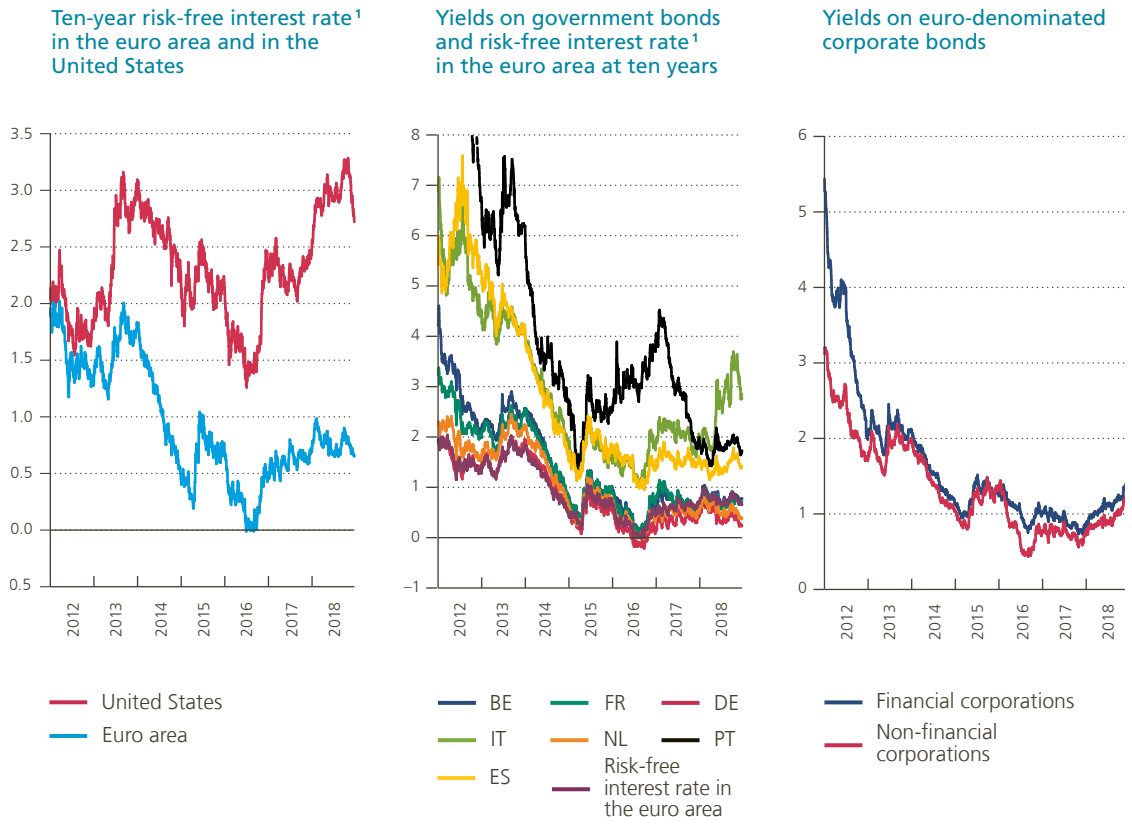
Lending continued to pick up

Although market-based funding is gaining ground, the banking sector still performs a fundamental

Chart 13

Relatively low volatility and contagion effects in nominal yields

(in %)



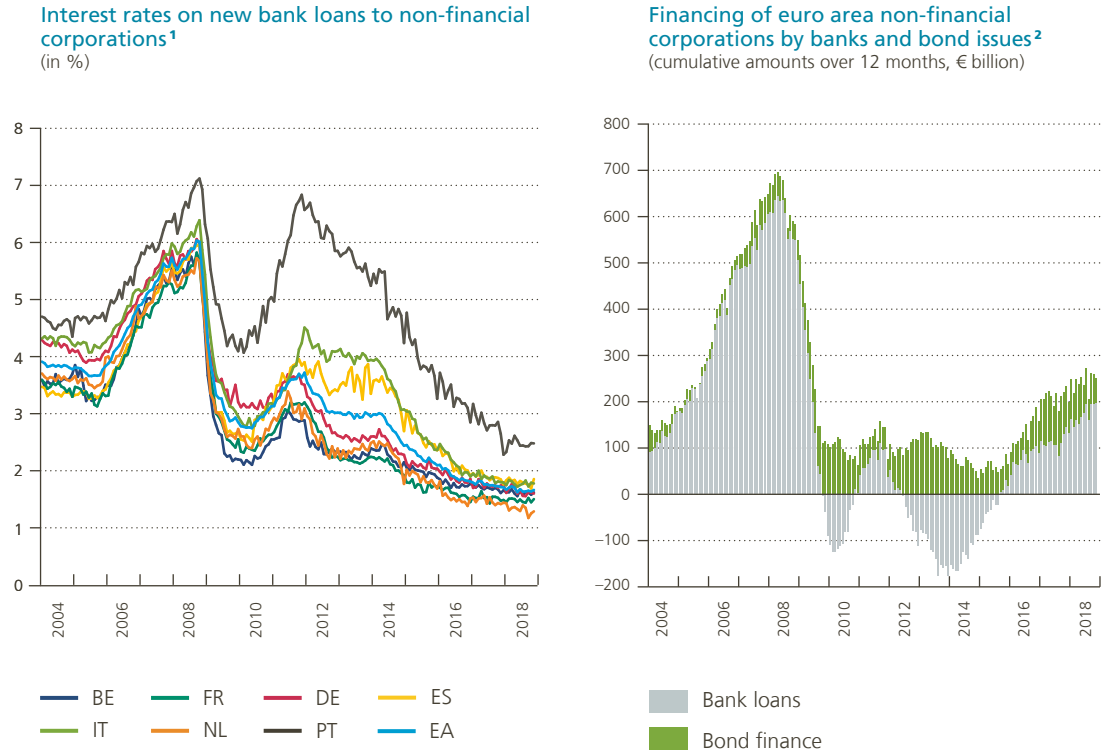
Sources: Bloomberg, Thomson Reuters.

1 For the euro area, Eonia swap interest rates; for the United States, interest rates on federal funds swap rates.

Chart 14

Lending to non-financial corporations continues to pick up

(in %)



Source: ECB.

1 Taking all maturities together.

2 Taking all maturities together. Bank lending volumes are adjusted for securitisation.

role in financing the euro area's economy. It continued to pass on the flexible stance of monetary policy to the real economy. Despite some tension concerning the cost of market-based financing for the banks, the interest rates on bank loans to households and businesses continued to decline, or at least remained very close to their historical low points. The Bank Lending Survey (BLS) also shows that the banks further eased their criteria for lending to firms and households, usually as a result of fiercer competition and attenuation of their risk perception.

This low interest rate environment continued to bolster the growth of demand for loans. Lending by the banks to households and non-financial corporations thus maintained its upward trend, although the dynamics still remain rather weak in some peripheral countries. The strength of bond issues was another source of support for the funding of non-financial corporations.

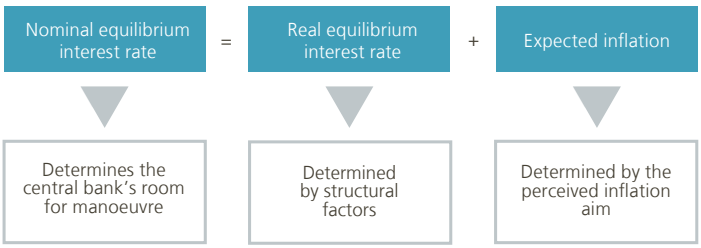
Although lending is rising steadily, it does not currently seem to harbour widespread risks to financial stability. The Eurosystem and the national authorities nevertheless continue to keep a close watch on those risks from a prudential angle. In that connection, some jurisdictions (including Belgium) have, for example, adopted (macro)prudential measures to address specific vulnerabilities detected on local markets, in most cases in the residential property sector.

Future room for manoeuvre in monetary policy

The year 2018 thus marked the start of a gradual and predictable normalisation of the monetary

Chart 15

Monetary policy room for manoeuvre



Source: NBB.

policy stance. In the case of both the key interest rates and the reinvestment of maturing securities, this process is explicitly linked to attainment of the inflation aim. Thus, the Governing Council reaffirmed its commitment to its price stability mandate in a context in which it takes longer than previously for the economic recovery to be reflected in prices, and where downside risks to the macroeconomic outlook exist.

It is also necessary to safeguard price stability in the medium term to ensure that monetary policy has sufficient room for manoeuvre in the future. As the nominal interest rate is the traditional lever that the central bank can use to stabilise the economy in the face of cyclical shocks, an adequate downward margin must be available for that instrument to continue operating in periods of sluggish activity.

Since the nominal equilibrium interest rate is determined jointly by the real equilibrium rate – which aligns the supply of savings with demand for investment – and by expected inflation, firm anchoring of inflation expectations at below, but close to, 2 % helps to keep the nominal interest rate clear of its lower bound of around 0 %, thus reducing the risk

of having to resort to non-standard instruments at times of impending severe economic turbulence.

It is necessary to continue with economic reforms in order to limit the situations in which monetary policy has to be highly accommodative

This contribution to price stability is all the greater as the real component of the nominal equilibrium interest rate is likely to remain small in the future. This downward trend in the real equilibrium interest rate is due to global structural factors supporting the supply of savings and/or depressing demand for investment, such as population ageing. Since the real equilibrium interest rate is determined by structural factors, the role of the other policy areas also becomes essential.

On the one hand, deeper structural reforms – capable of dealing with the gap between the supply of savings and demand for investment – are needed to boost the real equilibrium interest rate. But it is equally essential to pursue policies which can limit the occurrence of scenarios in which monetary policy would have to be highly accommodative if it were the only policy area that could mitigate the consequences of a severe negative shock. In that regard, both microprudential and macroprudential policies – which augment the financial system's resilience to shocks – and initiatives in the direction of deeper Economic and Monetary Union (EMU) – strengthening the fundamentals of the economic system in the broad sense – have a role to play. Moreover, the maintenance of sound public finances will ensure that fiscal policy retains sufficient scope to act alongside the central bank in the event of a future crisis.

BOX 3

The Bank's role in the Eurosystem's monetary policy

The Treaty on the Functioning of the European Union assigned the objective of maintaining price stability to the Eurosystem as a whole. Monetary policy is therefore not a matter for the ECB alone: the Bank also has an eminent role to play, in the same way as the national central banks (NCBs) of the 18 other countries which have adopted the euro. The Bank takes part in the adoption of monetary policy decisions, and in their preparation, as well as in the implementation of the measures approved.

Every six weeks, the Governor of the Bank and his 18 fellow NCB Governors plus the six members of the ECB Executive Board meet in Frankfurt for the ECB Governing Council. These meetings enable them to discuss the risks to price stability in the euro area and to take their monetary policy decisions accordingly. Those decisions are generally adopted by consensus or, if necessary, by a majority vote in accordance with a system of rotating voting rights[1]. NCB Governors each exercise their right to vote in person[2]. They do not formally represent their countries, but act in the interests of the euro area as a whole.

1 For more information on the system of rotating voting rights introduced in 2015, see https://www.ecb.europa.eu/explainers/tell-me-more/html/voting-rotation.en.html

2 See Article 10 of the Statutes of the European System of Central Banks (ESCB) and of the European Central Bank.

These meetings are prepared by various committees comprising staff of the ECB and the NCBs, including the Bank. The committees constitute forums for discussion and an exchange of views on the various aspects of the conduct of monetary policy. For example, this is the framework within which the Bank's staff contribute to the production of the Eurosystem's macroeconomic projections, a key input in the Council's deliberations. In addition, to prepare him to take part in Council debates, the NBB's Governor is able to draw upon both the various analyses and research conducted by the Bank's staff and their more specific strategic recommendations.

All in all, these preparations by the Bank's staff therefore promote the quality of the monetary policy debates in the Eurosystem. They offer an additional point of view, supplementing the views derived from the analyses of the ECB and the other NCBs, providing the committees and the Council with food for thought. In producing reliable statistics, the Bank likewise helps to ensure that the monetary policy decisions are based on good-quality macroeconomic indicators.

The Bank also plays a major role in the implementation of the monetary policy measures adopted by the Council: although the implementation guidelines are decided by the Council, the actual implementation is decentralised and delegated to the NCBs. Thus, the Bank conducts all the open market operations with banking institutions resident in Belgium. This includes inter alia the targeted longer-term refinancing operations (TLTRO). Under the expanded asset purchase programme (APP), the Bank's services purchased Belgian public debt securities amounting to a net cumulative total of almost € 66 billion between March 2015 and December 2018, as well as private debt securities. In particular,

from June 2016, the ECB mandated the Bank, along with five other NCBs[1], to make purchases of corporate sector securities on behalf of the Eurosystem. Altogether, these purchases made by the Bank came to around € 40 billion at the end of 2018.

Finally, and this is not the least important task, the ECB counts on the NCBs – including the Bank – to take charge of communication concerning the conduct of the Eurosystem's monetary policy, in order to explain its objectives and actions to a broader public. This aspect of the conduct of monetary policy has become more important since the crisis and the consequent recourse to non-standard monetary policy measures. With its local roots, the Bank is able to adopt the most appropriate way of communicating with Belgium's economic world and the general public.

1 The other NCBs are Deutsche Bundesbank, Banco de España, Banque de France, Banca d'Italia and Suomen Pankki/Finlands Bank.

Continuing consolidation of public finances

The budget deficit of the euro area as a whole declined a little further, from –1 % of GDP in 2017 to –0.6 % of GDP in 2018. As in 2017, this contraction was due to the maintenance of a favourable economic climate and a further fall in interest charges in the context of persistently low interest rates. The structural primary budget balance of the euro area was stable at 1.1 % of potential GDP, pointing to an all-in-all neutral fiscal policy.

The government budget balance improved in most euro area countries; in countries where that was not the case, the balance remained more or less stable, or only deteriorated slightly. The economic climate in fact had a favourable impact in most countries, and the burden of interest charges on the budget diminished almost everywhere. Portugal recorded a notable reduction in its budget deficit, mainly because one-off factors exerted less pressure on the budget in 2018 than in the previous year. Greece recorded a budget surplus and achieved the target of a primary budget surplus of 3.5 % of GDP, required under the enhanced budgetary surveillance of Greek public finances. For the first time since the introduction of the euro, the budget deficit was below the reference value of 3 % of GDP in all euro area countries.

In many euro area countries, the fiscal policy stance was fairly neutral in 2018, as is evident from the rather limited movements in their structural primary budget balance. However, some Member States, including Finland, the Netherlands and Greece, adopted a slightly expansionary policy, while Germany's policy was a little restrictive.

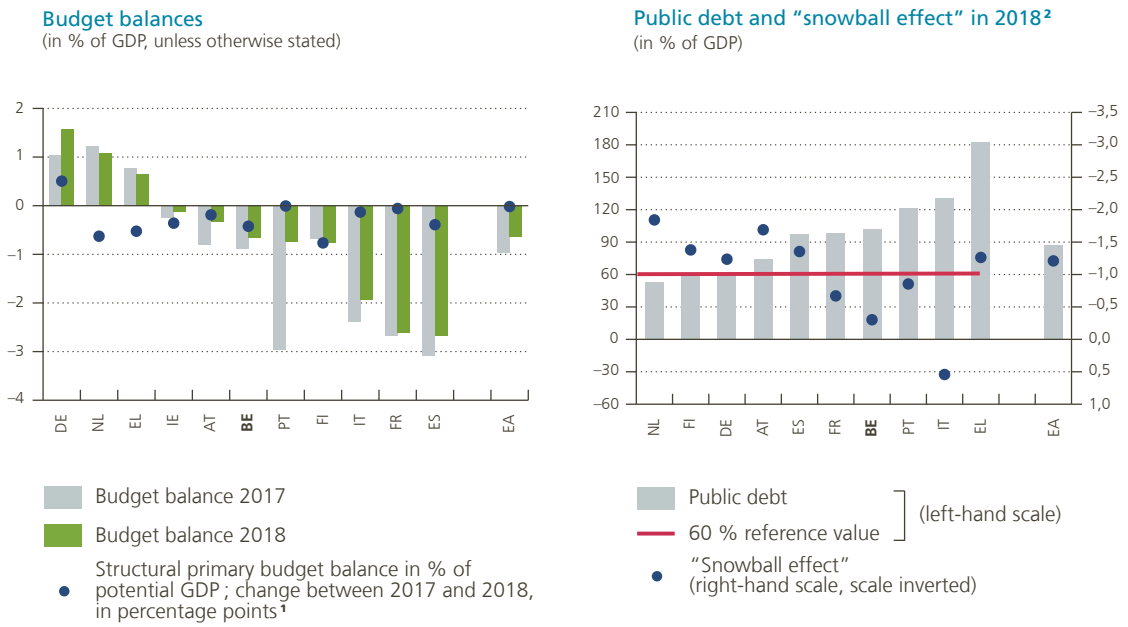
In the euro area as a whole, the public debt expressed as a percentage of GDP declined for the fourth consecutive year, dropping from 88.9 % of GDP in 2017 to 86.9 % in 2018. That improvement is due in equal measure to the primary budget surplus and the "snowball effect", i.e. the impact on the public debt ratio of the gap between nominal GDP growth and the implicit interest rate on the public debt.

In 2018, the public debt ratio declined in most euro area countries. That was due in particular to the "snowball effect", which pushed down the debt ratio everywhere except in Italy, where economic growth remained lower than the implicit interest rate. In seven euro area countries, including the Netherlands, the public debt as a ratio of GDP remained below the 60 % reference value, while in Finland and Germany, it hovered around that value in 2018. At 182.5 % of GDP, the Greek debt ratio remained by far the highest in the euro area.

Among all the euro area countries, only Spain was still subject to an excessive deficit procedure at the end of 2018, under the corrective arm of the Stability

Chart 16

Government budgets continue to improve in the context of a neutral fiscal policy stance and public debt declines



Sources: EC, NBB.

1 A negative sign (deterioration in the structural primary balance) indicates an expansionary fiscal stance.

2 The "snowball effect" measures the effect on the public debt ratio of the gap between nominal GDP growth and the implicit interest rate on the public debt.

and Growth Pact (SGP), as in June 2018 the Ecofin Council decided to end this procedure for France. Consequently, the EU surveillance of public finances is conducted under the preventive arm of the SGP for all Member States except Spain. Greece, which since the end of the third adjustment programme in August has been subject to enhanced budgetary surveillance by the EU, was also reintegrated into the European semester for the coordination of macroeconomic policies.

Under the preventive arm of the SGP, the public finances of the Member States are assessed on the basis of the medium-term objective (MTO). The MTO is a reference value for the structural budget balance specific to each country, which conforms to sound, sustainable public finances. As in 2017, the structural budget balance of various euro area countries, such as Spain, France, Italy, Belgium and Portugal, still failed to achieve the MTO. Those countries therefore need to make an additional effort to attain that objective. Conversely, some other countries, including Germany and the Netherlands, have some fiscal scope since their structural budget balance exceeds the MTO. As already mentioned, the Dutch government used that scope in 2018 to conduct a slightly expansionary policy; in contrast, the structural budget surplus grew larger in Germany.

The consolidation of public finances continued

Following the Italian parliamentary elections in March, the new government questioned the path previously agreed with the EU for consolidating public finances. As a result, there were growing doubts about the sustainability of the Italian public debt, and spreads in relation to the German Bund had widened considerably from May onwards. In November, the European Commission (EC) noted that Italy's draft budgetary plan for 2019 implied a significant deviation from the recommended adjustment path for achieving the

MTO. In November, the EC also launched the first step in the initiation of a new excessive deficit procedure for Italy, due to failure to meet the public debt criterion which stipulates that the 60 %-of-GDP reference value must not be exceeded unless the debt is declining sufficiently and approaching the reference value at a satisfactory rate. However, following intense negotiations with the EC, the Italian government readjusted its draft budget so that the public deficit would amount to around 2 % of GDP in 2019 with no deterioration in the structural budget balance. At the end of December, the Italian parliament approved this amended budget plan which, for the time being, avoided triggering the excessive deficit procedure. The EC also found that the draft budgets submitted by Belgium, France, Portugal, Slovenia and Spain implied a risk that the SGP would not be respected in 2019, as they could lead to a significant deviation from the adjustment path towards the MTO.

Boosting resilience and achieving sustained, stronger growth potential in the euro area

The widespread continuation of the growth in activity, investment and employment in recent years has contributed towards convergence between the euro area countries and has helped to correct the macroeconomic imbalances which had been the fundamental cause of the crisis. Moreover, in contrast to the pre-crisis years, the growth of domestic demand in the euro area countries has not been accompanied – or at least not to the same degree – by a loss of competitiveness or the creation of current account deficits on the balance of payments.

Despite the favourable rebalancing in the euro area, some member countries are still wrestling with the effects of the crisis. For instance, unemployment remains high in some countries such as Greece and Spain, although numerous jobs have been created in recent years in a number of countries, including Spain. Moreover, some euro area countries still have a substantial level of net debt in relation to the rest of the world, even though the significant current account deficits on the balance of payments have been wiped out. What is more, the debts of non-financial corporations or households remain substantial in some Member States, despite declining in recent years. The situation of the euro area banks has improved, but they still need to reduce large amounts of non-performing loans in certain countries. Finally, some euro area countries need to cut their high public debt ratios. These

weaknesses continue to affect the resilience of the countries in question and of the euro area as a whole, and reduce the capacity to absorb future shocks.

In view of the growing uncertainty, notably as regards international trade and Brexit, and the longer-term challenges such as ageing and climate change, the euro area still needs to become more resilient. Hence the need to continue ridding the euro area of the legacy of the crisis and the resulting vulnerability. In all euro area countries, it is also vital to continue building economic structures that function properly and, while strengthening the economic fundamentals, facilitate adjustment processes within the euro area and increase resilience to future crises. That process can also be backed by the EU's initiatives aimed at encouraging structural reforms in the Member States.

The Member States also need to devote efforts to reducing the risks in the financial sector and those facing public finances, so as to create the conditions for further deepening of EMU. In that regard, new steps were taken to strengthen EMU in 2018, but progress was meagre. At the December European Council, it was decided that, for the euro area, the European Stability Mechanism (ESM) would act as a backstop for the banks' Single Resolution Fund, granting it a credit line. Decisions were also taken on other reforms of the ESM, such as the use of the precautionary instruments. In addition, the European Council gave a mandate to devise a budgetary instrument to promote convergence and competitiveness in the euro area. In the future, that instrument is to be included in the EU budget.

The economies need to be made more resilient