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

The year 2020 was particularly difficult for us all. Around the turn of the year, COVID-19, a disease caused by a new coronavirus, was first identified in China. It very rapidly developed into a full pandemic. Belgium was especially hard hit, recording a high number of infections and numerous deaths. This caused great human suffering and exerted extreme pressure on the health care sector, both in the spring and in the autumn. The available capacity was almost overwhelmed and health care workers were persistently overburdened. In order to prevent an uncontrollable spread of the virus, radical restrictions were imposed on social, cultural and economic life. The country was twice placed in lockdown and, as elsewhere in the world, that gave rise to the deepest recession since the Second World War. The public health crisis consequently became an economic crisis. It was essential to take action, and not only on humanitarian grounds. Without intervention, the resulting economic situation would not necessarily have been any better: the uncontrolled spread of the virus would quickly have sparked panic, limiting social contact and causing just as much economic damage.

The virus is still not under control and will continue to affect the economy in 2021. However, there is now a prospect of some improvement. Several vaccines are already available and the government has launched a massive immunisation campaign. Moreover, the economy exhibited great resilience in the third quarter of 2020. That reinforced the conviction that policy must focus on finding the best way through the period in which the virus damages the economy. That will limit the long-term fallout. Tackling this challenge is the main subject of the Governor's review in this Report, published on behalf of the Council of Regency. The first chapter describes how the COVID-19 shock affected the economy in 2020. The second chapter examines the vigorous response of monetary, prudential and fiscal policy. That response averted the worst and laid the essential foundations for getting through this difficult period and looking ahead to the post-coronavirus era. The third chapter focuses on the future: what will it take to ensure that the economy and the financial system thrive in the post-coronavirus period and to safeguard social cohesion? The fourth chapter presents the conclusions.

Analysis reveals that, up to now, economic policy has responded well to this particularly serious crisis, averting total economic collapse. That is true both worldwide and in the euro area and Belgium. While the implementation of the support policies in 2020 was a difficult task, the challenges that lie ahead will be even greater. The pandemic is not yet under control, and since the government has cushioned much of the shock, the ultimate impact of the crisis is still highly uncertain. The main thing will be to make the Belgian economy more flexible so that it can adapt, without net job losses,

* One Regent has reservations about paragraphs 41 and 42.

to the inevitable transitions ensuing from the coronavirus crisis and the digital and climate agendas, and cope with the contraction of the labour supply due to population ageing. Some effort will be needed: in the past, scarring has persisted even after the actual crisis is over. Nonetheless, it is vital to limit the income loss resulting from the crisis and to strengthen future growth potential. That will also prevent the crisis from further threatening the sustainability of public finances following the heavy recourse to fiscal policy, and as the costs of population ageing become increasingly apparent. The monetary, prudential and fiscal authorities must gradually exit crisis mode while safeguarding the stability-oriented foundations of the Monetary Union. In the long term, sustainable public finances and constant attention to price stability and financial stability are vital to ensure that the economy functions smoothly and can withstand future crises.

The rest of the National Bank of Belgium's Report provides more detailed information and analysis on all these subjects. Sources include the work carried out and reports produced under the Economic Risk Management Group (ERMG). That group was set up in March by the federal government to monitor the economic impact of the coronavirus crisis. It was chaired by Mr Piet Vanthemsche and by the Governor of the National Bank.

1. Like many other economies, Belgium and the euro area experienced the deepest recession since the Second World War

A synchronised global recession

1. The coronavirus crisis caused the global economy to shrink by 3.5 % in 2020. That is more than double the contraction during the 2009 financial crisis, and the sharpest decline since the Second World War. Almost every economy – whether advanced or emerging – suffered a severe recession. Among the major countries, only China recorded positive growth, though the figure dropped sharply from 6.1 % in 2019 to 2.3 %. China was seriously affected from the first quarter of 2020, but then made a rapid recovery, having promptly gained control over the virus and supported the economy with an investment stimulus. Elsewhere in the world, it was not until March that COVID-19 fully emerged. In the first quarter, the contraction of economic activity was still quite limited, but became very marked in the second quarter. The third quarter then brought a strong but partial recovery. In the autumn, Europe was hit by a second wave of infections and the United States even suffered a third wave. That depressed economic activity again, albeit to a lesser extent than in the first wave. Construction and manufacturing industry proved more resilient, while services were still seriously affected.

World trade slumped in the first half of the year

2. Since the COVID-19 shock hit the entire world more or less simultaneously, individual countries were unable to cushion the impact via their exports as there was a universal sharp fall in import demand. Furthermore, during the first wave, international trade was hampered by interruptions in global supply chains and temporary transport restrictions, while it already had to contend with rising protectionism before the coronavirus crisis. Trade thus contracted by 9.6 % in 2020. Like economic activity, trade declined mainly in the first half of the year and then revived. In Belgium, too, import and export flows dropped sharply before picking up again from the summer. At the end of December, the EU and the United Kingdom reached a last-minute agreement on their future trading relations, thereby avoiding the worst-case scenario involving the introduction of customs tariffs and quotas. Nevertheless, trade with the United Kingdom is now impeded by customs formalities and other non-tariff barriers. In addition, the sudden collapse in demand in the global economy triggered a steep decline in oil prices, initially exacerbated by a price war between Russia and Saudi Arabia. The low price of oil was a key factor in the general fall in inflation.

The Belgian economy contracted by 6.2 %

3. On the European continent, the virus struck Italy first in February. From March onwards, the number of infections was rising in Belgium, too. The first restrictions were introduced in mid-March. Combined with the slump already evident in international trade, that led to a 3.4 % decline in GDP in the first quarter. That was followed by an even sharper contraction in the second quarter. The health restrictions remained in force until mid-May and were then only lifted gradually. During this period, the economy was in freefall. Economic activity declined by no less than 15 % during these first two quarters. The impact was hardest in the services sectors, where the business model centres on social contact, such as hotels and restaurants, the contact professions, event organising and the cultural sector, but also in non-essential retailing and in travel and aviation, the sectors facing the toughest restrictions. However, few branches of activity were spared during this period. Construction and manufacturing industry also suffered in the first wave.

Economy in freefall in the second quarter

4. In the third quarter, the economy expanded by 11.6 %. Although the recovery was only partial, it was still stronger than originally expected. The upturn was surprisingly vigorous, not only in Belgium but also in many other countries. There are three main factors behind that resilience. First, the current crisis is very unusual: it was caused by a factor totally unconnected with the economy, whereas recessions are often due to an accumulation of imbalances within the economy itself. It generally takes time to rectify such imbalances, and that diminishes the strength of the recovery. In the present crisis, the lifting of the health restrictions triggered an immediate economic revival, which was also aided by economic policies specifically designed to attenuate the COVID-19 shock and thus to prevent the start of a negative spiral. Finally, businesses, workers and the government were quick to adapt, and that boosted resilience. This suggests that, in the medium term, the economy will recover faster than in previous recessions unless the support policy is dropped too suddenly.

5. This resilience was also apparent in the second wave, which was more severe in health terms but had a much smaller impact on the economy. The experience of the first wave was instructive. This time, schools and nurseries remained open, making it easier for parents to continue working. There was wider recourse to working from home. In addition, the social partners established protocols for continuing to work safely if remote working was not possible. Online sales and click-and-collect services became more widespread, including on the domestic market, offsetting some of the losses resulting from the decline in physical transactions. Nonetheless, the segment of the services sector where digital consumption is not an option continued to suffer. Ultimately, it was services that felt the greatest impact. That is a characteristic specific to this crisis, as activity in the services sectors usually displays a less cyclical profile. In the fourth quarter, GDP actually edged upwards by 0.2 %. However, it was still around 5 % below the level reached at the end of 2019. Year-on-year, economic activity ultimately declined by 6.2 %.

Services were the worst affected, and that is a characteristic peculiar to this crisis

The government made up for most of the loss of income and thus protected the economy from an even deeper recession

6. The government absorbed most of the shock. That occurred automatically to a considerable extent, since households and firms faced a lower tax bill as their income declined. Social security has also acted as an automatic stabiliser. The government also took a range of measures to limit the losses and thus protect the economy from an even deeper recession. The temporary

lay-off scheme and the bridging allowance for self-employed workers played a key role here. These two schemes already existed but the expansion of their scope and the increase in benefits made them the main stabilisation mechanisms in this crisis. Thus, in April, at the height of the first wave, the schemes were used by one million employees and 400 000 self-employed workers. In addition, the tapering of unemployment benefits was suspended, local authorities received more resources to finance the increased demand for support, and the Regions granted supplementary allowances for the hardest-hit households. These measures to support purchasing power amounted to € 9 billion altogether, or 2 % of GDP. At macroeconomic level, households did not suffer any reduction in their purchasing power although some of them undeniably experienced a severe impact.

Temporary lay-offs and the bridging allowance for self-employed workers became the main stabilisation mechanisms

7. Businesses were able to resort to temporary lay-offs to cut their wage bill without having to make staff redundant. In addition, the Regions paid allowances to businesses which were forced to close or which suffered a large loss of turnover. The federal government also took measures concerning corporation tax in order to strengthen solvency. Finally, there were specific support measures for some sectors of activity. Altogether, aid for businesses and the self-employed totalled € 7.3 billion, or 1.6 % of GDP. Nevertheless, the gross operating surplus and the disposable income of firms both deteriorated in 2020, and the need for liquidity was particularly acute. Alleviating this shortage of liquidity was a key policy priority, and we shall come back to it. In that regard, a significant role fell to the banking sector and the federal and regional investment companies. All the same, many businesses faced a considerably higher risk of bankruptcy. While the number of actual bankruptcies declined in 2020, that was due to the numerous support measures and the implementation of a moratorium on corporate bankruptcies during the first and second waves. The set of support measures, and particularly the buffer effect of the temporary lay-off scheme, also kept job losses fairly low in 2020. The number of self-employed workers actually rose, while job losses among employees came to 23 000. There was only a small rise in the unemployment rate, which reached 5.7 % in 2020.

Businesses were much in need of liquidity and there was an increased bankruptcy risk

Domestic demand fell sharply

8. Business investment dropped by almost 9 %. While it was only certain sectors that suffered a steep fall in value added, the decline in investment affected all branches of activity. It therefore does not really reflect the direct impact of the restrictions but is more a secondary effect resulting from the deteriorating demand outlook, the great uncertainty about the future, and the weakened corporate balance sheets. For the future, there is a need to ensure that the restoration of corporate balance sheets does not become a difficult process, depressing investment for a lengthy period.

9. The decline in private consumption was a little less severe but no less striking. Private consumption is generally the most stable expenditure component of GDP. However, in 2020, it was down by 8.6 %. That is not attributable to the change in disposable income, which held up well at macroeconomic level. The fall in inflation from 1.2 % in 2019 to 0.4 % in 2020 also had a favourable effect on purchasing power. That was in fact due mainly to the lower oil prices, which are not fully reflected in income indexation. The impact of lower oil prices on inflation outweighed the sustained rise in food prices. Conversely, the public health measures restricted consumers' opportunities for spending. In addition, even during periods when the restrictions were eased, consumers remained cautious and spontaneously avoided the shops. Finally, consumers continued to rein in their spending as a precaution. Thus, almost 21 % of

Private consumption fell sharply, even though disposable income was well protected at macroeconomic level disposable income was allocated to savings in 2020, against 13 % in 2019. Such a sharp rise in the savings ratio is atypical, and the additional savings amounting to over € 20 billion could ultimately finance a strong expansion of private consumption or investment. In 2020, these extra savings led mainly to a marked increase in household deposits. This strengthened household balance sheets even though, during the first phase of the crisis, they had also suffered as a result of the drop in prices of equities and investment fund units. That last factor mainly affected wealthier households. By the end of the year, these losses had been largely offset.

A crisis with an uneven impact, both in Belgium and across the euro area countries

10. The crisis did not affect all sectors to the same degree. While some sectors, particularly in services, were hard hit, others actually recorded increased business in 2020. For instance, in commerce, there was a major difference between non-essential and essential components. While the coronavirus crisis had a serious impact on the former, the latter prospered, notably because part of the demand for food shifted from the hotel and restaurant sector to meals at home. With the strong expansion of e-commerce, sectors such as ICT services and home delivery enjoyed further growth at the expense of a loss of value added for traditional forms of business. Part of that turnover was transferred to large online retailers based in other countries. There are even significant variations within the sectors themselves, including a geographical dimension. For instance, Brussels was severely affected by the slump in business travel and tourism as well as the large reduction in commuting. However, part of the demand shifted to other areas of the country, notably because those working at home stepped up their consumption in the district where they live. Last summer, some segments of the tourism sector benefited for a time from demand for holidays in the home country, a demand rarely seen in Belgium. Nevertheless, travel agents and airlines had a tough time because of the sudden drastic reduction in foreign travel. At macroeconomic level, however, this same factor brought an improvement in the current account, as the amount that Belgians spend on foreign tourism normally exceeds the amount spent by foreign tourists in Belgium. The coronavirus crisis had a particularly severe impact on small businesses and on many self-employed workers because, on average, these groups are more represented in the hardest-hit sectors that were forced to close for business. Thus, during the first wave, more than half of self-employed workers claimed the bridging allowance.

Owing to the sectoral profile of the coronavirus, the impact was greater on small firms and the self-employed

11. This differing sectoral profile of the crisis also meant that the more vulnerable groups were worse affected. The impact of a cyclical downturn is generally greater for agency or temporary workers and freelancers. The crisis exacerbated this tendency, as these forms of employment are more common in the services sectors where the crisis had its greatest impact. Similarly, workers with flexi-jobs and students doing casual work were also severely affected. And for those in the informal sector, it was a rude awakening. Workers in the sectors most affected are usually less well-paid, often low-skilled, and disproportionately likely to come from non-EU countries. Consequently, the lowest income groups are much more heavily represented in the temporary lay-off scheme than higher earners who generally have better access to teleworking. Moreover, as a general rule, the former have smaller financial reserves to cope with a loss of income. Conversely, for the lower income groups, the temporary lay-off allowances make up for a larger proportion of their lost income on an annual basis. Women are in a special situation in this crisis. They are over-represented in the hardest-hit sectors, such as hotels and restaurants or non-essential retailing, but also in essential sectors such as health care. While the first group suffered a loss of income, the second had to contend with an extremely heavy workload. In addition, women are more often in charge of child care, and had to cope with the closure of

The most vulnerable groups were hardest hit schools and nurseries to a greater extent than men. Finally, in education, the crisis unfortunately highlighted the digital divide among young people. Children in disadvantaged families have less internet access. Also, they rarely have a computer and do not always have sufficient space at home. They experience the physical absence of the teacher as a greater handicap, since their parents are generally less able to take on part of that role. Policy-makers face a major challenge in ensuring that existing vulnerabilities are not perpetuated, or even amplified, by the crisis.

12. In the euro area, too, the COVID-19 shock had an uneven impact. The recession in Belgium was slightly less severe than in the euro area as a whole, but sharper than in the Netherlands and Germany, where GDP dropped by 4.3 % and 5.5 % respectively. Among the large countries, Italy, France and Spain are at the other end of the spectrum. In the first two, GDP was down by around 9 %, and in Spain the decline even reached 11 %. These differences are due primarily to the intensity of coronavirus infection in the various countries. The structural characteristics of the various economies likewise play a key role. Thus, owing to the specific sectoral profile of the coronavirus crisis, countries heavily dependent on foreign tourism were generally more seriously affected. The same goes for countries with a relatively large proportion of small businesses, since the latter often have less leeway to absorb a shock. On the other hand, it is not easy to ascertain whether differences in available budget resources played a significant role. True, at the start of the coronavirus crisis, the immediate question was whether countries with a high public debt would be able to cope with the crisis, especially as they were also relatively severely affected by the virus. During the initial weeks of the crisis, interest rates on their government bonds climbed rapidly, to a much greater degree than in the rest of the euro area. On top of that, the shortage of market finance for businesses was felt more acutely in countries with higher corporate debt leverage. These factors rekindled a risk of fragmentation in the euro area, forming an additional challenge in the battle against the crisis.

A risk of fragmentation re-emerged in the euro area

2. Unprecedented support from monetary, prudential and fiscal policy to get through the crisis

The need for strong measures

13. Not only is the scale of the coronavirus crisis unique, the intensity of the policy response is equally unprecedented. From the very start, all the available instruments were set at maximum throughout the world. The monetary and fiscal policy response was both speedier and stronger than at the time of the financial crisis, and where prudential policy is concerned, the coronavirus crisis actually prompted the easing of the banks' capital and liquidity buffers for the first time. The measures were not only vigorous, they were also driving in the same direction, so that they reinforced one another in supporting the economy.

14. The special character of the COVID-19 crisis accounts for that policy alignment. Never before had whole swathes of the economy been closed down on public health grounds. It was immediately obvious that this crisis would not only hit the sectors directly concerned but could also have a domino effect, triggering a strong negative spiral. A very deep recession threatened to wreck a large part of the production potential in a cascade of bankruptcies. It was the economic fabric itself that was at stake. Without a determined policy response, extremely negative scenarios could not be ruled out. That fear fuelled very sharp initial reactions on the financial markets. The panic threatened in turn to exacerbate the crisis, or even to add a financial dimension, whereas in contrast to 2009, the crisis did not originate in the financial sector.

The economic fabric itself was at stake

15. The scale of the shock demanded vigorous measures, and the nature of the crisis made it easier to adopt them: the origin of the COVID-19 shock was totally extraneous to the economic system, and that was a significant factor. It meant that there was very little moral hazard associated with the support policies, unlike in the financial crisis. At that time, short-term profit-seeking in the financial sector had contributed to the crisis. This time, however, intrinsically viable businesses and jobs were liable to disappear as a result of an external shock. And it is hard to insure against that type of shock, in view of its scale. It is precisely in circumstances such as these that the government has a role to play as insurer of last resort. Finally, since the economy has not stalled for internal reasons, it is more likely to flourish again once the health crisis is over, even though structural changes will also result the longer the crisis persists. In the first instance, it was therefore necessary to provide temporary support for the economy to enable it to weather the public health crisis.

16. Substantial liquidity was needed to achieve that, especially for businesses. Although their turnover was in freefall, firms could only reduce part of their costs, e.g. by using the temporary lay-offs scheme, without being able to eliminate other fixed and semi-fixed overheads, such as rent and rental charges, interest on borrowings, insurance premiums or the essential maintenance of the firm's infrastructure. Similarly, some households suffered a loss of income while still having to pay off their loans. The financial sector naturally has a key role to play in covering these liquidity needs. Back in 2009, the financial sector was part of the problem, but in contrast, in the present crisis, it will have to be part of the solution. The reforms of the financial and prudential landscape implemented since the financial crisis were in fact designed to make the sector more shock-resistant and to enable prudential policy to release buffers. Monetary policy also had a leading role here, as it is the ultimate source of liquidity and steers the economy's general financing conditions.

In this crisis the financial sector will have to be part of the solution

17. The massive liquidity need is not the only challenge of this crisis, which has also caused irreplaceable loss of income. From the start, this gave rise to an insolvency risk which is becoming more acute as the coronavirus crisis drags on. The effects of this crisis are also unequal: some sectors or businesses are very hard hit while the impact on others is far smaller. It therefore differs from a more traditional recession. These characteristics put fiscal policy in the front line. It is the best instrument for giving targeted support to those most in need. It can provide direct income support for the affected households and firms in order to avert the risk of insolvency. And if that risk should nevertheless materialise, it can then help the private sector to cope with it by guaranteeing bank loans or, more directly, by contributing to the restructuring of corporate balance sheets. That is why fiscal policy has become the central tool in the battle against the coronavirus crisis. The usual recommendation that fiscal support measures should be timely, temporary and targeted remains as relevant as ever. The temporary nature of this support is perfectly in line with its purpose, which is to steer the economy out of the coronavirus crisis. It also avoids the prospect of permanently burdening public finances. As for the targeted nature of the support, this is mainly on account of the very unequal effects of this crisis.

Fiscal policy is the best instrument for providing temporary targeted support where it is most needed

Monetary policy at work: stabilising the financial markets, easing financing conditions and supporting credit flows for firms and households

18. Throughout the world, central banks were the first to respond, often taking decidedly radical action. Their aims were threefold. First, they needed to stabilise the financial markets after the initial panic reaction led to spiralling market financing costs or had even resulted in a total credit drought. Purchasing securities – not just government bonds but also riskier asset categories – was

the appropriate means of remedying that. Some of those assets were purchased for the first time during the crisis. In addition, the biggest central banks arranged mutual currency swaps to safeguard dollar and euro financing outside their own jurisdiction. Central banks also aimed at a general easing of financing conditions; they did so by cutting the key interest rates where there was still sufficient scope, as in the case of the Federal Reserve and the Bank of England, by using forward guidance to lower interest rate expectations, and by further flattening the yield curve by the purchase of government bonds. Finally, specific programmes were established to support lending to businesses and households.

19. This same triple objective formed the basis of the response by the Eurosystem, which was already conducting a highly accommodative policy before the coronavirus crisis began. The key interest rate had been cut to –0.5 % in September 2019 and, since then, the Eurosystem has bought securities totalling € 20 billion a month under the asset purchase programme. Although the remaining scope looked rather limited at the start of the crisis, the Eurosystem actually responded very vigorously. Asset purchases are the principal instrument for pursuing the first two aims, namely stabilising the financial market and easing financing conditions. Most of these purchases took place under the Pandemic Emergency Purchase Programme (PEPP) set up on 18 March. The amount available for purchases under the PEPP was initially € 750 billion, but that figure was subsequently increased on two occasions – in June and December 2020 – to € 1 850 billion. The programme was also extended until at least March 2022. By that time, according to the ECB Governing Council's assessment in December, the economy should have received sufficient support to get through the emergency phase.

The PEPP has two aims: to stabilise financial markets and to ease financing conditions

20. From the start, the PEPP was a flexible programme in terms of the distribution of purchases, both over time and between asset categories and euro area countries. That flexibility was necessary in order to provide an appropriate response to the stress on the financial markets. Thus, in the first phase of the pandemic, purchases exceeded those made later and were also more concentrated on the assets under the greatest pressure. That is precisely why commercial paper was purchased on a massive scale at the start, because this segment had practically come to a standstill. For the same reason, the Eurosystem began by purchasing relatively more government bonds of countries where interest rates had risen the most, although the capital key remains the ultimate benchmark for allocation of these purchases. That enabled all euro area countries to enjoy flexible financing conditions, thus reducing the risk of divergent developments. The Next Generation EU recovery plan launched by the European Council last summer was another policy instrument – a fiscal one, this time – which curbed the tendency towards fragmentation.

21. Thanks to the PEPP, the sudden tightening of conditions on the financial markets in the initial phase of the coronavirus crisis was totally reversed. By the end of 2020, ten-year government bond yields were actually slightly below their level at the beginning of the year, while governments had issued a substantial quantity of new loans to finance their support for the economy. For example, while yields on Belgian ten-year government bonds stood at 0 % in January 2020 and had risen during March and April, they came back down to –0.4 % in December. That is only just above the Eurosystem's deposit facility rate (–0.5 %), so that the yield curve is unusually flat. In December, the Governing Council announced that purchases under the PEPP would be used to maintain favourable financing conditions from here on. Purchases will therefore depend on market conditions, and if those are favourable, the PEPP budget need not all be used. Conversely, if market conditions are unfavourable, it can be increased if necessary.

If market conditions are favourable, the PEPP budget of € 1 850 billion need not all be used

22. While the large-scale purchase of government bonds was a key instrument, the aim was always to ease financing conditions in general, particularly for the private sector. The government bond yield curve in fact forms the basis for setting the other interest rates in the economy. Maintaining low interest rates also means that an expansionary fiscal policy does not hamper private investment. This ensures maximum support for the economy, and that is necessary for price stability. In fact, inflation in the euro area fell sharply in 2020, and was even slightly negative at the end of the year. That does not only reflect the steep fall in oil prices and the temporary VAT cut in Germany but is also due to a more far-reaching effect of the crisis. At present, the crisis is having a more severe impact on demand than on supply, so that the downward pressure on prices, especially in the case of services, outweighs the rise in costs due to the crisis. While the price stability objective remains the primary motive for the highly accommodative monetary policy during this crisis, too, a major part of the impact currently takes place via government financing costs. Any lasting revival of inflation will be linked to the recovery of the economy which, in the specific circumstances of the coronavirus crisis, entails fiscal policy support.

23. It is precisely this interaction between the two spheres that has enabled monetary policy to make a major contribution towards stabilising the economy, even though the key interest rates were already close to their lower bound. There was therefore no reason to fear that this would render it powerless. Without any deliberate coordination, spontaneous synergy emerged between monetary and fiscal policy during the coronavirus crisis, as a strong fiscal response was necessary in any case. Fiscal policy is only effective if it remains credible and does not jeopardise the sustainability of the public debt. That does not depend solely on the current interest rate situation. The measures adopted must also be sufficiently targeted and temporary, and must provide effective support for growth potential. In that way, the debt can still be funded once conditions change. The spontaneous synergy created has the same inherent characteristic: it should not be seen as a structural feature. It is not monetary policy's job to ensure the sustainability of the public debt.

24. Since the private sector in the euro area is financed primarily through the banks, support for bank lending has been the ECB Governing Council's third main aim since the start of the crisis. The key instrument for that purpose was the easing of conditions for the targeted longer-term refinancing operations (TLTROs). During the emergency phase of the pandemic – initially from June 2020 to June 2021 but since extended to June 2022 – the banks can obtain finance from the Eurosystem at –0.5 %, or even –1 % if they do not reduce their lending to businesses. In addition, the eligible amount under the TLTROs was increased on two occasions. At the same time, the collateral criteria for the refinancing operations were eased. These very favourable conditions fuelled particularly strong demand for TLTRO funding. The banks were thus better able to respond to the strong demand for credit from firms during the first wave. Moreover, there was no increase in the interest rates charged to businesses and households in 2020.

The TLTROs are the main instrument for supporting bank lending

Prudential policy: support for lending and focus on the financial system's stability

25. The prudential regulators and supervisory authorities granted the banks additional scope for using the available capital and liquidity buffers to assist in the transmission of the monetary and fiscal support measures to the non-financial private sector while taking care not to endanger the stability of the financial system. Certain elements of the regulatory capital requirements were eased in order to support lending and absorb the losses caused by the crisis.

The Belgian banks' microprudential supervisory authorities – the SSM for significant institutions and the Bank for less significant institutions – freed up capital totalling around € 4 billion. The macroprudential countercyclical capital buffers, which had been activated in Belgium and in several other European countries before the public health crisis erupted, were very quickly cut back to 0 %. This gave the Belgian banks around € 2 billion in additional capital. Counting the margin already available, that gave them access to over € 20 billion in usable capital at the end of March. Micro- and macroprudential recommendations strongly advised against any inappropriate use of these buffers for the distribution of dividends or other profit sharing until 1 January 2021. The Bank extended this macroprudential recommendation to all Belgian banks and insurers, including subsidiaries of international groups.

More flexible capital requirements give the banks extra scope for safeguarding lending

26. The Bank has yet to release the macroprudential buffer of around € 2 billion for Belgian mortgage loans, but stands ready to do so in the event of rising losses on these portfolios. This buffer was introduced in 2013 to give banks the necessary resilience in the event of housing market shocks or a steep rise in unemployment. The Belgian residential property market stood up well during the initial months of the coronavirus crisis. Both lending and prices even showed signs of a further acceleration in the second half of the year. However, owing to the Bank's prudential expectations introduced on 1 January 2020 regarding credit criteria for new mortgage loans, this renewed dynamism no longer seems attributable to excessively loose lending. Ultimately, the application of prudent credit criteria will lead to a steady reduction in the risky sub-segments of Belgian banks' mortgage portfolios. For the time being, however, they continue to pose a risk to financial stability in Belgium. Tensions could arise, for example, on expiry of the moratoria for mortgage loans. Releasing the buffers could then help the banks to find lasting solutions for customers seriously affected by the crisis whose debt levels are too high. That will lower the risk of a housing market crisis resulting from a sharp increase in payment defaults and foreclosures.

The capital buffer for Belgian mortgage loans will be released as soon as the need arises

27. Although the proportion of problem loans has remained stable at around 2 % of total outstanding loans, the Belgian banks made preparations in 2020 for a surge in loan losses. In the first nine months, their profit and loss account recorded € 2.5 billion in additional loan loss provisions. There was also a marked increase in the proportion of restructured loans, despite the temporary exclusion of loans subject to a general payment deferral scheme.

28. That said, the low default rate in 2020 bears witness to the success of the measures taken regarding direct income support, temporary suspension of bankruptcy procedures, and the provision of bank credit to keep defaults to a minimum. Charters and legislative initiatives enabled eligible borrowers to defer their debt repayments and their insurance premiums. At the end of September, this concerned no less than 13 % of business loans and 6 % of mortgage loans. At the same time, many borrowers took out new bank loans to fund temporary, limited shortages of liquidity. In March and April, large multinationals made extensive use of existing credit lines with Belgian banks to strengthen their liquidity position and compensate for the decline in turnover. They then began to repay these loans as the economic situation improved and access to alternative funding sources was restored. In 2020, small and medium-sized Belgian firms' use of bank credit was more stable and slightly higher. Consequently, following the brief, temporary increase in March and April, lending to Belgian businesses recorded an annual growth rate of 2.4 % in November, compared to 4.1 % at the end of 2019. The extension of existing regional schemes and establishment of a new federal mechanism for State-guaranteed bank lending gave the banks additional scope for lending to risky but viable businesses in a highly uncertain economic situation. The federal mechanism was set up in April for a total of € 50 billion and covered loans with a maximum term of one year. It was expanded

Deferred repayment of loans and additional bank lending largely fulfilled firms' liquidity needs in July by a second mechanism targeting the specific needs of SMEs and covering loans with a maximum term of three years. At the end of the year, the latter mechanism was extended until 2021 and covered loans with a maximum term of five years. Although this is a crucial element of the economic policy mix, use of State-guaranteed loans for business borrowers has so far remained relatively limited. This may indicate that the other support measures and non-guaranteed bank credit met the liquidity needs of the majority of businesses during the year under review. As these other support measures decline or disappear in 2021, the banks will have to ensure that eligible businesses retain easy and sufficient access to this – as yet little used – alternative source of finance. Since the second lockdown has lasted longer than originally estimated, additional temporary measures must no doubt be envisaged for certain pockets of businesses, especially those sectors that are the most vulnerable in the face of the crisis.

Fiscal policy mainly supported households and businesses

29. Fiscal policy also responded very vigorously throughout the world in order to stabilise the economy. In many cases, the fiscal stimulus exceeded that at the time of the financial crisis. This applies not only to the United States, Japan, the United Kingdom and China, but also to euro area countries, including Belgium. Two EU decisions taken at the start of the crisis in March facilitated this decisive response in the euro area. First, the Ecofin Council activated the so-called general escape clause relating to the EU fiscal rules. Under that clause, the fiscal rules can be suspended in the event of a serious shock, provided that does not compromise the sustainability of public finances. This clause will continue to apply in 2021. Also, the EC introduced a temporary framework for the state aid rules, in view of the great need to support businesses. Furthermore, the fact that monetary policy has kept financing costs down greatly facilitated the expansionary fiscal policy. In the euro area, the budget deficit increased to around 8.8 % of GDP. In Belgium, France, Italy and Spain, it even exceeded 10 % of GDP, primarily because those countries had already recorded a relatively high deficit in 2019. In the euro area, the public debt climbed to around 100 % of GDP. In Belgium, it equals 115 % of GDP, while it is approaching 120 % of GDP in France and has reached that level in Spain. In Italy, the public debt actually escalated to 160 % of GDP. Although support was necessary in the short term, in the future it will be equally necessary to keep watch over debt sustainability.

The EU fiscal rules had already been suspended by March

30. In the various countries, fiscal support follows a similar pattern, comparable to that in Belgium. For instance, the automatic stabilisers represented about half of the fiscal stimulus in this country. There was also additional expenditure totalling around 1.3 % of GDP to deal with the public health crisis. Around four-fifths of that expenditure was borne by the federal government, and one-fifth by the Communities and Regions. Households received income support equivalent to 2 % of GDP, most of which was charged to the federal government. Direct aid to businesses amounted to 1.6 % of GDP in 2020. Over half of that aid came from the Communities and Regions. This consisted of subsidies in cases of compulsory closure or a slump in turnover. Overall, the budget deficit came to 10.1 % of GDP compared to 1.9 % in 2019. The debt of all levels of Belgian government combined increased to 115.1 % of GDP, up by 17 percentage points against 2019. Three factors account for this rise : the budget deficit itself, the steep fall in GDP, and a range of operations which drive up the debt even though they are not recorded in the budget deficit. Those operations also reflect a form of support via fiscal policy. This concerns the deferral of tax and social security payments and the loans granted to businesses by the federal and regional investment companies, e.g. in the aviation sector. The guarantee mechanisms set up by the various levels of government to support lending had no impact on either the deficit or the debt in 2020. However, they will do so once these mechanisms have to absorb actual loan losses.

The budget deficit reached 10 % of GDP in Belgium and the public debt amounts to 115 % of GDP

Next Generation EU: the first common fiscal instrument for combating the crisis

31. In parallel with the fiscal policy conducted at national level, the EU also adopted new common initiatives. These aim to ease the pressure on the public finances of the individual Member States by letting Europe shoulder part of the stabilisation burden. In April, three new safety nets were created: a new ESM credit line for Member States, a guarantee fund for business loans granted by the European Investment Bank, and a credit mechanism to fund schemes which help to safeguard the jobs of employees and self-employed workers. That is supplemented by an even more crucial instrument: the Next Generation EU (NGEU) plan launched in July. It concerns a total of € 750 billion to be financed by EU debt issuance. This is the first time that a common fiscal crisis management instrument has been activated.

32. The explicit aim of the NGEU is to help the weaker countries to withstand the coronavirus crisis, and they have proportionately greater access to the plan. In addition, just over half of the amount concerned, namely € 390 billion, will take the form of grants. That represents a stimulus of almost 3 % of GDP but is staggered over the period 2021-2026. For some countries, this stimulus is multiplied up, while it is smaller for the wealthier countries, including Belgium. The remainder will consist of loans to the Member States. In view of the plan's timing, the NGEU is not really a cyclical stabilisation instrument. Instead, it aims to strengthen the economic recovery from 2021 and boost both the resilience and the growth potential of the Member States. To that end, it comprises explicit governance rules which will ensure that the resources are used to promote investment and structural reform in the Member States. This plan is also to be used first and foremost for the essential green and digital transitions. In that regard, Member States have to submit their national recovery and resilience plans by 30 April 2021. The debt contracted for the NGEU will be repaid from 2028 over a maximum period of 30 years, either out of new EU own resources or, if need be, via contributions from the Member States. The NGEU is an important milestone in the process of European integration, even though it is only a temporary initiative. The success or failure of the NGEU will determine whether such instruments will also be deployed in the future.

From 2021, the Next Generation EU plan is to strengthen the recovery and boost both the resilience and the growth potential of the Member States

Although the worst was avoided in 2020, there are still major challenges ahead

33. The strong, coordinated stimulus in the various policy spheres managed to safeguard the economy and the financial system in 2020. In the euro area, the policies were even implemented in lockstep for the first time. This was in stark contrast to the 2011-2012 debt crisis, when monetary policy alone offered support, while banks and governments in the most vulnerable countries were trapped in a negative spiral. Nevertheless, there are still considerable challenges ahead, in both the short and the long term. To enable the economy to recover in the transition to the post-coronavirus era, it is necessary to be able to redirect resources speedily and to resolve solvency problems. The crisis must not leave permanent scars on the labour market, and social cohesion must be preserved. Moreover, all levers will have to be activated to attain by 2030 the 80 % employment rate set by the federal government. The digital and green transitions must become reality, making the economy both more efficient and more sustainable. Following extensive use of fiscal policy during this crisis, and now that the costs of population ageing are increasingly being felt, it will also be indispensable to attend to the sustainability of public finances. Finally, the authorities responsible for monetary and prudential policy must also move on from crisis mode. The economy cannot be supported indefinitely. Once the emergency is over, it must start finding its way to a structural recovery. If all these policy areas are fully deployed, the coronavirus crisis will eventually shape the economy of the future.

3. From support to recovery: what is needed to enable the economy and the financial system to prosper again and to preserve social cohesion?

The transition to the economy of the future requires a more fluid reallocation of resources

34. As the virus will continue to have repercussions on the economy in 2021, some support is still desirable at first. Some sectors are still in an acute crisis phase. However, as the public health situation and economic conditions return to normal thanks to vaccination, that support will need to be more selective, and be gradually but resolutely withdrawn. In the acute phase of the crisis, the principal risk is that, owing to a lack of adequate support, too much of the production potential is lost with the disappearance of viable businesses. Once the economy is out of this danger zone, however, another risk will predominate: the risk of excessive and inefficient support artificially ensuring the survival of unviable businesses. Not only would that entail immediate budgetary costs, it would also be bad for the recovery itself, which will be neither vigorous nor sustainable if it has to rely on so-called zombie firms. Their disappearance is ultimately beneficial to growth, as it frees up resources for more productive activities. The faster these resources are reallocated to future-oriented activities, the stronger the recovery will be.

The recovery can be neither vigorous nor sustainable if it relies on zombie firms

35. However, owing to the specific characteristics of the coronavirus crisis, this essential reallocation process is not easy. First, this crisis makes little or no distinction between viable and non-viable businesses. Consequently, a firm's financial health is far less reliable than usual as an indicator for guiding this reallocation process. Next, the crisis itself is engendering a whole range of changes, and it is harder to determine which activities will be viable in the future. These changes apply not only between sectors but also between firms in the same sector, depending for example on their location or their ability to adapt their business model. Furthermore, it is as yet unclear whether these changes are temporary or more structural. Nonetheless, it is already evident that the coronavirus crisis has reinforced the trend towards digitalisation. In addition, the economy must in one way or another respond to the challenges of the green transition and climate change and transition and the progressive ageing of the population. These factors must therefore always be taken into account in the transition to the economy of the future.

36. The strength of the recovery and the speed at which the Belgian economy absorbs the economic changes triggered not only by the health crisis, but also by the ongoing digital and environmental transitions will depend on a whole host of resilience factors. Although all of them are relevant, the capacity to reallocate resources – both capital and labour – to activities geared to the future deserves particular attention in the current context. Yet that kind of adaptability is effectively one of the Belgian economy's weaknesses. History has shown that the process whereby dead-end businesses disappear and new ones are created does not work very well here. On the contrary, some firms have managed to remain in business for long periods without resolving their profitability problems. That is one of the factors accounting for the weak productivity growth and the inadequate propagation of technological innovations. The wide geographical disparities in unemployment rates and the large number of unfilled vacancies are another indication of this lack of agility. The top priority for policy must be to facilitate the necessary transitions. Otherwise, the permanent loss of activity due to the coronavirus crisis will be greater and a persistent core of structural unemployment will develop, as it generally did in previous crises. It is therefore necessary to deploy a wide range of

The top policy priority must be to ensure that the necessary transitions are made easier mutually reinforcing levers. One of them is the creation of a competitive market environment allowing room for newcomers and encouraging innovation. The continuation of recent initiatives to stimulate the entrepreneurial spirit and the development of venture capital should also enable the rate of business start-ups in Belgium to be raised on a lasting basis. To back up these policies, the consequences of the 2019 insolvency law reform must also be studied once the situation returns to normal, so as to assess the impact on the dynamism of the economic fabric. Another priority involves judicious steering of the transition process on the labour market, notably by reinforcing and encouraging acquisition of the new skills demanded by the market, whether in the education system or throughout careers, by facilitating the geographical mobility of workers or by enabling a better match between wage and productivity dynamics at firm level. The financial sector is crucial in the reallocation of resources.

The financial sector plays a key role in the reallocation of resources to viable businesses

37. The financial sector has a key role to play in the structural reallocation of capital and labour to businesses and sectors capable of supporting growth in the recovery phase and in the transition to the economy of the future. By assisting in reducing the excessive debt burden in viable firms and phasing out funding of non-viable firms, the sector will help to determine the strength, dynamism and sustainability of the economic recovery. Previous financial crises have shown that it is vital to recognise and write off irrecoverable losses promptly and in full.

Certain sub-segments of the money, bond and property fund markets remain vulnerable to market shocks

38. On the financial markets, the prices of traded securities are very quick to take account of changes in the issuers' financial prospects. In the event of market imbalances and major shocks, this market valuation principle may lead investors to take refuge in secure assets and cash. The coronavirus crisis and the resulting "dash for cash" thus revealed some vulnerabilities in a number of sub-segments of the money market, the bond market and the property fund market. Intervention by the central banks limited the disruption of normal market operations, and most equity and bond markets bounced back fairly quickly in 2020. Even the hardest-hit sectors of activity were again able – subject to an appropriate risk premium – to attract third-party funding or to reschedule their debts on these markets. It should nevertheless be noted that, once the share and bond prices recovered, investors made a clear distinction between different firms and sectors on the basis of their appraisal of the business prospects after the corona crisis.

The Belgian banking sector has the necessary resources to tackle dynamically a crucial role in the recovery phase

39. For many businesses and households, the banking sector remains the sole source of external finance in the form of debt. For credit institutions, adequate provisioning for credit risk and the writing-off of non-performing loans are therefore important ways of wiping out irrecoverable losses caused by the crisis and preparing for the subsequent recovery. But the many support measures and the great uncertainty over economic developments have made it hard for banks to arrive at an accurate assessment of the underlying credit quality of loans on the basis of traditional indicators which have now been distorted. In view of the great uncertainty concerning the progress of the pandemic and the economy, this resulted in relatively large variations in the size of banks' provisions according to the IFRS 9 accounting standard, even between institutions in the same country. However, it is evident from these divergences that some banks, using relatively favourable assumptions, are liable to underestimate their loan losses. In so doing, they are not only over-optimistic about their financial capacity, they also risk compromising the vigour of the economic recovery, partly by not being quick enough to terminate the financing of zombie firms, and partly by not granting sufficient debt restructuring

and supplementary resources to viable businesses. Thanks to its sound financial position at the start of the crisis and its large capital and liquidity buffers, the Belgian banking sector has the necessary resources to adopt a dynamic approach in fulfilling this crucial role in the recovery phase, but without endangering financial stability. In the context of this crisis, a high degree of reticence in that respect is counterproductive, as it would considerably prolong and amplify the impact of the crisis on the real economy.

40. The recapitalisation of viable businesses facing temporary solvency problems preserves the economic fabric and speeds up the economic recovery. It can be achieved via debt reduction by arrangement with creditors, but also by the injection of new capital within the companies concerned or by the issuance of subordinated debt. The Belgian federal and regional authorities were very quick to recognise the need to supplement liquidity support with a series of measures aimed at promoting the reinforcement of the firms' equity capital. For many of them, the economic recovery combined with their own efforts and tax measures such as the reconstruction reserve will not actually be sufficient to restore a sound solvency margin in the short term. Therefore, the existing frameworks for public sector participation in firms have been expanded, and new initiatives adopted to attract more private and institutional investors to viable businesses.

The recapitalisation of viable businesses facing temporary solvency problems preserves the economic fabric and speeds up the economic recovery

The smooth reallocation of resources is needed on the labour market, too

41. The coronavirus crisis already inflicted some loss of jobs in 2020. The transition to the economy of the future will entail further job losses, but other jobs will be created elsewhere. It is absolutely vital that the essential reallocation of resources takes place smoothly on the labour market, too, in order to prevent the coronavirus crisis from becoming a source of structural unemployment. That adaptability on the labour market will also strengthen social cohesion. There is much at stake because the sectors most affected are highly labour-intensive activities in which many workers already have a fairly vulnerable profile. The crisis also curbed the growth of the labour force in 2020, whereas that is generally little affected by cyclical fluctuations. This could be a temporary phenomenon due to the health restrictions imposed, fears of infection or the sudden stalling of demand for labour, discouraging people from looking for jobs. Nevertheless, permanent departure from the labour market must be prevented. The low employment rate in Belgium is already attributable primarily to the low participation rate. It is therefore crucial to retain people in the labour force or, better still, to support their entry to the labour market, especially as the labour supply will be further reduced in the future as a result of population ageing. Consequently, it is inappropriate to revert to previous arrangements which encouraged workers approaching the end of their career to leave the labour market by taking early retirement. Restructuring needs to bring socially acceptable solutions and also aim to raise the employability of the workers in question, through interaction with the public employment services. In addition, maintaining the supply of labour is absolutely essential if the target of an 80 % employment rate is to be met.

Adaptability on the labour market will also strengthen social cohesion

42. The current support policy aims to ensure that the coronavirus crisis does not leave permanent scars on the labour market. The COVID-19 temporary lay-off scheme is a particularly suitable tool for that purpose, making it possible to withstand the temporary shock while preserving the intrinsic added value of existing employment relationships. Both employers and workers have often invested in acquiring human capital specific to the business. However, as time goes by,

there is an increasing risk that this same scheme may prevent the necessary adjustments. It must therefore be phased out. Instead, workers who lose their job must be able to find other work quickly via intensive support combined with training opportunities and appropriate financial incentives. Once job creation picks up again, there will no longer be any grounds for suspending the tapering of unemployment benefits. Even in 2020, the labour market proved highly responsive. Following the sudden stalling in the first wave, the supply of work in temporary employment agencies and public employment services rapidly began rising again. During the third quarter, the vacancy rate again reached 3.3 %, almost equalling its end-2019 level. The reallocation of resources due to the crisis had already begun in 2020, driven by the business activities which were doing best.

43. The coronavirus crisis in no way alters the usual recommendation to call on each individual's talents and responsibility. At a time of profound changes, it is important for everyone to have the necessary skills and abilities to find a place on the labour market, and to retain it. This crisis has highlighted two aspects in particular. First, the acquisition of basic digital skills proved to be more crucial than ever. The digital revolution depends on digitally proficient human capital. A major effort is needed here, in terms of both education and life-long learning. That will make digitalisation less disruptive. Also, since it changes the nature of work it may even enable people to continue working longer. Let us not forget that the coronavirus crisis has also inflicted serious harm on education. The educational shortfall must be made good and everything possible must be done to prevent pupils from dropping out early. In practice, remote learning has widened the gap with the most vulnerable pupils. Here, too, there is a danger of the coronavirus crisis leaving permanent scars, at a time when comparative international studies reveal that inequalities in performance at school were already particularly pronounced and the general quality of education had already declined before the crisis began.

In practice, remote learning has widened the gap with the most vulnerable pupils

44. In an environment where the coronavirus shock has had an asymmetric impact on different sectors or firms, and a reallocation of resources has already begun, the social partners must ensure that the forthcoming pay negotiations leave sufficient scope for sectors – or even specific firms – to make adjustments. That will enable wage setting to provide a clearer indication of where the most rewarding job opportunities are located and thus encourage reallocation. In accordance with the Law on the Promotion of Employment and the Safeguarding of Competitiveness, it is also necessary for the social partners to ensure that wages stay in line with those in neighbouring countries. It is actually vital to maintain competitiveness at a time when the economy is navigating a difficult period and the coronavirus crisis is liable to lead to a reorganisation of global value chains.

The urgently needed digital and green transitions, requiring not only public investment but above all guidance for the private sector

45. Public investment undoubtedly has a major role to play in the digital and green transitions. Moreover, in Belgium the infrastructure has suffered from a lack of government investment, despite the constant rise in primary expenditure. Boosting investment geared to growth potential is therefore recommended. The additional NGEU resources should be allocated to supporting the digital and green transitions. Indeed, that is stipulated in the NGEU governance framework. Although this supplementary stimulus is temporary, it still amounts to € 5.9 billion, or 1.2 % of GDP, over the next six years. That amount needs to be spent carefully and judiciously. The government also has an important role to play in facilitating this essential investment, as the private sector will actually have to supply much of the investment effort and the best way of doing so is to ensure coherence and synergy with public investment projects.

46. This interaction between public and private sectors also distinguishes the challenges of digitalisation. Governments need to be digital pioneers in their own operations and invest in the population's digital know-how and skills. At the same time, digitalisation is also a crucial issue for businesses, their workers and their customers, which in turn are also other businesses or consumers. Since digitalisation is already fairly advanced in Belgium, it helped to create resilience during the crisis, and progress has actually speeded up. Yet the application of the latest developments in areas such as robotics, 3D printing, cloud computing and artificial intelligence is only just beginning. Their successful implementation depends not only on technological progress itself but also on firms' adaptability. The entire operating and management model needs to adjust in the same way as workers' skills. The digital network infrastructure also comes under the private sector. Belgium has a high level of connectivity via fixed broadband. However, in the case of mobile internet, that connectivity is not so good and suffers from the government's delay in granting 5G licences. But this technology is crucial for the successful transition to the digital economy, especially for the development of new activities and production methods. Besides, this crisis should also be an opportunity to make up for the lag in the field of e-commerce in Belgium and lift the remaining obstacles.

Digitalisation created resilience during the crisis

47. The private sector's contribution will be equally crucial for the climate transition. This applies primarily to businesses, as they emit around three-quarters of the greenhouse gases. The remaining quarter comes from households, which will need to invest in adapting their homes and their motor vehicles. To achieve these investments at microeconomic level, the government must above all act as the coordinator of the transition process and offer appropriate incentives to steer private initiatives in the right direction.

48. There is a whole array of useful tools for this purpose, but from an economic point of view the most effective is to send a clear message via pricing. By setting a socially appropriate price for CO_2 emissions and at the same time announcing a plan for subsequent increases, the government makes it clear to businesses and households that they must adapt their choices. The EU emissions trading system applicable to large companies indirectly achieves such pricing. However, the resulting carbon price is highly volatile, and that may blur the signal. Action could also be taken by intervening directly in pricing, e.g. by introducing a carbon tax. That eliminates the uncertainty over prices and therefore facilitates investment decisions. In , e.g. other taxes. Of course, the arrangements for putting this appealing idea into practice will not be easy to establish. There is no doubt that carbon pricing will have an impact on businesses and households, even though current low prices of fossil fuels make this measure appropriate. But the impact will be even smaller if businesses and households have access to low-carbon alternatives. Hence the need to promote these alternatives and the importance of investment in research and development. Greater flexibility must form part of the answer in this area, too, as the creation of value must shift away from high-carbon to low-carbon technologies. In the short term, it is likely that introducing carbon pricing will lead to early amortisation of some equipment. Some households with no access to low-carbon alternatives will also see their spending increase. With a view to making the carbon tax budget-neutral as laid down in the government agreement, a redistribution mechanism funded by the proceeds of the tax would make it possible to preserve at least part of the purchasing power of the most needy and the competitive edge of vulnerable sectors, without however reducing their incentives to invest in low-carbon technologies.

Steering the climate transition via a clear price signal is the most effective approach from an economic viewpoint

49. The climate transition creates new challenges and opportunities for financial institutions. It is also reflected in their customers' expectations and needs. The prudential supervision authorities are taking various measures to ensure that the financial sector takes better account of the risks

associated with climate change. Owing to the financial sector's key role in financing the real economy, that should make it possible to speed up the transition to a low-carbon economy while still monitoring the inherent risks, especially in the event of an abrupt transition.

50. Climate and digitalisation are so systemic that they cover many areas of focus. Moreover, in a federal country like Belgium, they come under different levels of power. The lack of unanimity between these various entities is the main reason why 5G has yet to be adopted. There is likewise need for an agreement on the allocation of the climate targets, which have now been revised upwards. The management of the public health crisis in 2020 also demonstrated the complexity of the decision-making process in Belgium. The roll-out of the vaccination campaign also requires intense cooperation and coordination. Finally, in the future, the various levels of power must agree on their contribution to the sustainability of public finances. The Communities and Regions have also seen their deficits rise sharply; moreover, they are responsible for a large part of the expenditure. It is important for this coordination to be harmonious, with maximum synergy as the aim in view. That could speed up the decision-making process and avoid burdening economic life with a regulatory framework made more cumbersome by fragmentation or poor coordination between levels of power.

Harmonious coordination between the various levels of power is vital

Without adjustment, the sustainability of Belgian public finances is at risk in the medium term

51. At this stage, it is by no means certain that the economy will need a further fiscal stimulus to support the recovery. The exceptional character of this crisis and the efforts to preserve the economic fabric are such that the recovery could be largely spontaneous once the public health situation no longer inhibits activity. The marked revival in the third quarter of 2020 – admittedly interrupted by the second wave – clearly suggests that. Furthermore, the recovery will be stronger if the reallocation of resources can take place smoothly. In addition, the large savings buffer that has been built up could give a strong boost to demand once consumption opportunities are no longer hampered by the virus and confidence has been restored. For the years ahead, there is already some fiscal stimulus in prospect in the federal and regional governments' recovery plans, and in the fact that some of the measures adopted during the coronavirus crisis are not temporary: a significant proportion of the additional expenditure in the health care sector is structural. There are also plans for increasing the lowest pensions. Moreover, even without this last factor, the budgetary cost of ageing increases by 0.2 % of GDP, each year from 2022 onwards.

It is by no means certain that the economy will need a further fiscal stimulus to support the recovery

52. According to the Bank's latest estimates, if policy remains unchanged this implies that the budget deficit will only decline to a limited degree in the coming years, from 10.1 % of GDP in 2020 to 5.9 % in 2023. Apart from the disappearance of the temporary crisis measures, it is the revival of economic activity that accounts for this modest reduction in the deficit. That will restore the tax base following the severe impact of 2020, although not completely because the crisis is likely to have caused some permanent loss of income. It is therefore all the more important to put a determined effort into revitalising the economy in order to limit that loss, and that will have a favourable impact on the budget. Primary expenditure is expected to reach 55 % of GDP by 2023, or about 5 percentage points more than before the coronavirus crisis. However, only about half a percentage point of that increase will result from higher public investment to support growth.

53. A deficit of around 6 % of GDP will result in a further rise in the debt ratio, even with the currently exceptionally low interest rates. Adjustment will therefore be necessary as soon as the economic recovery is robust, otherwise the sustainability of public finances will be

at risk. The deficit must be cut fairly speedily to 3 % of GDP, which, in the current circumstances, is the level at which the debt ratio can be stabilised. After that, the aim must be to progress towards the medium-term objective of a structurally balanced budget so that the reduction in the debt ratio enables budgetary reserves to be built up once again. Without any significant increase in the fiscal and parafiscal burden, most of the effort will need to be made on the expenditure side. In any case, the effect on growth potential must be a key criterion in the adjustment of revenue and expenditure.

A 6 % deficit means a further rise in the debt ratio, even at current interest rates

54. It cannot be assumed that interest rates will remain permanently low and in themselves ensure the sustainability of the debt. According to its mandate, the Eurosystem's monetary policy is meant to preserve price stability, not the sustainability of public finances. Sooner or later the day will come when interest rates take off again, and governments will then need to be able to control their debt ratios. In that context, purchase programmes such as the PEPP must not be taken to imply that the Eurosystem will continue to buy up government bonds unconditionally. Those purchases are also motivated by price stability and by their key role in the transmission of monetary policy in the present circumstances. Safeguarding the sustainability of public finances is therefore intrinsically a matter for fiscal policy. Deviating from that would jeopardise the stability-oriented foundations of the Monetary Union.

55. Since the allocation of responsibilities benefits from a clear governance framework, the suspension of the fiscal rules should end as soon as possible once the acute phase of the crisis is over. That suspension does not mean that the Stability and Growth Pact no longer applies. On the contrary: it was specifically pursuant to the Pact that the escape clause was activated. In the meantime, it is preferable to agree on simplifying the rules, as their complexity hampers the implementation of the Pact. It is also necessary to examine how sufficient scope can be provided for public investment without compromising the debt's sustainability. However, simplification must not serve as a pretext for delaying the lifting of the escape clause. Once the crisis is over, reserves must be built up in order to safeguard the sustainability of public finances. That is the only way for social security to remain an effective stabiliser, and for new scope to be created for fiscal policy to absorb shocks. That is very important, as this crisis has once again demonstrated. Moreover, Belgium's fiscal policy would benefit from a further improvement in the national governance framework. It is desirable to obtain a better estimate of revenues when drawing up the budget and to introduce multiannual budget plans, possibly accompanied by an expenditure rule. Furthermore, the various levels of power need to conclude clear, binding agreements on the budget targets.

Creating buffers is necessary so that future shocks can also be absorbed

Monetary and prudential policy after the coronavirus crisis

56. In January 2020, the ECB Governing Council launched a review of its monetary policy strategy, as the strategy's current formulation dates back to 2003. Since then, the economic and financial environment in which monetary policy operates has undergone radical change. The advent of a low interest rate environment is one of the main structural changes. That is not so much due to monetary policy itself, but instead results from weaker productivity growth, a higher propensity to save, and a marked preference for risk-free assets. The result is a low equilibrium interest rate, which makes it more difficult to conduct a stimulating monetary policy and to counteract the downward pressure on inflation. That accounts for the increasing use of unconventional instruments, such as large-scale asset purchases. The coronavirus crisis has now exacerbated these challenges. Other factors such as globalisation, digitalisation, climate

The National Bank held a public hearing on 22 January concerning the review of the monetary policy strategy

change and the expanding role of non-bank financial intermediation are also altering the environment in which monetary policy is conducted, and merit serious consideration. The review is an inclusive process in which various stakeholders express their views. In that connection, on 22 January, the Bank held a public hearing attended by a wide range of societal organisations. Belgian citizens were also invited to state their point of view on monetary policy via an online portal, and the findings of these consultations will be taken into account in the Council's deliberations.

57. This review does not involve any debate on the price stability objective, as that mission is stipulated by the EU Treaty. Instead, the review concerns the best way of fulfilling that mission in a profoundly altered environment. In this regard, the formulation of the price stability objective and the factors underlying the low level of inflation are key issues. The discussion also concerns the effectiveness of current policies, notably the use of unconventional instruments, and their secondary effects, e.g. for savers and financial stability. In that regard, a particular issue is the extent to which macroprudential policies could mitigate the undesirable side effects of the monetary policy. If there is insufficient scope for that, then monetary policy must take on a bigger role in this area. It is also necessary to examine whether, within the limits of the Treaty and without prejudice to the pursuit of price stability, monetary policy can help to achieve other economic policy goals. Examples include the promotion of employment and the battle against climate change. Finally, it is necessary to analyse the interactions between monetary and fiscal policy. These are important in times of crisis, but also subsequently, as monetary policy must be able to fulfil its price stability mission totally independently at all times. The review is to be completed by the end of the summer of 2021. Its findings will help to determine the formulation of monetary policy after the current emergency phase of the coronavirus crisis. The Eurosystem is not the only body assessing its strategy: other central banks are doing the same. For instance, in August 2020, the Federal Reserve concluded its strategy review. Apart from a more voluntaristic approach to achieving the goal of full employment, following a period of inflation below 2 % the US central bank will, in principle, aim at slightly higher inflation for a while. The Federal Reserve expects this strategy to make it easier to anchor inflation expectations at around 2 %.

The review's findings will help to determine the formulation of monetary policy after the emergency phase of the coronavirus crisis

58. For the financial sector, the impact of the coronavirus crisis will remain a major concern in the short term. Although stress tests and strong solvency positions suggest that credit institutions and insurers have sufficient capital reserves to absorb losses in an adverse scenario, the regulatory and supervisory authorities will nevertheless need to keep a close eye on the impact on profitability and solvency of the expected increase in defaults on the part of households and businesses, and of any renewed turbulence on the financial markets. They must also ensure that, in this regard, financial institutions do not fail to perform their crucial functions in the financial system but, if need be, deploy the available capital and liquidity buffers to safeguard those functions at all times. In this connection, these authorities must watch for any impediments to the appropriate use of these buffers, and draw any lessons for the future, because the coronavirus crisis is the first thorough test of the new capital framework established in Europe for banks and insurers following the global financial crisis, and is an opportunity to assess – and, if necessary adjust – its operation.

Regulatory and supervisory authorities must ensure that financial institutions do not fail to perform their crucial functions

59. The prudential policy focus on preventive crisis management during the year under review was a crucial factor in the success of the decision-makers response to the eruption of the coronavirus crisis. Releasing the buffers and temporarily easing certain prudential rules gave credit institutions the necessary scope to perform their role fully in absorbing the initial

shock. In the future, this crisis mode must gradually give way to the recovery phase. So, the financial sector must do its part in the structural reallocation of capital and labour in favour of businesses and sectors capable of supporting economic growth in the recovery phase and shaping the economy of the future. In this phase, the supervisory authorities must continue to encourage the use of the released buffers, except for the distribution of dividends, share buybacks or capital writedowns which should be temporarily strictly limited according to the EU-level recommendations. In this connection, it could be useful to publicise the path and timetable to which the banks must adhere in rebuilding the reserves used. In order to facilitate the reconstitution of these reserves, the authorities will need to be attentive to ensuring that the conditions for sufficient profitability and competitiveness in the financial sector remain guaranteed.

60. In 2021, the Bank will need to maintain a close watch on the residential property market in Belgium. At the first signs of rising losses as a result of defaults and excess debt levels, it could release the macroprudential capital buffer activated since 2013, thus reducing the likelihood of a housing market crisis. Developments on the commercial property market, reflecting in particular the increased use of e-commerce and teleworking, will also need to be reviewed regularly in monitoring financial stability. Other points for the attention of the supervisory authorities predate the coronavirus crisis but remain relevant, such as the need to adapt the business model of financial institutions to the context of persistently low interest rates, digitalisation and heightened competition from non-bank financial players in niche markets, including the payments sector. The need for tighter control over operational risks, such as IT risks and cyber risks, and a sound framework for supervising compliance with the money-laundering obligations must also be borne in mind. Redefinition of business models and risk management must also take sufficient account of the growing importance of risks and opportunities associated with climate change. That will enable the financial sector to arm itself against unforeseen shocks to the economy and to continue helping its customers to absorb them and overcome the challenge.

4. Conclusion

61. In 2020, the public health crisis very rapidly became the most severe economic crisis since the Second World War. As in many other countries, economic activity in Belgium contracted severely, dropping by 6.2 %. The slowdown was most marked at the peak of the first wave of infections, while the impact on the economy was limited during the second wave. The crisis had a very asymmetric impact. It particularly affected the services sectors, where the business model centres on social contact. That also explains why small firms and self-employed entrepreneurs suffered the most, as they operate in the hardest-hit sectors. Furthermore, those sectors are highly labour-intensive, and the most vulnerable groups are the ones which have suffered most so far. That implies the risk that existing labour market vulnerabilities will be perpetuated, or even exacerbated. This is also a highly unusual crisis, in that it originates from entirely outside the economic system. That prompted the monetary, prudential and fiscal authorities to respond vigorously and simultaneously to enable viable businesses to get through the period afflicted by the virus. At the same time, they made it possible to safeguard existing jobs and support households' disposable income. The launch of the vaccination campaign now offers hope of some improvement, and the economy has demonstrated great resilience since the first wave. This reinforced the conviction that assistance in getting through the crisis was the only proper approach. It avoided the total collapse of the economic fabric and laid the foundations for tomorrow's recovery.

62. But the job is far from finished. There remains great uncertainty over the likely outlook for the economy. The virus will continue to affect the economy for some time yet, and the solvency problems facing firms will grow as the crisis persists. In the first instance, some support is therefore still desirable, and solvency problems must be appropriately addressed. However, as the economic situation returns to normal, the assistance must become more selective before being gradually but resolutely withdrawn. The economy cannot be supported indefinitely : it has to find its own way to structural recovery after the emergency phase. The Belgian economy will need great flexibility in order to adapt readily to the transitions ensuing from the coronavirus crisis and the digital and green agendas, and in order to cope with the reduction in the labour supply resulting from population ageing. The financial sector has a key role to play in this reallocation of resources. In 2020, the sector already took on board the various economic policy impulses aimed at addressing the massive liquidity need resulting from the crisis. Thanks to its sound financial position at the start of the crisis and substantial capital and liquidity reserves, the Belgian banking sector has the resources needed to perform this crucial role dynamically during the recovery phase. It is absolutely vital that, on the labour market, too, the essential reallocation of resources takes place smoothly in order to prevent the coronavirus crisis from becoming a source of structural unemployment. Such adaptability on the labour market will also strengthen social cohesion. That will take some effort, because in the past the scars left by crises have remained visible even after the actual crisis was over. What is also needed is intensive coordination between the different areas of action and all the various levels of power in Belgium to put the economy of the future in place.

63. At the moment, it is by no means certain that the Belgian economy will need any further fiscal stimulus in order to recover. If it does, that stimulus must in any case be both temporary and targeted, and must also genuinely support growth potential, e.g. via carefully considered public investment. Those principles have not always been followed. Some of the fiscal measures in the period 2020-2023 are not only structural but also sometimes concern current expenditure at a time when the budgetary cost of ageing already amounts to 2 % of GDP each year regardless of any crisis. That is one reason why, despite the assumed abolition of the temporary support measures, the budget deficit is only forecast to decline from 10.1 % of GDP in 2020 to 5.9 % of GDP in 2023. Another reason is the permanent loss of income

resulting from the crisis, eroding the tax base at a time when, without any change of policy, expenditure will continue to rise at the same pace as before the crisis. That again underlines the importance of resolutely tackling the process of revitalising the economy in order to limit that loss. The remaining deficit will need to be corrected by fiscal consolidation as soon as the recovery is sufficiently vigorous. The timing of the consolidation is therefore uncertain, but there can be no doubt that it will entail adjusting the budget. In fact, even given the current exceptionally low interest rates, a deficit of around 6 % of GDP will propel the debt ratio still higher, while the general government debt already reached 115 % of GDP in 2020. Structurally sound public finances are essential for social security to remain an effective stabiliser and to find new scope to enable fiscal policy to absorb shocks.

64. Not only the fiscal policy-makers but also the monetary and prudential authorities will need to make a gradual exit from crisis mode while taking care to safeguard the stability-oriented foundations of the Monetary Union. Sustainable public finances and constant attention to price stability and financial stability are essential in the long term to ensure that the economy functions well and to withstand any future crises. In view of the scale of the support, this return to normal in the various policy areas will be a particularly tricky balancing exercise. The outcome will be decisive for the ultimate success of the efforts to manage the coronavirus crisis initiated in 2020.

Pierre Wunsch
Governor

Brussels, 27 January 2021