REPORT 2023

Preamble

NationalBank OF BELGIUM

Eurosystem

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

After weathering a series of crises in recent years, the global economy entered calmer waters in 2023. The public health crisis and the robust recovery that followed the gradual lifting of pandemic-related restrictions were no longer the foremost factors influencing economic developments, although certain impacts were still being felt. Russia's war in Ukraine continued, and new military conflicts erupted around the European neighbourhood over the course of the year, but these have yet to have a significant impact on the global economy. Although geopolitical uncertainty was unusually high, the macroeconomic impact of exogenous shocks generally remained limited throughout the year.

The rapid tightening of monetary policy did not lead to a crisis and seems to have been accompanied by a soft landing for the global economy. Interest rates rose further in 2023, causing some volatility in the financial markets, which was exacerbated by the collapse of a number of, primarily US, banks. However, the rise in interest rates had a significant impact only on certain sectors of the real economy. The global economy showed robust growth, despite the fading momentum of the post-pandemic recovery. The major economic crisis that was often forecast did not materialise. At the same time, inflation fell sharply almost everywhere. While annual averages remain relatively high, they provide an incomplete and delayed picture of actual inflation given that they reflect year-on-year price movements. Price growth nevertheless slowed over the course of the year and was already much closer to central banks' targets by the end of 2023.

As the impact of large exogenous shocks has now eased, the focus of policymakers can shift from managing acute crises to tackling more structural challenges. The return to a more stable environment also implies that potential growth differentials are more apparent when looking at the economic performance of individual countries and regions. In this respect, the European economy is clearly lagging behind: the euro area did not suffer a severe crisis but teetered on the brink of recession for almost the entire year. A number of other advanced economies showed much more resilience. Moreover, most forecasts, including those of the Eurosystem, expect the euro area to see only a modest rebound in growth in the coming years, with its growth potential eroding against the backdrop of population ageing. The key, therefore, will be to create the right conditions to encourage investment and use the available means of production as efficiently as possible. This need to boost economic potential through structural reforms certainly also applies to Belgium, although growth in the country last year was bolstered to a greater extent by strong domestic demand than was the case in the euro area.

* Two regents have not endorsed paragraphs 38, 40, 64 and 65 of this report.

The succession of crises in recent years also underscored the importance of adequate buffers to absorb shocks. In calmer times, sufficient attention should thus be paid to building up reserves. This applies not only to public budgets, but also to bank balance sheets. Non-financial institutions should likewise maintain healthy reserves. On average, Belgian companies were able to absorb a portion of the recent cost shocks thanks to large cash reserves or relatively high profit margins, which dampened inflationary pressures. Buffers at various levels will also be needed to meet the major policy challenges of the future, including the transition to a climate-neutral economy which will, in any case, require significant investment.

This introduction to the NBB's annual report, prepared on behalf of the Council of Regency, outlines the main economic developments of the past year, with a particular focus on the euro area and Belgium. It also examines the specific policy challenges facing Belgium, looking primarily at the reforms needed to safeguard and improve growth potential. This summary is followed by a more detailed analysis in the report's various thematic chapters.

1. The global economy remained very resilient, while inflation fell sharply

1. **Global economic growth continued to normalise after the strong post-pandemic recovery.** Russia's war in Ukraine continued, while new regional conflicts erupted and caused untold human suffering. However, the economic impact of exogenous shocks generally remained much more limited than in previous years. Global growth slowed somewhat, year-on-year, but this was mainly due to the euro area. Growth outside the euro area remained almost unchanged, on average. Given the sharp interest rates hikes resulting from monetary policy tightening, this was a noteworthy development. There was a partial slowdown in the second half of the year but current business cycle analyses and indicators suggest that this should remain relatively limited in scope and that growth should pick up somewhat in 2024.

2. **The strong economic resilience can be explained in part by labour market trends, particularly in advanced countries.** Even after the winding-down of the protective measures adopted during the pandemic, uncertainty and a temporary slackening of demand appear less likely to lead to redundancies, primarily due to labour shortages. This should allow employment to continue to grow, thereby preventing a somewhat weaker business cycle from turning into a steeper downturn. At the same time, however, increasing labour scarcity is limiting the growth opportunities for many industries in advanced economies.

3. **It is important to note, however, that global trade remains unusually weak, although a recovery is expected.** Trade flows are expanding much less than expected based on global growth and previously observed elasticities. As a result, the global economy is less connected and less dynamic : growth thus has to be shored up mainly by domestic demand. Trade weaknesses appear to result partly from temporary factors. For example, consumption growth is currently proportionally more focused on services, which account for a relatively smaller share of global trade. This may be linked to the post-pandemic recovery and the lengthy period during which the consumption of many services requiring inter-personal contact was interrupted or avoided. More generally, the very subdued growth in trade also reflects the weakness of the industrial sector in most countries. In this context, trade should in principle rebound as consumption and production patterns return to a distribution between goods and services more akin to that seen in the past.

4. **However, there are also signs of increasing protectionism which will eventually weigh more on international trade and, hence, growth.** Worryingly, trade barriers

are increasing globally. Such moves are, in many cases, closely tied to industrial and energy transition policies. In this regard, legitimate concerns around boosting environmentally friendly investments or strengthening the security of the supply of strategic goods will have to be reconciled with wealth creation through international trade. Measures that primarily shield the domestic economy, through subsidies, tariffs or qualitative trade barriers, should be avoided as they tend to trigger similar reactions by trading partners. International one-upmanship when it comes to subsidies reduces wealth, particularly for small open economies. In that context, within the European Union, the correct application of state aid rules should remain the guiding principle insofar as possible so as not to undermine the single market or encourage economic fragmentation. More generally, multilateralism and balanced free trade offer, in principle, the best guarantees for maximum wealth creation, especially for small open economies such as Belgium, yet geopolitical instability weighs on this reality.

5. **Growth differentials between countries and regions reflect in part the timing of the economic recovery from the various shocks.** As such, it was generally harder for the economy to rally in developing countries which could devote fewer resources to social safety nets during the pandemic. Sharp price increases for basic necessities, such as food, also played a major role in these countries, while the subsequent tightening of monetary policy, particularly in the US, led to lower capital inflows.

6. **Among emerging economies, China saw much lower GDP growth than expected in 2023.** In an attempt to contain the pandemic, China closed parts of its economy until the end of 2022, longer than other countries. However, the boost to growth from the reopening in 2023 remained very limited. Persistent problems in the mainly debt-financed real estate sector depressed confidence, with investment in housing, in particular, being scaled back and households also saving more as a precautionary measure.

7. **Among advanced economies, the US, in particular, rebounded strongly in 2023, while growth elsewhere, including in the euro area, slowed.** US domestic demand was bolstered by strong job creation and wage growth, combined with cooling inflation and supportive fiscal policy. Investment in environmentally friendly technologies and purchases of electric and hybrid vehicles were encouraged through tax credits, strongly boosting industrial activity, while manufacturing in other countries fell back. This is an example of a protectionist industrial policy that increases the US public deficit. As a general rule, such a policy reduces global wealth and can trigger responses from trading partners.

8. **Inflation declined sharply almost everywhere, driven mainly by falling energy prices, but increasingly also the easing of underlying price pressures.** The latter factor was due to decisive monetary policy responses by central banks, which prevented the temporary flare-up in inflation from turning into a longer-term wage-price spiral. However, this remained a difficult balancing act. The inflationary wave led, in general, to a marked decline in real wages. The current catch-up of nominal wages is aimed at restoring purchasing power and results in part from tensions in the labour market; it should be noted, however, that too rapid a rise in wages risks rekindling inflation.

9. **On the financial markets, the steep rise in interest rates increased volatility.** The sharp increase in the risk-free rate was, for public debt securities, compounded by a downgrading of the creditworthiness of some key countries and accompanied by sharply higher lending rates, including for mortgages. Equity markets faced major turbulence, with the effects of the interest rate rise amplified by several banking crises, mainly in the United States. However, problems at individual financial institutions were dealt with quickly and decisively by the authorities before they could undermine confidence in overall financial

stability. The rise in interest rates did have a negative impact on lending, but this was mainly limited to the real estate sector, and has not, at this stage, resulted in a general fall in demand.

10. **Overall, the global economy appears to be on course for a soft landing.** Along with the relatively significant tightening of monetary policy, fiscal policy also became somewhat more restrictive in many countries – with the exception of the United States – due in part to the unwinding of a wide range of measures taken during the energy crisis to support purchasing power. These actions did not trigger an economic crisis. After a few particularly turbulent years, the global economy sailed into 2024 on calmer waters.

2. In the euro area, inflation retreated rapidly, while economic growth was weak, partly due to a decline in competitiveness

11. **As in other advanced economies, monetary policy in the euro area continued to tighten sharply.** The ECB's policy rates have been raised by 450 basis points since July 2022, which, compared to previous monetary cycles, represents a substantial tightening over a relatively short period of time. However, taking into account average inflation in 2023, real interest rates have remained rather low. Alongside this, the ECB began to reduce the size of its balance sheet, albeit in a rather modest and passive manner, namely through the repayment of outstanding loans – so-called targeted longer-term refinancing operations (TLTROs) – and discontinuance of the reinvestment of principal payments from maturing securities under the asset purchase programmes (APP).

12. **In 2023, headline inflation in the euro area fell sharply to 5.4 % on average.** A year earlier, it had been over 8 %. This drop was mainly due to the very marked decline in energy prices, which were lower in 2023 than in 2022. Annual average core inflation, which excludes more volatile energy and food prices, continued to grow, however, reaching almost 5 %. Importantly, nevertheless, both headline and core inflation fell sharply over the course of the year. By early 2024, euro area core inflation had already dropped to below 3.5 % year-on-year, after a steady decline from the summer onwards. Along with monetary tightening, this development also reflected an easing of external cost pressures. Not only did energy prices drop, but supply chains also returned to normal, leading to a fall in the prices of various raw materials and intermediate goods.

13. **The focus of monetary policy subsequently shifted to how long the period of higher interest rates should last.** If maintained long enough, the current level of policy rates will contribute to a timely return of inflation to the medium-term target of 2 %. This is also evident from the Eurosystem's latest macroeconomic projections, which anticipate that headline and core inflation will retreat further to reach a level close to 2 % as from 2025.

14. **At the same time, the ECB remains vigilant to a resurgence of inflation**. This is related, among other things, to the risk of a new rise in energy prices in the context of heightened geopolitical tensions or to too high increases in nominal wages. Wage growth in the euro area is still very strong and difficult to reconcile with the inflation target. This is nonetheless normal after a period of real income losses and given the labour scarcity seen in many countries. However, the current rate of wage growth should not become entrenched, and future monetary policy will therefore depend on whether the pace of European wage growth slows again, as expected. Expectations of future interest rate cuts also play a role : too rapid a decline in long-term market interest rates, due to the fact that the financial markets erroneously expect a rapid easing of monetary policy, could rekindle inflation.

15. **Furthermore, it is important that inflation expectations remain well anchored.** Compared with the level reached during the second half of 2022, inflation expectations have started to fall again globally. This was, moreover, also a key objective of monetary tightening: initially, inflation was undoubtedly due mainly to temporary supply shocks, but it was vital to avoid high inflation leading to a persistent increase in the inflation dynamics.

16. **Fiscal policy developments are also an important factor in determining inflationary pressure.** While the exceptional measures taken during the inflation wave, including to bolster demand, were gradually reversed, budget deficits remained relatively high in many countries in 2023. The consolidation of public finances will need to be decisively pursued. This is necessary to ensure sufficient buffers in the event of a future crisis and to make it easier to return to the inflation target. Indeed, an overly accommodative fiscal policy fuels demand, and growing price pressures may necessitate further increases in the policy rates.

17. **In any case, the normalisation of monetary policy in the euro area is not over.** For instance, the ECB's balance sheet is still much larger than before the pandemic, having almost doubled, as a percentage of GDP, since the launch of the asset purchase programmes (APP) in 2015. In 2023, it was decided, furthermore, to delay until mid-2024 implementation of the decision not to continue to reinvest in full the principal payments from maturing securities purchased under the Pandemic Emergency Purchase Programme (PEPP).

18. **Monetary tightening was quickly transmitted to commercial bank lending rates, with fragmentation between countries remaining limited.** Interest rates on government securities rose sharply. There were limited changes to the risk spreads between euro area sovereign bonds which appeared mainly linked to underlying domestic fiscal developments. The transmission of monetary policy was not disrupted, possibly due to the existence of the Transmission Protection Instrument (TPI), although it has yet to be used. Interest rates on new loans to businesses and households rose to their highest nominal level since the global financial crisis. In the final months of 2023, however, there was a marked decline in market interest rates, perhaps based on market expectations of an imminent easing of monetary policy.

19. **Lending slowed abruptly but the downward pressure on demand has not, for the time being, led to a deep crisis.** Lending to households and businesses is stagnating, mainly due to less demand for credit and a tightening of lending conditions by euro area financial institutions. Loan applications are being rejected more frequently due, in part, to stricter collateral requirements. The impact of more limited credit growth seems primarily to have affected the property market: investment in housing has declined sharply, while property prices have seen slower growth and even fallen in some euro area countries. In contrast, other types of investment, including business investment, continued to expand.

20. **Growth in the euro area was, however, weaker than in certain other advanced economies.** The US economy fared markedly better, although it also underwent an abrupt tightening of monetary policy. With very limited growth, the European economy has in fact teetered on the brink of recession since the last quarter of 2022. Domestic demand – especially household consumption – remained weak despite relatively low unemployment, while exports dropped sharply in 2023. Countries that rely heavily on exports to drive growth, and that have done less to shore up domestic consumption, are struggling in particular. In Germany and the Netherlands, the wheels of the economy almost ground to a halt. In contrast, certain southern euro area countries, such as Spain, continued to benefit from the rebound of tourism.

21. **The relatively weak economic performance of the euro area cannot be unequivocally attributed to the business cycle or to monetary and fiscal policy; there are also**

structural causes at play. Indeed, according to most analyses, the competitiveness of European firms is deteriorating. This has to do with energy prices which, despite a recent decline, remain much higher than in the United States or in key emerging countries, in part owing to policy choices and measures related to the energy transition. This weighs particularly heavily on energy-intensive industries. Companies also point to uncertainty around energy supplies and the negative impact of tighter regulation. European exports declined in 2023 due to both weak global trade and the shrinking global market share of European companies, unlike in the previous period, with the latest Eurosystem forecasts pointing to a further decline in the coming years. Less wealth is therefore being created via exports.

22. **Moreover, the growth potential of the euro area is eroding.** Population ageing will reduce the contribution of the volume of labour to growth, thereby shifting the emphasis to productivity growth. The latter is lower in Europe than in other parts of the world. This gap is likely to widen further due to the fact that the EU has set clearly more ambitious climate transition targets than other countries. This is tantamount to a negative supply shock and will certainly drive up production costs in the short and medium term. In this context, it is worrying to note that an increasing number of industrial companies, which tend to have relatively high productivity levels, are indicating that they are mainly seeking to expand outside the European Union or considering discontinuing certain production processes in Europe. This would weaken the foundations for future growth and prosperity.

23. **Sufficiently high growth is necessary to successfully meet longer-term challenges such as population ageing and the transition to a low-carbon economy.** After all, the required expenditure and investment can best be sustained by an economy with the highest possible value creation. Policies should therefore aim to increase growth potential or mitigate the "collateral damage" of the measures adopted in this area. In so doing, the benefits of existing regulations, and certainly of any additional regulations, should be thoroughly weighed against the potential adverse effects on competitiveness and productivity.

3. Belgian economic growth is being shored up by domestic demand

24. **Belgian economic growth in 2023 was notably stronger than in the euro area.** Strong and relatively stable growth in economic activity was recorded throughout the year. Not only was the growth rate in Belgium higher than in the euro area and in neighbouring countries, but it also exceeded most prior estimates of potential growth. On a year-on-year basis, growth reached 1.5 % in 2023. Nonetheless, the malaise affecting Europe did not spare Belgian industry, which saw its value added fall sharply. However, this was offset by strong growth in services, albeit less than the year before when the post-pandemic normalisation was a key driver. In terms of its expenditure components, growth was sustained exclusively by domestic spending ; net exports, by contrast, exerted downward pressure.

25. **Household consumption continued to grow strongly even after the rapid post-pandemic recovery.** This was due to strong income growth : in the period from 2020 to 2023, the real disposable income of Belgian households increased by around 5 %, despite negative external shocks and skyrocketing inflation. In 2023 alone, household income in Belgium actually grew by approximately 3.5 % – much more than in the euro area as a whole.

26. **The purchasing power of Belgian households grew substantially in 2023 mainly due to the delayed effects of the automatic indexation of nominal income.** As a result of this delay, real income and purchasing power fell in 2022, but this deterioration was made up for in 2023 by the combination of significant indexation and an already declining inflation

rate. Most euro area countries do not have a system providing for the almost fully automatic adjustment of wages and replacement income to changes in prices. This meant that purchasing power grew more significantly in Belgium than elsewhere in 2023, at a time when specific government measures providing substantial, yet temporary, income support were being gradually phased out everywhere, and given that wage growth in other countries rebounded only gradually. More generally, as in previous years, Belgian household income growth was of course also bolstered by robust job creation and specific budgetary measures to reduce energy costs.

27. **Households did not, however, spend all of this additional purchasing power.** In 2022, the Belgian household saving rate dipped fairly significantly, but rebounded as expected in 2023, reaching more than 14 % of disposable income. Households react to substantial income volatility by adjusting slightly their saving rate. Consequently, household consumption tends to fluctuate less quickly than household income. That being said, the household saving rate is, at present, clearly higher than before the pandemic. According to the Bank's autumn projections, this will remain the case in the coming years due to higher interest rates, which render saving relatively more attractive. Moreover, higher savings generate more income from assets, which is saved more than other types of income.

28. **Despite strong growth in average income, some low-income households are exposed to financial difficulties.** Just under one-fifth of the population can be classified as poor, in relative terms, according to the statistics on income and living conditions (SILC) survey, a harmonised EU data collection exercise. It should be noted, however, that the risk of poverty has recently diminished somewhat and is lower in Belgium than in the euro area as a whole, although many countries, including the Netherlands, are still doing better. Poverty is concentrated among certain groups of the population, such as the low-skilled, the unemployed and inactive, tenants, single people (particularly single parents), residents of large cities, and people born outside the EU. Statistics show that, on average, the net wealth of Belgian households is among the highest in the euro area. In addition, inequality is relatively low compared with other countries and has even decreased recently.

29. **Belgian growth was mainly driven by business investment.** This increased spectacularly despite slackening business confidence, falling profit margins and markedly higher financing costs. Initial statistics and estimates even pointed to the highest investment growth rate in around twenty years. Based on interviews conducted for the NBB Business Echo, this was a fairly widespread trend, with companies continuing to invest in techniques to boost productivity (automation and digitalisation) as well as to reduce energy consumption or make processes more environmentally friendly. Overall, therefore, the impact of monetary tightening on business investment remained very limited. This was due not only to the significant cash reserves that companies had, on average, accumulated but also – for larger entities – to the internal financing possibilities within multinational groups. This means that the decline in bank lending to companies is not having a proportionate effect on investment growth.

30. **Household investment in housing has, however, been declining significantly for some time.** According to the latest statistics, by the end of 2023, investment was already down more than 10 % compared to two years earlier. Large rises in building costs and higher mortgage rates are slowing housing construction. Forward-looking indicators, such as the number of building permits issued and the number of new mortgage loans originated, notably dipped, suggesting that a recovery is not yet on the horizon. Although precise statistics for 2023 were not yet available at the time of writing, detailed figures on mortgage lending show that investment in both new construction and the renovation of existing housing has fallen

drastically. Nonetheless, under any realistic scenario, such investment should be scaled up relatively quickly in the transition to a net-zero economy.

31. **Exports also fell sharply last year. This was mainly owing to weak global trade but also to the fact that, as expected, the foreign market share of Belgian companies shrunk more than usual.** This was presumably due to worsening competitiveness, resulting, among other factors, from a faster rise in labour costs and still relatively high energy costs. A number of specific factors also weighed on exports, such as the drop in exports in the pharmaceutical industry, reflecting, amongst other things, the decline in vaccine sales. Imports fell much less, in part due to robust domestic demand, meaning net foreign trade clearly dampened GDP growth.

32. **Employment continued to grow, albeit at a somewhat slower pace, despite an uncertain outlook and a labour supply crunch.** In 2021 and 2022, employment growth reached record levels of almost 100 000 additional jobs per year. As economic growth moderated after the rapid post-pandemic recovery, the pace of growth in the labour market also normalised, with around 40 000 jobs added in 2023. At sector level, job creation reflected trends in performance, with strong employment growth in services and construction, but stagnation in the manufacturing industry. In addition, the average working time continued to increase, yet still remained below pre-pandemic levels, especially in manufacturing. Thus, growth remained largely based on higher labour utilisation, with productivity growth stuck below the long-term average. The unemployment rate held roughly steady at around 5.6 %, a level comparable to that recorded prior to the pandemic and thus still close to the lowest rates seen so far this century. In contrast, although the share of the working-age population not participating in the labour market dipped slightly, it remains high compared to other countries.

33. **The structural resilience of the labour market is mainly due to an acute labour shortage.** Vacancy rates remain very high and companies report increasing difficulty attracting workers, especially those with the right profiles. In this type of situation, employers are reluctant to lay off workers when demand falls, as they could face recruitment difficulties. Of course, if the drop in demand is perceived as temporary, this will further exacerbate matters. The overall result is a higher-than-usual degree of so-called labour hoarding, which adversely affects productivity and complicates the transition of workers to firms or industries with greater growth potential.

34. **In terms of price developments, in particular, the economy has moved into less troubled waters following the sharp decline in inflation.** After peaking in autumn 2022, headline inflation fell swiftly to just above 2 % on average for 2023 according to the HICP methodology, which has been harmonised at EU level. For a brief time in autumn, inflation in fact turned negative, meaning prices were declining year-on-year. Inflation, as measured by the national index of consumer prices, was somewhat higher, at just over 4 %, due to methodological differences, including concerning the weight of various products in the index. However, even by that measure, the reduction in inflation was very high – mainly due to the sharp drop in energy prices. On average, energy prices were almost 30 % lower than in 2022, despite the temporary flare-up in international oil prices seen over the summer, but still remain higher than in other countries. Nevertheless, this significant downturn in energy prices also explains why inflation in Belgium is today much lower than in the euro area as a whole. More specifically, changes in energy prices on the international markets are reflected more quickly in average consumer prices in Belgium due in part to a larger share of monthly index-linked energy contracts and the exact reporting of energy prices in the official price index.

35. **Food prices remained relatively stable in the second half of 2023, while core inflation dropped over the course of the year.** Processed and unprocessed foods have been a major

driver of high inflation. Since the end of 2021, prices for these products have risen by more than 20 %. This increase – in addition to even larger price rises for household gas and electricity – drove up perceived inflation sharply. Subsequently, however, this pressure on prices subsided, although food prices have barely budged since the summer. This means that, unlike energy prices, they currently remain at very high levels. The gradual easing of inflationary pressures was also reflected in core inflation, which excludes food and energy prices. The increase in the annual average compared to 2022 masked the decline in inflation seen in 2023. Thus, as from mid-2023, prices have risen by around 0.25 % on average per month. A year ago, this core rate was around twice as high. Nevertheless, it remains above the long-term average, with inflation in the services sector retreating much more slowly than for goods. In line with the Bank's projections, it seems clear however that the risk of a prolonged wage-price spiral – as observed in the wake of past supply shocks – has further diminished.

36. **On the property market, housing price growth cooled but affordability remains under pressure.** The price of an average home continued to rise in 2023, although growth was more limited than in previous years and may have partly reflected a better average quality of properties sold. In contrast, across the euro area as a whole, housing became cheaper, with relatively large price decreases reported in certain countries. Price increases in Belgium are in general being driven by lower investment in housebuilding and thus more limited supply, yet the averages conceal differences across market segments. For instance, prices for new-build homes have risen significantly more than for existing homes. This is due to marked increases in construction costs, as well as rising demand for energy-efficient homes in view of high energy prices and the (anticipated) introduction of increasingly stringent renovation obligations. Higher prices, together with significantly higher mortgage rates, are making it more difficult to buy a home. Despite the large increase in household purchasing power, this situation worsened somewhat in 2023. The monthly mortgage repayment burden has been partially mitigated by shifts towards longer loans and larger downpayments, with the latter often required by lenders. Empirical research suggests, however, that lengthening the term of mortgage loans may exert upward pressure on house prices. Irrespective of this, the affordability of home ownership remains a concern.

37. **Wage costs increased sharply due to the pass-through of inflationary pressures by automatic indexation mechanisms.** In 2023, the rise in hourly private-sector wage costs accelerated further owing to the delayed effect of indexation. In two years, despite zero growth in contractually negotiated wages and the availability of temporary targeted reductions in social security contributions, these wage costs rose by approximately 12 %. The bill for the supply shock thus fell largely on companies. In neighbouring countries, wage growth has been much more moderate than in Belgium, but also began to rebound by year's end. At least in the short term, this difference in labour costs implies a relatively significant worsening of cost competitiveness for Belgian companies.

38. **As expected, the rise in costs, particularly labour costs, was largely absorbed by high average corporate profit margins.** These margins had risen to record levels in the years leading up to the cost crisis and were much higher than in neighbouring countries, but have fallen sharply since 2022. This rise in profit margins partly reflected favourable composition effects, as relatively profitable sectors gained importance in the Belgian economy, but were above all the result of policies aimed at curbing labour costs. The abrupt rise in costs as from 2022 could thus be partially offset by lower margins. This was crucial to avoiding a prolonged wage-price spiral and, together with the tightening of monetary policy, allowed for a rapid drop in inflation once the various supply shocks ended.

39. **Competitiveness is important for an open economy.** The moderation of wage costs in the years preceding the pandemic helped to mitigate the loss of competitiveness. The labour

cost differential that had previously existed between Belgium and its neighbours was virtually eliminated in the period from 2014 to 2019, thereby restoring cost competitiveness. Export performance thus started to pick up: the downward trend in the goods balance was halted and the balance even began to improve, with Belgian exporters losing less market share than before. The labour cost differential that emerged following recent indexation is narrower than initially feared and smaller than the approximately 6 % recorded around the time of the global financial crisis in 2008-2009. However, according to initial statistics, it was once again accompanied by a relatively substantial loss of export market share in 2023 and, therefore, vigilance on this issue is required.

40. **The rapid fall in inflation should, in principle, help to narrow this newly emerged macroeconomic labour cost differential over time, according to our current projections.** Wage growth is now stronger in neighbouring countries, and the gap should therefore narrow in the future, provided wage cost increases in Belgium, aside from those resulting from indexation, remain very limited, in line with the regulatory framework. The combination of automatic indexation and highly regulated wage bargaining helps to prevent excessive or persistent slippage in this respect.

41. **Belgium's public finances remain a cause for concern, with the general government deficit projected to deteriorate significantly in 2023 and to exceed 4 % of GDP.** This is notable given that the budgetary impact of temporary effects actually improved in 2023, mainly due to larger temporary receipts, such as from the taxation of excess profits, alongside relatively little change in temporary expenditure. All in all, the improvement in the budgetary impact of temporary factors related to the energy crisis should reduce the deficit by approximately 0.5 % of GDP, compared with the 0.8 % deterioration currently forecast. This means that the budget deficit has structurally deteriorated.

42. **The upward trend in current primary expenditure is the main cause of the structural deterioration in public finances.** This item has been rising faster than potential growth for several years and gained further momentum in 2023. Compared with the year prior to the pandemic, primary expenditure rose by 2.4 % of GDP. About two-thirds of this increase is attributable to federal government and social security expenditure, but primary expenditure by the communities and regions also rose sharply.

43. **Social spending and personnel costs are the main drivers of public expenditure.** Social spending accounts for about half the increase seen since 2019, with the impact of population ageing already visible, e.g. a rising number of pensioners and, to a lesser extent, higher healthcare spending. In addition, the minimum amounts of certain benefits have also risen. Moreover, public sector wage costs have increased markedly. This is due in part to successive indexation over the past two years, which outstripped growth in the GDP deflator, thus causing indexed expenditure items (such as social benefits) to grow relative to nominal GDP. Wage costs also increased due to the upward trend in public sector employment, primarily pertaining to additional jobs in regional or local government or institutions falling under their authority, such as in the field of education. In contrast, federal employment has remained relatively stable of late. There has been a notable acceleration in public sector recruitment in recent years: from 2020 to 2023, an average of around 10 000 jobs per year were added to the public sector, while in the previous decade the rate was half this. In 2023, the public sector accounted for close to 20 % of net job creation.

44. **Government revenue also increased in 2023, once again reaching half of GDP.** Hence, the increase in primary expenditure was partly offset by an increase, albeit limited,

in government revenue. Following a slight drop in recent years, revenue again reached the symbolic threshold of 50 % of GDP, a level comparable to that seen before the pandemic.

45. **Compared with other euro area countries, the fiscal outlook for Belgium is far from rosy.** According to almost all institutional forecasts, including those of the Bank, should current policies remain unchanged, Belgium's budget deficit and public debt will continue to increase relative to GDP. In contrast, other countries with high public debt and a budget deficit are expected to see the latter shrink, as per the estimates of the European Commission, for example. By 2025, according to current forecasts, only Slovakia is expected to have a larger budget deficit than Belgium. This does not mean that there are immediate refinancing risks, but Belgium is among the countries presenting the greatest risk to the medium-term sustainability of its public finances.

46. **Large-scale fiscal consolidation is therefore urgently required.** As a member state of the European Union, Belgium is committed to respecting the common fiscal rules. This regulatory framework was suspended against the backdrop of the pandemic and other exogenous shocks, but will become fully applicable again in 2024. While a review of the technical and operational aspects of the framework has since been prepared, the basic objective will remain unchanged: member states should maintain sound fiscal positions. In that context, the EC has already announced that it will reinstate excessive deficit procedures in the spring of 2024 should countries not be in compliance with the fiscal rules, based on outturn data for 2023. In its July 2023 country-specific recommendations, the Council of the European Union recommended, moreover, that Belgium make an annual improvement in its structural budget balance of 0.7 % of GDP in 2024, primarily through limiting expenditure growth. Regardless of European regulations, it is important to build buffers during a period of normal economic conditions in order to be able to absorb future shocks. Adherence to the recommendations of the European Semester and the High Council of Finance should therefore be seen as a minimum objective by all levels of government.

47. **Keeping the budget deficit under control is made more difficult by rising interest rates and population ageing.** In 2023, for the first time in many years, the interest payments the government had to make on its debt grew, as a result of a rise in market rates on public debt securities. The latter are now well above the implicit interest rate, meaning maturing debt needs to be refinanced at a higher rate. As a result, interest expenses are automatically growing year-on-year, even as market interest rates are marginally falling back. Moreover, population ageing will lead to higher annual expenditure for some time to come, particularly on pensions but also on healthcare. Growth in pension expenditure could be curbed by additional reforms to align the parameters of the pension system more closely with those of other countries. This should, however, take into account the heterogeneity of these different systems and the fact that the average replacement ratio (between the pension and final salary) is currently no higher than the euro area average. In any case, assuming unchanged policies and based on current market interest rates, public spending is estimated to increase by 0.4 % of GDP each year over the next few years. Expressed relative to 2023 GDP, subsequent governments will need to reduce the budget balance by almost €2.5 billion each year simply to keep the deficit stable. Bringing the debt ratio down to a more sustainable level will obviously require a significant reduction in the budget deficit, making the efforts required that much greater.

48. **An analysis of the efficiency and effectiveness of expenditure should serve as an important guide as the required fiscal consolidation is pursued.** Almost all studies and indicators show that Belgium's very high public spending comes with relatively modest quality and efficiency. This applies to both the government as a whole and to many specific policy areas. Consequently, initiatives to improve quality should not take the form of – or in any case

should not be limited to – increased resources. More generally, giving greater priority to the government's core tasks is desirable. Tools such as spending standards and spending reviews can prove useful in this regard.

49. **The sustainability of public finances is a responsibility shared by all levels of government.** The increase in the budget deficit in 2023 was almost entirely at the federal level, and it is the federal government that has to shoulder the bulk of the interest burden and, through social security expenditure, the costs related to population ageing. This poor budgetary position is also the result of failures in fiscal coordination. Returning to a sound budgetary position as soon as possible will require efforts at all levels of government, which will in turn require effective coordination, for instance to deliver on commitments under European regulations. It is therefore high time for clear and binding agreements to be reached on the allocation of these efforts between the different levels of government.

50. **The required fiscal consolidation is also linked to, and should be supported by, other reforms.** Healthier public finances are easier to achieve if an economy shows greater structural growth. Fiscal and macroeconomic reforms should therefore go hand in hand. The main levers for the latter are undeniably productivity growth and the employment rate.

4. Further structural reforms are needed to improve the performance and resilience of the economy in the future

51. **The relatively good overall macroeconomic performance seen in 2023 should not obscure the fact that the growth potential of the Belgian economy, like that of the euro area, is eroding.** Tight labour market conditions mean businesses are hesitant to lay off workers, a situation which can serve to absorb shocks in difficult times but also limit growth opportunities. Due, in particular, to population ageing and despite the planned raising of the statutory retirement age, the growth contribution of labour will be put under increasing pressure in the coming years. To maintain GDP growth, it is thus all the more important to use the available factors of production as efficiently as possible while supporting productivity growth. To this end, further reforms are necessary. The challenges to be met in certain key areas are detailed below. A period free from disruptive exogenous shocks would offer the greatest scope to implement these reforms, which cannot be postponed, even in the event of more turbulence.

Higher productivity growth requires greater resilience, better adaptability and increased efficiency in several areas

52. **A particular concern regarding Belgium's longer-term growth potential is that the country's productivity growth is trending downwards, even more so than elsewhere.** This is due in part to the law of diminishing returns, as Belgian productivity is still relatively high in absolute terms. Moreover, productivity growth is also declining in other countries. Nevertheless, if this trend is not reversed, economic growth will be slower in the future. There are a number of explanatory factors for this low productivity growth, but it is generally seen as the result of a lack of dynamism in the Belgian economy. For instance, the level of regulation is, on the whole, relatively high, the diffusion of innovations is insufficient, scant attention is paid to lifelong learning, and the business landscape is not dynamic enough, with too little creative destruction and worker mobility. These factors feed on each other and lead to a relatively high degree of rigidity in the economy and thus lower productivity growth.

53. **Synthetic indicators, such as those of the OECD, consistently point to heavier regulation in Belgium than in comparable countries.** This is increasingly affecting more and more aspects of doing business in almost every sector of the economy, thus curbing productivity growth. Reference can be made here to the entry requirements for certain professions as well as to the permits and licences needed to establish a business. Launching new real estate or industrial projects is often complicated by a tangled web of permits and procedures, not to mention appeals by various stakeholders. As a result, large-scale investments are often delayed or even called off.

54. **Belgian companies lead the way in terms of innovation, but the diffusion of innovations throughout the economy remains too weak.** This strong capacity for innovation, as measured against European Commission indicators, is due in part to significant spending on research and development and constitutes an important asset for the Belgian economy. However, efforts to innovate are often concentrated within very large companies and in certain industries. The vast majority of firms lag behind when it comes to technology and invest relatively little in research and development. A more balanced distribution, including via greater attention to the marketing of innovations, would have a greater impact on productivity growth. In any case, new productivity-enhancing technologies, such as those based on artificial intelligence, should be appropriately regulated and embraced rather than discouraged.

55. **The business landscape is not dynamic enough and the concept of lifelong learning has yet to take root.** Corporate inflows and outflows are both lower in Belgium than elsewhere in the euro area. Again, this is mainly due to regulation, which affords a relatively high degree of protection to existing companies. For example, the bankruptcy rules in Belgium are among the most complex and costly in advanced countries. Furthermore, a number of rankings produced by international organisations point to the relative difficulty of starting a business in Belgium. The participation rate of Belgian workers in on-the-job training is also low. This is especially true for the low-skilled, despite how crucial it is to acquire skills that are or will be needed in times of economic change. Finally, studies show that, due to highly centralised wage setting, wage dispersion is relatively low in Belgium, which also limits labour mobility. All of these factors make it more difficult to shift productive resources from sectors or firms with low productivity to those with high productivity.

56. **Over time, productivity growth will be further impaired by a decline in the quality of education and the competitiveness of the Belgian economy.** Although technological developments are difficult to predict, it is already possible to identify certain factors that will weigh on productivity growth going forward.

57. **In this sense, reports pointing to the declining quality of education in Belgium are very worrying.** Although Belgium’s learning performance scores remain close to or just above the OECD average, they are deteriorating for all basic skills, in both primary and secondary education. This is partly a global development, which can be seen in neighbouring countries as well. It is also likely that the most recent results were negatively affected by school closures during the pandemic, but they are nonetheless consistent with a longer-term trend. In Belgium, this worsening in performance does not appear to have been caused by an insufficient deployment of resources, although labour shortages have been affecting schools in recent years. Far-reaching reforms are necessary as the quality of education is a decisive factor in future productivity. In addition, Belgium still lags behind in terms of STEM profiles, which could restrain the country’s relative productivity growth or increase costs for companies, as they will need to provide more training.

58. **In addition, declining competitiveness could reduce Belgium's attractiveness in the eyes of foreign investors.** Currently, the country still performs relatively well in studies measuring overall competitiveness and manages to attract substantial investment from multinational groups. Worsening competitiveness could lead, however, to lower net investment inflows. Thus, at the European level, energy-intensive industrial companies face a particularly pronounced competitive disadvantage given that energy prices are still higher overall than in other parts of the world. The at times substantial support mechanisms and rebates for energy-intensive companies available in several other European countries constitute an additional competitive disadvantage for Belgium. The country also performs less well than its neighbours with regard to other aspects of competitiveness, such as wage costs, red tape, regulation and labour scarcity. A decline in foreign investment, which often brings with it new technologies, would further dampen productivity growth.

In the labour market, the employment rate should be increased by making work more financially attractive and by putting in place effective activation policies

59. **The Belgian labour market has been thriving for several years now.** Despite the pandemic, net job creation stood at around 200 000 in the period from 2020 to 2022. Employment growth has since normalised somewhat but remains clearly in line with the historical average. Other euro area countries have also reported strong employment growth, however. During the pandemic, job losses were much more limited in Belgium, but in recent years the euro area has seen slightly faster employment growth, despite lower growth in economic activity. Belgium's relatively greater labour shortage may already be playing a role in this respect.

60. **The employment rate has been rising gradually, but the gap with the euro area, as a whole, has not narrowed.** Over the last decade, the proportion of the population aged 20 to 64 in employment in Belgium climbed by almost 0.5 percentage points per year on average, to approximately 72 %. This increase mainly concerns women and older workers and primarily reflects cohort effects (as more women participate in the labour market with each successive generation), as well as a tightening of the conditions allowing workers to withdraw prematurely from the labour market. However, other countries have also reported increases, and the difference between Belgium's employment rate and the European average remains considerable.

61. **The labour market is characterised by pronounced regional differences, although the improvement in the Brussels-Capital Region is striking.** The employment rate in the Flemish Region is below that of the best-performing EU member states but slightly above the European average and clearly higher than in the other two regions of the country. Compared with the Walloon Region, the difference remains more than 10 percentage points. In the Brussels-Capital Region, the employment rate is clearly below the national average, but climbed more than in the other two regions.

62. **The main reason for the lower employment rate in Belgium is not high unemployment but rather a large inactive population.** In 2023, the unemployment rate remained below 6 %, which is very low by Belgian standards and even lower than the European average. While this figure masks regional differences, it should be noted that the unemployment rate in each of the three regions came close to its historical low. In the Flemish Region, the rate was scarcely 3.5 %, which corresponds to roughly the minimum frictional unemployment rate, while unemployment in the other regions continued to be much higher than the European average. For the country as a whole, the unemployment

rate remains fairly low, but is accompanied by a high inactivity rate. The inactive population is comprised of people, including those of working age, who, voluntarily or out of necessity, abstain from participating in the labour market. This group is, yet again, relatively larger in the Brussels‑Capital Region and the Walloon Region. Although some people may have valid reasons for not participating in the labour market, the clearly larger size of this population in Belgium compared with other countries raises the question of what other factors could be at play here.

63. **At any rate, this sizeable non‑working population stands in opposition to substantial unmet demand for labour.** The various indicators of labour shortages have recently fallen back slightly, but the job vacancy rate remains extremely high, compared both to the past and the situation in other countries. Businesses continue to report, through surveys, that it is very difficult to find workers with the right profiles, which restricts manufacturing capacity. In the construction sector, which alone accounts for 8 % of job vacancies in Belgium, this could be a crucial factor in the energy transition, which will increase global demand for labour in a sector that already relies heavily on foreign workers. More generally, tensions on the Flemish labour market are also reflected in the increasing share of workers with flexible employment arrangements and the rising number of people with more than one job. Furthermore, labour shortages are likely to increase in the coming years due to population ageing.

64. **However, increasing the employment rate further will require more far‑reaching reforms.** The available figures on the labour market integration of Ukrainian refugees in all three Belgian regions offer some useful insight in this regard. First, it is striking that, overall, the integration process appears to be relatively laborious and slow compared, for example, with a neighbouring country like the Netherlands, where a considerably higher percentage of Ukrainian refugees are in work. It can be assumed however that, in both countries, the groups at issue are fairly similar, and, based on the job vacancy rate, there are relatively more jobs available in Belgium. This indicates that incentives to seek or accept a job could be strengthened, which seems to be mainly an issue of financial attractiveness. Furthermore, the employment rate of Ukrainian refugees remains noticeably lower in the Brussels‑Capital and Walloon Regions, underscoring the role played by public employment services and worker mobility schemes.

65. **Effectively guiding jobseekers to the large number of available vacancies is a first step towards improving the employment rate.** The number of registered jobseekers has grown sharply in all three regions, despite relatively stable unemployment. This trend is due in part to new rules or clearer obligations to register as a jobseeker, such as for the recipients of certain social benefits in the Flemish Region who are not in work. There are thus more opportunities to integrate this group into the labour market but appropriate follow‑up by public employment services is required. Here, too, the available resources must be allocated as efficiently as possible to guide jobseekers into work effectively, as was recently recommended by the Court of Audit in a case involving Actiris. Close cooperation between the various regional authorities and consistent compliance with the criteria for suitable employment are needed to increase the interregional mobility of jobseekers. Several initiatives have already been taken to this end, but mobility remains relatively limited. This is striking insofar as the rules on unemployment, for example, define "suitable employment" in relatively broad geographical terms and, in principle, as not being limited to the region of origin. Greater attention to removing barriers, for example through linguistic assistance, and tailored mobility solutions could, to some extent, improve mobility. Cooperation with employers could also increase the effectiveness of public employment services by, for example, allowing the most targeted training possible to be offered.

66. **However, extensive efforts in various policy areas are needed to increase the relative attractiveness of employment.** A number of factors can complicate the transition from unemployment or inactivity to employment. These mainly concern the match between required and acquired skills. Other factors such as the professional environment and working conditions, access to childcare, or even the availability of public transport before and after working hours, can also play a role. However, a major cause of unemployment or inactivity traps is that the difference in the financial gain derived from having a job and from receiving benefits is simply too insignificant or even negligible, especially for workers on the lowest pay. This is certainly the case when the additional costs associated with working, such as commuting and childcare, are taken into account, whereas the recipients of certain benefits often qualify for other advantages. For example, persons eligible for the so-called living allowance are also entitled to the social tariff for electricity and gas and increased coverage of medical costs. In general, those who accept a job quickly become ineligible for these additional advantages. A clear cross-cutting policy stance is needed to make work more financially rewarding, one that covers tax policy (taxes and social security contributions on earned income, particularly on lower salaries), pensions policy (the proportion of years effectively worked compared with periods treated as such for the purpose of calculating pensions), and the rules on various social benefits, including the availability of and access to affordable childcare for working parents and jobseekers.

Long-term climate goals require a coherent and holistic policy approach that minimises costs

67. **In recent decades, Belgium, like other countries, has significantly reduced its greenhouse gas emissions with less central guidance than today.** Between 1990 and 2022, emissions fell by around a quarter. It is notable that this was done while the economy and population continued to grow briskly: real GDP increased by 76 % over this period. The fall in emissions is therefore attributable to less energy-intensive growth and a reduction in emissions per unit of energy used. The first factor reflects in part the declining share of industry as well as technological progress, namely greater efficiency in power generation and use. The second factor is mainly related to changes in the energy mix, especially the gradual expansion of renewables. The recent closure of a number of zero-emission nuclear power plants could, however, slow the impact of the latter. In principle, technological progress will further reduce the energy intensity of growth. Nonetheless, it is clear that the past pace of emission reductions will not be sufficient to achieve complete decarbonisation by 2050, as required by the European Climate Law.

68. **Speeding up emissions reduction requires a more top-down approach.** In doing so, governments should ensure that sufficient emissions-free energy is made available and encourage households and businesses to use these energy sources (instead of fossil fuels) through an adequate combination of price setting and regulation. The EU's Fit for 55 package, adopted in 2023, defines the European framework for the climate transition, including an extension of the EU emissions trading scheme (EU ETS) and the creation of a Social Climate Fund, to support the most vulnerable households through targeted measures and investment. In addition, interim emission reduction benchmarks are imposed, including for sectors not covered by the ETS. In Belgium, emissions from the latter sectors must be reduced by 47 %, from their 2005 levels, by 2030.

69. **Belgium has opted to increase the electrification of end-use consumption, for example in transport and heating.** In addition to the planned generation of electricity

from renewables, this implies, above all, an urgent need for major investment in network infrastructure (as is the case at European level). Widespread electrification cannot be achieved without substantial expansion of the power grid, which will require a series of investment programmes whose total cost, for Belgium, is already estimated at close to €20 billion. These costs will have to be factored in to energy tariffs. Once the network infrastructure has been adapted and further reductions in emissions from power generation achieved, the relative prices of electricity and fossil fuels could be fully adjusted through targeted fiscal measures to encourage electrification.

70. **The acceleration of the climate transition is likely to increase the burden on households and businesses in the short term.** In this sense, the transition can be compared to a negative supply shock. With this in mind, a clear social agreement on the sharing of the bill between households, businesses and the government must be reached.

71. **A heavier burden on companies could further worsen cost competitiveness and productivity growth.** The EU, which is responsible for around 7 % of global greenhouse gas emissions, currently imposes much more ambitious rules in terms of decarbonisation than other major blocs or countries. This gives rise to an additional competitive advantage for non-EU companies, which can produce more cheaply for longer. Energy-intensive industries, in particular, may come under pressure as a result. It should also be noted that further technological progress is still needed to achieve full decarbonisation for certain production processes, although to some extent this objective can be met through emissions offsetting methods.

72. **The carbon border adjustment mechanism (CBAM) was created to counter this competitive disadvantage but does not offer a comprehensive solution.** The mechanism works like a tariff wall and imposes a levy on imports so that they are subject to the same carbon price as equivalent goods produced in the EU (based on emission allowances). It should be noted that the mechanism does not protect European exporters competing in foreign markets with non-European producers for whom the carbon price is lower. Furthermore, like any import duty, it may drive up prices in the EU, which could lead to higher labour costs. This will, incidentally, be the case in Belgium due to automatic wage indexation. Moreover, the mechanism is being introduced very gradually and will only reach cruising speed by 2030. Therefore, the relocation or further development of certain industries outside the EU, in addition to a strong exchange rate shock, appears to be a real risk of which policymakers should take account.

73. **In addition to price setting, governments are also using regulation to navigate through the climate transition.** This is true for transportation and, particularly, housing. Regulation should preferably be technology-neutral and focused solely on the primary objective of decarbonisation. For example, emissions from the existing building stock can be cut by reducing demand for heating (including through better insulation) and decarbonising heating sources. At the moment, efforts are mainly focused on reducing the demand for heating, through a renovation obligation and the use of energy certificates. However, this results in high or very high renovation costs for most homes. The question is whether this is the most efficient solution from a macroeconomic perspective. Greater regulatory neutrality, with a better balance between the reduction of demand and the decarbonisation of heating sources, may be desirable.

74. **Developing the required flanking policies should be an integral part of the climate transition.** A general policy direction has been clearly defined. While the macroeconomic costs of full decarbonisation will be substantial though highly uncertain, the same goes

for a scenario in which the effects of climate change cannot be avoided. This uncertainty should not hold back the climate transition. That being said, the transition to a net-zero economy will be disruptive at several levels and will require coherent long-term planning. The supply side also needs to be considered: given possible supply constraints and current labour shortages, a too abrupt increase in demand for the raw materials, products or labour necessary for the climate transition will mainly result in higher prices. Furthermore, the transition will have a heterogeneous impact on households at different income levels. In this respect, undesirable redistributive effects should be avoided. It is also important to safeguard strategic independence at the European level. The energy supply should not be overexposed to geostrategic risks by relying on non-European countries for the supply of essential components in the value chain, as is also the case for other production processes. Finally, the transition will also affect public finances, given the current taxation of fossil fuels. This loss of revenue will need to be made up.

5. Turbulence in the global banking system underscored the importance of good risk management, strict regulation and adequate buffers to absorb shocks

75. **In March and April, the global banking sector experienced some turbulence due to the failure of several US regional banks and the Swiss bank Credit Suisse.** Tighter monetary policy and higher interest rates increased banks' funding costs and reduced the market value of fixed-rate long-term assets. Against this backdrop, investors became wary of the impact of rate hikes on the profitability and solvency of financial institutions.

76. **In the US, this situation led to an abrupt and large-scale outflow of deposits from some medium-sized regional credit institutions.** These banks had a number of specific vulnerabilities in common, such as a business model focused on a single economic sector and a high percentage of uninsured deposits. Above all, however, inadequate management of interest rate and liquidity risk led to the recognition by these institutions of large losses on their income statement, thereby undermining depositor confidence. Deregulation by the Trump administration and ineffective supervision also played an important role. To ensure the stability of the US banking system and contain the crisis, the US authorities had to intervene decisively and take control of these banks.

77. **Credit Suisse also lost the confidence of the financial markets and had to be bailed out.** The bank, considered a systemically important institution for the global financial system, had, in recent years, been affected by a series of scandals, serious shortcomings in its anti-money laundering system and poor risk management and had undergone several restructurings. It had also reported recurring losses. Following further losses, the bank announced a thorough restructuring in the second half of 2022, accompanied by a CHF4 billion capital increase intended to absorb the losses the reorganisation would generate. Against this backdrop, heightened turmoil on the financial markets in the wake of bank failures in the United States completely undermined already weakened confidence in this fragile European bank. Backed by Swiss government guarantees and emergency liquidity from the Swiss central bank, Credit Suisse was sold to UBS in March for a low price. The Swiss regulators also decided to fully write down Credit Suisse's so-called Additional Tier 1 bonds. This type of subordinated debt instrument can be converted into capital or written down in a crisis situation. Since Credit Suisse's shareholders received payment from the acquirer, UBS, in exchange for their shares, this decision amounted to an unexpected reversal in the normal ranking of creditors. European regulators rushed to confirm that they would continue to respect the normal ranking in this kind of situation.

78. **However, the crisis of confidence did not spread to other European countries or to the Belgian banking sector.** Aside from the fact that Belgian banks were only negligibly exposed to the most affected institutions, the more robust financial position of Belgian institutions, their diversified business model, better risk management, proper supervision, and the quality and quantity of their liquidity and capital buffers all played an important role. For instance, unlike the hardest-hit US banks, Belgian and European banks are subject to the Basel standards on banking supervision, which have been transposed into European law. While strict regulation and effective supervision helped make the difference, there is no room for complacency, and it is important to draw lessons for the future from these recent events.

79. **The resilience of the Belgian banking sector in the face of this turbulence was bolstered by a further improvement in profitability in 2023.** With an annual return on equity of 12.5 % over the first nine months of 2023 and of 10 % in 2022, the Belgian banking sector (excluding financial market infrastructure) posted very good, albeit not excessive, results over the past two years. This level of profitability was, however, sufficient to allow a return on equity in line with market expectations. An institution must offer a return in line with market expectations in order to maintain adequate access to the capital markets, allowing it to raise additional capital, if necessary. This level of return also ensures that shareholders will support the organic growth of the balance sheet in accordance with the demand for credit in the economy. Insufficient profitability or accrued losses weaken the financial position of banks and, as demonstrated by Credit Suisse and the US regional banks, can ultimately undermine the confidence of depositors and other creditors.

80. **The higher profits recorded by the Belgian banking sector were mainly driven by an increase in income from its core business, namely the transformation of short-term deposits into long-term loans.** A large proportion of Belgian household savings consists of bank deposits. Banks therefore have access to a large and stable source of funding, which they mobilise to provide credit to households and businesses. The classic model of financial intermediation assumes, after all, that short-term stable deposits can be used, in part, to finance long-term fixed-rate loans, provided the risks associated with this maturity transformation are carefully managed. The return on this transformation and on the associated risks for banks is called the interest margin, i.e. the positive difference between the average return on assets and the average return on liabilities. This margin was under severe pressure when interest rates were low, as the average return on liabilities bottomed out, while returns on assets continued to decline. With the rise in policy rates and other market interest rates, however, the profitability of this core banking business improved substantially in 2022 and 2023, for both large banks and smaller (savings) banks. Over the first nine months of 2023, net interest income was €2.4 billion higher than in the same period in 2022. Although high inflation also sharply increased banks' costs (by €0.9 billion), the (consolidated) banking sector's net profit for the first nine months of 2023 rose by €1.9 billion to €7.2 billion.

81. **The interest paid on regulated savings accounts increased less than would be expected based on market interest rates.** With an effective return of 0.62 % earned in November, the interest paid on savings accounts fell short of what could be expected based on the pass-through of higher market rates to bank interest rates observed in the past. Such pass-through would have resulted in interest rates on savings of around 1.1 % in November 2023. While banks ultimately raised their interest rates for savings accounts to levels well above this figure, they often tied the highest returns to certain conditions (the opening of a new account, a maximum monthly deposit) or to a proportionately large loyalty bonus compared with the base rate, as a result of which the average effective and acquired returns on all regulated savings accounts remained limited through the fourth quarter of 2023.

82. **To manage interest rate risks, banks are obliged to maintain an appropriate balance between the interest rate sensitivity of their assets and that of their liabilities and to use hedging instruments, where necessary, to offset imbalances.** In doing so, they must take into account the specific repricing characteristics of these assets and liabilities and try to estimate in advance, to the best of their abilities, the reaction of customers to changes in market interest rates. In the past, little or no interest was paid on a large proportion of sight deposits, while interest rates on savings accounts generally followed market rates, albeit gradually and with a certain delay, regardless of whether they were rising or falling. Banks take into account historical trends in the stability and remuneration of deposits when managing their interest rate risks. On this basis, they model, for example, that for regulated savings accounts, a permanent 1 % rise/fall in the yield curve translates, after the first year, into a rise/fall in the saving rate of around 0.4 %, an additional 0.3 % in the next two years, and then into further gradual pass-through, up to full pass-through, in subsequent years. These characteristics and the interest rate risk modelling of sight and savings deposits determine the financing possibilities for fixed-rate assets without excessive (and, in that case, risky) reliance on interest rate derivatives. Today, about three quarters of Belgian mortgages have a fixed interest rate for the entire term of the loan. The flip side of this protection for households against interest rate rises is that the average yield on the mortgage portfolio has been slow to evolve and barely exceeded 2 % at the end of November 2023.

83. **Belgian banks nevertheless have sufficient financial leeway to continue to increase gradually the interest paid on savings accounts and thus consolidate the stability of this important source of funding without compromising their financial health or interest rate risk management.** Stable regulated savings accounts are important for ensuring sound financial intermediation and the stability of the Belgian financial system. For this reason, the Bank advocated maintaining the statutory minimum interest rate (0.01 % base rate and a 0.10 % loyalty bonus) during the period of low, sometimes even negative, interest rates. When market rates start to rise, the interest rate on savings accounts should reflect these changed market conditions. If not, banks are exposed to the risk of seeing a portion of this stable source of funding shifted to other investments. In August and September 2023, households invested a total of €21.9 billion in the new one-year State note, which benefitted from a reduced withholding tax rate (15 %) and a net yield of 2.81 % and thus offered an attractive alternative to savings accounts. As a result of this issuance and the efforts made by banks to retain deposits through the offer of high-yield term accounts, savings account balances fell by almost €30 billion to €265 billion between the end of July and the end of September. Overall, Belgian household deposits with Belgian banks fell by almost 6 % over this period. Banks were able to manage this large outflow, which could be absorbed by their liquidity buffers, but it nevertheless constituted a material shock to their funding base, interest margin, and profitability.

84. **The Bank supports measures that could lead to greater transparency and customer mobility on the savings market but has warned of the risks associated with introducing a higher statutory minimum interest rate on savings by tying this rate to a market rate.** In 2023, the finance minister requested substantiated opinions from the Bank on three legislative proposals to tie the minimum interest rate on savings accounts to the ECB's deposit facility rate or the 10-year OLO rate. In assessing the potential implications for and risks to financial stability of these legislative proposals, the Bank took into account the broad spectrum of reliance on savings accounts as a source of funding by credit institutions. In particular, small and medium-sized savings banks, which have a relatively high proportion of savings accounts and mortgage loans on their balance sheets, would face significant losses if, due to government intervention, the interest rate on savings were to be raised in

an accelerated and abrupt manner rather than being allowed to rise gradually. As savings accounts play a central role in interest rate risk management, the government would thus be intervening in an area that falls primarily within the strategic management of banks, without having to assume any responsibility in this regard. In addition to a lack of precedent in other European countries, the opinions pointed out potentially undesirable side effects on the volume, pricing and nature of lending to Belgian households and businesses, including the risk of it becoming more difficult for banks to grant fixed-rate mortgages.

85. **In November, the Competition Authority issued an opinion setting out a number of possible options to stimulate competition on the retail banking market without changing its existing structure.** These proposals seem to be a good starting point to consider measures (with appropriate transitional provisions) to improve transparency and customer mobility on the savings market while minimising the risks to financial stability, costs to the government or banks, legal obstacles, and undesirable side effects.

86. **Macroprudential policy contributed to an orderly downturn in the credit and real estate cycle and ensured the resilience of Belgian banks to future shocks through a realignment of and increase in macroprudential capital buffers.** By previously pushing for a reduction in the longest-maturity mortgages, macroprudential policy created room for the recent welcome extension of these maturities a few years ago. In this way, the impact of the sharp rise in mortgage rates on household borrowing capacity could be mitigated, contributing to an orderly, albeit material, slowdown in transactions on the residential property market. The share of mortgages granted to first-time homeowners rose in 2023 as investors became less active and existing homeowners chose to move house less frequently. Overall, the annual growth rate of outstanding mortgage loans to Belgian households slowed from 5.8 % at the end of 2022 to 2.3 % in November 2023. This lending continued to be characterised by a lower share of risky loans owing to the adoption of the Bank's macroprudential supervisory expectations in early 2020. The success of this measure allowed the macroprudential capital buffer for Belgian mortgage loans to be revised downwards. This sectoral systemic risk buffer will be reduced from its current level of €2 billion (a rate of 9 %) to €1.3 billion (a rate of 6 %) as from 1 April 2024. At the same time, the Bank decided to reactivate the countercyclical capital buffer as from 1 October 2023, with effective build-up to €1.1 billion on 1 April 2024 (a rate of 0.5 %) and to around €2.3 billion as from 1 October 2024 (a rate of 1 %). The combined level of these two macroprudential capital buffers will thus increase to €3.6 billion as from 1 October 2024. These buffers can be used by banks in emergency situations to absorb credit losses and to provide financial support to customers. However, they in no way limit the current room for manoeuvre of the banking sector, which disposes of more than €15 billion in available capital over and above these buffers and other risk-based regulatory capital requirements.

87. **The results of the International Monetary Fund's five-year review of the Belgian financial sector in the framework of the Financial Sector Assessment Programme confirmed that the Belgian financial sector is able to withstand severe macrofinancial risks and shocks.** The International Monetary Fund (IMF) noted that the Belgian financial sector has proved resilient to a series of shocks in recent years, such as the pandemic and the war in Ukraine, and remains well capitalised and profitable. The solvency and liquidity stress tests carried out by the IMF show that Belgian banks, insurance companies and investment funds can cope with risks arising from a simulated sharp deterioration in macrofinancial conditions. The resilience of the Belgian banking sector was confirmed by European Banking Authority stress tests carried out during the year under review. Aside from its overall positive assessment of the health of the Belgian financial sector, the IMF noted a number of challenges and made a series of recommendations to further strengthen

the regulatory and supervisory framework. In line with similar recommendations from 2018, the macroprudential policy decision-making process should be better aligned with the Bank's mandate in this area. The report also recommends further efforts to strengthen the governance rules for institutions falling under the Bank's supervision. Furthermore, the resources allocated to combat money laundering and terrorist financing should be increased and implementation of the sanctions framework strengthened. With regard to the completion of the banking union, the IMF reiterated that, during the transition period, it is essential to maintain sufficient capital and liquidity buffers for subsidiaries of foreign banking groups, which occupy an important position in the Belgian financial sector. Finally, referring to the banking sector turbulence seen at the start of the year, the IMF emphasised the need to focus on the implementation of resolution plans, the development of resolution tools that do not form part of the preferred resolution strategy, and reinforcement of the emergency liquidity assistance framework.

88. **At both the international and European levels, regulators and supervisors must draw the necessary lessons from the turbulence observed in March and April and act decisively and in a sufficiently ambitious manner to tighten regulation where necessary.** The Basel Committee on Banking Supervision published a report analysing these events and outlining lessons for financial sector supervision and regulation. The report focused, in particular, on liquidity regulation in a context characterised by the heightened volatility of certain funding sources and deposits in the digital age, as well as the lack of provisions on deposit concentration. The report also scrutinised banks' approach to interest rate risk management, over which they currently have considerable regulatory flexibility, and the supervision thereof. A stringent and credible regulatory and supervisory framework not only strengthens the stability of the banking system and the confidence of financiers, investors and depositors in the sector but also ultimately delivers the best economic and social outcomes. Banking regulators should therefore continue to ensure that the regulatory and supervisory framework remains robust and that the banking sector is armed against potential risks. The adoption into European banking law of the final parts of the Basel III standards, which were reformed and tightened in the wake of the 2008 global financial crisis, is especially welcome in this respect. It is unfortunate, however, that European regulators have again included a number of significant derogations from the Basel standards and imposed lengthy transition periods. This is all the more regrettable given that the EU is already the only Basel Committee on Banking Supervision jurisdiction in which regulations derogate materially from these global standards for capital requirements.

89. **To ensure financial stability, further efforts should be made towards integrating appropriate climate-related risks into the regulation and risk management of financial institutions and related supervision.** At the behest of the ECB, significant euro area credit institutions had to assure by March 2023 that they adequately detect and analyse the climate-related and environmental risks to which they are exposed, in order to integrate these risks into their governance, strategy and risk management by the end of the year. The Bank has asked less significant credit institutions under its supervision to meet these prudential expectations as well, albeit with a modified timeline and taking into account the nature, size and complexity of their operations. These prudential expectations are consistent with the principles for the effective management and supervision of climate-related financial risks published by the Basel Committee on Banking Supervision in 2022. Furthermore, the ECB is studying how to impose a Pillar 2 capital buffer as from 2024 on increased exposure to climate-related and environmental risks. Lastly, climate-related and environmental risks are increasingly being taken into account in inspections of traditional risks such as credit, market and operational risks, and inspections focusing specifically on

these types of risks are also being carried out. The Bank has long considered the transition risk associated with real estate to be the greatest climate-related risk for the Belgian banking sector, due to the high CO_2 emissions of buildings and the substantial real estate exposure of banks. Therefore, in 2020 the Bank urged lenders to collect data on the energy efficiency of properties serving as collateral in their mortgage loan portfolios, and to report this information to the Bank for new mortgage loans granted from 2021 onwards. Banks are also explicitly expected to take into account energy efficiency in their risk management. While banks have made great progress in collecting this data, additional efforts are needed, especially for existing mortgage loans. Therefore, for several years now, the Bank has been actively supporting efforts by the banking sector to access regional databases of energy performance certificates. The increased availability of these certificates may have contributed to a reduction in the transition risks associated with the Belgian housing stock, as the wider gap between the prices of high and low energy-efficiency dwellings seems to correspond to the average cost of a comprehensive energy renovation of less energy-efficient homes.

90. **For the insurance sector, the Bank conducted a cross-cutting analysis in 2023 of the assessment of climate-related risks included by insurance companies in their own risk and solvency assessments.** This exercise revealed that most insurance companies meet the Bank's expectations, although some need to carry out deeper analyses. The Bank also wished to ensure that the risk parameters of the standard formula in the capital requirements sufficiently take account of all risks to which insurance companies are exposed, including those related to the effects of climate change. Lastly, the Bank is participating in European efforts to recalibrate the natural catastrophe risk parameters of the standard formula in order to incorporate climate-related impacts.

91. **The development of a clear statutory framework on allocation of the costs of damage related to future natural disasters remains of the utmost importance.** More than two years after the July 2021 floods and despite various legislative initiatives that partially addressed this issue, there is still no new statutory framework in place. If this situation continues, reinsurers could decide to scale back their activity in Belgium. As a result, insurance companies would no longer be able to cover this type of risk, and Belgian households would no longer be able to insure themselves against fire and natural disasters or would be able to do so only at a much higher premium. Belgian fire insurers' reinsurance premiums have increased by 50 %-60 % over the past two years. In order to provide greater certainty to all parties involved, a clear statutory framework governing allocation of the costs of future natural disasters, the financing of regional disaster funds, and the robustness of the framework in the face of worsening flooding and other natural disasters is needed.

92. **The digital transformation of the financial sector requires appropriate solutions in terms of both the regulatory framework and financial sector supervision.** As digitalisation leads to greater interconnectivity, cybersecurity and the continuity of underlying systems and infrastructure are becoming increasingly crucial. Against this backdrop, the European regulation on digital operational resilience for the financial sector (DORA), which entered into force in January 2023, sets out important principles and requirements on governance and risk management in relation to information and communication technologies (ICT). It clarifies the essential and proactive role that the management bodies of financial institutions should play in this area and formulates requirements for the handling of ICT-related incidents, the periodic assessment of resilience to cyberattacks and the management of ICT third-party risks. The Bank welcomes this important legislation, which will apply as from 2025, and will use it to strengthen digital operational resilience in the Belgian financial sector.

93. **At the government's request, the Bank conducted a study in 2023 on the state of the Belgian fintech sector.** In order to provide an initial objective basis to determine whether fintech could become a strategic industry with strong growth potential for the Belgian economy and finance, the Bank conducted a study in 2023 describing the state of the sector. The aim was to identify the various segments of the sector, get an idea of its economic importance and reveal the main financial characteristics of companies active in this field. The study also described the cross-cutting pillars in the Belgian fintech ecosystem that act as levers and could serve as facilitators. According to the ecosystem mapping, there are two main fintech segments in Belgium. The first consists of fintech companies offering business-to-business (B2B) solutions, particularly in the financial sector ("tech4fin companies"). The demand for business-to-consumer (B2C) solutions is obviously lower in Belgium, due to the already large range of digital financial products and services offered by Belgian banks. Fintech companies in the second segment offer payment-related solutions. Some of these companies are leading international players active in Belgium. This study has provided the authorities with food for thought and will help them assess the extent to which Belgium is ready to become a European fintech hub in which financial innovation and the provision of services by the sector are more strongly promoted.

94. **The Governing Council of the ECB gave the green light for the preparatory phase of the digital euro.** Following an in-depth 24-month investigation into the feasibility of developing a digital currency and how it could be issued, the ECB's Governing Council decided to embark on a two-stage preparatory phase starting on 1 November 2023. During this phase, the aim is to further develop and test the digital euro in accordance with the design choices and technical requirements identified during the research phase, eventually laying the groundwork for the possible issuance of a digital euro. This will entail finalising the rulebook for the digital euro and selecting providers that could develop a platform and infrastructure for the new digital currency. The first stage of the preparatory phase will last for two years. Based on the results of this stage, as well as legislative developments, the Governing Council will decide whether to proceed to the second stage and determine what this stage would entail and how long it would take. The digital euro would be an electronic form of cash for a digitalised world, complementing banknotes and coins, allowing individuals, businesses and governments to use central bank money in digital form for online or offline payments, including person-to-person. Like cash, the digital euro would be risk-free, generally available and easy to use ; basic use would be free of charge. However, to prevent an outflow from bank deposits and avoid risks to the stability of the financial system, a holding limit would be introduced. The digital euro would also strengthen the euro area's strategic autonomy and monetary sovereignty, the efficiency of the European payments landscape, and resilience to possible cyberattacks or technical disruptions. The Bank is participating in this project, together with other national central banks, through the so-called High-Level Task Force.

95. **For a number of matters falling within its remit and areas of expertise, the Bank will cooperate with the minister of finance to lend support to the Belgian presidency of the Council of the European Union in the first half of 2024.** For example, a number of the Bank's staff members are closely involved in trilogues to strengthen European anti-money laundering rules, including the creation of a new European authority in this area, and to revise the European Market Infrastructure Regulation (EMIR). This regulation aims to make the EU a more attractive hub for derivatives clearing by improving the liquidity of EU central counterparties and strengthening the supervisory framework. The Bank will also contribute to ongoing Council negotiations on the revision of the European bank crisis management and deposit insurance framework and the Payment Services Directive. Under the Belgian presidency, work will also continue on the revision of the prudential

supervisory framework for the insurance sector, the text of the trilogue agreement on the resolution of insurance companies, and the preparation of a European statutory framework for the digital euro, on the basis of which the European Central Bank could decide to launch this digital currency.

Pierre Wunsch
Governor

Brussels, 14 February 2024

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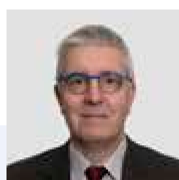
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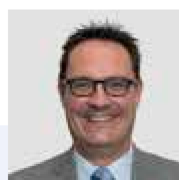
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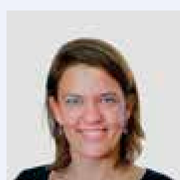
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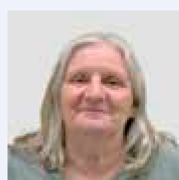
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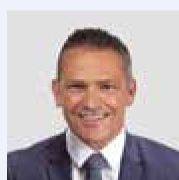
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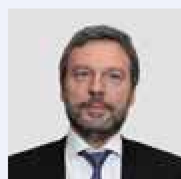
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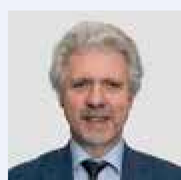
Hans D'Hondt
Representative of the Minister of Finance

* As at 31 December 2023, only 12 of the 14 seats on the Council of Regency were filled owing to the resignation of Ms Géraldine Thiry, effective 3 July 2023, and of Mr Eric Mathay, effective 8 September 2023. Ms Thiry was appointed to the Bank's Board of Directors on 1 September 2023. Both vacancies will be filled at the general meeting of shareholders to be held on 21 May 2024.

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