REPORT
2019

Preamble

NationalBank
OF BELGIUM
Eurosystem

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

In this report, published on behalf of the Council of Regency, the Governor describes the main economic and financial developments in 2019 and the policy challenges which consequently came to light. The first chapter deals with the slowdown in economic activity in 2019, caused largely by the uncertainty surrounding trade policy. It led to further easing of monetary policy, notably in the United States and in the euro area. Chapter 2 discusses the monetary stimulus in the euro area and explains why a symmetrical approach to the price stability mandate is so important. Chapter 3 examines the optimum economic policy mix in Belgium against the backdrop of the 2019 economic developments and the challenges ahead. There is evidently no scope for a fiscal stimulus, but the impediments to sustainable and inclusive growth need to be eliminated. Chapter 4 analyses the situation in the financial sector and explains how prudential regulation and policy can ensure that the sector remains robust in the face of a persistently low interest rate environment and other structural challenges. The remainder of the National Bank of Belgium's Annual Report provides more detailed information and in-depth analysis on these various subjects.

1. The economy in 2019: declining growth, absence of inflationary pressure and particularly low interest rates

The growth of the world economy dropped to its lowest level since the crisis

1. In 2019, the growth slowdown which had already begun in 2018 persisted in most of the leading economies. Consequently, the global economy expanded by barely 2.9 %. Not only is that lower than the 2017 figure, when growth still came to 3.8 %, but it is also the lowest since the 2008 financial crisis. This growth slowdown affected both emerging and advanced economies, and prompted many central banks – including the Federal Reserve and the Eurosystem – to reverse the monetary policy normalisation process which they had initiated or planned, and to introduce a new round of easing.

2. The sharp deceleration of growth stemmed primarily from the continuing erection of trade barriers between the United States and China, and the ensuing great uncertainty surrounding trade policy and, by extension, the entire global economic and geopolitical order. The United States is also threatening to introduce new customs tariffs on car imports, which would have serious consequences for the European Union. However, at the end of the year the situation eased somewhat, and in December the United States and China concluded an agreement cancelling some of the tariff increases. Brexit was likewise a major source of anxiety throughout the year. Now that the United Kingdom has left the EU, uncertainty persists over the exact scope of a future trade agreement between the two parties, as it is unlikely that a comprehensive free trade agreement can be concluded by

the end of 2020. The tariff increases not only have an impact on the economies directly concerned but also affect third countries involved in the relevant production chains. Moreover, they disrupt the organisation of those chains, already under pressure from technological upheavals and the prospect of more stringent requirements to meet the challenge of climate change. That created a great deal of uncertainty, holding back investment – which is generally very trade-intensive – and exacerbating the more structural trends hampering the global economy, such as weak productivity gains and population ageing. Those factors also apply in many emerging economies which, by the process of catching up, had constituted a powerful engine of growth in the past two decades. In China, in particular, those factors were aggravated by the economy's reorientation towards more consumption, less investment and the reduction in debt leverage effects, primarily in the case of public enterprises. This led to additional pressure on investment, while demand for motor vehicles also declined sharply as the tax incentives for their purchase were abolished.

The sharp decline in growth stems primarily from the great uncertainty over trade policy

3. It was therefore mainly manufacturing industry – especially the production chains for investment goods and motor vehicles – and the associated trade flows that experienced a sharp decline. Conversely, in the services sector, the level of economic activity held up well, so that the labour market remained buoyant, bolstering consumption. Fiscal policy also provided some support, in China as well as the United States, and in the euro area. This divergence between the manufacturing and services sectors was apparent worldwide, although it became less obvious as time went by. On the one hand, towards the end of the year, there were signs that the decline in trade and manufacturing industry had bottomed out. At the same time, there were also signs of some contagion affecting services, the labour market and consumer confidence. While most projections – including those of the Eurosystem – assume that growth will gradually pick up in the years ahead, there are still some downside risks. A resurgence of trade tensions and/or geopolitical tensions could stifle the expected recovery in the manufacturing sector. That would also heighten the risk of more serious contagion in other sectors of the economy and would increase financial market volatility, leading to tougher financing conditions. Throughout 2019, those conditions remained particularly favourable, providing substantial support for domestic demand, as the reversal of monetary policy attenuated the impact of the trade tensions on the financial markets and led to a further easing of financing conditions. That is in marked contrast to the end of 2018, when the financial markets became much more jittery.

Clear impact on growth in the euro area – especially in Germany, to a lesser extent in Belgium

4. In these circumstances, growth in the euro area dipped sharply, from 2.5 % in 2017 to 1.9 % in 2018 and 1.2 % in 2019. This was attributable mainly to the marked deceleration of the German economy, where growth subsided to 0.5 %, the reason being that manufacturing industry and exports play a key role there, to a much greater extent than elsewhere in the euro area. Moreover, the geographical focus of German exports, destined largely for the Chinese market, and the specialisation of German products, heavily dependent on investment goods and motor vehicles, weighed on economic activity. In 2017, these two factors had still been beneficial. Furthermore, the decline in motor vehicle production there was proportionately greater than the fall in global demand for cars. That was due partly to temporary output disruptions, but the drop in demand for German cars was also a factor. At the end of the year, the German motor vehicle sector announced radical restructuring to free up resources for the transition to electric vehicles; previously, the emphasis had been on diesel engines. The German manufacturing industry is a pivotal link between suppliers in the rest of the euro area and the global economy as a whole. Consequently, the loss of momentum in Germany was also reflected in the manufacturing industry of other countries. Nonetheless, business in the euro area – including Germany – was still quite buoyant in the branches of activity geared to the domestic market, and employment continued to expand.

5. In Belgium, there was a somewhat similar but less pronounced growth slowdown. In 2019, growth still came to 1.4 %. The fact that the deceleration was less marked than in the euro area mainly mirrors the moderate growth pick-up to 2 % in 2017. In view of the international environment, the importance of the trade flows with Germany and the heightened uncertainty, manufacturing industry in Belgium also experienced a slowdown. The same was true for exports, and also – albeit to a lesser degree – for business investment. The fact that the ups and downs are less pronounced in Belgium mainly reflects the lesser importance of manufacturing industry in the Belgian economy and, within that industry, the specialisation in sectors where demand is less volatile, such as the pharmaceuticals industry. Economic activity in services and construction remained vigorous and employment continued to grow strongly in 2019, although the labour market did slacken somewhat at the end of the year. Employment was up by 1.5 %, creating over 74 000 new jobs. Combined with the wage rise, the tax cut resulting from the tax shift and the reduction in energy prices, this provided the strongest boost for purchasing power in a long time, namely 2.5 %. Apparently, this mainly reinforced the impact of lower interest rates on residential investment and, owing to the rise in the saving ratio, it had less effect on private consumption, which increased by 1.1 %.

Manufacturing industry plays a less important role in the Belgian economy than in Germany

New monetary policy stimulus to support growth and thus steer inflation towards the target

6. The growth slowdown gradually extinguished the inflationary pressure which was steadily building up in the euro area, and worsened the outlook for a sustained return to the inflation target set by the ECB Governing Council, namely a level below, but close to, 2 % in the medium term. A year earlier, that prospect had triggered the start of normalisation of monetary policy.

7. As the signs of the slowdown became clearer, the Governing Council indicated that it was prepared to adapt all its instruments in order to get inflation back on target. This led to the announcement of a significant set of new measures in September. The deposit facility interest rate was cut by 10 basis points to –0.50 %. The communication on the expected path of the policy interest rates was stepped up considerably by announcing that interest rates could fall further, and by explicitly stating that the timing of the first interest rate rise would depend on inflation making a sustained return to a level sufficiently close to 2 %. That creates a powerful automatic stabiliser which drives down the expected level of interest rates if new downward shocks were to cause further delays in inflation convergence, but which also works in the opposite direction in the event of positive developments. In addition, net asset purchases were resumed at the level of € 20 billion per month. This new package of measures, and the anticipation of it, exerted further downward pressure on both short- and long-term interest rates in the euro area, so that the risk-free yield curve largely returned to negative territory. The same was true in Belgium, where the ten-year interest rate on government bonds was predominantly negative in the second half of the year.

Enhanced communication on the expected path of the key interest rates creates a powerful automatic stabiliser

8. In the United States, too, inflation was below the Federal Reserve's target of 2 % in 2019. Despite a still relatively buoyant economy, it was this decline in inflation and the essentially negative risks from the international environment that prompted the Federal Reserve to cut its key interest rates on three occasions in 2019, whereas at the beginning of the year, the cycle of rate increases had been expected to continue. The Federal Reserve intends this to create a margin in the event of negative shocks, notably by ensuring that inflation expectations remain anchored at 2 %. This reduction in policy interest rates and the slight rise in long-term rates at the end of the year accompanying the first signs of bottoming out ended the inversion of the yield curve in the United States. Earlier in the year, that inversion had fuelled fears of a recession.

2. Price stability: close-up on monetary stimulus in the euro area

Symmetry of the inflation target: why low inflation is also a problem

9. Over the past 50 years, central banks' endeavours to achieve price stability have focused mainly on combating excessive inflation and creating an environment of low and stable inflation, generally around 2 %. As the stagflation of the 1970s (high inflation accompanied by weak and volatile economic growth) had highlighted the distortions that escalating inflation engenders in the economy, that aim steadily gained widespread support. Not only has inflation itself become less volatile, but economic activity and employment have also become more stable as a result. However, since the financial crisis, inflation has tended to fall short of the target. The fact that high inflation is damaging does not necessarily mean that particularly low inflation is good for the economy. For instance, low inflation does not imply an increase in purchasing power if it is the symptom of a fragile economy. In those circumstances, it also fails to foster the smooth adjustment of relative prices and wages. The same applies if it is due to declining inflation expectations. Those are precisely the main factors operating in the euro area.

The fact that high inflation is detrimental does not mean that very low inflation is necessarily good for the economy

10. Core inflation, which excludes prices of energy and food, remained stable again in 2019 at around 1 %. However, wage increases had already accelerated owing to the strong job creation in recent years. Nevertheless, this cumulative cost pressure was not reflected in prices, probably because the growth slowdown eroded the scope for passing it on. Moreover, if this slowdown were to have an impact on the labour market, too, then wage rises could become smaller again, further compromising the revival of inflation. The slow pace of inflation convergence so far also lowers inflation expectations, and that is in turn an additional obstacle. It means that real interest rates are higher so that a given monetary policy stance provides less of a stimulus, whereas in the current circumstances that is precisely a key factor for continuing to support domestic demand and protecting it against the uncertainties associated with the international environment. Higher inflation therefore needs to be achieved via support for the economy and employment, steering them towards full use of the factors of production, and that support, in turn, will benefit from inflation expectations that are firmly anchored.

Higher inflation needs to be achieved via support for the economy and employment; that support will itself benefit from firmly anchored inflation expectations

11. If the economy were to languish in a low inflation environment in the long term, that would give rise to a number of permanent complications. First, in such a context, inflation cannot fully perform its role of lubricating the machinery of the economy. A slightly positive inflation rate – of 2 %, for example – in fact facilitates the adjustment of both real wages and relative prices, and that facilitating effect is liable to be lost. Moreover, the economy will then drift permanently towards a low interest rate environment, with nominal interest rates stuck at a low level owing to the decline in inflation expectations. That would perpetuate the pressure on pension funds and the life insurance sector, for example, since their commitments are often expressed in nominal terms. For the central bank, this means that – starting from a lower neutral interest rate – there is less scope available for cutting interest rates in the event of a recession. That makes it harder to support the economy, and requires more frequent use of non-standard monetary policy instruments. To sum up, in order to avoid making it harder to absorb future shocks, excessively low inflation must also be tackled. The pursuit of price stability therefore calls for a symmetrical approach.

Subsiding into a low inflation regime perpetuates the low interest rate environment and reduces the necessary scope for absorbing a recession

Negative interest rates and bank transmission: could the monetary stimulus become counterproductive?

12. Since the persistence of low – or even negative – interest rates puts pressure on banks' interest margins, there is a danger that they might no longer be able to transmit the monetary policy stimulus. The pressure originates mainly from the banks' difficulty in passing on negative interest rates in their retail deposit rates. That could create a situation in which interest rates on new loans ceased to fall, or in which banks were actually obliged to reduce their lending because of declining profitability. Once that point is reached, any additional easing of monetary policy becomes counterproductive for transmission via the banks, and the key interest rate reaches its effective lower bound. However, there is no sign that this is happening already. In 2019, interest rates on loans to non-financial corporations and households continued to fall, while lending continued to expand, both in the euro area as a whole and in Belgium. In addition, there is little evidence of tighter credit conditions due to balance sheet considerations. It was precisely in order to avert those effects that the ECB's September decisions included two measures to support bank-based transmission. First, a part of the reserves that banks hold with the Eurosystem is now exempt from the negative interest rate on the deposit facility. Second, a new series of targeted long-term refinancing operations was launched. In addition, the pressure on the interest margin was eased by the sharp decline in the cost of market financing and by the fact that a growing number of banks gradually started passing on the negative interest rate, particularly on non-financial corporations' deposits.

13. There are other factors which may also render the monetary stimulus counterproductive, as the stimulus may encourage excessive risk-taking and jeopardise financial stability. For example, the banks might decide to preserve their interest margin by granting loans with a riskier profile. As explained below, those risks call for constant vigilance and, in some cases, targeted action by the prudential authorities, and especially on the part of macroprudential policy. Such measures do not counteract monetary policy, because macroprudential and monetary policies are largely complementary. It is precisely because macroprudential policy aims to attenuate the secondary effects of the low interest rate environment that monetary policy can focus on the macroeconomic impact on growth and inflation. Macroprudential policy also has the advantage of being able to target either certain segments of the financial system or certain euro area countries where the risks are multiplying, whereas monetary policy cannot be differentiated. Were the risks for financial stability to become so widespread that they could no longer be controlled by targeted macroprudential measures, then monetary policy would be an appropriate instrument. In that case, pursuing a less accommodative monetary policy with a view to financial stability is not necessarily at odds with the price stability objective, as financial instability would in fact have serious repercussions on economic activity, and hence on inflation. However, in the current circumstances, macroprudential policy is still able to mitigate the risks sufficiently so that the monetary stimulus can be maintained without becoming counterproductive.

Macroprudential and monetary policies are largely complementary

Low interest rates: driven principally by structural factors which are beyond the control of monetary policy but which make it harder to conduct monetary policy

14. The main reason why – notwithstanding the cyclical motivation of easing – monetary policy is obliged to set negative interest rates is the downward trend in the real equilibrium interest rate, as monetary policy only provides a stimulus if it can cut real interest rates below that level. This equilibrium interest rate is in turn the outcome of the structural determinants of

Higher savings face insufficient investment opportunities and tend to drive down the equilibrium interest rate

saving and investment. Weak productivity growth, population ageing, rising income and wealth inequality at global level, heightened uncertainty over intended policies and strong risk aversion are all factors which mean that there are insufficient investment opportunities for the higher savings, so the result is a downward trend in the equilibrium interest rate. Demand for risk-free financial assets is particularly high, whereas the supply of those assets – especially in the euro area – has dwindled since the financial crisis because the rating of many governments has been downgraded. Consequently, the downward pressure on risk-free interest rates far exceeds the pressure on yields in the case of riskier portfolio investment or real investment.

15. Monetary policy has little control over the factors driving down the real equilibrium interest rate, yet that fall has serious consequences for monetary policy: it reduces the available scope for conducting an expansionary monetary policy, as the policy interest rates will more quickly reach their effective lower bound. That strengthens the above-mentioned argument in favour of a strictly symmetrical approach to the pursuit of price stability. Allowing inflation to remain below the objective for a prolonged period would further reduce the room for manoeuvre. But at the same time, the low real equilibrium interest rate makes it more difficult to implement that symmetrical approach. In coming up against the effective lower bound sooner, monetary policy will have more difficulty in stimulating inflation where necessary. This paradox is one of the starting points for the review of the monetary policy strategy to be undertaken by the Eurosystem in 2020. Whether the current formulation of the definition of price stability unnecessarily hampers efforts to achieve symmetry is one of the questions to be addressed. It is also necessary to take stock of the new instruments introduced since the crisis. In addition, examination of the way in which structural trends such as population ageing, inequality, digitalisation or – in the future – climate change influence the inflation process – either directly or via their impact on the equilibrium interest rate – will permit consideration of how best to implement the price stability mandate from now on, a mandate which the Treaty on the Functioning of the European Union defines as the primary objective of monetary policy. Another point to be examined is whether monetary policy can, without prejudice to its primary objective, also promote other objectives such as the attenuation of climate change. The monetary policy strategy review is all the more necessary since the strategy was last reviewed in 2003, whereas there have been considerable changes since then in the functioning of the economy – and in particular the inflation process – and the financial system.

The low equilibrium interest rate is one of the starting points for the assessment of the monetary policy strategy in 2020

Towards a richer policy mix

16. The fact that it is difficult for monetary policy to control the factors driving down the equilibrium interest rate also implies that other economic policy spheres play a key role, too. The competent authorities at national, European and international level therefore urgently need to work on a sustained increase in growth, and hence a rise in the equilibrium interest rate. Structural reforms designed to boost productivity and growth potential could compensate in part for the downward pressure on the equilibrium interest rate. Removing uncertainty over the proposed policies and setting clear guidelines for the great challenges of the future, such as population ageing, digitalisation and climate change, could reduce the propensity to save and expand investment opportunities. Fiscal policy could make a greater contribution to the stabilisation of economic activity by ensuring that the necessary buffers are available for the optimal functioning of automatic stabilisers, and by adopting a more expansionary stance in countries where there is scope to do so. Besides, a more growth-friendly fiscal policy composition could be pursued, for instance by making more scope for public investment. Compliance with the European budgetary rules fosters the sustainability of public finances and can thus help to restore the supply of risk-free assets. Better risk differentiation, based on the completion of the Banking Union and reinforcement of the Capital Markets Union, could

reduce precautionary savings. This richer mix of economic policies will enhance the effectiveness of monetary policy and thus speed up its normalisation. That will attenuate its secondary effects. In addition, growth will be sustained at a higher level, thus raising the equilibrium interest rate and reducing the pressure on the financial sector and savers.

3. The economic policy mix in Belgium: no scope for fiscal manoeuvre, but obstacles to sustainable and inclusive growth must be removed

Where does the problem lie in Belgium: the cycle or growth potential?

17. Before trying to decide on the right policy mix, it is necessary to examine the exact situation, because the remedy depends on the diagnosis. So far, the Belgian economy has stood up relatively well to the international slowdown. This implies that, in contrast to the situation in other euro area countries, the economy needs hardly any cyclical stimulus – apart from the support provided by monetary policy. In any case, there is barely any scope available, as the budget deficit rose to 1.7 % of GDP in 2019 and the debt ratio is still particularly high, at 99 % of GDP. Hence the need to consolidate public finances, even from a cyclical point of view, in order to create the necessary buffers to absorb any future shocks. Although this is an intrinsically national argument, it is what prompted the European Commission and the ECB Governing Council to send a differentiated message on the fiscal policy stance in the euro area. Governments with scope for fiscal manoeuvre are requested to use it in the current circumstances, while countries with a high level of public debt are advised to adopt prudent policies to create the necessary conditions to enable the automatic stabilisers to operate freely. This implies that Belgium must again make fiscal consolidation a priority.

Belgium must again make fiscal consolidation a priority

18. But there is more. Further expansion of economic activity encounters constraints in various fields. That implies weak growth potential. The particularly strong job creation in recent years is liable to be thwarted by an inadequate labour supply. Firms are finding it increasingly difficult to fill vacancies, sometimes even for jobs that do not require any special skills. Yet despite the progress made in recent years, almost 30 % of the working age population is not in work. That mainly reflects low labour market participation rather than a high unemployment rate. Moreover, the working age population is set to shrink in the future, as a result of population ageing. The labour shortage is often cited as a factor preventing firms from investing. Consequently, productivity growth is still under threat, while in Belgium it has already slowed more than in other advanced economies. Yet productivity gains are essential to generate sustainable growth, once the labour potential has been fully exploited. It is therefore vital to render the economic fabric more dynamic. In addition, both the mobilisation of the labour potential and productivity growth are increasingly impeded by infrastructure deficiencies. The problems concerning mobility and energy supply are the most striking examples, but the National Pact on Strategic Investments also identified significant needs in education, health care, cyber security and the digital transition.

The scarcity of labour, weak productivity growth and deteriorating infrastructure lead to low growth potential

19. Boosting growth potential by removing these obstacles is the only sustainable source of purchasing power and income creation. Both productivity and the number of people at work must increase. If more people are integrated into the labour market, growth will also become more inclusive, as employment is a powerful driver of social inclusion, and the best protection against poverty. Generating more growth and employment also makes it easier to consolidate public finances. That is the only way to continue mobilising sufficient resources to provide an effective social security safety net in the face of population ageing.

20. This diagnosis is not new, since it has been stated before by the Bank and by other institutions. But that does not affect the relevance of the analysis, or the pressing need to embark on reforms, as emphasised in various spheres in 2019.

The challenges are undiminished

21. First, tensions in international trade are putting pressure on the existing structure of global value chains, but so are the rapid technological developments in the field of digitalisation. Brexit is another contributory factor. Becoming part of these value chains has invariably proved beneficial for Belgium, as a small open economy: in a way, its business model is to link the major North Sea ports with the European hinterland. In the current circumstances, however, that implies increased fragility. Moreover, international openness – to both trade and investment – is a catalyst for productivity gains and for widespread innovation. That impetus is therefore liable to weaken. The promotion of openness to trade on the international stage must therefore remain, as always, the starting point for Belgian policy-makers. Whether or not a free trade agreement is signed on completion of the Brexit process is of great consequence for the Belgian economy owing to its relatively large exposure to the United Kingdom. Be that as it may, a small country like Belgium will above all have to ensure that flexibility, adaptability and innovation ultimately make up for the loss of value creation liable to ensue from these changes. A more agile economy is also in a better position to seize new opportunities.

Tensions surrounding international trade and Brexit are putting pressure on value chains in which Belgian firms operate

22. Managing climate change is another factor which, though not new, has only recently been highlighted, after having received insufficient attention in Belgium. The question is not whether the transition to a climate-neutral economy must be achieved, as commitments on that have been given with the other EU countries. For instance, last year's December European Council approved the aim of making the EU climate neutral by 2050. Long-term considerations in fact necessitate that transition, and failure to take them into account would also entail economic consequences. The question is how the transition can be achieved as efficiently as possible by controlling the increase in costs and minimising the impact on production potential. That is a major policy challenge. Once again, agility will have to form part of the answer, because value creation will need to shift from high-carbon to low-carbon technologies. The smoother the reallocation of not only capital but also labour, the more efficient the transition will be. In view of the importance of the subject, the Bank will devote its two-yearly conference to it in 2020.

The transition to a climate-neutral economy is a formidable challenge

23. While the challenges are therefore undiminished, it must be said that 2019 was a year of stagnation at federal level in Belgium. That is in stark contrast to the period 2011-2018, when two successive federal governments implemented reforms to boost the Belgian economy's potential. The phased restoration of competitiveness stimulated demand for labour, while the labour supply was supported by the activation of an increased number of job-seekers, cuts in personal income tax and a set of reforms aimed at extending careers. Those reforms also moderated the budgetary cost of population ageing. The improvement in the labour market apparent since then suggests that the reforms were effective. While the employment situation was initially affected by the sovereign debt crisis in the euro area, it steadily picked up over time. That does not only reflect the economic recovery, because growth in recent years has been noticeably more job-intensive than in the past. The employment rate, which stood at 67 % in 2011, has now risen to 70.6 %. Moreover, the increase is greatest for people in the 55-60 age group. The unemployment rate has dropped to 5.4 %, its lowest level in several decades. Since it is therefore below the levels recorded after the previous recovery periods, there is every indication that structural unemployment has also fallen. As regards public finances, the structural budget deficit has improved over the period, declining from 3.9 % in 2011 to 1.7 %

in 2017 ; but there has been no further progress since then. On the contrary, although the caretaker government situation has undoubtedly had an impact on many areas of policy, its main feature has been a deterioration in public finances.

After the deterioration in 2019, it is high time public finances were put on a sound footing

24. The rise in the Belgian government's budget deficit, up from 0.7 % in 2019 to 1.7 % of GDP, is due mainly to lower revenues from the final settlement of corporation tax. In 2017 and 2018, more was collected via advance payments, temporarily increasing revenues. This factor accounts for around 0.5 of a percentage point – or half – of the total deterioration. Since these temporary factors are excluded from the structural deficit, the improvement in recent years was less marked, with that deficit amounting to 1.7 % of GDP in 2017 and 1.8 % in 2018. The structural deficit deteriorated again to reach 2.4 % in 2019, mainly owing to the tax cuts under the tax shift and a rise in social expenditure due to population ageing. On the other hand, interest charges were down by 0.2 of a percentage point.

25. Belgium's public finances have therefore made no further progress towards the medium-term objective of a structural budget balance. On the contrary, the gap has widened further. Yet it is essential to achieve a structurally balanced budget. At 99 % of GDP, Belgium's public debt is among the highest in the euro area and there is no prospect of reducing it without adjustments. Is it not the case that low interest rates create more budgetary leeway ? Indeed they do, but most of that scope has already been used. Interest charges have in fact fallen sharply in recent years, dropping to 1.9 % of GDP in 2019. Yet that reduction did not produce a corresponding fall in the public deficit, precisely because it permitted a less ambitious approach to the primary balance. That is not contrary to the European governance framework for public finances since that framework is anchored in the structural budget balance, i.e. the balance adjusted for cyclical variations and temporary factors, but including interest charges. But it does imply that the low interest rate environment offers hardly any further scope. On the other hand, the high public debt makes Belgium particularly vulnerable to an interest rate rise, creating a need for caution. With a structurally low equilibrium interest rate, it seems unlikely that the risk-free rate will rise strongly in the immediate future. However, in the event of insufficient progress, the risk premium on the Belgian public debt could escalate, especially if a cyclical deterioration were to result in a further widening of the deficit without the creation of safety margins. That is exactly what has happened in the past. All the major fiscal consolidation phases – in 1982, 1993 and 2011 – had to start during a recession, under pressure from the financial markets. Preventing that procyclicality by choosing the timing of the consolidation of public finances is much more efficient in both economic and social terms. The route to structural equilibrium must respect the rules of the stability and growth pact. That is also desirable from a purely national viewpoint : to escape from the danger zone, sufficient progress needs to be made without delay.

The persistently high debt ratio renders public finances vulnerable

26. The effort will be smaller if it is built in a way that supports growth. Given the continuing heavy fiscal and parafiscal levies, there is little scope on the revenue side. Even though payroll levies have come down, they are still high and constitute a factor that continues to constrain the employment rate, especially for the most vulnerable groups on the labour market. At the same time, the tax reforms of the last few years, which were supposed to have been budget-neutral, have turned out to be underfunded. Continuing efforts are also needed to ensure that taxes are properly collected, including in relation to the new forms of production and consumption arising from the sharing economy, and there must be further efforts to combat tax evasion and social security fraud. Those are key elements of effective government intervention.

27. Primary expenditure totalled around half of GDP in 2019, up by 6 percentage points of potential GDP compared to twenty years ago. In 2012, primary expenditure was even higher; it has fallen by 2 percentage points since then. But that decline has come to a halt in the past two years. Just under two-thirds of the total increase since 2000 is attributable to social expenditure, although the latter's dynamics have slowed since 2012 as a result of the policies implemented. Unemployment benefits fell sharply thanks to job creation, and the continuing strong rise in pension expenditure between 2008 and 2012 was moderated after that by the efforts to extend working life. Health care expenditure also remained under control during that period, although there was a further strong rise in 2019. On the other hand, sickness and disability benefits continued rising steadily. The budgetary cost of ageing is set to rise further by 0.2 of a percentage point of GDP per annum over the coming decade. There is therefore little choice but to keep control of social expenditure, notably by continuing to put the emphasis on activation and the extension of working life. That is vital so that the statutory pension system – one of the major pillars of the Belgian social model – remains both affordable and adequate. It also ensures the continuing availability of sufficient resources for other government functions, and more particularly for public investment, which is very low in Belgium, whereas it could bolster growth potential. Despite the low level of that investment, total primary expenditure seems high in comparison with most advanced economies, though the services provided are not always correspondingly better. Consequently, a simultaneous effort is needed to improve the effectiveness of government action on the expenditure side. The public authorities must seize the opportunity of the increasing shift to a more digital economy in order to reap productivity gains. At the same time, they must ensure that all segments of the population continue to have easy access to the supply of services. Guaranteeing the sustainability of public finances is a task incumbent upon all components of Belgian government, certainly now that the Communities and Regions are responsible for a larger proportion of expenditure. That is why the federal government and the Communities and Regions must agree on binding budget targets, as laid down in the cooperation agreement of 13 December 2013. That will clarify the responsibilities of each party while permitting independent monitoring by the High Council of Finance.

Social expenditure should not eclipse other government spending

Infrastructure, climate transition and productivity: mobilise the private sector to the full

28. Public investment undoubtedly has a role to play in modernising the infrastructure or bringing about the transition to a climate-neutral economy. That must be done in compliance with the rules of the Stability and Growth Pact and the statistical rules on accounting for such investment. That said, the ongoing assessment of the European budgetary framework will in fact provide an opportunity to examine whether public investment could be given more favourable treatment, albeit on condition that this does not jeopardise debt sustainability and that the investment in question does actually boost the growth potential. Besides, it would be wrong to assume that all the investment effort should come from the public sector. In reality, much of it should take place in the private sector. That applies equally to businesses – whether they produce or consume energy – and to households. In the case of the latter, it should primarily entail adaptations to the stock of motor vehicles and housing. The low interest rate environment actually makes it easier to finance these investments, as do the additional incentives in the form of specific green funding or the support that the European Investment Bank intends to provide. But above all, the direction of the transition must be sufficiently clear for this investment to take place. All levels of government therefore need to act primarily as coordinators, using appropriate incentives to steer private initiatives in the right direction. Well-conceived environmental taxes, which are rather low in Belgium, can play an important role to steer the necessary adjustments from a climate policy perspective. At the same time, the public authorities

Well-conceived environmental taxes can play an important role to steer the necessary adjustments from a climate policy perspective

must take account of the transition's economic and social dimensions. The establishment of beacons creates clarity and facilitates the mobilisation of private investment, whereas a lack of guidance erodes confidence and leads to a wait-and-see attitude. Thus, uncertainty over the direction to take is the main reason why electricity supply remains a sticking point. There is an urgent need for clarity in this area. As the climate transition concerns numerous spheres, it cannot succeed unless the competent authorities strive for maximum consistency in their mutual coordination. In a federal country like Belgium, that is crucial. Synergy also avoids making economic life subject to excessively onerous regulations as a result of the fragmentation or inadequate coordination of powers.

29. However important it may be to improve the infrastructure, there is no magic way of boosting productivity. On the contrary, to achieve that, it is necessary to apply a wide range of mutually reinforcing levers. In that connection, it is important to have a competitive market environment giving access to newcomers and encouraging innovation. But in Belgium, competition is limited for some services in particular, so it needs to be stimulated. While e-commerce is very widespread in Belgium as a method of transacting business between firms, it is less common in relations with consumers. In addition, a relatively large proportion of online consumer purchases concern foreign suppliers. Consequently, the Belgian retail sector does not make enough use of a potential sales channel and there is now fierce price competition from foreign e-commerce businesses. On top of that, Belgian retailers have problems delivering the goods as quickly. There are also problems with the logistical support for this type of activity, but now that the rules on night work and flexible hours have been relaxed, that is not such an impediment. But there is still a need to promote a level playing field for e-commerce at European level. The mobility issue is another factor that increases firms' costs, reduces the range of their operations – both for marketing their products and for obtaining inputs and workers – and lowers their productivity. Moreover, productivity gains in Belgium are evidently concentrated on a small number of efficient firms, which are supported by sound innovation activity. Belgian universities also have world-renowned innovation centres which cooperate closely with the business world. But it is not easy to disseminate innovation and productivity. The latter could be improved if resources could be readily transferred from less productive to more productive activities. That is clearly not yet sufficiently the case in Belgium, given the low rate at which non-viable firms close down and new businesses are established. Finally, in the current knowledge economy, and in the context of the digital revolution, productivity depends on investment not only in physical capital but also in intangible assets – and increasingly in human capital. The knowledge and skills of the workforce have become a crucial factor in the successful application and spread of the new technologies and largely determine the workers' opportunities on the labour market.

Stimulating competition results in lower prices and increased productivity

The labour supply: empowerment of people for a strong and inclusive economy

30. More people need to join the labour market. That is also the common denominator of the coalition agreements concluded after the elections in the three Regions. The difficulty of filling vacancies indicates that there is demand for labour, but that supply is lagging behind. Even in the Flemish Region, where labour market participation is highest, inactivity stands at 28 %. As the unemployment rate in that Region has dropped to 3.3 %, raising the participation rate there has become the primary way of meeting demand for labour. In the Walloon and Brussels Regions, the activity rate is even lower, while the unemployment rate is considerably higher, at 7 % and 13 % respectively. Labour market policies must therefore respond to each Region's specific needs, although coordination is also necessary, notably to increase workers' geographical mobility. A combination of measures offering appropriate incentives, support and training will always be the key to success.

31. It is important for everyone to have the necessary skills to find a place on the labour market, and to retain that place in a fast-changing environment. That applies to both technical and language skills and soft skills. Special attention must focus on the most vulnerable groups. Apart from a large number of low-skilled people, citizens from non-EU member countries still have difficulty in securing a place on the labour market. Doing more for their empowerment will be an important lever, but it is equally important that any form of discrimination is avoided. There are signs pointing to a deterioration of education standards. This trend needs to be reversed. Besides, school results in Belgium are strongly correlated with the pupils' socio-economic and cultural characteristics, which implies that education is not an adequate driver of social mobility. The low employment rate of certain groups can often be traced back to their schooling or training. In that respect, dual apprenticeships can enable some groups of young people to join the labour market. However, education does not end on leaving school. Life-long learning is the best way of keeping up with rapid changes in the working environment, especially in the context of extended careers. This is a responsibility shared by workers and employers. In addition, career development must be geared to retaining older workers in employment. Sufficient attention must be paid to adapting tasks and working conditions. In order to activate persons who are currently still very remote from the labour market, intermediate stages could also be provided prior to full transition to an employment situation. In comparison with neighbouring countries and other euro area members, Belgium has scope for voluntary part-time work. Mobilising all talents at every stage in their career will promote diversity in the workplace – in all its dimensions – and the complementarity of skills and approaches can become an advantage for businesses.

Everyone must be able to acquire the necessary skills for the labour market

32. Finally, wage-setting also plays a key role in aligning labour supply with demand. It is in fact crucial that labour costs should be in line with productivity levels. Ideally, that link should be respected at macro, meso and micro levels. For instance, at macroeconomic level, labour costs in Belgium are higher than in the three neighbouring countries, but that largely reflects higher productivity. Nevertheless, vigilance is still needed here. That is why wage-setting in Belgium is governed by the Law on the Promotion of Employment and the Preventive Safeguarding of Competitiveness. Compliance with that Law should not necessarily preclude an increase in purchasing power. Thus, at the end of February 2019, the social partners concluded a draft agreement on the maximum margin for wage cost increases excluding indexation of 1.1 % for the period 2019-2020. Since one of the social partners did not approve the agreement, it was eventually fixed by Royal Decree. In 2019, 0.7 % of the margin was used, and was one of the factors behind the strong rise in purchasing power. At mesoeconomic level, too, wage-setting must take sufficient account of the underlying fundamentals. For instance, both the productivity situation and labour market tensions vary between firms, sectors, geographical areas and the skills required. By taking account of these factors, wage-setting can better maintain favourable labour market dynamics. In addition, it can identify more clearly where the most worthwhile job opportunities are located, and thus increase labour mobility. Finally, at micro level, it is preferable to take account of the fact that if seniority is a major determinant of wage-setting, as is the case in Belgium for employees and management staff, that reduces the job opportunities for older workers and weakens their position on the labour market.

Wage-setting must take sufficient account of the underlying fundamentals

4. The Belgian financial sector is sound and robust, but faces major structural challenges implying systemic risks

A strong financial sector to support sustainable economic growth

33. A robust, efficient and dynamic financial system is essential for the economy and for society. It facilitates payments by households, firms and government, mobilises savings and allocates

them to investment projects, and supports wealth creation in the economy. Not only is an efficient, balanced financial sector thus a key driver of economic growth and innovation, it ultimately also helps to determine the direction and nature of economic development. Conversely, as demonstrated by the latest financial crisis, a dysfunctional or unstable financial sector can lead to serious and persistent economic and social losses. It is because of this decisive role of financial institutions that the stability of the financial system is crucial to society.

Owing to the decisive role of the financial sector, its stability is essential to society

34. Restoring the stability of the Belgian financial sector, and particularly the banks – the main financial service providers – was vital to the economic recovery. The Belgian financial sector now operates in a stronger regulatory framework and under strict supervision, and, as a result of the extensive restructuring previously carried out, it is now in a sound, comfortable solvency and liquidity position. The Belgian banking sector – which has a core capital ratio of 15.1 % and a liquidity coverage ratio of 136 % – and the insurance sector, with a solvency ratio (SCR) of 187 % – amply meet the supervisory authorities' solvency and liquidity requirements. Moreover, the stress tests conducted by the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) show that these comfortable starting positions are more than sufficient for withstanding serious adverse shocks, thus ensuring the continuity of financial services and fostering sustainable economic growth.

35. Its strengthened financial position also enables the Belgian financial sector to perform efficiently in transmitting the stimulus of the ECB's accommodative monetary policy to the real economy via the bank credit channel. The reflection of the historically low policy interest rates in credit interest rates and the substantial credit supply made available to the Belgian economy by Belgian banks have given a strong boost to lending and underpinned economic growth. However, the acceleration of the credit cycle in many EU countries, including Belgium, and the increasing use of credit clearly indicate that a close watch must be kept on the productive use of these loans. Such a cycle could go off the rails if low-performing loans are granted on over-generous terms, and thus lead to a excessive debt positions in the private non-financial sector.

The strong monetary policy stimulus is reflected in historically low credit interest rates and dynamic lending

36. It is also necessary to ensure balanced financial intermediation in which, alongside the banks, other financial sector segments make a substantial contribution to the diversified financing of the economy on the basis of their own comparative advantages. Significant structural funding needs – such as those relating to infrastructure improvements and development, and the transition to a sustainable economy or support for innovation – require very long-term financing or the mobilisation of sufficient quantities of risk capital. Non-bank financing – be it via insurance companies, pension funds or direct capital market funding – is a necessary and complementary source of funds which the banks cannot provide, or at least not in sufficient quantities, owing to their financing structure and their business model. A more attractive system of taxing households' savings could create an additional means of funding the economy along these lines.

37. At European level, too, the aim is to achieve this transition to a more balanced and diversified financial structure, with the gradual introduction of the Capital Markets Union, intended to develop liquid, integrated European capital markets. Alongside the Banking Union, the Capital Markets Union constitutes an important pillar of Economic and Monetary Union, which not only promotes financial stability and the mobilisation of financing conducive to growth and innovation in Europe, but also reinforces risk-sharing in the private sector. However, effective measures must be taken to realise the full potential of this Capital Markets Union. With the launch of the High-Level Forum on Capital Markets Union, the European Commission intends to revitalise the Capital Markets Union and, in particular, to support the capital financing of innovative SMEs,

Effective measures are needed to realise the full potential of this Capital Markets Union

the development of a European capital markets architecture and the improvement of access to the capital markets for retail investors.

Sustainable financial stability requires constant vigilance on the part of the authorities responsible for regulation and supervision, within a strict risk-based framework

38. The maintenance of a balanced and stable financial sector requires strict regulation and a tough supervisory framework which is rigorously applied while respecting the proportionality principle. The lessons of the financial crisis must be firmly embedded in stringent regulations which limit the risks, and the supervisory authorities must be rigorous in applying the regulations. The completion of this framework is more necessary than ever, especially at a time when, at European level, one part of the sector is increasingly calling it into question. A strict regulatory and supervisory framework is the best way of guaranteeing a sustainable supply of financial services which can support the economy in the long term.

39. In this context, it is important for the whole of the final Basel III agreement to be fully transposed into European legislation, and then incorporated into national law where necessary. The latest components of the Basel III framework are intended both to strengthen the credibility of the banks' risk management based on internal risk weightings, and to ensure a level playing field between banks. Implementation of the whole of the Basel III agreement from 2022 onwards will reinforce the capital requirements of – primarily large – European and Belgian banks. However, the costs are more than offset by the long-term benefits, as the implementation of the final Basel III agreement will strengthen the banking sector's resilience, and that will not only reduce the risk of future financial crises but will also promote more stable economic growth.

The Basel III agreement will strengthen the banking sector's resilience and reduce the risk of future financial crises

40. The completion of the Risk Reduction Package and publication of the amended EU Capital Requirements Regulation and Directive (respectively CRR 2 and CRD V), as well as the Bank Recovery and Resolution Directive (BRRD 2), heralded the adoption of fundamental reforms of the European regulatory framework. This package provides for a series of new risk mitigation measures inspired by Basel III regarding the solvency and liquidity requirements – such as the leverage ratio and the net stable funding ratio – or the minimum requirements for bail-in instruments – the total loss-absorbing capacity (TLAC) requirement for global systemically important institutions –; it also strengthens and clarifies the regulatory framework already in force. The transposition of the CRD V and BRRD 2 Directives into national law is therefore a priority. In the Belgian context – featuring the presence of large subsidiaries of international banking groups – the maintenance at local level of appropriate bail-in instruments and adequate capital and liquidity buffers for all banks operating in Belgium – as provided for by the Risk Reduction Package – is very important to continue ensuring the resilience of the Belgian banking sector in the current – i.e. incomplete – Banking Union. In that regard, unequivocal, formal regulations guaranteeing unconditional support within international banking groups, both in the event of resolution or liquidation and in cases where there is a shortage of liquidity or capital in certain parts of the group, is an essential requirement for finalising the Banking Union. However, in the course of the transition towards this new balance, it remains necessary to preserve local buffers in order to ensure that the sector is resilient at all times.

Maintaining appropriate bail-in instruments and adequate capital and liquidity buffers at local level is very important for financial stability

41. That said, the increasing complexity and extent of the new financial legislation demands considerable efforts on the part of the financial sector. The proportionality principle must be applied consistently

so that the prudential requirements remain commensurate with the nature and complexity of the risks. That principle was fully applied at the time of the revision of the CRR and in the financial legislation on investment firms, where the banking rules now apply solely to systemically important investment firms and new, modified legislation has been devised for smaller institutions. As the supervisory authority, the Bank also pays due attention to the proportionate application of the legislation, and is examining a range of supplementary measures to address the sector's concerns. Finally, the Bank advocates a stable regulatory framework, in order to give financial institutions the time to introduce the regulatory reforms gradually in their risk management and, if necessary, to modify their business models.

42. The Bank also performed a number of important tasks in its capacity as the national resolution authority. Apart from the work in connection with the single resolution mechanism, it paid special attention to the institutions which are directly subject to its authority. Thus, it completed the process of imposing minimum requirements on less significant credit institutions, involving a minimum level of bail-in instruments (the so-called MREL). Consequently, most Belgian credit institutions already have to conform to a binding MREL requirement, or must do so in the near future. These requirements could prove very important for ensuring an orderly resolution and, in extreme cases, for not excluding the possibility of State intervention if that is deemed necessary. Finally, at European level, the Bank will continue to work on removing certain obstacles which could arise in the application of banking group resolution strategies. Those obstacles were revealed by a European crisis management exercise in which the Bank took part during the year under review, and confirm the relevance of a formal framework which, in the event of resolution, guarantees unambiguous support from the group, and within international banking groups as well.

The persistently low interest rate environment is increasing pressure on the structural profitability of the financial sector

43. With the persistence of the low interest rate environment and widespread negative interest rates in a substantial part of the global economy, the financial sector is entering unknown territory, and the pressure on its structural profitability is increasing as time goes by. The financial markets are steadily coming to believe that, even in the context of a structurally lower equilibrium interest rate, a highly accommodative monetary policy will still be needed to support the economy and attain the inflation target. As various monetary policy levers are applied in succession, and market expectations and risk premiums are influenced in the same way as the key interest rates, pricing on a growing number of financial markets is dominated by this idea of "low for long". This tendency in asset prices is reflected, in particular, in a marked flattening of the forward interest rate structure on the international money and bond markets, high valuations and declining risk premiums on a number of equity markets, and the widespread incidence of negative yields on investment-grade government bonds or the interbank market.

44. Although the current low interest rates have probably not yet reached the reversal rate – i.e. the level below which the cheap capital policy and further interest rate cuts start to have a contractionary effect – the sector's structural profitability is under threat. The persistently low profitability of large banking institutions in the euro area – which, with an average return on capital of 6.4 %, barely offsets the cost of capital – is a major challenge which could ultimately also disrupt the smooth operation of financial intermediation. In addition, it causes polarisation of the European banking landscape, with the more profitable banks able to consolidate or reinforce their position by substantial investment, while less profitable – often smaller – banks generally invest less heavily. Overall, the Belgian banks have managed to maintain their profitability at an average of 8.7 %, notably by lower provisions and by very dynamic lending, which has made up for shrinking net

There is growing pressure on the profitability of Belgian banks

interest margins. However, that profitability is also under mounting pressure, particularly for some smaller banks. The costs associated with increased investment and high levies, notably in the form of specific taxes and contributions to the guarantee and resolution funds, erode profitability, and – looking ahead – the persistently low interest rate environment and fierce competition on the main banking markets threaten net interest income, the Belgian banks' primary source of revenue. In addition, in this context, commercial interest margins are being forced down, sometimes to levels which no longer reflect all the inherent credit and liquidity risks. Yet this structural profitability of the banking sector is essential to support its long-term solvency and hence to ensure financial stability.

45. The far-reaching structural adjustments which the insurance sector has undergone in recent years, resulting in a better match between asset and liability maturities and the disposal of some loss-making portfolios, have made the sector less sensitive overall to the low interest rate environment. All the same, persistently low interest rates ultimately also undermine the viability of insurers' standard remuneration model, particularly in the case of those specialising in life insurance. The need for assets generating sufficiently high returns to cover existing commitments offering guaranteed yields in fact prompts these firms to step up the search for yield on their investments, by replacing low-return secure assets – mainly government bonds – with riskier assets. In addition, the sector is systematically introducing more flexibility in the life insurance policies that it offers, and the low guaranteed yields are curbing demand for this type of insurance product. Leaving aside these changes in their business models, insurers need to look ahead and pursue a prudent dividend payment policy in order to build up sufficient reserves to be able to continue to meet their commitments in the future.

Insurers must pursue a prudent dividend payment policy

46. Furthermore, negative interest rates make it expensive to hold cash, and that discourages not only the maintenance of comfortable liquidity reserves in the financial sector, but potentially also the proper coverage of the interest rate risk. As in most euro area countries, Belgian banks – which, owing to the high level of funding via deposits, have large reserves of liquidity – have so far only passed on these negative interest rates to a limited extent in the case of large companies, while retail deposits are unaffected. But these large savings deposits provide a stable source of funding that gives the banks great flexibility, enabling them to act quickly in effecting new, longer-term investments without any serious risk to their liquidity.

47. These deposits – including regulated savings deposits totalling € 270 billion – also remain an important component of the net financial assets of Belgian households, which increased further in the third quarter of 2019 to reach € 1 090 billion. However, against the backdrop of serious geopolitical uncertainty and financial volatility, Belgian households are building more security into their decisions on saving, and investing mainly in low-risk, liquid instruments such as savings deposits. Nevertheless, in the current low interest rate context, this shift towards low-risk investment instruments also means weaker growth of financial assets. In addition, the household debt ratio is maintaining its upward trend, mainly as a result of strong demand for mortgage loans. Estimated at 61.1 % of GDP, it recently surpassed the euro area average of 57.9 % of GDP. This debt ratio is not a problem in itself, as the persistently low interest rates create some leeway permitting a higher equilibrium debt ratio. Conversely, a higher debt ratio makes the economy less resilient to major income shocks, eroding households' repayment capability.

The shift to low-risk investment instruments in a low interest rate environment is reflected in weaker financial asset growth

Given the growing systemic vulnerabilities, the Bank adopted new macroprudential measures

48. In order to safeguard financial stability, it is extremely important to keep a close eye on the changing macrofinancial situation and to act promptly to deal with any systemic vulnerabilities. The potentially

very destabilising effects of these vulnerabilities – particularly the so-called financial cycle – highlight the need for a proactive macoprudential policy that supplements the microprudential policy geared to individual institutions, and the monetary policy geared to price stability, in order to preserve the stability of the financial system as a whole. However, the macroprudential framework is a recent introduction and has not yet been fully tested in practice. Provided macroprudential policy is effective and it limits or offsets any negative macrofinancial side effects of an expansionary monetary policy on certain market segments and/or countries, it in fact supports the highly accommodative monetary policy for the Monetary Union as a whole.

49. Given the proliferation of systemic vulnerabilities – such as the acceleration of the credit cycle, the increasing debt ratios and developments on the Belgian property market and related credit markets – the Bank, in its capacity as the macroprudential authority, adopted some additional macroprudential measures. In the light of the accelerating credit cycle, the countercyclical capital buffer was activated in July 2019, as in many EU countries – including Germany, France and Luxembourg. Under this measure, which will become binding from July 2020, the Bank imposes additional capital buffers of around € 1 billion to strengthen the Belgian banks' resilience in the event of a severe recession, so that they can cope with the increased credit risks and losses and ensure the continuity of lending to the real economy. The Bank stands ready to release these buffers in the event of serious and persistent negative shocks, even during the current buffer-building phase.

The Bank activated the countercyclical capital buffer in 2019

50. Various international institutions, such as the ECB, the ESRB, the OECD and the IMF, have also repeatedly warned against the build-up of systemic risks on many European property markets, including the Belgian market. The Bank shares their concern because, apart from the already substantial and risky real estate exposures on credit institutions' balance sheets, Belgian banks continue to expand their mortgage portfolios, often on terms which do not adequately cover the credit or liquidity risks. In so doing, they unintentionally add to the systemic vulnerabilites and the risks to the financial system's stability. In those circumstances, and in response to the ESRB Recommendation on the introduction of credit-curbing measures, the Bank adopted a new macroprudential measure in the form of prudential expectations. By publishing these expectations regarding minimum qualitative standards for loan-to-value ratios, the repayment burden and the debt level, the Bank provides benchmarks for sound mortgage lending. Its intention is that these guidelines should actually be incorporated into the internal risk management and lending policy of banks and insurers from 2020, and that ultimately they should limit the emergence of excessive credit risks on the balance sheet. At the same time, this new macroprudential measure is flexible enough to ensure access to borrowing for households with a good credit record and for young families.

The Bank's new prudential expectations should lead to a more cautious lending policy on the part of the banks

51. By activating the countercyclical buffer and publishing prudential expectations, the Bank has significantly tightened its macroprudential policy. It takes the view that the new measures combined with the macroprudential capital requirements already in force for systemically important banks and for the mortgage portfolios of banks which use internal models for their risk management (IRB banks) adequately cover the macrofinancial risks. On the basis of current developments, it does not expect to need any new measures in the immediate future.

The structural transformation of the financial landscape continues

52. The entire European financial sector will need radical reform and restructuring in the years ahead, as various factors and trends – both within the financial sector and elsewhere, and especially in connection with excess capacity and progressive digitalisation – imply a fundamental and far-reaching transformation of the sector.

53. The adaptation of business models to a potentially persistent low interest rate environment is a major, pressing challenge for the financial sector, especially as this transformation is taking place on saturated financial markets, and against the backdrop of rather sluggish economic growth and a less-than-rosy outlook for profits. In that climate, the emphasis tends to be on measures to raise efficiency – by cost-cutting or economies of scale, based in particular on the use of new technologies – in order to achieve a sustainable increase in profitability. These restructuring efforts have led to the loss of over 20 000 jobs in the Belgian financial sector since the financial crisis, most of them in the banking sector. That is in stark contrast to the creation of more than 500 000 jobs in the Belgian economy as a whole. However, in some cases, cost-cutting and internal rationalisation are insufficient, and there is also the need to address the issue of excess capacity on national markets in some European countries. Some consolidation of the financial sector in national markets via mergers and acquisitions, or even business closures, may be advisable if it helps to counteract excessive market fragmentation and allows financial institutions to operate on an appropriate scale with adequate scope. Universal banks in fact need to be of a certain minimum size in order to apportion their overheads efficiently across a large number of assets. While overbanking is probably not the most pressing structural challenge facing the Belgian banking sector, the structurally weaker profitability of the smaller Belgian banks could indicate that they are not achieving the optimum scale.

54. The global trend towards digitalisation of financial services is probably one of the most disruptive innovations at the moment, and represents a major challenge for the financial world. The transition to the new paradigm of a digital financial system is in fact proceeding very rapidly and requires financial institutions to make a fundamental switch in the short term to business models centred on the customer's experience, on the basis of efficient service offering an extensive range of personalised products. In various segments of the financial sector, new digital applications are emerging at an accelerated pace, such as digital banking or insurance, trading platforms or automated investment advice. Although these applications can improve customer satisfaction among computer-savvy generations by cutting transaction costs or extending the product range, due consideration needs to be given to financial inclusion of the whole population. The transition to digital business models demands intense effort from the financial sector and heavy investment in the new technologies. It is nevertheless vital for survival in the digital age. In an environment where network effects and data use are essential – and offer significant advantages for first movers – it is crucial that, on the basis of the necessary investment and commercial strategy adjustments, all players act sufficiently promptly to embrace the digital finance transformation. The wait-and-see attitude adopted by small and medium-sized institutions is probably not a sustainable strategy.

The digitalisation of the supply of financial services is a major challenge for the financial sector

55. This digital transformation also requires a suitable regulatory and supervisory framework which takes explicit account of the specific character of digital finance and guarantees a level playing field between existing financial institutions and any newcomers from outside, especially BigTech firms. That applies in particular to the European context where, on the basis of the PSD 2 Directive, the regulator is opening up the payment markets and payment data to third-party service providers, and where, on the basis of the GDPR Directive, it imposes strict limits on access to other data. IT risks and cyber risks also require close attention and coordinated action on the part of the supervisory authorities. Owing to the large-scale digitalisation and digital interconnection of society, IT risks and cyber risks are becoming increasingly systemic, and it is an absolute priority of the Bank to watch over these risks in the financial sector, which is considered strategic in regard to cyber security. In this connection, the Bank is working with the national and international stakeholders concerned in order to ensure the cyber resilience of the financial sector, and particularly of the systemic banks and critical financial market infrastructures. To that end, it is implementing the TIBER-BE project, which supports ethical hacking.

Attention to the broader societal role of the financial sector

56. The financial sector also carries a significant societal responsibility and needs to be aware of its impact on society. Corporate social responsibility (CSR) means not only managing financial risks in a responsible way but also supporting essential projects or those which are relevant to society. As a financial intermediary, at the interface between savings and investment, the financial sector plays a key role in assisting, funding and supporting the transition to a more sustainable economy. In that context, the Bank advocates an appropriate attitude to CSR, including adequate attention to transparency in regard to environmental, social and governance (ESG) aspects throughout the economy, and especially for the financial sector, the disclosure of information relevant to society and the expansion of financial services supporting sustainable economic activities. However, the provision of financial services should not be to the detriment of financial stability. Risk-based monitoring will continue to be necessary for these activities and assets, notably on account of the high risk of stranded assets (assets that cease to be of interest to investors because they have lost most of their value as a result of structural technological changes and/or changes in policy). For financial stability reasons, the Bank monitors the potential impact of climate-related risks on banks and insurers.

Corporate social responsibility concerns not only responsible risk management but also support for socially relevant projects

57. Finally, the financial sector must continue to abide by the highest standards and best practices in combating money-laundering and terrorist financing. There have been several recent cases demonstrating that financial institutions remain vulnerable to such practices – which may have potentially serious consequences in the form of financial costs or loss of reputation. In accordance with the EU Directive on the subject, the Bank continues to apply a risk-based approach, with heavy emphasis on the most vulnerable sub-sectors. Recent infringements in Europe show that an integrated framework paying sufficient attention to cross-border and intersectoral activities is vital for monitoring these risks. The recent European decisions aimed at establishing a more integrated supervisory framework, based on the extensive exchange of data and closer cooperation, coordinated by the EBA, between the various competent supervisory authorities, is a key step along the road to effective control of these practices and, ultimately, socially responsible financial services.

Pierre Wunsch
Governor

Brussels, 29 January 2020

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