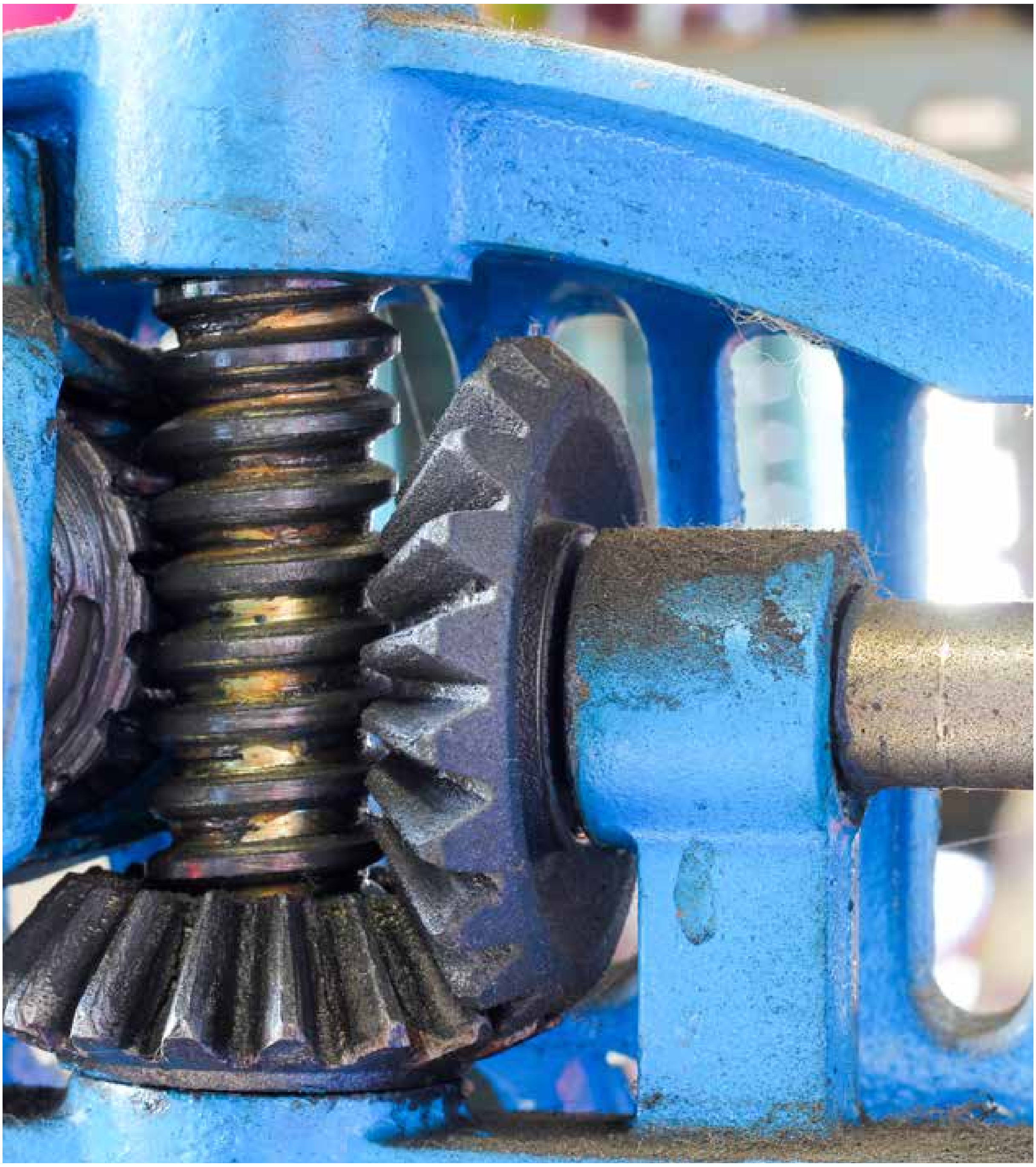
Report 2014

Economic and financial developments

National Bank of Belgium
Eurosystem



Global economy and euro area

1. Global economy and euro area

In 2014, the growth of global activity was moderate and patchy. The economic upturn was most evident in the United States and the United Kingdom. In China, growth slowed slightly owing to a residential property market correction and risks in the shadow banking sector, while commodity producers suffered from the slump in prices. Like Japan, which slipped back into recession, the euro area trailed behind the other economies. Although its GDP grew by 0.8% on average over the year, following a 0.5% fall in the previous year, activity slowed from the spring despite the accommodative monetary policy stance, the improvement in financing conditions and the less restrictive fiscal policy. Inflation continued to decline more steeply than expected, dropping to 0.4% in 2014. While most economies that had made radical adjustments began expanding again, growth was generally sluggish in the euro area, as was potential growth. In view of the downward trend in risks to price stability in the euro area, the ECB Governing Council cut the key interest rates on two occasions in 2014, bringing the rate on the main refinancing operations to 0.05% and taking the deposit facility rate into negative territory. In its forward guidance, the Governing Council constantly repeated that, in view of the assessment of the economic outlook, the key rates would remain low for an extended period. In addition, the Eurosystem conducted targeted longer-term refinancing operations to boost lending by the banks. From October, it also began purchasing assets – asset-backed securities (ABSs) and covered bonds issued by euro area banks – to achieve a further easing of monetary policy. In January 2015, the Governing Council decided to include these transactions in an expanded asset purchase programme covering government bonds as well, amounting to € 60 billion a month. These asset purchases are expected to be made until the end of September 2016 and in any case will be continued until there is evidence of a sustained change in the inflation trend in line with the price stability objective.

1.1 Global economy

Moderate and patchy revival of global activity…

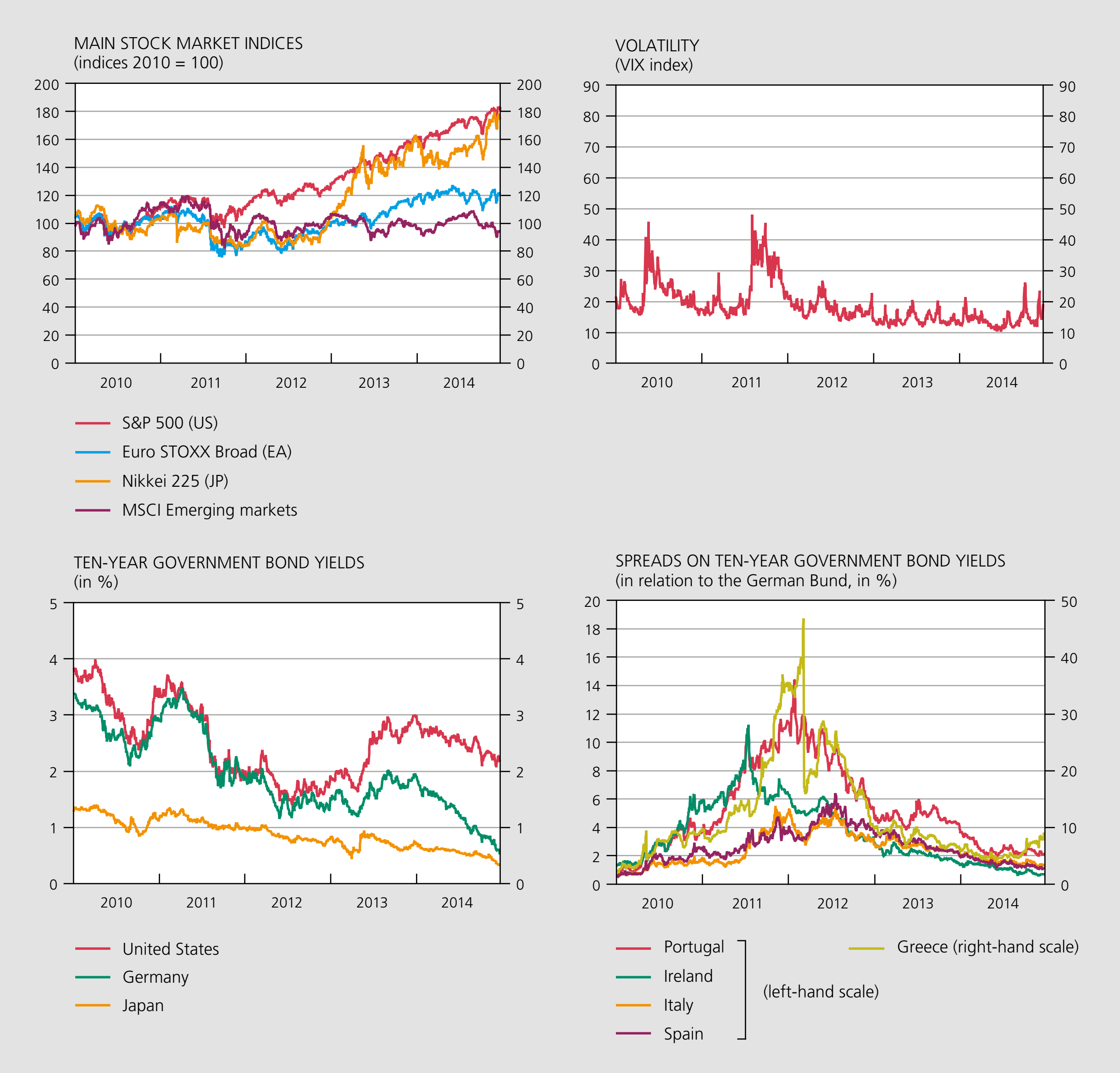
The revival of global activity that had been fairly widespread in 2013 continued at a modest pace in 2014. The lack of vigour contrasted with the plainly more optimistic sentiment which still prevailed on the financial markets. It also reflected the varying strength of the recovery across the different economic regions.

The clearest signs of economic recovery were seen in the United States and the United Kingdom. Although the emerging countries still record the highest average growth rates, their growth was nevertheless lower than in 2013, following a sometimes marked slowdown in a number of countries. In contrast, Japan slipped back into recession during the course of the year, and the recovery in the euro area that had begun in the spring of 2013 weakened significantly after the first quarter. The euro area therefore lagged seriously behind the other economies, not only because of a larger exposure to heightened geopolitical risks in neighbouring regions, but also owing to its difficulty in overcoming the effects of the great recession and the sovereign debt crisis.

… in a generally favourable financial market climate

During the year under review, financial markets were greatly influenced by the still highly accommodative – albeit increasingly divergent – monetary policy stance in the advanced countries. That situation continued to exert downward pressure on long-term government

CHART 1 INTERNATIONAL FINANCIAL MARKET DEVELOPMENTS
(daily data)



Source: Thomson Reuters Datastream.

bond yields. The low interest rates and the likelihood that rates would remain low for a long time also gave rise to a persistent search for yield among investors. That had begun in mid-2012 after a number of important measures – the ECB's introduction of outright monetary transactions (OMTs), the establishment of the European Stability Mechanism (ESM) and, later, the agreement on the European single supervisory mechanism (SSM) for credit institutions – eased the tension generated by the sovereign debt crisis in the euro area. Stock markets in the advanced countries therefore began rising again, and that trend was clearly maintained in the year under review. At the same time, premiums on riskier financial assets, such as high-yield government bonds in the peripheral euro area countries or in emerging countries, subsided in 2014 to their lowest levels since the crisis.

However, there were several periods of financial turbulence during the year, a reminder that the markets could still react nervously to heightened geopolitical tensions and ultimately minor changes to growth forecasts. But these phases were short-lived, and the contagion effects were generally limited. Overall, the losses were also fairly soon made good.

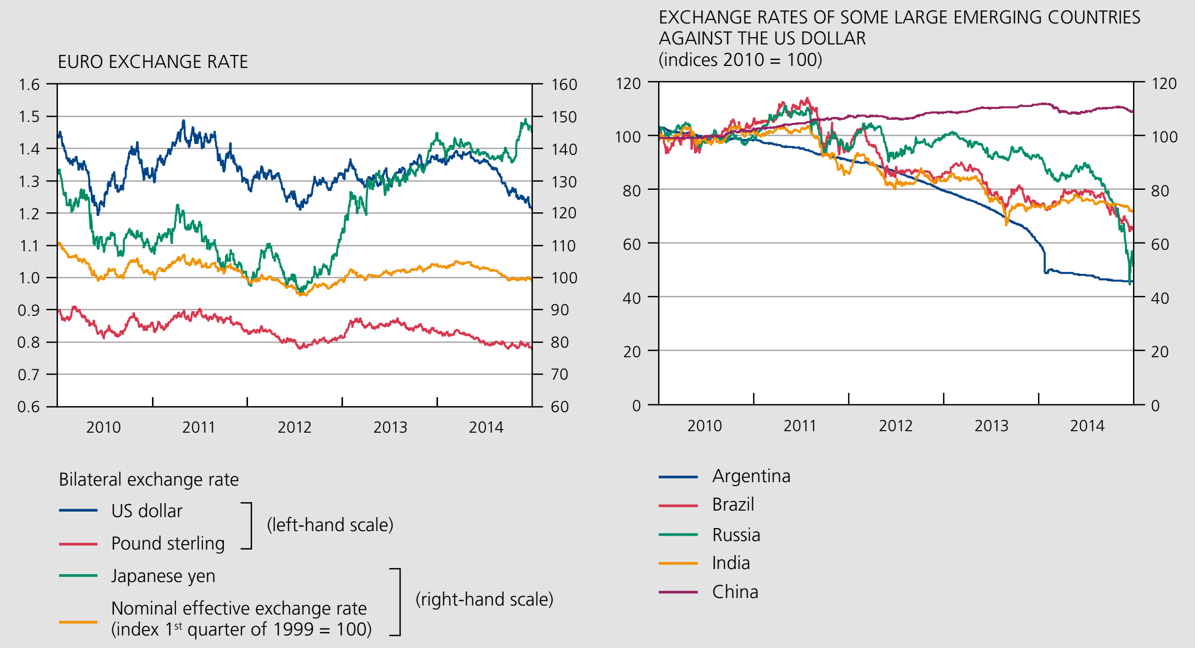
At the end of 2013 and at the beginning of the year under review, investors reassessed the situation in the emerging economies, in view of the deteriorating macroeconomic conditions – even though the outlook was improving in the advanced economies – and the imbalances present in some of them. Mounting uncertainty also emerged in China over the slowdown in the manufacturing industry and the worsening financial risks. Spreads between the government bonds of those countries and US Treasury bonds began to widen, and stock markets fell, as did exchange rates. The pressure escalated on 23 January when the central bank of Argentina devalued the peso by more than 10 % against the US dollar. The central banks of the countries affected responded by raising their interest rates or dipping into their exchange reserves. Thanks to that vigorous response, most of the losses on the stock and currency markets were made good by February. The impact on stock markets in the United States, Japan and the euro area was limited, although government bond yields declined as a result of the shift towards these safe-haven investments.

Apart from these temporary effects, for the euro area, the downward trend in sovereign bond yields reflected not only the effect of a further easing of monetary policy but also disappointing economic figures, a fall in long-term inflation expectations, and uncertainty caused by the increased geopolitical tensions. In the United States, too, the yield on ten-year government bonds diminished, though to a lesser degree than in the euro area, partly on account of expectations of a speedier normalisation of monetary policy. In Japan, the yield on government bonds was more or less stable at a very low level, in view of the expectation of a long period of accommodative monetary policy.

Following the market turmoil in January, stock markets resumed their upward trend. It was the American market indices that recorded the biggest rise – the S&P 500 having surged by more than 10 % during 2014 – and reached an all-time high. In Japan, the rise came to around 7 %. Stock markets also rose in the euro area. Over the year as a whole, the Euro STOXX index was up by around 2 %, after having peaked in June.

Towards the end of the second quarter, adverse macroeconomic figures – low inflation, waning confidence and a downturn in economic activity – began to depress the European markets. In addition to these factors, there were escalating geopolitical tensions when, on 29 July, the EU

CHART 2 EXCHANGE RATES
(daily data)



Source : Thomson Reuters Datastream.

announced new economic sanctions against Russia. At the beginning of September, however, most of the losses had been wiped out, notably on account of the expected continuation of the accommodative monetary policy in the euro area.

In October, the markets were again jittery. After disappointing macroeconomic figures had been published, concerns about the weakness of global growth mounted, and stock markets plummeted simultaneously throughout the world, falling by almost 10 %. In the United States and Japan, they soon climbed back, following the emergence of encouraging macroeconomic data in the US and the decision by the Bank of Japan to ease its already very accommodative monetary stance still further. The losses on European stock markets took longer to make good, against the backdrop of mediocre growth rates published for the euro area. In regard to bond yields, it was mainly US Treasury notes that saw a marked fall in yields, partly because investors believed that the monetary tightening in the United States would take place more slowly than initially planned, since the recovery appeared more hesitant than expected at that time, and partly because investors were somewhat dubious about the euro area. Subsequently, the yield began rising again following the emergence of positive economic data for the US.

During the year under review, the peripheral euro area countries also benefited from investors' declining risk aversion and their search for yield. Spreads between government bonds of those countries and the German Bund thus continued to narrow, and reverted to their lowest level since the crisis. It is striking that the periods of increased turbulence on the financial markets had no adverse contagion effects in that respect. It was only in October, during the period of maximum volatility, that the spreads widened in Greece after the Greek government had announced that – by the end of 2014, on expiry of the EU programme – it wanted an early exit from the IMF financial assistance programme which was scheduled to run until March 2016. The exit from the EU programme, originally planned for the end of 2014, was postponed by two months.

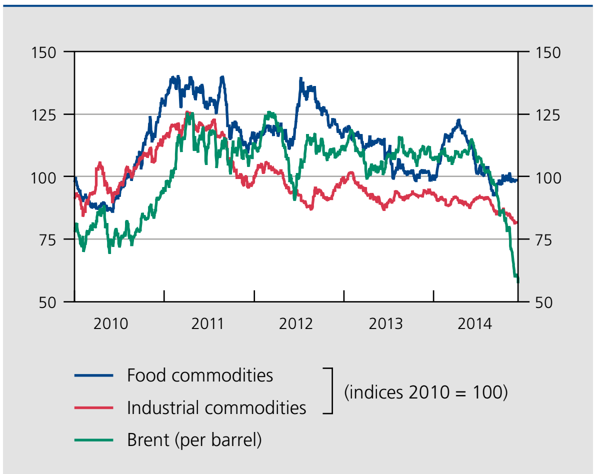
Once the turbulence early in the year had abated, capital flows to the emerging economies revived and were generally steady for the rest of the year under review. In that context, exchange rates in emerging countries such as China and India remained stable overall. In the first part of the year, the euro area also benefited from capital inflows; their effect in bolstering the exchange rate reinforced the impact of growing current account surpluses. From the summer, the euro's appreciation that had begun in mid-2012 went into sharp reverse when the ECB announced new monetary easing measures. Conversely, the euro appreciated considerably against the yen following the Bank of Japan's announcement at the end of October that it was expanding the programme of quantitative and qualitative monetary easing. The value of the rouble began falling steeply against the US dollar, especially in the second half of the year under review, on account of persistent geopolitical tensions in Ukraine and western sanctions against Russia. The pressure on the rouble intensified at the end of the year, owing to a persistent decline in the oil price on the international markets and the announcement of new sanctions by the United States. In Brazil, the depreciation of the real from September reflects the declining investor confidence in the Brazilian economy, further exacerbated by the election result at the end of October.

Weak global demand depresses commodity prices and international trade

Partly as a result of the still rather weak macroeconomic climate and the slump in global demand, commodity prices fell in 2014, and the expansion of world trade slackened pace.

Prices of energy commodities displayed the most striking movement, as the price of Brent crude oil in US dollars plunged by almost 50 % in 2014, despite rising geopolitical tensions. While the production of unconventional oil in North America and the substantial reserve capacity in Saudi Arabia more than made up for the interruptions in provisioning from Libya and Iraq, thus maintaining

CHART 3 **COMMODITY PRICES**
(daily data, US dollars)



Source: Thomson Reuters Datastream.

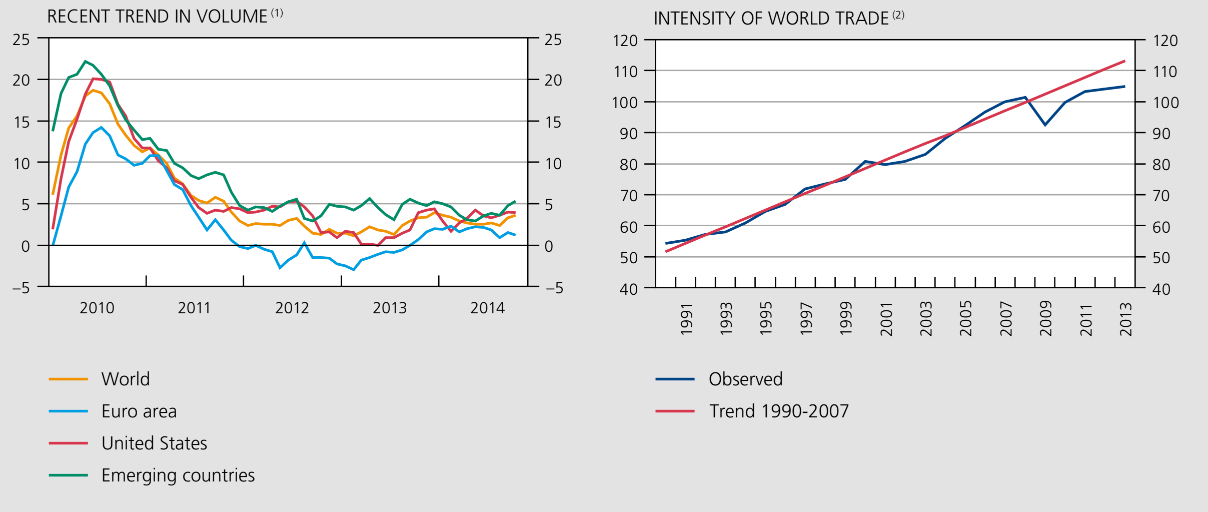
abundant supplies, the level of global demand remained weak. That was particularly true of demand from China and the other emerging economies, which had stepped up their consumption very sharply in the previous decade, but it was also true of Europe. The fall in oil prices on the international markets accelerated after the OPEC meeting on 27 November 2014, when it was decided to leave the production quotas unchanged.

As had already happened in 2013, anaemic world demand also depressed the prices of non-energy commodities. Food commodity prices declined during the year, although they did increase at times on account of bad weather in certain countries and concern caused by the situation in Ukraine, which is a major exporter of cereals. Industrial commodity prices contracted, essentially as a result of the rebalancing of growth in China in favour of less commodity-intensive activities.

After a temporary surge in the second half of 2013 following a lengthy period in the doldrums, the growth of world trade slowed again from 2014, in parallel with slackening economic activity. The decline was most marked in the emerging economies of Asia, and was reflected mainly in a sharp fall in Chinese imports, but the persistently weak demand from the euro area also played a part.

This decline originated both from cyclical factors – notably the marked slowdown in the growth of highly world-trade-intensive demand components, such as business investment, and the weakness of euro area industrial activity that generally involves substantial international trade in goods – and from more structural factors. Thus, in recent decades, some of the drivers of the strong expansion of world trade have become less powerful. The awakening of the emerging countries in the 1990s and 2000s was accompanied by a rapid expansion of world trade as a result of a combination of institutional, technological and organisational developments in production methods. The growing number of countries joining the World Trade Organisation has led to a reduction in regulatory and tariff barriers to trade, while the cost of transport and data exchange has come down considerably. In these circumstances, firms in western countries outsourced a growing proportion of their production to the emerging countries, where labour costs were much lower. These conditions favouring the very rapid expansion of international trade in goods are tending to fade away. For instance, wages in China and Eastern Europe have risen relative to those in the advanced economies over the past ten years. The extension of global production chains also appears to be slowing down. In some cases, those chains are actually tending to shorten again, as experience has shown that local problems can cause serious disruptions in the outsourcing process. The said factors seem to have weakened the elasticity of international trade to economic growth. Thus, according to the data and estimates currently available, it seems that the growth of world trade was hardly any higher than GDP growth in 2012-2014, whereas it had been double that figure in the first half of the 2000s.

CHART 4 INTERNATIONAL TRADE



Sources: CPB, OECD.
(1) Seasonally adjusted three–month moving average of exports and imports by volume; percentage change compared to the previous year.
(2) International trade as a percentage of global GDP, by volume.

TABLE 1 GDP OF THE MAIN ECONOMIES [1]

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

	2012	2013	2014	*p.m. Contribution to global GDP growth* [1] *2014*	*p.m. Share of global GDP* [1] *2008*	*2013*
Advanced countries	1.2	1.3	1.8	*0.8*	*48.8*	*43.6*
of which:						
United States	2.3	2.2	2.4	*0.4*	*18.0*	*16.5*
Japan	1.5	1.6	0.1	*0.0*	*5.2*	*4.6*
Euro area	–0.7	–0.5	0.8	*0.1*	*14.6*	*12.2*
United Kingdom	0.7	1.7	3.1	*0.1*	*2.7*	*2.3*
Emerging countries	5.1	4.7	4.4	*2.5*	*51.2*	*56.4*
of which:						
Central and Eastern Europe	1.4	2.8	2.7	*0.1*	*3.5*	*3.5*
Russia	3.4	1.3	0.6	*0.0*	*3.8*	*3.4*
Emerging Asia	6.7	6.6	6.5	*1.9*	*23.1*	*28.7*
of which:						
China	7.7	7.8	7.4	*1.2*	*12.0*	*15.8*
Latin America and Caribbean	2.9	2.8	1.2	*0.1*	*8.8*	*8.7*
World	3.1	3.3	3.3	*3.3*	*100.0*	*100.0*
World excluding the euro area	3.6	3.6	3.6	*3.2*	*85.4*	*87.8*
p.m. World trade [2]	*3.0*	*3.4*	*3.1*			

Sources: EC, IMF, OECD.
(1) For regions outside the euro area, GDP is calculated according to the IMF definitions and on the basis of purchasing power parities.
(2) Average of exports and imports of goods and services.

United States [1]

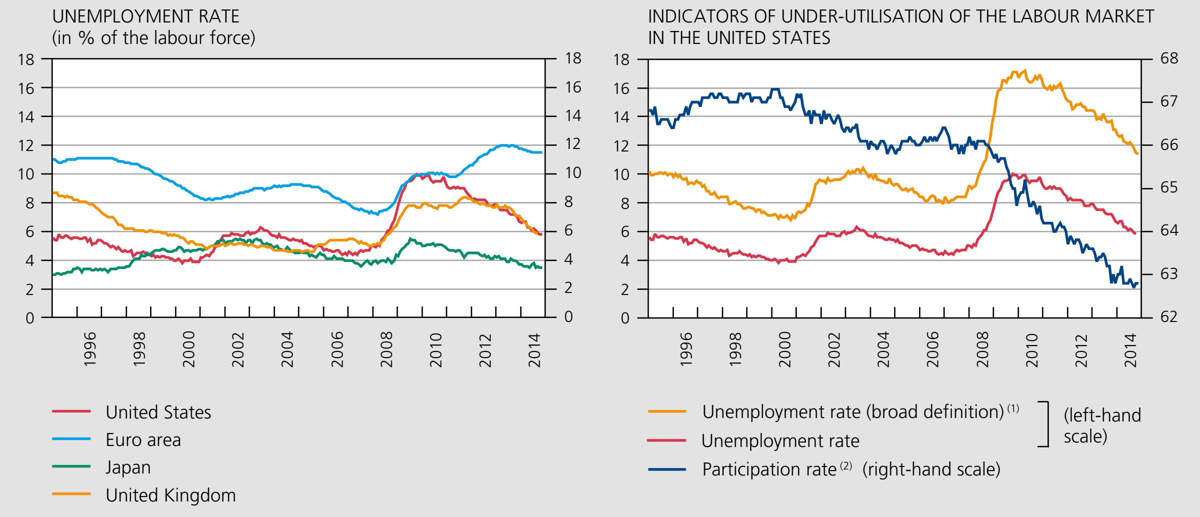
The US economy continued to recover in 2014. Following a slight, temporary fall in GDP in the first quarter, attributable primarily to severe weather, the expansion of economic activity was supported mainly by domestic demand. Private consumption, which grew at the same rate as in the previous year, was stimulated by the expanding job creation and the improvement in households' wealth position resulting from the rise in asset prices and the fact that the deleveraging process begun in the aftermath of the financial crisis was more or less complete. Household debt declined from 96 % of GDP in 2007 to 79 % in 2013. The continuing positive demand outlook, favourable financing conditions and improvements in competitiveness and profitability resulting partly from the fall in energy costs due to the exploitation of shale oil and gas and moderate wage pressure, are all factors that contributed to the faster growth of business investment. Under the policy of restricting public expenditure that had been in force for two years, government consumption spending remained stable in real terms, and public investment declined.

However, fiscal policy was much less restrictive and had a less adverse effect on economic growth than in previous years, even though the structural primary deficit contracted further from 2.3 % of GDP in 2013 to 1.3 % of GDP during the year under review. Thus, following a deterioration of 5.5 percentage points of GDP between 2007 and 2009, at the height of the crisis, the structural primary balance improved by 6.2 percentage points between 2009 and 2013. In the euro area, the movements were on a smaller scale, the decline of 2.3 percentage points of GDP giving way to a 3.8 percentage point improvement since then. The American public debt remained more or less stable at 109.7 % of GDP.

The recovery on the US labour market produced a stronger expansion of employment and a sharp fall in the unemployment rate, down from around 7.4 % in 2013 to

(1) The main macroeconomic variables for the large economies are presented in table 1 in the statistical annex.

CHART 5 LABOUR MARKET INDICATORS IN THE MAIN ECONOMIES



Sources: Labour Statistics, EC, Thomson Reuters Datastream.

(1) The broad definition refers to the U-6 unemployment rate which also includes unemployed persons who have stopped looking for work on account of the economic situation (discouragement), all persons who have actively looked for work in the past year – but not necessarily in the past four weeks – and persons working part-time for economic reasons.

(2) Proportion of employed and unemployed as a ratio of the labour force aged 16 years and over.

below 6 % at the end of 2014. All the same, the labour market still showed clear signs of under-utilisation, as the decline in unemployment is also due to the lower participation in employment among the population of working age. In fact, the participation rate dropped from around 66 % before the crisis to less than 63 % in 2014. That was due partly to structural factors such as the ageing of the labour force or non-availability on account of illness or training, and partly to cyclical factors such as the deteriorating job prospects and the resulting discouragement that deters some sections of the population from presenting themselves on the labour market. Although the gap between the standard unemployment rate and the rate based on a broader definition did narrow during the year under review, it still remained considerable, and is actually bigger than in previous recessions. This unused labour reservoir explains why the upward pressure that wages should exert on prices remained modest in 2014.

In that context, the Federal Open Market Committee (FOMC) of the Federal Reserve adopted an approach to communication intended in particular to avoid any unnecessary financial market volatility by abandoning its threshold-based forward guidance in March 2014 together with the explicit reference to the unemployment rate, which had become of limited informative value. From then on, the FOMC based its forward guidance on broad qualitative information including a vast range of labour market indicators, so as to assess correctly how far the US economy still had to go to achieve full employment.

In addition, the FOMC took the first steps on the road to normalisation of its monetary policy, against a backdrop of stronger growth of economic activity and employment and rising inflation, even though the latter remained below the long-term objective of 2 %. In accordance with the decision of the FOMC in December 2013, the process of tapering purchases of securities was launched in January 2014. Since then, the rate of asset purchases, which originally stood at $ 85 billion per month, was cut by $ 10 billion after each FOMC meeting. At its October 2014 meeting, the FOMC decided to suspend the purchases as of November 2014.

In September 2014, the monetary policy normalisation principles, the first version of which dated from June 2011, were also updated. Those principles clearly state that monetary policy will be tightened by use of the interest rate instrument rather than by actively influencing the size or composition of the central bank balance sheet.

The FOMC will therefore tighten monetary policy by raising the range of the federal funds rate. The overnight money market interest rate will be guided by increasing the interest rate payable since October 2008 on the excess reserves that US depository institutions hold with the

Federal Reserve. Since this rate is currently higher than the overnight money market rate, potentially hampering the smooth transmission of the policy rates to short-term market rates, the FOMC created reverse repos accessible to money market funds as well as to traditional counterparties such as depository institutions and government-sponsored agencies. The interest rate on these reverse repos is an additional floor rate for monetary policy. According to the Federal Reserve, the tests conducted in 2014 on its use as an additional floor rate were conclusive.

In regard to the size of the balance sheet, the monetary policy normalisation principles also stress that there will be no reduction in the balance sheet so long as there is no rise in interest rates. Following these initial increases, there will be a review of whether it is appropriate to restrict or suspend altogether the reinvestment of the amounts reaching maturity.

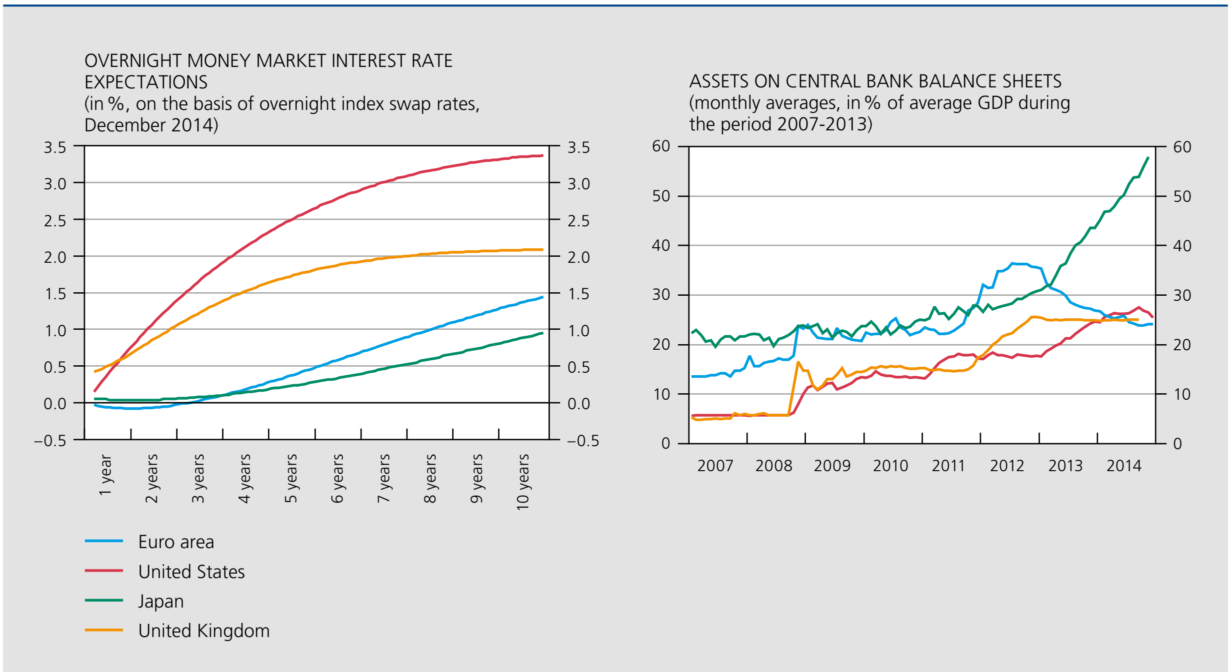
United Kingdom

In 2014, the United Kingdom's real GDP growth came to 3.1 %, outpacing its historical trend and recording the highest growth rate among the advanced economies. The clear revival of consumer confidence coupled with favourable financing conditions bolstered private consumption, while business investment increased to cater for the strengthening of domestic demand, particularly in the services sector. In manufacturing industry, investment lagged behind somewhat on account of the weak exports. As the euro area is the UK's main trading partner, external demand remained subdued, driving the external current account deficit up to 4 % of GDP. The exceptional surge in employment combined with an increase in the labour supply is noteworthy. In general, the unemployment rate continued to fall, subsiding to 6.2 %. Nonetheless, pay rises remained limited since many of the jobs created were in the low-skilled segment. In this situation, the persistent negative growth of real wages restrained the disposable income of households.

The government's medium-term fiscal consolidation programme continued in 2014. However, fiscal revenues were disappointing, particularly as a result of the slower pace of wage increases, the decline in property transactions and the reduction in gas and oil revenues. Nevertheless, the budget deficit fell by 0.4 percentage point to 5.4 % of GDP. Britain's public debt increased to 89 % of GDP.

The rise in consumer prices was down to 1.5 % in 2014, against 2.6 % in the previous year, as a result of the fall in prices of energy and food. Similarly, the low level of inflation in the euro area, the source of a large share of

CHART 6 OVERNIGHT MONEY MARKET INTEREST RATE EXPECTATIONS AND ASSETS ON THE BALANCE SHEET OF THE MAIN CENTRAL BANKS



Sources: Bank of England, Bank of Japan, Federal Reserve, Thomson Reuters Datastream, ECB, own calculations.

British imports, and sterling's appreciation against the euro held prices down in the United Kingdom. Moreover, unit labour costs declined compared to the previous year. In view of the low inflation below the 2% target and the weak upward pressure on prices in the short term, the Bank of England was able to keep its policy interest rate at 0.5 % while leaving the outstanding total of its asset portfolio unchanged at £ 375 billion.

Japan

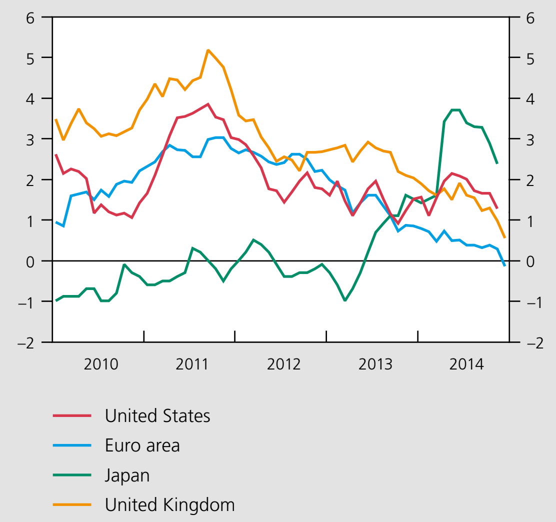
In Japan, the April VAT rate increase from 5% to 8% caused some volatility in real GDP growth at the beginning of the year. A vigorous first quarter boosted by early purchases to avoid this higher rate gave way to a particularly weak second quarter, particularly on the private consumption front. However, that gloom persisted in the third quarter, taking the economy into a technical recession situation, defined as a fall in GDP for two consecutive quarters. In all, the real growth of activity slowed significantly over the year as a whole, down from an average of 1.6 % in 2013 to 0.1 % in 2014. Nonetheless, buttressed by a revival in business confidence and comfortable profit margins due, in particular, to a cut in the corporation tax rate from 38 % to 35 %, non-residential investment supported the expansion of activity. Employment also continued to grow, causing a tightening of the labour market despite the rise in the female participation rate resulting partly from targeted structural reforms. That tightening brought a fall in the unemployment rate, which was down to 3.6 %, while – according to the Tankan survey – firms increasingly reported a labour shortage. For the moment, these developments have not triggered any large increases in nominal wages. Such rises are traditionally seen mainly in variable components of wages, such as overtime pay and bonuses.

For the first time in a long while, Japanese fiscal policy adopted a restrictive stance, partly owing to the first VAT increase. Under its medium-term fiscal consolidation strategy the Japanese government is planning a second increase, but has postponed it from the end of 2015 to 2017 in view of the adverse impact on consumption and activity that it caused in 2014. However, the primary deficit of 7.2 % recorded in 2014 was still remote from the aim of a balanced budget to be achieved by 2020.

Headline and core inflation rose to 2.7 and 1.7% respectively, mainly as a result of the VAT increase. In that connection, while inflation expectations declined in the third quarter and doubts about the economic recovery intensified, the Bank of Japan extended its programme of quantitative and qualitative easing. In so doing, it aimed to demonstrate its determination to achieve the 2% inflation target. On 31 October, it decided to step up the annual expansion of the monetary base, which increased from around 60-70 trillion yen to some 80 trillion Japanese yen. On the assets side of its balance sheet, the outstanding amount of Japanese government bonds will increase further, and their residual maturity will go up from an average of 6-8 years to 7-10 years. Furthermore, the annual rate of purchases of equity funds or property funds will triple. At the same time, the Government Pension Investment Fund – which currently manages 129 trillion yen – announced that it was adjusting its investment strategy in favour of national equities and foreign assets rather than Japanese government bonds. This decision should support the Japanese stock market and weaken the Japanese currency.

CHART 7 INFLATION IN THE MAIN ECONOMIES

(monthly data, changes in the consumer price index compared to the corresponding period of the previous year)



Source : Thomson Reuters Datastream

Emerging economies

In the emerging economies, growth continued to lose momentum in 2014, falling to 4.4 %, compared to 4.7 % in 2013. Geopolitical tensions combined with various types of structural impediments which curbed the increase in productivity were among the reasons for the lower growth. However, the easy financing conditions, export growth and the recovery of domestic demand in some countries contributed to a rebound in the second half of the year, though the aggregate result conceals ever greater divergences between regions and countries.

In China, the stated GDP growth target of about 7.5 % was virtually achieved. In the first quarter, however, the expansion of investment slowed more sharply than expected after the People's Bank of China had taken steps to tighten financial conditions for shadow banking and for unproductive projects. The government and the central bank responded immediately by respectively proposing selective incentives for investment in social housing and social infrastructure, and the provision of specific liquidity for bank loans to SMEs and the agricultural sector. Nonetheless, in the second half of the year under review, growth slackened further owing to the persistence of the correction on the housing market, which put a damper on investment and consumption. At the end of November, the People's Bank of China decided to revise its interest rates downwards for the first time since 2012. Moreover, the recovery in the United States brought a strong rise in Chinese exports, which were the main driver of economic activity in the second half of 2014. In value terms, imports increased more slowly owing to the fall in commodity prices and the anaemic demand from heavy industry, so that the current account surplus expanded from 2 % in 2013 to 2.4 % in 2014.

The consolidated public deficit is estimated at 1.1 % of GDP in 2014, implying a stable debt ratio of around 50 % of GDP. In recent years, the financial situation of Chinese local authorities has given reason for some concern. Those authorities traditionally play a key role in funding infrastructure projects, which had expanded rapidly in the immediate aftermath of the global financial crisis, but they were generally financed off-budget by means of ad hoc vehicles. The local authority debt ratio is estimated at just over 30 % of GDP, compared to around 20 % for the central government. The new budget law promulgated in August is viewed as a major reform designed to remedy this situation. That law, which establishes a framework for greater transparency and accountability, gives local authorities the power to issue their own debt securities, and outlaws the funding of public investment by *ad-hoc* vehicles. It was supplemented by a no-bail-out clause.

Growth slowed most sharply in **Latin America**, where it fell from 2.8 % in 2013 to 1.2 % in 2014. A major commodity producer, the region was hit by the widespread fall in prices and the weakness of demand, particularly that from China. The disappointing situation in Argentina and the structural problems confronting Brazil, particularly as regards infrastructures, also exerted additional downward pressure. At 2.7 %, average growth in **Central and Eastern Europe** was relatively stable compared to the previous year, supported partly by the vigour of domestic demand. The impact on the region of the conflict between Russia and Ukraine – namely the array of import restrictions imposed by Russia in response to western sanctions – and the effect of the economic stagnation in both countries was generally confined to a few small countries. **Emerging Asia** remained the most dynamic region, with growth averaging 6.5 %, despite a temporary dip at the start of the year. In general, activity was underpinned by exports, favourable financial conditions, and the return to a supportive macroeconomic policy stance, once the budgetary scope had been restored in the preceding years and inflation was back under control. Specific factors also played a part, such as the gathering pace of exports by China, which has a central position in the region's production chains, the evident optimism in India following the elections, and the stabilisation of the political situation in Thailand.

Box 1 – The "secular stagnation" concept

Origin

The term "secular stagnation" is not new, since it dates back to the 1930s, the era of the Great Depression. It is attributed to the American economist Alvin Hansen, from Harvard, who used it for the first time in 1938 in a speech about the link between economic progress and declining population growth (1).

(1) Hansen A. H. (1939), "Economic Progress and Declining Population Growth", American Economic Review, vol. XXIX, No. 1, Part I, March.

At the time, Professor Hansen was interested in the changes in the structure of the economy and their effects on the economic cycle. He was particularly concerned about the risks of under–investment and slower real income growth which in his view accompany declining population growth and the decelerating rate at which new territories are opened up, either by establishment of businesses there or by the exploitation of the territory's resources. In fact, he considered that, in the context of the day, the declining population growth was a key factor behind the inability of the economic recovery to generate full employment, suggesting the possibility of a self-perpetuating depression that would maintain unemployment at an abnormally high level. While he doubted the ability of an interest rate cut to stimulate investment, he advocated measures such as encouraging innovation in order to revive private investment and to strengthen public investment, though he acknowledged the latter's limits.

Professor Hansen's worries appeared largely unfounded, as events at that time contradicted the idea of secular stagnation. Immediately after the Second World War, the United States consolidated its global economic dominance in the context of a baby boom, a marked expansion of investment and sustained economic growth. Nonetheless, the fundamental idea that changes in the structure of the economy may prevent a lasting revival in activity following a recession, and lead to persistence of an abnormally high level of unemployment, has not entirely disappeared.

The modern view

It was another Harvard economist, Lawrence Summers, who actually resurrected the expression "secular stagnation" when speaking at an IMF conference at the end of 2013 [(1)]. Since then, in view of the limited, hesitant and patchy recovery in the advanced economies, the idea has attracted great attention and elicited comments from numerous renowned economists [(2)]. While interpretations of the concept differ to some extent, there appears to be a consensus that "secular stagnation" refers to a situation in which the economy is bogged down in zero or feeble growth that prevents it from achieving full employment.

Such a situation arises if, owing to a combination of structural and cyclical factors, the propensity to save increases and/or the propensity to invest declines to the point where the real interest rate which balances saving and investment at the level of full employment – also known as the real equilibrium rate – becomes significantly negative. In those circumstances, the effective real interest rate that can stimulate the economy may prove unattainable, and traditional monetary policy is therefore impotent. It is not actually feasible for the nominal interest rate to fall significantly below zero, given the possibility of replacing book-entry money with paper money which does not attract any remuneration. The emergence of a disinflationary – or even worse, a deflationary – trend reduces the ability of monetary policy to provide impetus in that it counteracts the policy's effects by exerting upward pressure on the effective real interest rate. Thus, an economy where output is below its potential level and under-employment prevails may be condemned to a protracted period of stagnation.

In the extreme case, there could be a situation in which a recession is self-perpetuating. If there is no way of providing a stimulus, a decline in output and a simultaneous rise in unemployment are liable to drive down prices in the economy, causing the real interest rate to rise and triggering a further contraction in activity. That raises the spectre of a recessive vicious circle and a deflationary spiral. It is also conceivable that a protracted recession may damage an economy's labour force and its productivity, thereby reducing its production potential. Such a "hysteresis" effect in turn depresses the real equilibrium interest rate.

Finally, even if it remained possible to stimulate the economy via a real interest rate compatible with full employment, it should be noted that the slightest decline in employment may entail risks for financial stability,

(1) Summers L. (2013), IMF 14th Annual Research Conference In Honor Of Stanley Fisher, International Monetary Fund, November 8.
(2) See for example Teulings C. and Baldwin R. (2014), Secular stagnation: facts, causes and cures, VoxEU.org ebook.

as the effective real interest rate would need to be lowered to stimulate the economy. Yet low interest rates tend to favour inappropriate lending and encourage investors to take risks, as well as having the potential to create bubbles.

Possible solutions

In principle, a decline in the real equilibrium interest rate and/or a disinflationary trend posing the threat of secular stagnation call(s) for three types of strategy. A first option is to acquire the means to reduce the effective real interest rate further, e.g. by using unconventional monetary policy instruments or by raising the central bank's target inflation rate. Although such an approach is necessary, it does have a potential cost in terms of financial stability. An alternative, as advocated by Hansen in his day, might be to encourage investment and consumption at the expense of saving. While there are many ways of doing that, such a strategy could involve expansion of public investment combined with measures to encourage private investment and a policy to reduce inequalities that generally depress the propensity to consume. That approach aims to raise the real equilibrium interest rate. It therefore favours output and employment without damaging financial stability. Finally, measures aimed at boosting the economy's growth potential, such as structural reforms, generally also promote a rise in the real equilibrium interest rate and are therefore equally desirable. However, the best measures to adopt for protecting against secular stagnation depend on the specific characteristics of each economy.

1.2 The economy in the euro area and its Member States

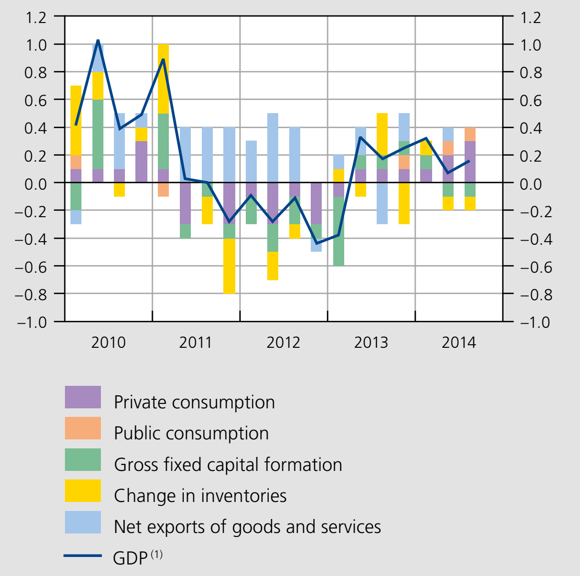
Although the euro area is seeing renewed growth, the economic situation remains fragile

In 2014, the development of activity again revealed an intrinsically fragile economic situation in the euro area. Although growth was slightly positive, it fell short of the expectations aroused by the, albeit modest, recovery that had begun in 2013. On average, the volume growth of GDP came to 0.8 % in 2014, after a 0.5 % contraction in the previous year. However, that outcome was due largely to the temporary revival at the end of 2013 and in the first quarter of 2014 when quarter-on-quarter growth reached 0.3 %. In the second and third quarters, it declined to 0.1 and 0.2 % respectively, destroying hopes of a gradual improvement.

This new slowdown occurred despite the accommodative monetary policy stance, improved financing conditions and a less restrictive fiscal policy. True, it is attributable partly to temporary adverse factors, such as the increased geopolitical risk caused by the crisis in Ukraine, but more fundamentally it also reflects the economy's low potential

CHART 8 QUARTERLY PROFILE OF GDP AND THE MAIN EXPENDITURE CATEGORIES IN THE EURO AREA

(data adjusted for seasonal and calendar effects; contributions to the change in GDP by volume compared to the previous quarter; in percentage points, unless otherwise stated)



Source: EC.
(1) Percentage changes compared to the previous quarter.

growth and hence its lack of ability to overcome the after-effects of the great recession and the sovereign debt crisis. Those after-effects are still evident in the high debt ratios of the private and public sector, the decline in bank lending to businesses and households, and the persistently high level of unemployment and chronic under-utilisation of production factors.

On the whole, economic growth picked up in the peripheral countries during the year under review, though admittedly from a still low level of activity. Thus, real GDP growth exceeded 4 % in Ireland, after having remained more or less stable in 2013. Spain and Portugal managed to convert the previous year's contraction of GDP into positive growth at least equalling the euro area average. Even Greece achieved positive growth again for the first time since the very severe recession that it had suffered. In those countries, the renewed momentum of activity was generally supported both by the further expansion of exports and by a gradual strengthening of domestic demand.

In the so-called core euro area countries, growth was less marked. In Germany, GDP remained more or less unchanged in the second and third quarters of 2014, after a sharp rise at the beginning of the year. In France, growth was once again very modest, while in Italy, Finland and Cyprus it was negative.

Inflation continues falling to a low level

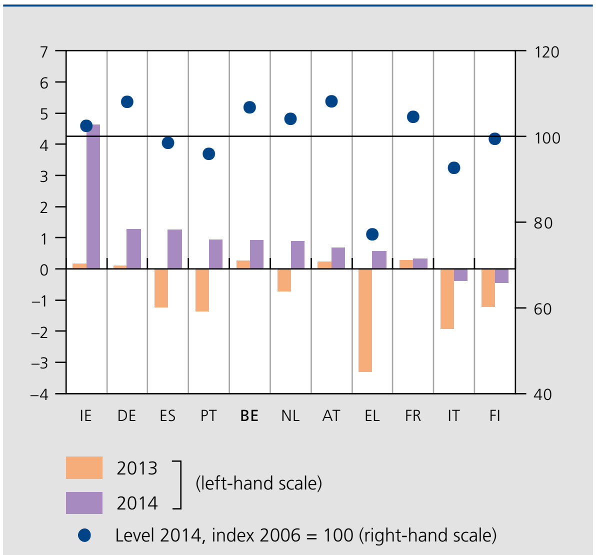
In parallel with the slackening of activity, inflation continued to fall sharply in the euro area in 2014, thus maintaining the downward trend that had begun at the end of 2011. Inflation declined from 1.3 % in 2013 to an average of 0.4 % in 2014, and even dipped to –0.2 % in December.

This marked deceleration was due mainly to a fall in energy prices and more moderate increases in food prices. In a sluggish economic environment, core inflation – which excludes those two components – also declined, although less sharply, dropping from 1.1 to 0.8 %. The main reasons were that price rises in the services sector continued to ease and prices of non-energy industrial products only rose slightly. The low level maintained by core inflation throughout the year included the effect of the increase in indirect taxes, estimated at around 0.2 %. As in the case of economic activity, the rise in prices was therefore much weaker than expected as the months went by, owing to both imported deflationary pressure and the effects of the sluggish economy in the euro area.

The decline in inflation throughout the euro area was accompanied by a marked reduction in the variations in inflation between Member States. In almost all countries, the rise of the HICP slowed to a greater or lesser degree,

CHART 9 GDP IN A SELECTION OF EURO AREA COUNTRIES

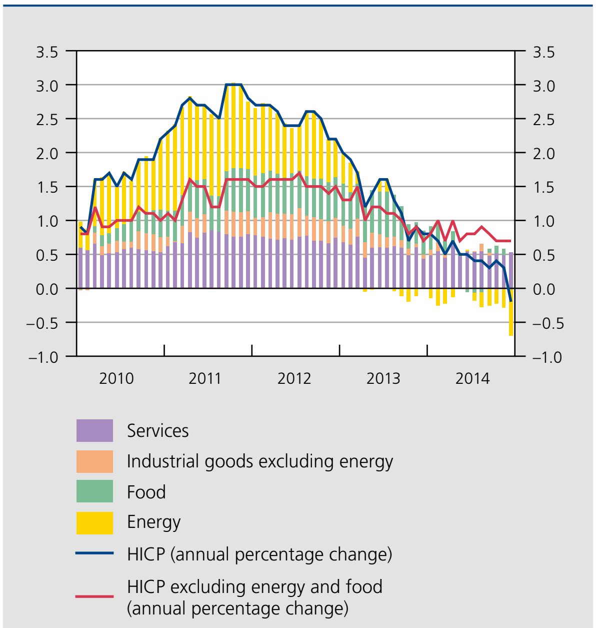
(percentage changes compared to the previous year, unless otherwise stated)



Source: EC.

CHART 10 INFLATION IN THE EURO AREA

(contributions to the annual percentage changes; percentage points, unless otherwise stated)



Source: ECB.

TABLE 2 OVERVIEW OF THE MAIN MACROECONOMIC VARIABLES IN THE EURO AREA

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

	2012	2013	2014
GDP	–0.7	–0.5	0.8
Final household consumption	–1.3	–0.6	0.7
Final government consumption	–0.2	0.2	0.6
Gross fixed capital formation	–3.2	–2.5	0.6
Change in inventories (1)	–0.7	–0.1	0.1
Net exports of goods and services (1)	1.4	0.4	0.1
Exports	2.5	2.1	3.1
Imports	–1.0	1.2	3.2
Inflation	2.5	1.3	0.4
Unemployment rate (2)	11.3	11.9	11.6
General government fiscal balance (3)	–3.6	–2.9	–2.6
Gross public debt (3)	90.8	93.1	94.5

Source: EC.
(1) Contributions to the change in GDP, percentage points.
(2) Ratio between the number of persons unemployed and the labour force, in %.
(3) In % of GDP.

dropping to between 0 and 1%. However, consumer prices in Greece fell sharply again by around 1.5%.

After contracting for two years, domestic demand picks up

The recovery of economic activity apparent in 2014 for the euro area as a whole, though fragile and uncertain, was primarily attributable to domestic demand.

Private consumption, which had fallen in the previous two years in the aftermath of the sovereign debt crisis, began rising again. That growth was in line with the modest improvement in the real disposable incomes of households in a context of falling inflation and a virtually stable savings ratio. Conversely, the obstinately high unemployment rate and necessary household deleveraging continued to depress household spending.

Public consumption continued to recover, though still slowly on account of the narrow budgetary scope in almost all Member States, so that it made only a meagre contribution to annual GDP growth.

Like private consumption, investment also returned to positive growth in 2014 throughout the euro area.

CHART 11 INVESTMENT IN THE EURO AREA

(volume data, in % of GDP)

Source: EC.

This revival was based on the acquisition of capital goods, while expenditure on construction continued to fall, albeit less steeply than in previous years. In a fragile economic context, the expansion of investment remained hesitant, as it was still curbed by the low level of production capacity utilisation, modest demand, limited bank lending and renewed uncertainty.

Thus, although the renewed momentum in 2014 was a turn for the better, it was nothing like enough to wipe out the negative effect that the economic and financial crisis had produced for the formation of the stock of physical capital in the economy. In relation to GDP, the investment rate for the euro area as a whole was in fact still below the average for the period 2000-2007, both for investment in housing and for all other investment. Some countries, such as Germany, maintained their gross fixed capital formation at the pre-crisis level. Conversely, in other core euro area economies the investment ratio declined. That was the case in the Netherlands, Austria and Finland, while the decline was even steeper in Italy, Spain and the countries subject to an adjustment programme. In most of the countries in this last group, investment was stable or even picked up in 2014 after having fallen for several years.

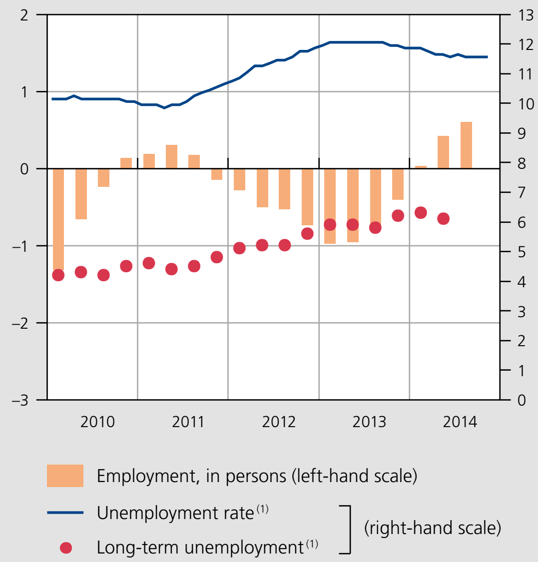
In a context of gradually expanding foreign markets, the euro area's exports also gathered pace during the year. The reforms implemented in the countries with an adjustment programme helped to restore their competitiveness, which had been seriously impaired. The delayed effect of the earlier appreciation of the euro probably still had some adverse impact in 2014, before the second half of the year brought a sharp decline in the value of the euro against the US dollar and the pound sterling. Nonetheless, the net exports of the euro area as a whole made only a meagre contribution to GDP growth overall as imports also began rising faster.

The reforms aimed at strengthening growth potential need to be consolidated and continued

Along with the strengthening of activity, the labour market situation also improved somewhat in the euro area. While employment had continued to contract sharply in the preceding two years, net job creation was restored from the beginning of 2014, bringing a slight increase in employment, on average, over the year amounting to 0.4 %. The unemployment rate subsided a little during the first half of the year, but still came to 11.6 % of the labour force in 2014, against 11.9 % the year before.

CHART 12 LABOUR MARKET IN THE EURO AREA

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



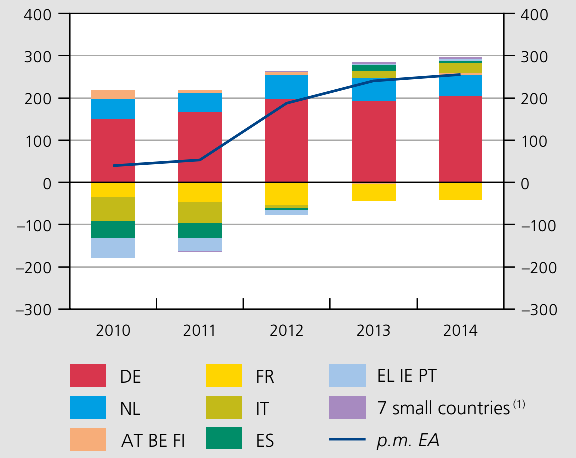
Sources: EC, ECB.
(1) Ratio between the numbers of unemployed and the labour force, in %.

That level is still high, not only compared to the other large global economies but also in relation to the average unemployment rate in the euro area over the past two decades. In that respect, it should be noted that long-term unemployment has risen almost continuously since the financial crisis and therefore represents a growing proportion of total unemployment.

The unemployment rate declined mainly in the peripheral euro area countries, especially in Ireland and Portugal, and to a lesser extent in Spain and Greece. With the exception of Ireland, however, unemployment remained high. Greece and Spain recorded the highest unemployment rates, in the region of 25 % of the labour force. In Greece, this mainly concerned the long-term unemployed.

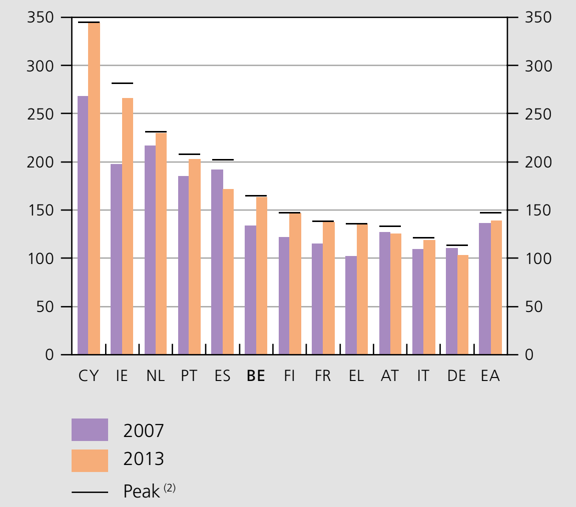
In the euro area, the persistently anaemic domestic demand, and in particular weak investment, since the financial crisis was accompanied by a growing current account surplus on the balance of payments, amounting to 2.5 % of GDP in the year under review. On the one hand, the peripheral countries which had recorded a large current account deficit before the crisis have greatly reduced that deficit since then or even turned it into a surplus. The reforms which they implemented helped to make them more competitive. Also, the sluggishness of domestic demand and the slump in investment in those countries depressed

CHART 13 BALANCE OF PAYMENTS CURRENT ACCOUNT BALANCE
(annual data, in € billion)



Source: EC.
(1) Slovakia, Luxembourg, Slovenia, Latvia, Estonia, Cyprus and Malta.

CHART 14 CONSOLIDATED DEBT OF THE NON–FINANCIAL PRIVATE SECTOR IN THE EURO AREA [1]
(outstanding amount at the end of the year, in % of GDP)



Source: ECB.
(1) The countries are ranked in descending order according to the peak debt of the non-financial private sector.
(2) Peak debt of households and non-financial corporations over the period 2007-2013.

their demand for imports. This last factor also does much to explain why the current account deficit was transformed into a surplus in Italy. Conversely, France is still posting a large current account deficit. On the other hand, in the countries traditionally in surplus, the current account balances have not diminished. For instance, the surplus still came to 7 % of GDP in Germany, and even reached nearly 8 % in the Netherlands. However, in an improving economic climate with domestic demand gradually picking up in the peripheral countries, the rebalancing of current accounts in the euro area slowed slightly during the year under review. Thus, the current account balances grew by less than in previous years in Ireland, Portugal and Italy while they actually deteriorated slightly in Spain and Greece.

The economic reforms in the countries with an adjustment programme are beginning to yield results. However, there are various factors that may hinder the economic recovery. For instance, the total debt of households and non-financial corporations in the euro area as a whole, measured on a consolidated basis – i.e. excluding mutual financial assets and liabilities within the same sector – still amounted to around 139 % of GDP at the end of 2013, slightly below the peak of 146 % of GDP reached in 2009. For comparison, the debt reduction process in the United States was more marked, even though the debt level of the non-financial private sector is still higher there. The debt ratio in the United States declined from 165 % of GDP at the outbreak of the crisis to 147 % at the end of 2013.

In the euro area, despite sometimes substantial adjustments, the debt level is still well above the average in Ireland, Portugal, and the Netherlands, where household mortgage debt far exceeds that in most other Member States. In Cyprus, the debt of the non-financial private sector is now by far the highest in the euro area. In addition, many euro area countries face a large public debt. Although the debt level of the non-financial private sector is relatively low in Greece and Italy, the public debt ratios in those countries are the highest in the euro area. In Cyprus, Ireland and Portugal, the heavy public debt comes on top of the non-financial private sector's debt.

Fiscal consolidation slows in the euro area

After the public sector borrowing requirement in the euro area as a whole had declined sharply between 2010 and 2013, fiscal consolidation slowed down in 2014. Although the budget deficit continued to fall, dropping from 2.9 % of GDP in 2013 to 2.6 %, the improvement was slower than in previous years. Furthermore, it was attributable partly to the more favourable economic climate, since the structural public deficit – namely the net financial balance adjusted for cyclical and temporary factors – declined only very marginally from 1.2 % of GDP in 2013 to 1.1 % in 2014.

TABLE 3 GENERAL GOVERNMENT BUDGET BALANCE AND DEBT IN THE EURO AREA

(in % of GDP)

	General government net financing balance		General government structural balance		Public debt	
	2013	2014	2013	2014	2013	2014
Germany	0.1	0.2	0.6	0.7	76.9	74.5
France	–4.1	–4.4	–3.3	–3.0	92.2	95.5
Italy	–2.8	–3.0	–0.8	–0.9	127.9	132.2
Spain	–6.8	–5.6	–2.3	–2.2	92.1	98.1
Netherlands	–2.3	–2.5	–0.6	–0.5	68.6	69.7
Belgium	**–2.9**	**–3.2 e**	**–2.7**	**–2.8 e**	**104.5**	**106.5 e**
Austria	–1.5	–2.9	–1.3	–1.1	81.2	87.0
Greece	–12.2	–1.6	3.1	2.0	174.9	175.5
Finland	–2.4	–2.9	–0.7	–1.1	56.0	59.8
Ireland	–5.7	–3.7	–4.8	–3.8	123.3	110.5
Portugal	–4.9	–4.9	–1.9	–1.3	128.0	127.7
Slovakia	–2.6	–3.0	–1.4	–2.1	54.6	54.1
Luxembourg	0.6	0.2	2.0	1.1	23.6	23.0
Slovenia	–14.6	–4.4	–1.8	–2.5	70.4	82.2
Latvia	–0.9	–1.1	–1.0	–1.5	38.2	40.3
Estonia	–0.5	–0.4	–1.1	–0.8	10.1	9.9
Cyprus	–4.9	–3.0	–2.1	–0.8	102.2	107.5
Malta	–2.7	–2.5	–2.7	–2.7	69.8	71.0
p.m. Euro area	*–2.9*	*–2.6*	*–1.2*	*–1.1*	*93.1*	*94.5*

Sources : EC, NBB.

Except for Germany and Luxembourg, where the budget was practically balanced, the governments of all euro area Member States had a net borrowing requirement. In some countries the deficit increased in 2014, while it remained stable in Portugal and diminished sharply in Ireland, Spain and Greece, as it did in Slovenia and Cyprus. In this latter country as well as in Ireland and Portugal, this was accompanied by a substantial fall in the structural public deficit. In Greece, where the costs of recapitalising the banks had swollen the budget deficit to 12.2 % of GDP in 2013, the public deficit dropped to 1.6 % of GDP in 2014, as a result of the tax reform and spending cuts.

In all, according to the European Commission's (EC) autumn forecasts, the public deficit was still well above the limit of 3 % of GDP in Spain, Portugal, France, Slovenia and Ireland. Apart from those countries, Cyprus, Greece and Malta were still subject to an excessive deficit procedure (EDP) at the end of the year under review. In November 2014, when the EC assessed the budget plans for 2015, it found that, on the basis of the information available at that time, France had not taken effective action to comply with the Council's recommendations under the EDP for achieving the budget targets for 2014. The EC will determine its position on that at the beginning of March 2015. As regards the other euro area countries, the Ecofin Council ended the procedures against Belgium, the Netherlands, Austria and Slovakia during the year under review.

The public debt of the euro area as a whole continued to grow, reaching 94.5 % of GDP at the end of 2014. However, that increase was smaller than in previous years owing to a primary budget balance that was more or less in equilibrium, and a weakening of the snowball effect caused by interest charges. The increase was more or less universal, affecting most of the euro area countries. The decline in the public debt ratio in Ireland is due mainly to the liquidation of the Irish Bank Resolution Corporation, initiated in 2013. In contrast, the public debt in Austria increased as a result of the government taking over problem assets of a bank which was being wound up.

Box 2 – Structural reforms in the euro area

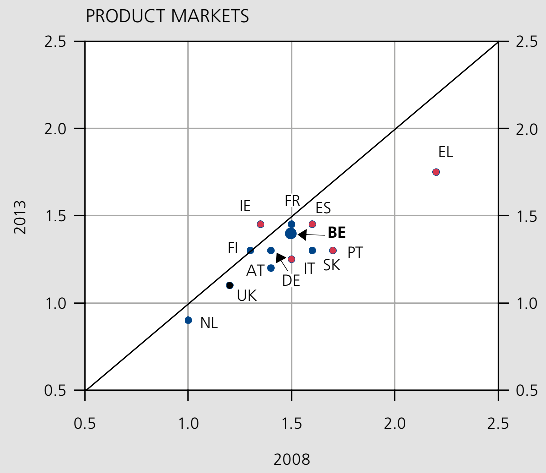
The hesitant and fragile economic situation evident again in the euro area in 2014, against the backdrop of a still highly accommodative monetary policy and a less restrictive fiscal policy, is a clear demonstration of how difficult it is for the euro area to maintain sustainably robust and resilient growth. In parallel with the measures taken since the crisis to consolidate public finances, stabilise the financial sector, reform the pension systems and – in some countries – to restore the seriously impaired competitiveness, it is absolutely essential to make radical improvements to the general operation of the economy. That is all the more urgent for the smooth functioning of the monetary union, because the spillover effects between the Member States are considerable and those countries are no longer able to correct macroeconomic imbalances *ex post* by devaluing their currency.

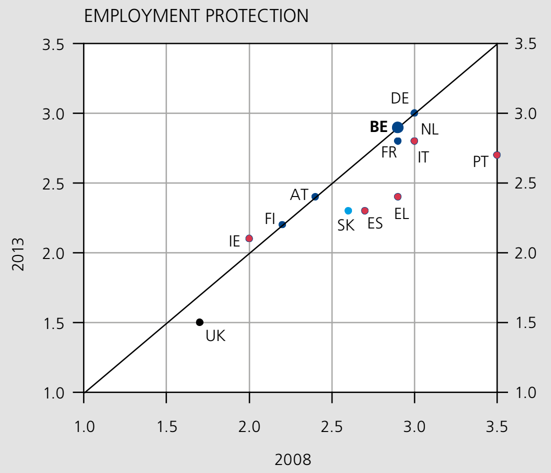
These lessons have now been well learnt, and European economic governance has been reinforced by the introduction of the macroeconomic imbalance procedure (MIP) under the European Semester and the specific recommendations formulated for the countries, many of them related to structural policies.

From now on, the priority must be to ensure the actual implementation of the reforms in the Member States. In the most vulnerable countries, the pace of reform has in fact been speeded up, particularly under pressure from the financial markets and the Troika, which supervises compliance with the conditions attached to the aid programmes implemented in a number of those countries. Conversely, in the core euro area countries, the pressure for implementing radical reforms has often been lacking.

SYNTHETIC INDICATORS OF MARKET REGULATION IN EUROPE

(scale from 0 to 6, from less restrictive to more restrictive)





Source: OECD.

Structural reforms of the labour and product markets: progress so far

Smoothly functioning labour and product markets permit a more efficient allocation of capital and labour, favouring their use in the most productive firms. If such reallocations operate flexibly, it is possible to limit the degree and duration of the loss of output and jobs in a recession.

The scale of the measures taken since the great recession varies from one country to another. In regard to the product markets, the measures were more radical in the programme countries, namely Greece, Spain and Portugal, but also Slovakia and Italy. They were less significant in the core euro area countries, especially France, Germany and Belgium. The completion of the Single Market in services and its exposure to increased competition is proving to be a particularly complicated and long drawn-out process.

In addition, almost all the euro area countries have stepped up their initiatives to reform the organisation and operation of the labour market. Those initiatives mainly concerned an increase in the financial incentives to work, activation of the unemployed, and the rules with regard to unemployment benefit and early retirement schemes. Conversely, they hardly affected the process of wage-setting. Some Member States simplified the procedures relating to mass and individual redundancies and/or reduced redundancy pay in order to stimulate employment while combating the segmentation of the labour market. Portugal, Spain, Greece and Slovakia undertook ambitious reforms.

Impact of structural reforms

The IMF and the EC recently carried out two simulation exercises to estimate the impact of a series of structural reforms on growth in the regions (IMF) or individual countries (EC) of the euro area. Those simulations assume that all euro area countries implement the reforms simultaneously. They model the structural reforms as changes in a number of structural indicators of the labour market and the product markets, but do not establish any link with the policy measures that may be behind them. Next, they adopt a distance-to-frontier approach to quantify a country's reform potential for each structural indicator in the model on the basis of the difference between the

POTENTIAL IMPACT OF STRUCTURAL REFORM PACKAGES ON POTENTIAL OUTPUT

(deviations in % from the baseline scenario)

	After one year	After five years	After ten years	In the long term [3]
IMF [1]				
Euro area	1.2	4.1		12.3
Core (euro area, excl. periphery)	1.1	3.7		10.6
Periphery (EL, ES, IE, IT, PT)	1.4	4.8		15.4
EC [2]				
Core (BE, DE, FR, NL, AT, FI)		3.2 (DE) – 5.5 (BE)	5.5 (DE) – 10.4 (BE)	8.7 (DE) – 17.9 (BE)
Periphery (EL, ES, IE, IT, PT)		2.4 (PT) – 4.5 (EL)	5.5 (PT) – 9.7 (EL)	10.0 (ES) – 17.6 (EL)

Sources: IMF (2014), "Jobs and growth: Supporting the European recovery", (Chapter 7), and Varga J. and J. in 't Veld (2014) "The potential growth impact of structural reforms in the EU: A benchmarking exercise", European Economy Economic Papers 541, December.

(1) The IMF uses the GIMF model and assumes that a set of reforms concerning the product markets, the labour market, and the tax structure will be phased in during the first five years. These reforms lead to halving of the gap in relation to the best performing OECD country (which varies according to the criteria).

(2) The EU uses the QUEST model and assumes that a set of reforms concerning the product markets, the labour market, and the tax structure, R&D expenditure and the skills structure will be phased in. These reforms lead to halving of the gap in relation to the average of the three best performing EU Member States (which vary according to the criteria).

(3) The long term extends until 2060 for the IMF calculations while it is 20 years for the EC calculations.

score of the country in question and that of the best performing country, regarded as the benchmark. Finally, it is assumed that a country will take a series of measures which, for each indicator considered, will lead to a linear halving of the gap in relation to the benchmark over five years. The estimated impact on potential output is determined *inter alia* by the design of the models used, the structural indicators included and the definition of the benchmark. The results must therefore be interpreted and compared with caution.

Structural reforms have an impact mainly in the medium and long term, but a beneficial influence may still be felt in the short term as a result of the restoration of confidence. Logically, the countries or regions which, on average, have a bigger gap to close in relation to best practices have the most to gain from ambitious structural reforms. As already mentioned, that gap is larger, on average, in the periphery than in the core euro area, although there are wide variations between countries within each group. For instance, in the periphery, Greece still has a long way to go while Ireland has a high degree of flexibility.

According to the EC, if a country implements reforms unilaterally, the impact after 20 years will be around 3 percentage points lower than in the above scenario in the case of small open economies such as the Netherlands, Belgium and Austria. In contrast, for closed economies such as Greece and Portugal, the difference will be negligible. In the joint reform scenario, the positive contagion effects resulting from stronger demand among trading partners therefore appear to outweigh the gains in competitiveness in relation to trading partners in the scenario where only one country conducts reforms.

In the current context of zero nominal interest rates, structural reforms may have a slightly negative impact on growth at first, owing to their influence on the real interest rate, as noted by the EC in a recent publication (1). However, the EC stresses that this is no reason to postpone the reforms since the costs associated with the resulting loss of credibility would probably be much higher. On the contrary, resolute commitment to structural reforms will alleviate uncertainty about the future, which may lead to a reduction in precautionary savings.

(1) EC (2014), *Special issues on the euro area economy*, *Quarterly Report on the Euro Area*, Vol. 13, N° 3.

1.3 Monetary policy of the Eurosystem

Downside risks to price stability

Economic analysis

Whereas optimism prevailed at the beginning of 2014, the Governing Council later faced a steady deterioration in the economic outlook for the euro area. That was particularly marked in the fourth quarter, despite some signs of a stabilisation of activity at the end of the year. In that situation, the expectation was that the absorption of the excess production capacity would be a slow and gradual process.

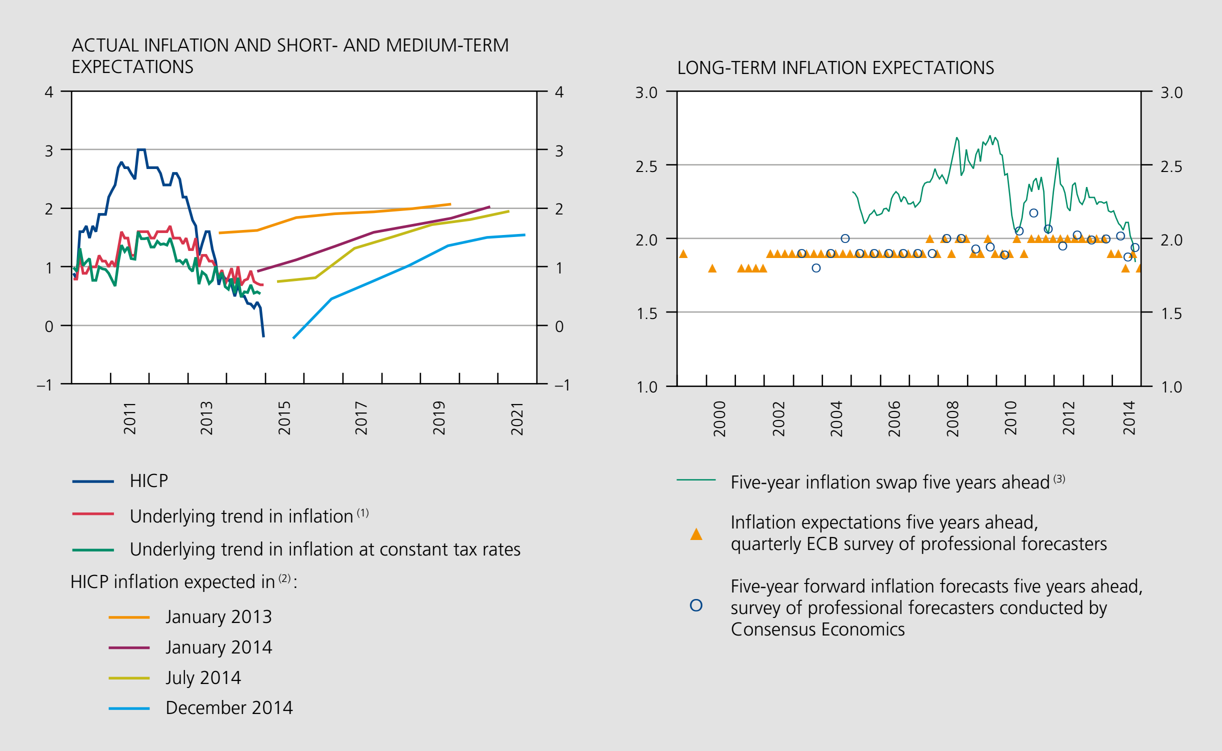
As the months went by, actual inflation proved significantly weaker than expected, as did economic activity, and the corresponding projections were also systematically revised downwards. At the end of the year, inflation fell to particularly low levels, a long way from the Governing Council's medium-term objective of an inflation rate below but close to 2 %.

In addition, throughout the year, the Governing Council considered that these economic prospects were subject to downside risks, relating in particular to geopolitical developments, insufficient structural reforms in the euro area countries, and the still faltering recovery. From April onwards, it also systematically noted risks relating to an excessively long period of low inflation. As explained in the box below, while deflation was still considered an unlikely prospect, a situation in which inflation is too low also implies a whole set of risks and problems.

Short- and medium-term inflation expectations in the private sector confirmed and even reinforced the Governing

CHART 15 INFLATION AND INFLATION EXPECTATIONS IN THE EURO AREA

(year–on–year percentage changes)



Sources: EC, Bloomberg, Thomson Reuters Datastream, ECB.

(1) HICP excluding food and energy.

(2) Measured on the basis of the implicit forward rate for an inflation swap. Since consumer price indexes are published after some delay, inflation swap contracts reflect the inflation expected in the month three months ahead of their due date. For instance, one–year contracts dated December 2014 reflect inflation rates expected in September in subsequent years.

(3) Implicit inflation rate derived from swaps covering the inflation risk in the euro area, for a period of five years beginning five years after the conclusion of the contract.

Council's assessment, as they foresaw only a slow and very gradual return to inflation levels compatible with the definition of price stability. Following a series of surprisingly low inflation figures, expectations were also down sharply over the year as a whole. Long-term expectations based on financial data likewise displayed a downward trend, reaching an all-time low at the end of the year. This led to fears that inflation expectations might become disanchored, a worry which was reinforced by the relatively low level of long-term expectations derived from the survey data. Those data are available less frequently than the financial data, but they do not incorporate risk premiums. Although the decline is very small, it is worrying in that these data are typically stable in the context of a monetary policy geared to price stability.

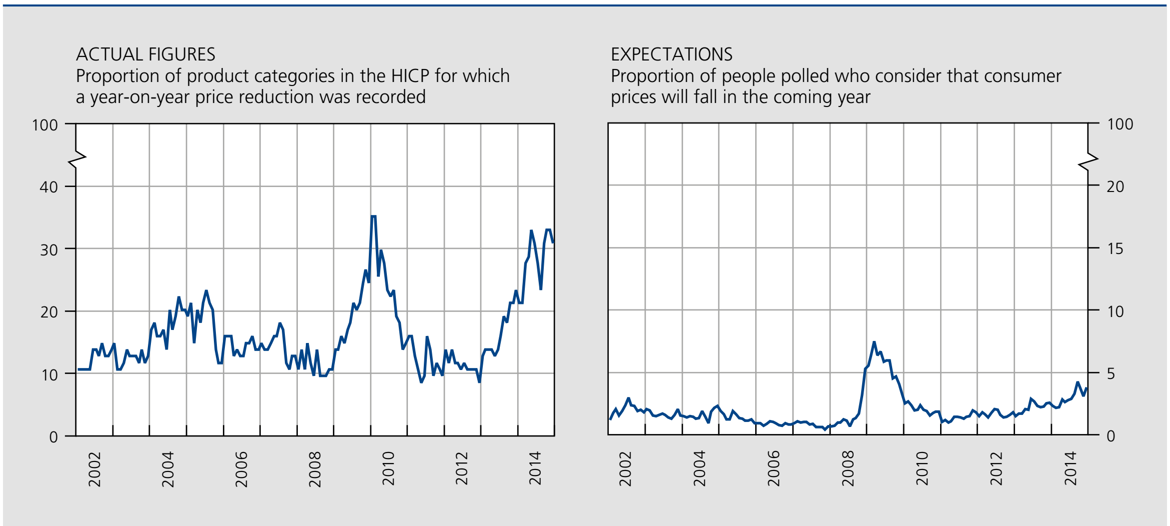
Box 3 – Why is persistently low inflation a problem?

The ECB's primary aim is to maintain price stability, defined as inflation below but close to 2 % in the medium term in the euro area. If price trends are stable and predictable, that in fact helps the economy to function better. Conversely, unexpected fluctuations in inflation may lead to sub–optimal macroeconomic results, e.g. owing to distortion of the signal given by individual price–setting, arbitrary redistribution of income and wealth, or the resulting uncertainty surrounding long–term decisions. However, not all fluctuations in inflation are equally harmful, nor do they all require a monetary policy response: much depends on the type of shock generating such movements. For instance, in the case of a negative demand shock, both inflation and economic activity come under downward pressure. A swift response by monetary policy is then recommended since a monetary stimulus stabilises the two variables. Conversely, in the case of a positive supply shock – which exerts downward pressure on inflation but at the same time supports economic potential – monetary policy faces a dilemma. A more gradual response may then be advisable, at least if inflation expectations remain firmly anchored. If that last condition is not met and if the positive supply shock is not accompanied by an increase in demand, and therefore generates persistent downward pressure on inflation, intervention by monetary policy is required.

Various factors account for the downward trend in inflation in the euro area since the end of 2011. At global level, commodity prices have fallen sharply while the rise in food prices has been modest. Moreover, the resulting downward pressure on import prices was reinforced by the euro's appreciation, which continued until the beginning of May 2014. By supporting consumers' purchasing power, these external supply factors have a favourable influence on the economy of the euro area. In addition, a rebalancing process is taking place within the euro area, with the peripheral countries endeavouring to restore their competitiveness with the core countries, notably by means of structural reforms. The decline in inflation in the peripheral countries resulting from those reforms at the level of the economy's production potential can be considered necessary and beneficial. Apart from these factors, however, the persistence of low inflation is due essentially to the flagging demand in the euro area, which is depressing economic activity, wages and profits, and hence also prices. Unlike the lower inflation caused by a reduction in import prices, that is not a source of increased purchasing power.

Thus, inflation in the euro area has for a long time been below a level compatible with price stability, and is expected to rise only very slowly towards 2 %, as indicated by the persistent decline in inflation expectations in the short, medium and long term. Nonetheless, the ECB Governing Council considers that there is little risk of deflation (defined as a self–perpetuating fall in prices which threatens to lead to the postponement of purchases) in the euro area. Although the proportion of goods and services in the consumption basket recording a year–on–year decline

SCALE OF PRICE REDUCTIONS IN THE EURO AREA
(monthly data, in %)



Source: EC.

in prices did increase in 2014, it did not exceed the 2009 level. Also, the EC's monthly survey shows that only a very small number of consumers expect consumption prices to fall over the next twelve months.

Even without a general fall in prices, an excessively long period of low inflation causes damage, particularly if it is due to a decline in demand and is accompanied by inflation expectations becoming disanchored. An unexpected fall in inflation increases the real value of outstanding debts, since the real interest rate proves to be higher *ex post* than was expected *ex ante*. When inflation remains persistently below the target, there is therefore a redistribution of wealth from debtors to lenders. The opposite is also true in the event of inflation persistently exceeding the target. However, if inflation is too low, it is liable to have an additional adverse impact on demand, as in principle borrowers – who face a higher real interest rate – have a greater propensity to consume than lenders. If the debt is substantial, as is the case for the euro area, an unexpected decline in inflation may curb the economic recovery because it hampers debt reduction and may exacerbate the fall in demand. In that connection, it should be noted that the peripheral euro area countries are the ones facing the biggest challenge: they have the lowest inflation combined with the heaviest debts.

As already mentioned, the low inflation in the peripheral countries is to some extent an indication of the success of the structural reforms implemented in order to restore competitiveness. However, it is not offset by an increase of more than 2 % in wages and prices in other countries, so that on balance, inflation in the euro area as a whole is still too low. That situation complicates and delays the adjustment process, which requires a relative decline in wages and prices, i.e. only in relation to the rest of the euro area and not necessarily in absolute terms. Thus, with inflation close to 2 % on average in the euro area, a price and wage freeze in the peripheral countries could be enough to achieve a fairly rapid adjustment in relative prices. Conversely, in a low inflation situation, it is necessary to make absolute cuts in wages and prices to achieve that adjustment. For various reasons, workers and businesses display reluctance in that respect (1), thus slowing the adjustment process in the peripheral countries, driving up unemployment and further eroding demand. It is therefore hard for the structural reforms on the labour market and on the product markets to produce their beneficial effects.

Finally, in a low inflation environment, it may be more difficult to pursue a sufficiently accommodative monetary policy, as the nominal interest rate – which corresponds to the sum of the expected inflation rate and the real interest rate – has a floor of around 0 %. Once the policy interest rate has reached that low point, as is currently the case in the euro area, the central bank loses the instrument that in normal times enables it to lower the real interest rate further in the short term. If inflation expectations are firmly anchored, the situation need not be a problem so long as the negative real interest rate thus obtained is sufficiently accommodative. However, this scenario still entails risks. For example, even if the real interest rate is already negative, it may still be too high in relation to the level of the real equilibrium rate (2), e.g. because of an additional, persistent fall in demand. Moreover, inflation expectations that are no longer firmly anchored and exhibit a downward trend will exert upward pressure on the real interest rate and lead to a monetary policy that is unintentionally more restrictive. Traditional monetary policy might then be incapable of restoring economic activity to its potential level. That would aggravate the risk of very weak growth persisting for a prolonged period, a phenomenon known as "secular stagnation" (3), causing lasting damage to growth potential.

Admittedly, a central bank faced with such an environment can still resort to alternative measures. Even if the policy interest rates are at their minimum level, those measures must make it possible to conduct an accommodative policy to restore inflation and inflation expectations to a stable level close to the target, in order to limit the negative effects described here. The measures adopted by the Eurosystem should in fact be viewed in that light.

(1) For studies of *inter alia* the downward rigidities in wages and prices in the euro area, see the work of two Eurosystem working groups, namely the Wage Dynamics Network and the Inflation Persistence Network.
(2) The real equilibrium rate is the rate prevailing when output reaches its potential level. It is also a benchmark for the monetary policy stance: if the real interest rate is higher than the real equilibrium rate, monetary policy is restrictive, whereas if it is lower than that rate, monetary policy is accommodative.
(3) For a general view of the subject, see Box 1.

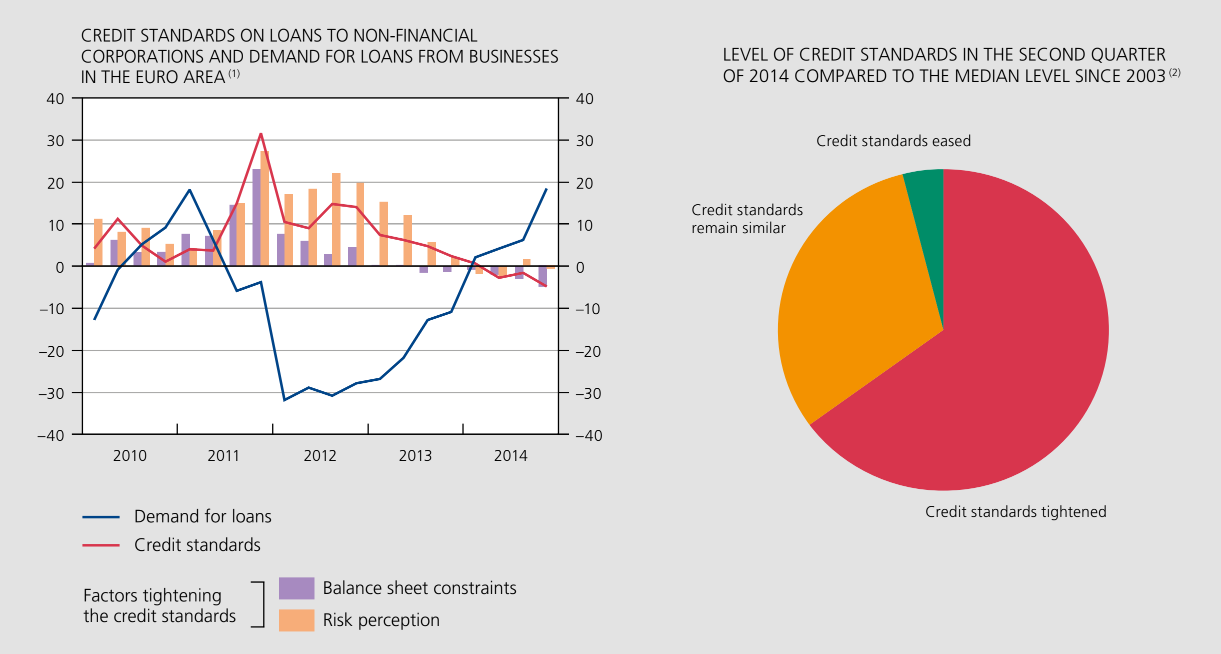
Monetary analysis

The scenario in which inflationary pressure is expected to remain particularly low for a long time was largely borne out by developments in the money supply and in lending.

Bank lending to the private non-financial sector remained sluggish, and was restrained in particular by the weak economic activity and the ongoing balance sheet adjustment. However, during the first quarter there were signs that lending was picking up. Year-on-year growth of lending to businesses thus increased from –3.2 to –1.3 % between February and November, although it remained decidedly negative, while the growth of lending to households was up from 0.2 to 0.7 % between January and November. In line with these developments, the results of the bank lending survey (BLS) indicate a slight easing of credit standards and a rise in demand for both business loans and home loans. Nonetheless, it must be borne in mind that the level of the credit standards remained restrictive in historical terms, especially in the peripheral economies. In a calmer financial environment, it was mainly the reduction in balance sheet constraints that contributed to the easing of standards in 2013 and 2014, while in view of the still uncertain macroeconomic context, risk perception continued to be a source of concern for banks in their lending. The slight increase in the growth of bank lending to the private sector was evident in many countries, but there were still substantial differences in terms of level between the centre and the periphery of the euro area, bearing witness to variations in macroeconomic dynamics and debt levels. At the same time, debit interest rates continued to display wide variations, although they did diminish overall as a result of new measures adopted by the ECB Governing Council. The disparity in bank financing costs between countries is due mainly to divergences in banks' funding conditions and capitalisation, but also to variations in credit risk from one country to another.

The modest revival in lending to the private sector during the year under review was accompanied by a steady expansion of the money supply. After having declined to a low of 0.8 % in April, the year-on-year growth of the broad monetary aggregate M3 thus gradually gathered pace to reach 3.1 % in November. That growth indicates an increased preference for liquid assets, given the low level of interest rates. In that context, the annual expansion of M3 continued to be supported by its most liquid components, and especially sight deposits, as their opportunity cost is very low in an environment where other risk-free assets offer meagre remuneration.

CHART 16 EUROSYSTEM'S BANK LENDING SURVEY FOR THE EURO AREA
(quarterly data)

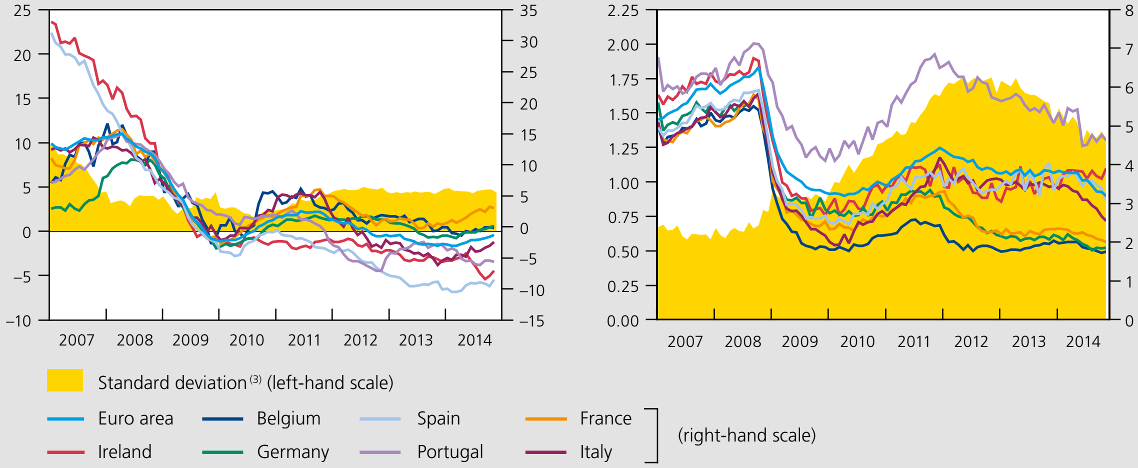


Source: ECB.
(1) Net percentages of replies from banks to the Eurosystem's bank lending survey indicating the degree of tightening (+) or easing (–) of credit standards and the movement in demand for loans.
(2) Net percentages of replies from banks.

CHART 17 BANK FINANCING OF NON–FINANCIAL CORPORATIONS IN THE EURO AREA

BANK LOANS TO NON-FINANCIAL CORPORATIONS [1]
(percentage changes compared to the corresponding period of the previous year; monthly data, adjusted for securitisation effects, unless otherwise stated)

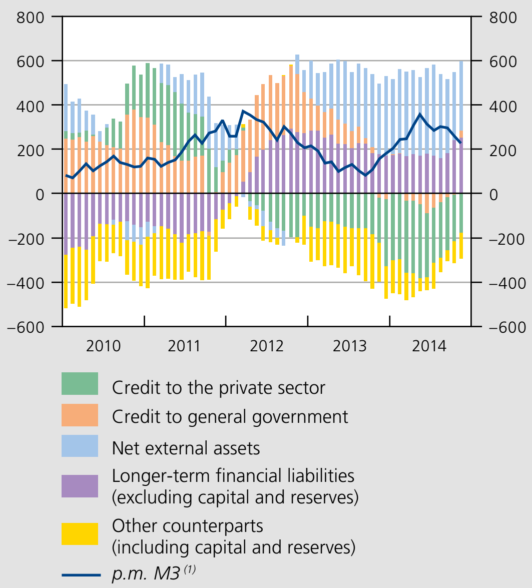
DEBIT INTEREST RATES ON BANK LOANS TO NON-FINANCIAL CORPORATIONS [2]
(monthly data, loans up to €1 million)



Sources: ECB, NBB.
(3) All maturities together. The data for Belgium are adjusted for securitisation over the whole period. Those for the other countries are adjusted from February 2010, except for the data for Italy which are not adjusted.
(4) Interest rates offered on new loans for an initial term of less than one year.
(5) Standard deviation for the twelve euro area Member States on 1 January 2002, with the exception of Luxembourg.

In general, the decoupling of M3 growth from the expansion of lending to the private sector persisted, as other factors contributed to the growth of the broad monetary aggregate, headed by the increase in the net external position of the banks and the continuing contraction of their longer-term financial commitments. The first factor reflects the surpluses on the euro area current account and the net inflow of capital into the euro area. Although it has been the main driver of M3 growth since mid-2013, its dominance diminished a little from the summer of 2014 following a slight fall in investors' demand for euro area securities. That reduced preference was probably due to yield considerations relating in particular to the reinforcement of the accommodative monetary stance. The second factor reflects the reduction in the financing needs of banks in the euro area and the tendency towards a funding strategy centred on deposits, as encouraged by the current regulation. It also reflects the particularly flat shape of the yield curve, which is causing savers to keep their liquidity in the form of deposits. Taking account of these factors, the underlying growth rate of the money supply in the broad sense thus remained very low, even though it accelerated slightly.

CHART 18 COUNTERPARTS OF M3
(annual flows, amounts in € billion, seasonally adjusted data)



Source: ECB.
(1) M3 corresponds to the sum of the various counterparts. Since longer–term financial liabilities (excluding capital and reserves) are liabilities of the banking sector, they are shown with a negative sign.

Monetary policy measures adopted in 2014

The developments revealed by economic and monetary analysis – the two pillars forming the basis of the Eurosystem's monetary policy strategy – prompted the Governing Council to adopt a range of new conventional and non-conventional measures during the year under review. Although they were staggered throughout the year, these various measures all form part of the same programme designed to reinforce the accommodative monetary policy stance and give greater support to lending to the real economy in the euro area.

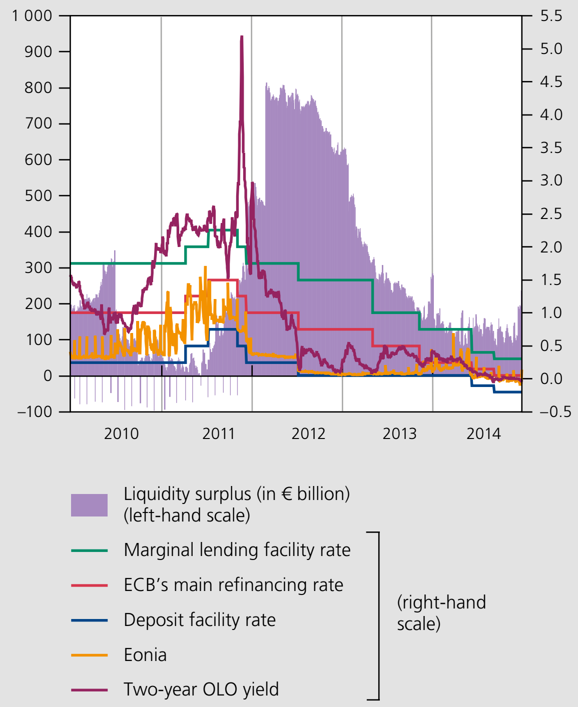
Reduction of key interest rates and maintenance of forward guidance

In view of the persistently languishing economic activity, the steady and unexpected decline in inflation and the weak underlying inflationary pressures in the medium term, the Governing Council cut the key rates on two occasions in 2014.

On 5 June, it was decided to cut the rate on the Eurosystem's main refinancing operations by 10 basis points to 0.15 %, and to reduce the marginal lending facility rate by 35 basis points, to 0.40 %. The deposit facility rate was cut by 10 basis points, thus taking it into negative territory at –0.10 %. To avoid arbitrage, the Governing Council also decided that the current account balance held in excess of the reserve requirement would in future be remunerated at the deposit facility rate and not at a zero rate as had previously been the case. In view of the persistently weak inflation outlook and signs that growth was slowing down in the summer, the Governing Council considered at its meeting on 4 September that its policy interest rates needed to be reduced further. It thus agreed to cut all the rates by a further 10 basis points, bringing the interest rate on the main refinancing operations to 0.05 %, the marginal lending facility rate to 0.30 % and the deposit facility rate to –0.20 %. Following these cuts, it was announced that the interest rates had reached their floor so that there would be no further reductions.

The decline in the main refinancing rate reduced the cost of Eurosystem refinancing for banks in the euro area, while the reduction in the deposit facility rate exerted pressure on money market rates. In a situation of excess liquidity, which has very often prevailed since the fixed-rate tenders with full allotment were introduced on 15 October 2008, the floor policy rate in fact plays a key role in determining the overnight Eonia rate, for which it is a lower bound. However, although the overnight money market rate did fall, it was still significantly above the deposit facility rate and only descended briefly into negative territory. This limited transmission of the movements in the policy rate to the Eonia rate is attributable to a lower level of liquidity surplus and to the reluctance of a segment of the euro area banking system to effect transactions at (too) negative interest rates.

CHART 19 INTEREST RATES, MONEY MARKET RATES AND LIQUIDITY SURPLUS IN THE EURO AREA



Sources: Thomson Reuters Datastream, ECB.

It should be noted that the banks are generally willing to pay a negative interest rate to deposit their liquidity with the Eurosystem because the other options are also expensive or less secure. The alternative of holding paper money, on which the nominal remuneration is zero, thus entails banknote transport and storage costs, while investment in more remunerative assets is not in principle risk free. In this context and owing to the banks' arbitrage strategies, yields on risk-free short-dated assets such as certain sovereign securities also became negative.

Apart from the aim of easing monetary policy, the simultaneous adjustment of the interest rates on the main refinancing operations and the deposit facility are intended to maintain a constant corridor between the two lower key interest rates, and therefore not to discourage trading on the interbank market. The decision to make a bigger cut in the marginal lending facility rate reflects the desire to narrow the gap between that rate and the central policy rate in order to limit the potential upward volatility of the money market rates. The interest rate on the marginal lending facility is in fact an absolute ceiling for Eonia. This therefore curbed the periodic peaks in the overnight money market rate in the first half of the year under review, which – in a situation of lower liquidity surplus – indicated that the banks want to conserve liquidity at the end of a month or quarter in order to embellish their financial position.

According to the Eurosystem's forward guidance introduced in July 2013, the policy interest rates will remain low for an extended period in view of the assessment of the economic outlook. That forward guidance has been continuously reaffirmed, and has helped to reduce the interest rate expectations and the uncertainty surrounding them.

Towards more active balance sheet management

Since the summer of 2012, following the adoption of the OMTs and with the prospect of a revision of European economic governance, financing conditions in the euro area had already been getting better, particularly for government securities. That improvement continued in early 2013. Spreads on government bonds became steadily narrower, as did the spreads on private sector instruments, confirming the easing of financial fragmentation. At the same time, the liquidity surplus which had diminished considerably in recent years remained at a relatively low level, indicating that the Eurosystem was playing a smaller role in intermediation, that role being increasingly taken over by the interbank market. Despite these favourable developments, recourse to Eurosystem liquidity remained concentrated on the countries which had been at the heart of the sovereign debt crisis. Bank lending conditions – the most relevant for the transmission of monetary policy to the real economy in the euro area – therefore remained very disparate and relatively restrictive in some jurisdictions. That situation, which reflected a persistent disruption of the transmission of the monetary policy signal to the real economy, threatened the recovery of activity and the maintenance of price stability.

In these circumstances, to maintain access to liquidity for all banks in the euro area and thus bolster lending, the Governing Council announced at its meeting on 5 June that it would continue to conduct the Eurosystem refinancing operations in the form of fixed-rate tenders with full allotment for as long as necessary, and at least until December 2016. It agreed that the central policy rate would continue to apply to the main refinancing operations, and that the interest rates on the longer-term refinancing operations would remain equal to the average of the rates on the main refinancing operations conducted during the period of the operation concerned. Given their minor role in a procedure for granting unlimited liquidity at a fixed rate, the operations whose term coincides with a reserve maintenance period – or around one month – were terminated, while the weekly fine-tuning operations to sterilise the provision of liquidity under the Securities Markets Programme (SMP) were suspended. This last decision had only a small, temporary impact on the liquidity surplus, as it was more than offset by a fall in demand for funds via other operations; that confirms the reduced role of the Eurosystem in intermediation.

Targeted longer-term refinancing operations

The Governing Council also took measures to safeguard the effective transmission of the accommodative monetary policy stance to lending conditions. Thus, June also saw the announcement that the Governing Council would conduct a series of targeted longer-term refinancing operations (TLTROs). These offer banks long-term financing – up to four years – in exchange for new lending to businesses and households, with the exception of home loans. The interest rate on these operations was initially set for the entire duration of the loan at 10 basis points above the rate on the main refinancing operations prevailing at the time of the operation. Thus, subject to certain conditions, the TLTROs make it possible to obtain cheap finance up to September 2018, regardless of the movement in the main policy interest rate.

On the occasion of the first two operations in September and December 2014, banks were allowed to request liquidity up to a maximum of 7 % of their total outstanding loans to the private non-financial sector of the euro area as at 30 April 2014. The additional amounts which can then be borrowed each quarter between March 2015 and June 2016 will depend on the banks' lending activities in excess of the benchmarks defined specifically for each bank. The amounts that institutions can request from the Eurosystem must not exceed three times the difference between the net amount of loans granted since 30 April 2014 and the benchmark at the time of the request. The benchmark takes account of the institutions' need for deleveraging and balance sheet adjustments. Banks which have recently scaled down their lending are therefore encouraged above all to slow the pace at which they shrink their loan portfolio. Banks which fail to meet their benchmark by 30 April 2016 will be required to repay all their borrowings in full in September 2016.

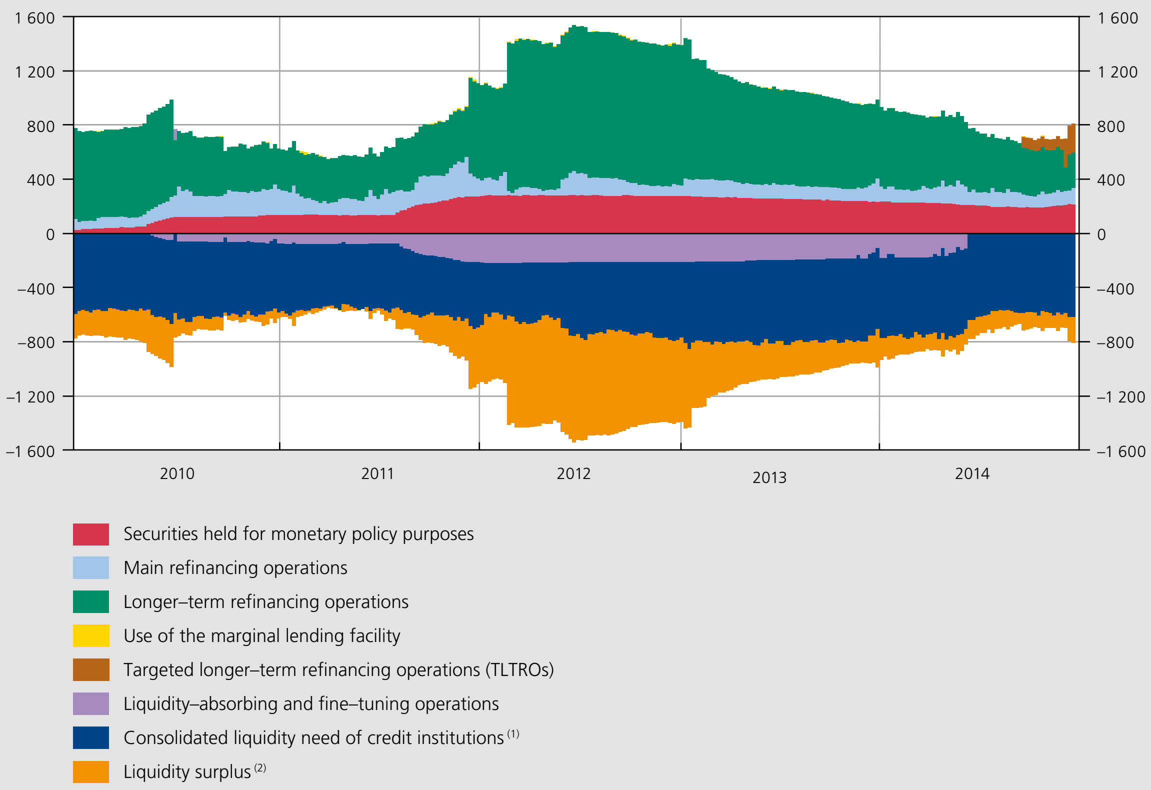
In contrast to the long-term refinancing operations previously introduced by the Eurosystem, these operations thus comprise an incentive mechanism to encourage the banks to ease their credit standards and stimulate their loan volumes. Since these operations are conducted at a fixed rate, they also implicitly signal the Eurosystem's intentions regarding the policy interest rates and its commitment to maintaining an accommodative policy in the future.

Despite fairly advantageous conditions, the demand for liquidity in the first two operations conducted respectively on 18 September and 11 December was at the lower end of the expected range. While the potential cumulative total came to around € 400 billion, only € 212.4 billion was requested. There are two possible reasons for the relatively weak demand for liquidity in the TLTRO. First, the announcement of securities purchase programmes at the beginning of September (see below) may have dissuaded some banks from borrowing, as the prospect of obtaining liquidity under the Eurosystem securities purchase programme may have convinced credit institutions to reduce their demand for liquidity in the refinancing operations. Also, the signs that the recovery was losing momentum in the second half of the year potentially implied a weaker outlook for demand for loans from the real economy, and hence lower financing needs for the banks.

While € 82.6 billion was lent in September, the December figure was € 129.8 billion. This stronger demand at the time of the second operation can be explained in three ways. First, the publication in October of the results of the comprehensive assessment probably gave banks in the euro area more certainty about their balance sheet capacity to expand their lending. Next, as the three-year longer-term refinancing operations (LTROs) conducted at the end

CHART 20 LIQUIDITY IN THE EUROSYSTEM

(outstanding amounts, weekly data, in € billion)



Source: ECB.
(1) Liquidity need due to "autonomous factors" (such as demand for banknotes) and reserve requirements.
(2) The liquidity surplus is equal to the difference between the outstanding amount of the operations leading to the expansion of liquidity – namely the refinancing operations, purchases of securities for monetary policy purposes, and use of the marginal lending facility – and the sum of the outstanding amount of the liquidity-absorbing operations and the consolidated liquidity need of the banking system. It corresponds to the sum of the amounts placed on the deposit facility and on current accounts in excess of the reserve requirements.

of 2011 and in early 2012 and maturing respectively on 29 January and 26 February 2015 offered an interest rate equal to that on the main refinancing operations, namely 0.05 % and 10 basis points below the TLTRO rate, it was advantageous to wait for the second operation to substitute the targeted refinancing for the three-year financing. Finally, some banks may have needed more time to be operationally ready to request funds under the TLTROs.

In accordance with the reduced intermediation role of the Eurosystem, the TLTRO allotments had a limited impact on liquidity. Overall, taking account of the other lending operations conducted by the Eurosystem during the tendering periods and the repayments under the three-year LTROs, liquidity amounting to around € 47 billion, in net terms, was injected as a result of the first operation, while the second provided a net amount of around € 84 billion.

Private sector asset purchase programmes

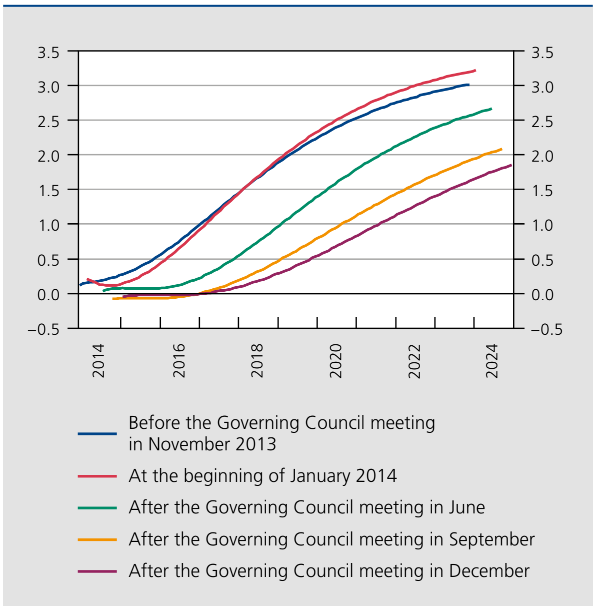
At its meeting on 4 September, the Governing Council considered that it needed to reinforce the measures taken in the spring and ease its monetary policy still further to avert the threats to the recovery and to the anchoring of inflation expectations. It therefore decided to embark on asset purchases, a logical step towards monetary stimulation when interest rates have reached the lower bound. First, after the June announcement that the relevant preparations would be stepped up, it was agreed that the Eurosystem would acquire a large portfolio of simple and transparent asset-backed securities (ABSs), with the underlying assets being claims on the non-financial private sector of the euro area. It was also announced that the Eurosystem would likewise acquire a massive portfolio of euro-denominated covered bonds, issued by banks incorporated in the euro area, under a third covered bond purchase programme (CBPP3). As had already been the case in 2009 and 2011, these securities were targeted because they are key financing instruments for the banks in a number of euro area countries, and because the market is large enough to acquire substantial volumes. Initially, the two programmes were set up for a minimum period of two years with the aim of injecting liquidity into the money market, revitalising the securities markets concerned, stimulating issues and supporting the underlying lending.

The Governing Council said it expected the purchases of securities, in combination with the TLTROs, to have a significant impact on the balance sheet of the Eurosystem. The decision to resort to outright asset purchases in fact gives the Governing Council more direct control over the growth of this balance sheet. The programmes adopted therefore mark a break with the previous situation in which the growth of the monetary base depended mainly on the behaviour of the banks, which determine recourse to euro area liquidity in the context of a full allotment liquidity procedure. Although it did not mention any figures, the Governing Council indicated that the Eurosystem balance sheet was expected to be restored to the size it had been at the beginning of 2012. At that time, just after the two three-year LTROs, the balance sheet exceeded € 3 000 billion, a historically high level and about € 1 000 billion above the September 2014 figure.

All these new measures taken in September show that the Eurosystem is adopting a new approach to strengthen its accommodative monetary stance in an environment where interest rates have reached the lower bound. In such a situation, the monetary policy stance in fact depends on the size and composition of the central bank's balance sheet.

Transactions under the covered bond purchase programme started on 20 October and acquisitions had reached € 29.6 billion by the end of the year. ABS purchases began on 21 November and totalled € 1.7 billion at the end of December. The relatively low volume of ABS purchases can be explained by the fact that there is only a very small market for them.

CHART 21 IMPLICIT EXPECTATIONS REGARDING THE OVERNIGHT INTEREST RATE IN THE EURO AREA (1)



Sources: Bloomberg, NBB.
(1) Measured on the basis of the implicit overnight interest rate derived from interest rates on Eonia swaps with varying maturities.

The Governing Council has constantly and unanimously reaffirmed that, if necessary, it is ready to take new measures to address the risks of an excessively long period of low inflation. In particular, it indicated at its meeting in December 2014 that in early 2015 it would review the degree of monetary easing already attained, as well as the growth of the balance sheet and the outlook for inflation.

The measures adopted in 2014 put downward pressure on nominal interest rates and the exchange rate

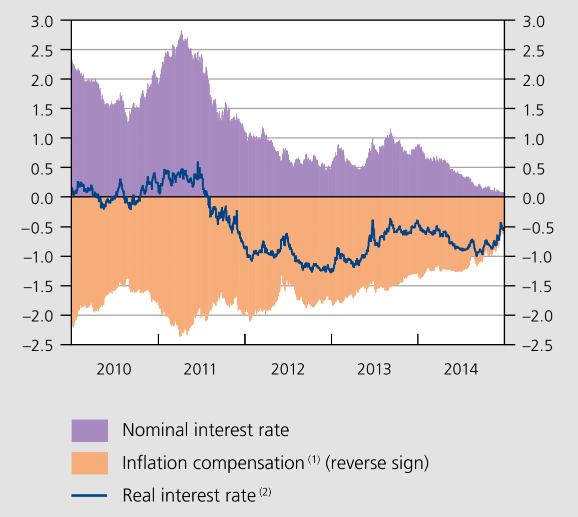
The measures adopted in 2014, together with the statements issued by the Governing Council bearing witness to its determination to take new action if necessary, have certainly not been ineffective.

Combined with the forward guidance, the cuts in the key interest rates led to a lowering of expectations regarding the Eonia rate and hence longer-term money market interest rates. The decision to conduct liquidity-providing operations with a maturity of up to four years and the decision to buy assets also reinforced the flattening of the interest rate term structure by lowering expectations in respect of both interest rates and term premiums. Expectations of a possible upcoming reinforcement of the monetary policy measures adopted during the course of the year under review – and most notably the prospect of a further expansion of the securities purchase programmes – fuelled the downward trend in interest rates. Towards the end of the year, the forward rate curve thus reached a historically low level, taking all maturities together. The Eonia rate was expected to remain negative until early 2017 and was unlikely to exceed the current central policy rate, namely 0.05 %, before September of that year. Yields on sovereign bonds of a number of countries, including Belgium, had become negative for maturities up to two years, and had dipped below 0.85 % for maturities up to ten years. The yield on the German ten-year Bund, the benchmark risk-free asset in the euro area, dropped below 0.60 %. The search for yield in a low interest rate environment had also increased the attraction of more remunerative financial products, causing a further decline in risk premiums.

However, since the decline in nominal interest rates largely offset the fall in inflation expectations, real interest rates rose slightly. For example, the five-year interest rate, relevant for private sector decisions on consumption and investment, edged up to –0.5 % during the closing months of 2014 from a trough of –1 % at the end of September.

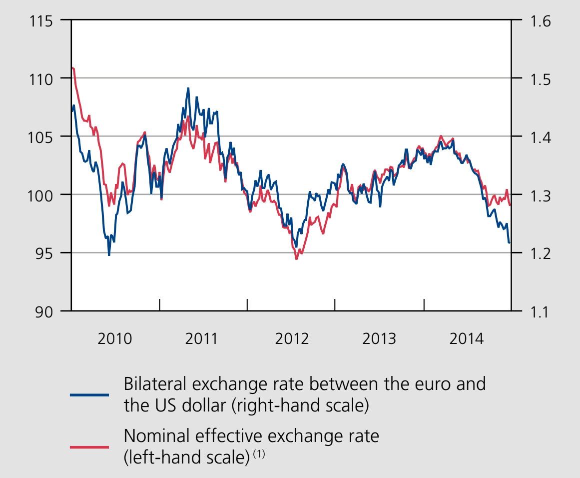
As regards the later – crucial – stage of monetary transmission, the bank interest rates on new loans to the private sector declined after a long period of relative stability. These developments tally with the responses to the BLS concerning the third and fourth quarters of the year. Questioned about the TLTROs, the banks stated that they

CHART 22 REAL INTEREST RATE IN THE EURO AREA
(5-year swap rate ; daily data, in %)



Source : ECB.
(1) Measured on the basis of swap contracts covering the inflation risk in the euro area for a 5-year period.
(2) Calculated as the difference between the nominal interest rate and the inflation compensation.

CHART 23 EURO EXCHANGE RATE



Sources : Thomson Reuters Datastream, ECB.
(1) Nominal effective exchange rate against the 19 main trading partners of the euro area.

were notably going to use the liquidity obtained to ease their lending conditions.

On the foreign exchange markets, the euro depreciated sharply against the dollar and in nominal effective terms against the main trading partners of the euro area. Whereas the euro had appreciated by around 10 % against the dollar between June 2012 and April 2014, reflecting the restoration of confidence in the euro area, it thus fell by as much as 13 % between the beginning of May and the end of December. This picture reveals the effects of the decline in interest rates, pushing investors to rebalance their portfolios in favour of assets in foreign currencies offering higher yields. In that context, the euro's depreciation can be considered welcome in that it should help to drive inflation higher in the euro area and bolster exporters' competitiveness.

Expanded asset purchase programme launched at the beginning of 2015

At the beginning of 2015, the Governing Council noted, on the one hand, that inflation dynamics had turned out to be persistently below expectations. While the main factor behind this trend is the sharp and prolonged drop in oil prices, it felt that there was now a greater risk of second-round effects on wage- and price-setting. This assessment was also corroborated by a further drop in inflation expectations. On the other hand, the Governing Council felt that, beyond their effect of shoring up prices on the financial markets, the monetary policy measures adopted between June and September 2014 had not had the desired quantitative impact. It therefore reached the conclusion that the degree of monetary policy easing was not sufficient to address the risks inherent in an excessively prolonged period of low inflation and that a forceful response was needed.

On 22 January 2015, the Governing Council thus decided to launch an expanded asset purchase programme, encompassing the existing programmes for buying up ABSs and covered bonds introduced in 2014, and also including the acquisition of bonds issued by euro area central governments, agencies and European institutions. The new asset purchases will start in March and will amount to a total of € 60 billion per month. They are expected to be continued until September 2016 and in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its objective. This decision is fully in line with the approach that it has taken since September 2014, which involves more direct control over the size and composition of the Eurosystem balance sheet.

The new purchases will be made on the secondary market, against central bank money. The liquidity obtained in this way will be able to be used by credit institutions to acquire other assets and to lend to the real economy. On top of its direct impact on the interest rates on the bonds acquired, by triggering portfolio reallocations, the asset purchase programme should also have some effect on yields of other assets and help support credit conditions in the entire economy. It also amplifies the signal that the Eurosystem intends to keep its key policy rates low for an extended period of time. And last but not least, the impact on inflationary expectations is reinforced by the explicit reference to the aim of bringing inflation back up to around the 2 % mark.

In addition, the Governing Council has announced that the interest rates applicable to the six remaining TLTROs would be brought down to the rate of the Eurosystem's main refinancing operations (MROs) prevailing at the time when each TLTRO is conducted. This decision to eliminate the 10 basis point spread over the main refinancing operation rate should support the effectiveness of these operations by reflecting the reduction in funding costs for banks that has been observed since the TLTROs were first announced on 5 June 2014.

These two decisions aim to bring about a further and considerable easing of monetary and financial conditions in the euro area. By easing financing conditions, the implementation of the new monetary policy instruments should support consumption and investment in the euro area. The decisions also aim to ensure that inflation expectations remain firmly anchored, in both the medium and long term. It is expected they will help to restore the inflation rate to a level close to 2 %. The box below presents some indications of the potential macroeconomic impact of the recent balance sheet measures on the basis of the effects of the measures adopted between 2008 and 2013.

It must be said that, though monetary policy has an important role, it cannot on its own pave the way back to a sustainable growth path in the euro area. In that connection, the Governing Council has constantly reiterated that, together with monetary policy, the other economic policies must also be activated to help restoring inflation to its target level as quickly as possible.

On the demand side, the Governing Council has insisted that fiscal policy must be coordinated with the macroeconomic situation in the euro area, while complying with the Stability and Growth Pact, as this pact is the anchor point for confidence in public finances, vital for the promotion of private consumption and investment. The existing rules are flexible enough to deal with the weakness of the recovery and offer some scope for funding structural reforms. On the supply side, as the Governing Council has often repeated, these reforms are essential to improve the operation of product and labour markets and the business environment. They need to encourage investment and economic activity, thus helping monetary policy to produce the maximum effect.

While the Governing Council has given assurances that it would do everything necessary to restore inflation rapidly to around 2 % and thus fulfill its mandate, it has effectively called on all euro area economic policy-makers to shoulder their responsibilities.

Box 4 – Impact of the balance sheet measures adopted between 2008 and 2013 and the role of banking sector capitalisation

The non-conventional measures adopted by the Governing Council in the year under review and at the beginning of 2015, such as the TLTROs and the asset purchases, will have a considerable influence on the size of the Eurosystem balance sheet. The aims of these measures are clear: to facilitate lending to the non-financial private sector and to contribute to the easing of monetary policy. However, it is not easy to assess their specific impact on the economy of the euro area, especially as the euro area has relatively little experience of this type of policy.

Nevertheless, this situation is not entirely new to the Eurosystem, because since the autumn of 2008 various decisions have been approved leading to changes in the size and composition of its balance sheet. Those measures, which aimed to safeguard financial stability and the effective transmission of monetary policy, took various forms, such as the adoption of a procedure for granting unlimited liquidity at a fixed rate, extension of the range of assets accepted as collateral, extension of the maturity of the refinancing operations, and purchases of securities. Among other things, they led to a substantial expansion of the Eurosystem balance sheet amounting to around € 1 800 billion between the end of 2007 and the June 2012 peak. The potential impact on the real economy of the measures taken in 2014 can therefore be estimated according to the impact of the earlier decisions.

An analysis using a structural vector autoregression (SVAR) [1] makes it possible to quantify the dynamic effects of non-conventional monetary policies separately from the effects of conventional policy measures, namely changes in the key interest rates, and to identify their transmission channels. This model was estimated for the euro area and its various constituent countries for the period from January 2008 to December 2013.

For various reasons, the results based on the earlier policy measures must be interpreted with caution in the context of the recent measures. First, the model studies the impact of a general expansion in the size of the Eurosystem balance sheet, without differentiating between the various possible sources. For example, the impact of balance sheet expansion due to purchases of sovereign securities under the SMP cannot be separated from the impact of expansion on the same scale resulting from an extension of the range of collateral accepted or lengthening of the maturity of the refinancing operations. Next, the previous balance sheet measures aimed mainly to ensure the appropriate transmission of monetary policy decisions, whereas the latest measures are intended primarily to ease the policy stance. In addition, between 2008 and 2014, the change in the size of the Eurosystem balance sheet mainly reflected fluctuations in the banks' demand for liquidity, whereas the growth now envisaged will be due more directly to decisions by the central bank concerning the volume of securities that it will purchase. Finally, the model does not include the adoption of the OMTs in the summer of 2012. Although that measure had no impact on the balance sheet as no securities were purchased, its macroeconomic effects may still have been considerable.

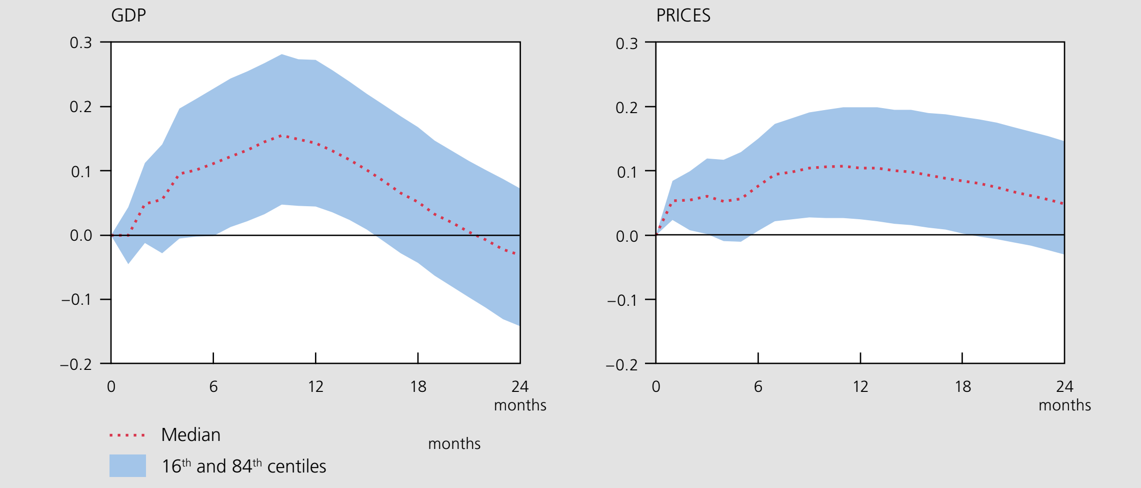
In order to assess the effect on the economy of the expansion of the Eurosystem balance sheet, it is necessary to observe the impulse responses derived from the model. Those responses indicate how the different variables

(1) Boeckx J., M. Dossche and G. Peersman (2014), *Effectiveness and transmission of the ECB's balance sheet policies*, NBB Working Paper 275.

considered change on average over the period in question following an exogenous expansion of the balance sheet due solely to non-conventional policies.

These impulse responses show that non-conventional shocks have a positive effect on economic growth and inflation. More specifically, an unexpected shock of around 2 % of the Eurosystem balance sheet boosts GDP by an estimated 0.15 percentage point and raises prices by up to 0.1 point. It is also evident that this impact is similar in quality to the impact of conventional monetary policies. Finally, the authors show that non-conventional policies seem to act by reducing financial market tension and – via the bank lending channel – by leading to a fall in debit interest rates and growth in the volume of lending.

IMPACT ON GDP AND PRICES OF A POSITIVE SHOCK OF 2 % ON THE EUROSYSTEM BALANCE SHEET
(in %)



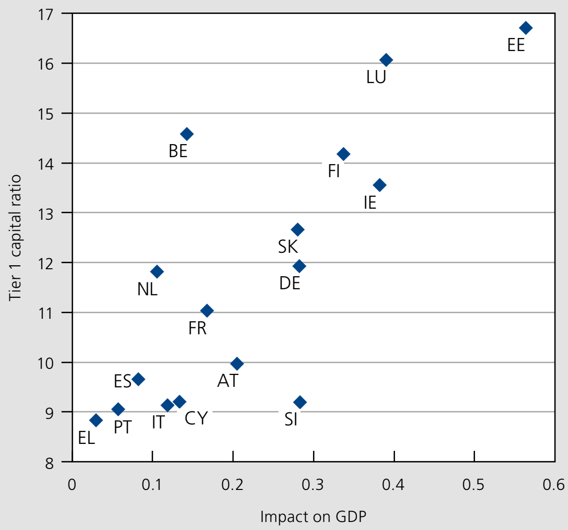
Source : Boeckx J., M. Dossche and G. Peersman (2014).

Although these measures have a clearly positive impact on the GDP of the euro area as a whole, their effect appears to vary from one country to another. In general, the effects of the Eurosystem balance sheet measures are less marked in the countries where, owing to the greater fragility of the banking sector, the transmission of monetary policy via the bank lending channel is less smooth. Less solvent banks appear in fact more risk averse and, when confronted by balance sheet constraints, seem more reluctant to grant loans. There is therefore a strong positive correlation between the maximum impact on a country's GDP of a shock concerning the size of the Eurosystem balance sheet and the average Tier 1 capital ratio of the banking sector in that country.

Since correlation does not necessarily imply causality, these results must be interpreted with caution. However, they are consistent with the movement in bank lending to the non-financial private sector in recent years in the various countries of the euro area. A similar connection is also evident at the level of the debit rates charged by the banks and their capitalisation ratio, which supports the theory that the health of the banking system is crucial to both the volume and the price of lending. The health of the banking system is therefore a vital factor in the transmission of both conventional and non-conventional monetary policy measures, especially as the banking sector plays a major role in the financing of the euro area's economy. The comprehensive assessment of the main banks in the

CORRELATION BETWEEN THE MAXIMUM IMPACT ON GDP OF A EUROSYSTEM BALANCE SHEET SHOCK AND THE TIER 1 CAPITAL RATIO OF THE BANKING SECTOR IN THE EURO AREA COUNTRIES

(in %)



Source: Boeckx J., M. Dossche and G. Peersman (2014).

euro area, conducted jointly by the ECB and the national competent supervisory authorities, thus emerges as a key factor in restoring the efficient transmission of monetary policy, as it identified the institutions with a delicate balance sheet position and encouraged them to reinforce their capital. Against that backdrop, there is reason to hope for a more uniform transmission of the balance sheet measures adopted most recently.

Economic developments in Belgium

2. Economic developments in Belgium

Belgium's gross domestic product (GDP) increased by 1 % in 2014. However, as the year progressed, the recovery that began in 2013 lost pace amidst the weakening economy in the euro area, major geopolitical uncertainties and doubts about the ability of Europe's economies to develop sustainably. Employment showed a tentative recovery, rising by 15 000 units, but the net creation of jobs failed to prevent a renewed increase in the number of job-seekers. Unemployment reached 8.6 % of the labour force as a result. Against the backdrop of weak demand, inflation continued the decline started in 2011. Falling to a year-on-year average of 0.5 %, inflation even reached a low of –0.4 % in December. Whereas the slowing rate of inflation is due to lower energy prices, underlying inflation appeared to be more robust, at 1.5 %. The marked drop in inflation had a significant impact on hourly wage costs, their growth slowing to 0.7 %. According to the Central Economic Council's technical report, the higher cumulative cost of labour in Belgium relative to its three most important neighbouring countries (since 1996) dropped from 4.2 % in 2013 to 2.9 % in 2014. Growth in economic activity in 2014 may be attributed primarily to a pick-up in domestic demand, excluding stock adjustments. Private consumption rose relatively strongly, in tandem with trends in purchasing power. Business investment continued to grow. The current account on the balance of payments increased on the strength of the effect of higher net exports in volume terms.

2.1 Economic situation

Economic activity somewhat slower since the spring

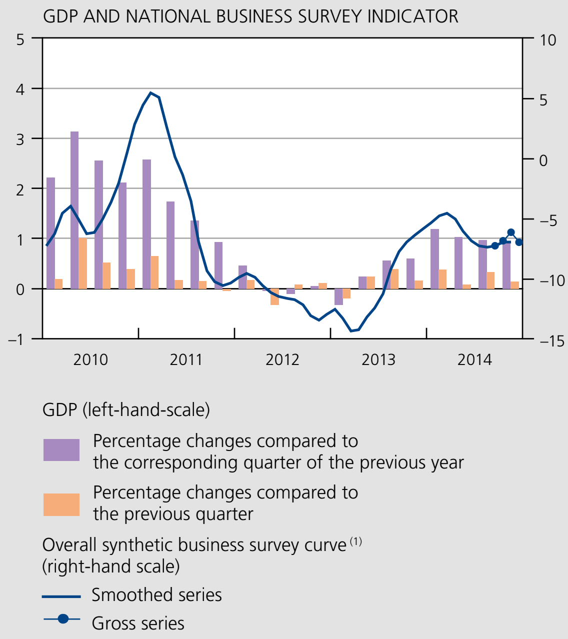
In 2014, economic developments in Belgium were comparable to those in other euro area countries. After two years of virtual stagnation, Belgium's GDP – like that of the euro area – showed clear growth, albeit modest. In volume terms, GDP was up by 1 % on average over the year, compared with very slight increases of 0.1 % and 0.3 % respectively in the previous two years. Growth for the year as a whole may be attributed mainly to increased economic activity at the start of the year, as was the case elsewhere in the euro area. Contrary to expectations, the economic recovery that got underway in the spring of 2013 actually lost pace in the year under review. Quarter-on-quarter growth remained positive, but the rate of growth dropped by almost half, to 0.2 % on average, compared with the first quarter of 2014.

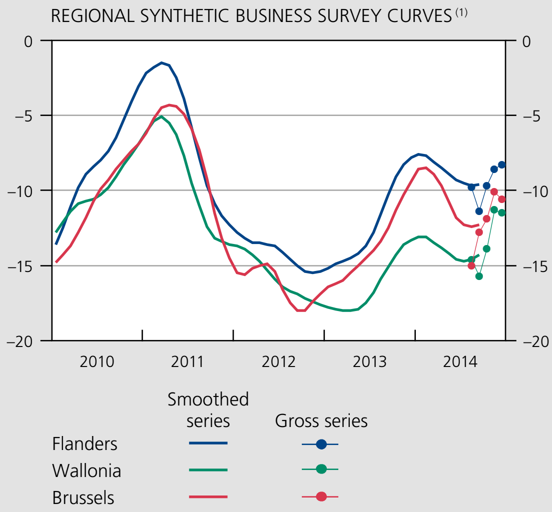
Slackening economic activity during the course of the year gave rise to uncertainty. Business confidence clearly deteriorated in the spring and stabilised at a relatively low level in the summer. Recent months have seen a slight renewed recovery. It is worth noting that the weakening confidence was visible in all three of the country's Regions. The fact that business confidence is lower in Wallonia than in the two other Regions is due mainly to the fact that its economy did not improve as strongly during the short-lived economic upswing of 2013.

The flare-up in uncertainty was a phenomenon shared by Belgium's European partners. It was fuelled by perceptions of increased geopolitical risks, especially in the wake of the heightened conflict in Ukraine in the first half of the year, the subsequent deterioration of relations with Russia and the ever-intensifying clashes in the Middle East. Both in Belgium and in the euro area as a whole, the negative impact on the economy of battered confidence seems to have been stronger than actual trade flows would suggest. These risks may well have stirred up latent doubts about the ability of Europe's economies to show sustainable growth and about the robustness of the global economy against the backdrop of lacklustre international trade.

In Belgium, economic uncertainty does not seem to have had too great an impact on domestic demand, which

CHART 24 GDP IN BELGIUM AND CONFIDENCE INDICATORS





Sources: NAI, NBB.
(1) Balance of replies to the monthly surveys, non calendar adjusted data.

declined markedly less than production. The downturn in production is attributable mainly to the relatively modest growth in exports, which were hard hit by low economic growth, in particular among Belgium's major trading partners. Another factor at play here was the renewed negative effect of stock adjustments. Despite the significant statistical uncertainty of this variable, it seems that in light of the uncertain economic environment, companies did not boost their production volumes as strongly as would otherwise have been possible, considering that domestic demand was still relatively robust.

Decline in market services and industrial sectors

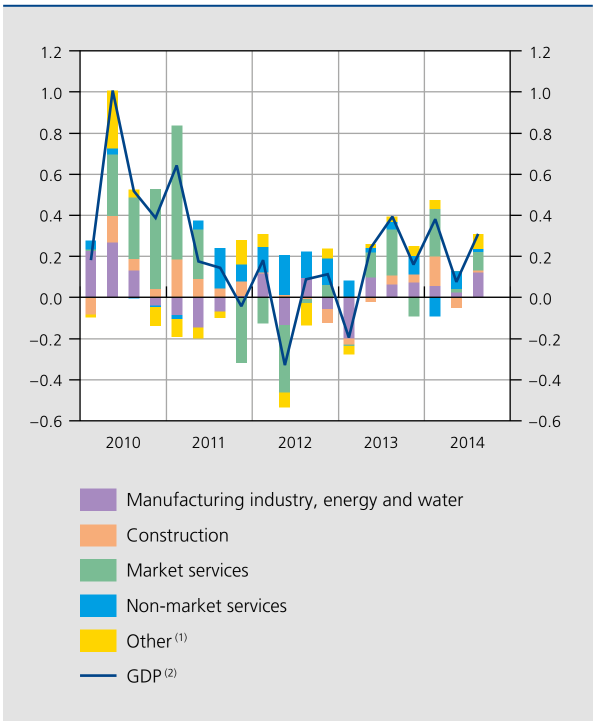
Industry typically responds strongly to changes in actual demand or fluctuations in demand expectations. This sector, which accounts for around 17 % of the Belgian economy's value added, often operates in highly integrated international production chains, making its foreign markets absolutely vital. The manufacturing industry's synthetic business survey indicator may have edged down only slightly and even showed signs of revival by the end of the year, but key sub-indicators, which are more closely correlated with the value added generated by companies in the sector, recorded steeper falls. Demand forecasts, and the assessment of total order books especially, have dipped well below the synthetic indicator, for instance, and industry's value added suffered a temporary dip in growth relative to the increase recorded in the spring of 2013. In the first half of 2014, value added growth in the industry edged down temporarily compared to the increase notched up in the spring of 2013.

The market services sector, which comprises trade, accommodation and food service activities, transport and communication, and financial, real estate and business services, and which accounts for a much bigger proportion of Belgium's total value added – around 52 % – likewise reported a significant economic slowdown from the spring, following a strong first quarter. Trade was hit hardest, but business services also experienced a steep decline in confidence and in demand forecasts.

Economic activity in the construction industry – which has seen its share of total value added gradually edge up in the past few years to reach nearly 6 % in 2014 – was boosted in the first quarter by an exceptionally mild winter. Partly because of this unusually robust first-quarter showing, it subsequently fell, while quarterly value added growth remained weak or negative, as had been the case in the two previous years. Developments in construction are typically

CHART 25 VALUE ADDED OF THE MAIN BRANCHES OF ACTIVITY

(contributions to the change in GDP compared to the previous quarter, unless otherwise stated; volume data adjusted for seasonal and calendar effects)



Source: NAI.
(1) Namely the "Agriculture, forestry and fishing" branch and product-related taxes net of subsidies.
(2) Percentage changes compared to the previous quarter.

dominated by factors specific to the Belgian economy, which nevertheless tend to differ for residential and commercial property and for infrastructure. In that respect, confidence in structural building took a singularly different path from that in civil engineering and road works in 2014. Confidence in the latter sub-sector again deteriorated sharply and continued the trend seen since 2011, in the wake of sharply contracted government investment as part of fiscal consolidation – a factor exacerbated in 2013 and 2014 by the traditional downtrend following local elections. By contrast, confidence in structural building would seem to have stabilised in 2014, in parallel with the tentative recovery in residential housing investment, after a lengthy downward movement (albeit less marked).

Fiscal consolidation at federal and regional levels also restrained value added creation in non-market services in 2014. This sector, which includes education, public administration, health care and social work, typically records strong increases irrespective of economic conditions. This time, however, its growth was weaker than in previous years.

2.2 Labour market

Tentative recovery in employment in 2014

Even though it was fragile, the recovery that started in 2013 had a favourable effect on the labour market. Heightened economic activity first led to improved productivity, as is often the case. Productivity per hour worked increased from the start of the upswing and this improvement was sustained throughout 2014. That said, it was a modest increase given that the level of productivity at the end of 2014 remained below that observed before the crisis, in early 2008. Labour volumes quickly followed suit, rising by 0.4 % on average for the economy as a whole during 2014. This was due mainly to an increase in working hours per person. After this initial increase, however, average working hours edged down. Labour volume growth was therefore reflected in a rise in job numbers of 0.3 %.

The drop in average working hours, particularly pronounced in the second quarter, may be attributed primarily to the construction and manufacturing industries. Additionally, the higher numbers of temp agency workers, who these days are contracted for ever shorter periods, is also resulting in reduced average working hours. To an extent, the fact that employers have increasingly been using temp agency workers since the end of 2013 reflects their reluctance to take on permanent employees in times of economic uncertainty, as well as a need for labour market flexibility.

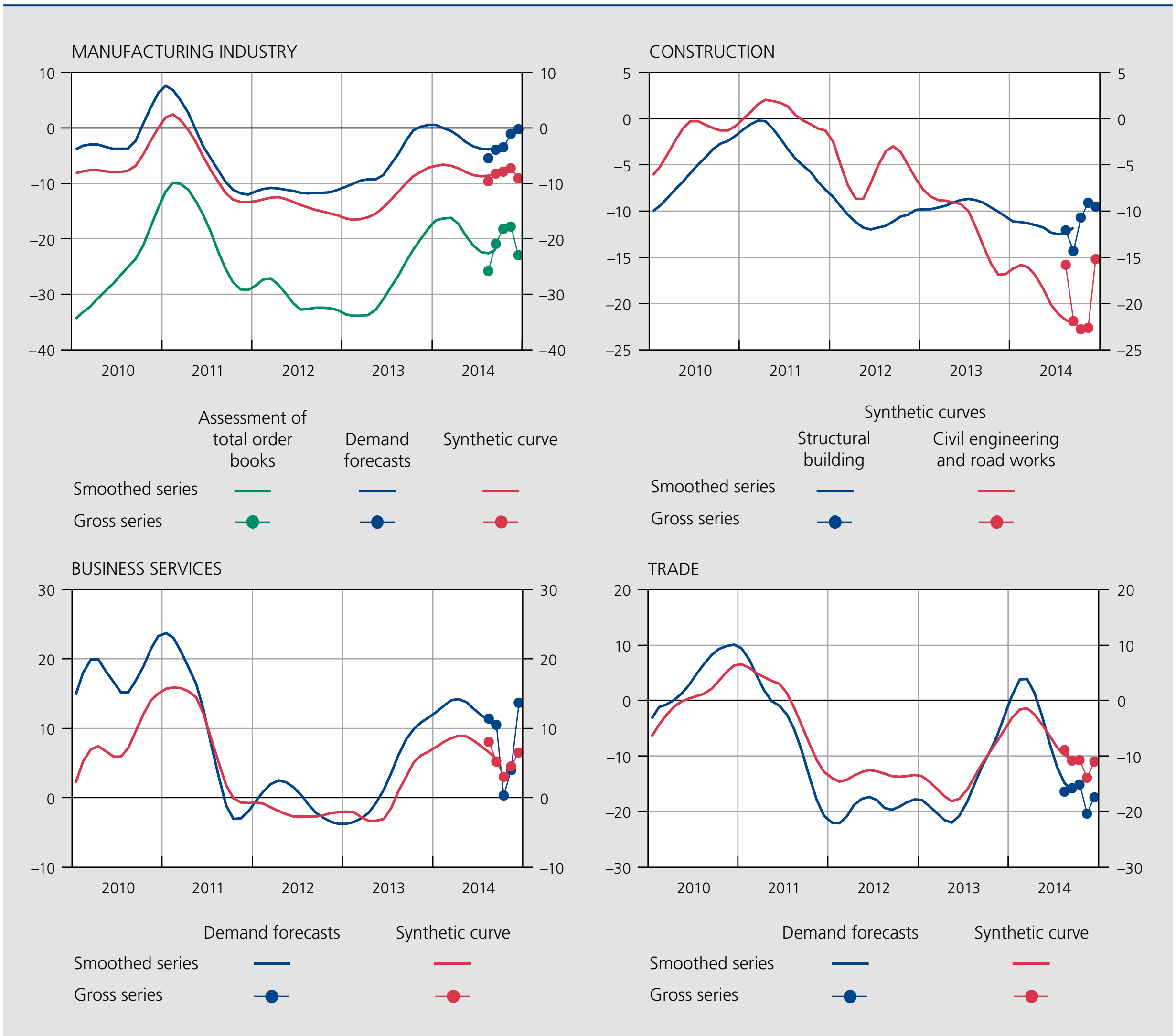
Meanwhile, the number of days of temporary lay-offs came down in 2014 – markedly so at the beginning of the year, continuing a trend that had started to emerge as early as the second half of 2013. Companies had been trimming their workforces in that year in the wake of stagnating economic activity in 2011 and 2012, reducing the number of days of temporary lay-offs. In 2014, employers in branches hit by the embargo on fruit and vegetables exports to Russia compensated for the steep fall in their business by using temporary lay-offs. Companies in the construction sector widely used the same option in the third quarter, citing unfavourable weather conditions in the summer months.

Against this backdrop, domestic employment increased by an average 15 000 people in the year under review, after having recorded a fall of 12 000 people in 2013, that is to say an even stronger decline than during the great recession.

Providing jobs for the majority of all workers, employers in branches of activity sensitive to the business

CHART 26 BUSINESS SURVEY INDICATORS FOR THE MAIN BRANCHES OF ACTIVITY

(balance of replies, seasonally adjusted data)



Source : NBB.

cycle – primarily industry, construction and the market services sector – did not contribute to these higher numbers, cutting 1 800 jobs. In 2013, these industries saw over 23 000 jobs lost. Trends nevertheless diverge within this group. So, companies in industry, construction and financial services reduced their workforces by 12 900, 6 400 and 1 200 in the first three quarters of 2014, with industry thus confirming a strong downward trend and financial services continuing the decline that had started in 2002. Conversely, workforce numbers in market-services companies, comprising temporary work and a significant proportion of service voucher jobs, were up by 17 100. Of these new jobs, nearly 4 000 are estimated to come under the service voucher scheme. However, the scheme's growth looks to be decelerating due to a gradual saturation of demand and the higher hourly cost to its users, as well as the recruitment problems facing providers of these services (see Box 5).

In 2014, the highly subsidised activities that make up "other services" (primarily health care and social services) further contributed to rising employment by adding 9 600 jobs.

By contrast, in the "public administration and education" branch, job numbers stagnated, as budgetary measures resulted in a proportion of employees not being replaced upon retirement.

CHART 27 EMPLOYMENT, WORKING TIME AND PRODUCTIVITY

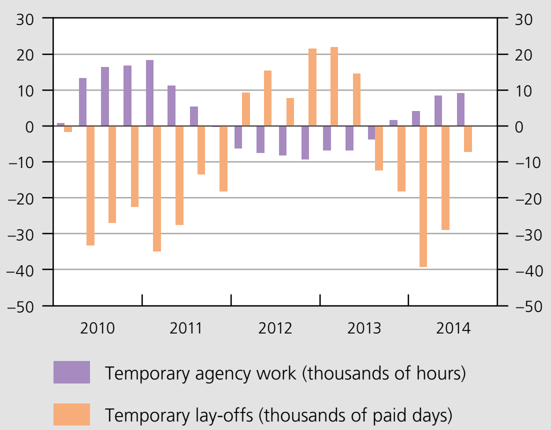
(contribution to annual growth of GDP, percentage points, data adjusted for calendar effects)

Sources: NAI, NBB.

Lastly, self-employment grew faster than average at around 1 %, corresponding to 7 300 extra people. This is in keeping with the consistent increase in self-employment as a share of employment since 2008.

CHART 28 TEMPORARY AGENCY WORK AND TEMPORARY LAY-OFFS

(changes compared to the corresponding quarter of the previous year)



Sources: Federgon, NEO.

Job creation failed to prevent unemployment from inching up

2014 witnessed a continuation of the gradual slowdown in growth of the working age population seen since 2007, with an increase of 10 500 people as compared with record growth of 70 200 in 2007. The labour force grew by 28 900 people in the year under review, at a faster pace than in the two previous years. But the modest upturn in employment was not enough to absorb the growth of the labour force, and joblessness rose further. A total of 14 000 extra job-seekers were recorded, an increase that was well below the 2013 surge. On annual average, though, the 600 000 jobless mark was nearly breached in 2014.

This upsurge was visible in the harmonised unemployment rate, which, at 8.6 %, has reached its highest level since 1999. Based on the labour force survey and the definitions of the International Labour Office, this indicator expresses the relationship between the number of job-seekers – i.e. unemployed people available for work and actively looking for jobs, regardless of whether they are registered as benefit claimants with the National Employment Office (NEO) – and the labour force. In November 2014, the Belgian unemployment rate was 3 percentage points below the figure for the euro area. However, the euro area rate – though diverging strongly between countries – has been on a downward trajectory since the start of 2013, whereas Belgium's unemployment levels have remained virtually static.

The rise in administrative unemployment varies across the country's three Regions. If year-on-year changes are taken into account – in order to iron out seasonal effects –, the number of job-seekers grew strongest in Flanders in 2014, in both absolute and relative terms. Wallonia, by contrast, has been seeing a gradual reduction in the number of unemployed job-seekers since the middle of 2014. In December 2014, Flanders recorded nearly 252 000 job-seekers, Wallonia 230 000 and Brussels 108 000.

Youth unemployment declined in the year, after shooting up in 2012 and 2013. As in the past, the young were quicker to benefit from recovering growth, while they had been hit first by the crisis because of their lack of experience. That said, there were still 111 000 unemployed job-seekers under the age of 25 by December 2014, accounting for nearly one-fifth of the total.

In contrast, the over-50s age group among unemployed job-seekers continued to swell, if slightly more moderately than before, continuing the trend started in the early 2000s. To a degree, the rise reflects successive

TABLE 4 LABOUR SUPPLY AND DEMAND

(calendar adjusted data; annual averages, unless otherwise stated)

	2010	2011	2012	2013	2014 e
			(percentage change)		
Labour volume in hours	1.0	2.2	0.4	–0.1	0.4
Domestic employment in number of people	0.7	1.4	0.3	–0.3	0.3
			(change in thousands of persons)		
Population of working age	55.3	45.3	21.9	12.0	10.5
Labour force	44.7	42.9	27.9	11.5	28.9
National employment	31.0	62.8	13.5	–13.0	14.9
Frontier workers	0.8	–0.3	0.3	–0.7	–0.1
Domestic employment	30.2	63.0	13.2	–12.4	15.0
Employees	23.9	53.3	4.3	–19.1	7.8
Cyclical sectors	2.5	31.8	–7.5	–23.4	–1.8
Agriculture	0.2	0.6	0.1	1.4	0.3 (2)
Manufacturing	–18.9	–1.3	–6.3	–12.4	–12.9 (2)
Construction	1.0	4.0	–0.5	–5.5	–6.4 (2)
Market services	20.3	28.5	–0.9	–6.9	15.9 (2)
Public administration and education	7.5	3.8	–1.6	2.2	0.0
Other services	13.9	17.8	13.4	2.1	9.6
p.m. Service vouchers	*15.2*	*11.5*	*8.1*	*8.5*	*5.2*
Self-employed	6.3	9.7	8.8	6.7	7.3
Unemployed job-seekers	13.7	–19.8	14.5	24.6	14.0
p.m. Harmonised unemployment rate (1)	*8.4*	*7.2*	*7.6*	*8.5*	*8.6*

Sources: DGS, NAI, NEO, NBB.
(1) In % of the labour force between 15 and 64 years.
(2) Average of the first three quarters, according to the NAI.

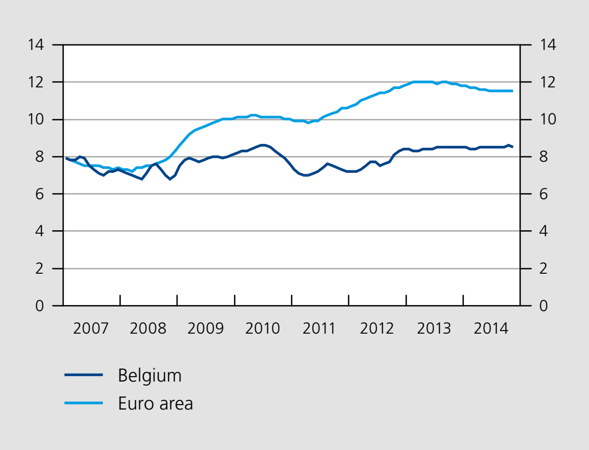
tightening of the criteria granting older unemployed people exemptions from looking for work. The minimum exemption age has gone up from 50 in 2002 to 60 in 2013. From 1 January 2015, all unemployed people, irrespective of age, will be subject to the same rules governing availability and active job-searching. Exemptions will continue to apply to people who were registered as unemployed and had turned 60 before the end of 2014. In December 2014, Belgium recorded 145 000 unemployed job-seekers aged 50 and over, 60 000 of them in Flanders, 62 000 in Wallonia and 23 000 in Brussels.

The number of unemployed workers receiving an employer top-up has edged down slightly since 2010. This trend continued into 2014, with the overall number standing at 100 000 in November, compared with 118 000 in early 2010. Under the October 2014 coalition agreement, the eligible age for the scheme will go up to 62 from 60 with effect from 1 January 2015, and for restructuring companies from 55 to 60 years of age from 2017. The social partners have agreed a government-approved option to deviate from these new rules until the end of 2017, provided they do so in a collective labour agreement (CLA) before 30 June 2015. By the same token, companies can also agree to postpone the increase from 55 to 60 of the eligible age for taking end-of-career time credit.

In keeping with the steady increase in the share of older unemployed workers, there has been an uninterrupted rise in long-term unemployment since mid-2013, as measured by the number of unemployed job-seekers looking for work for two years or longer. Unlike other categories of unemployed people, this group did not see the upward trend decelerate but rather pick up in the year under review. By December 2014, the long-term unemployed accounted for over one in three job-seekers

CHART 29 HARMONISED UNEMPLOYMENT RATE IN BELGIUM AND THE EURO AREA

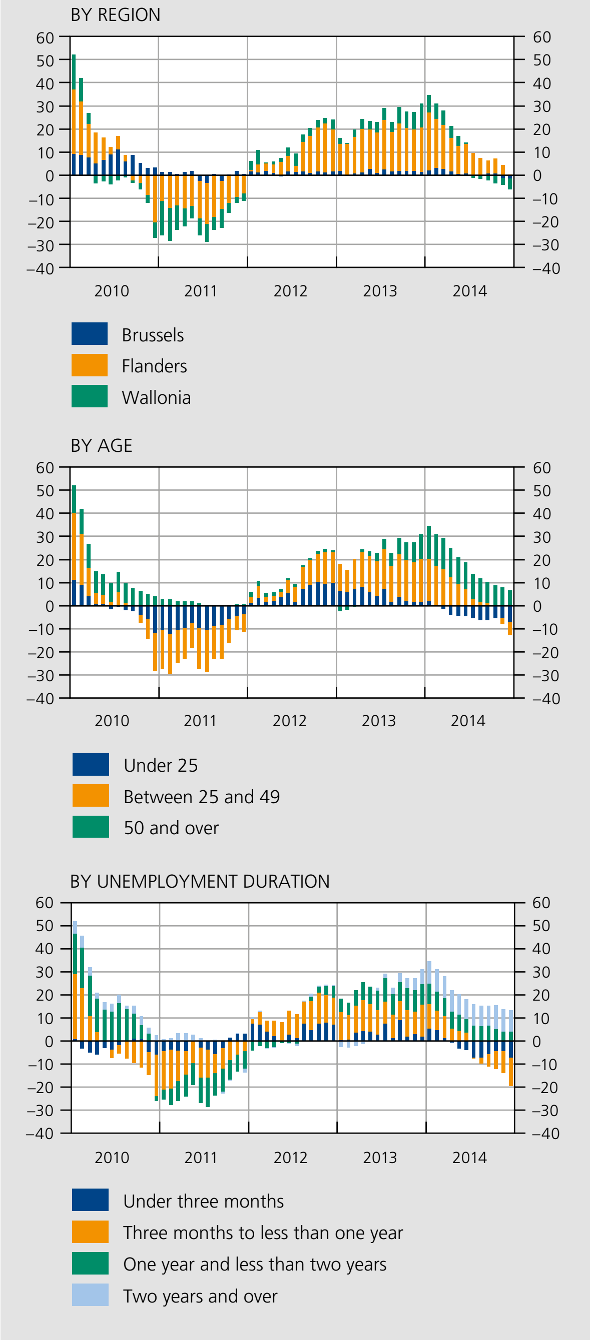
(seasonally adjusted monthly data, in % of the labour force, aged 15 and over)



Source : EC.

CHART 30 UNEMPLOYED JOB-SEEKERS IN BELGIUM

(changes in thousands of people compared to the corresponding month of the previous year)



Source : NEO.

and totalled 211 000. In terms of knowledge, skills and attitudes, these people are the furthest removed from the labour market and the hardest to re-employ, even when economic activity revives. Slower unemployment growth in the year under review is primarily attributable to a fall in very short-term unemployment (under three months) and short-term unemployment (between three months and less than a year). If these trends continue, structural unemployment might rise and depress the economy's growth and employment potential.

Box 5 – The development of the service voucher scheme

The service voucher scheme, which was introduced by the Law of 20 July 2001 and came into effect on 1 January 2004, aims to promote neighbourhood services and jobs, these being primarily held by low-skilled workers, and to regularise some of the work done in the shadow economy. Under the scheme, private individuals buy home help services from authorised companies and pay with special vouchers that they buy from the voucher issuer. Authorised companies return to the issuer all vouchers paid to these employees for the hours worked, for which they are reimbursed. The amount reimbursed equals the nominal value of the service vouchers, plus an addition from the government to defray the cost to the employer of one hour of work as well as structural costs, such as administrative expenses and supervision of the employees.

Service vouchers were initially priced at € 6.20, an amount that has been incrementally raised since 2004 to reach € 9 in 2014 for the first 400 vouchers purchased and € 10 for any subsequent purchases. Voucher users enjoy tax breaks, calculated at a tax rate of 30 % (so they end up paying only € 6.30 for a € 9 service voucher). Since 1 January 2014, the tax deduction on service vouchers has been capped at € 1 400 per person a year. Authorised companies receive a total of € 22.04 per voucher, implying that the government pays € 13.04 (or € 12.04 as the case may be) towards every voucher used. In its 2013 annual review, Idea Consult put the total gross costs of the scheme in 2012 at € 1.8 billion (0.5 % of GDP). Factoring in the direct payback effects – the unemployment benefits that do not need to be paid, social security contributions and income taxes levied on employee wages – in addition to the indirect first-order effects such as tax receipts from supervisory staff, takes around 45 % off the cost.

NUMBER OF EMPLOYEES IN THE SCHEME AND SERVICE VOUCHER PRICES

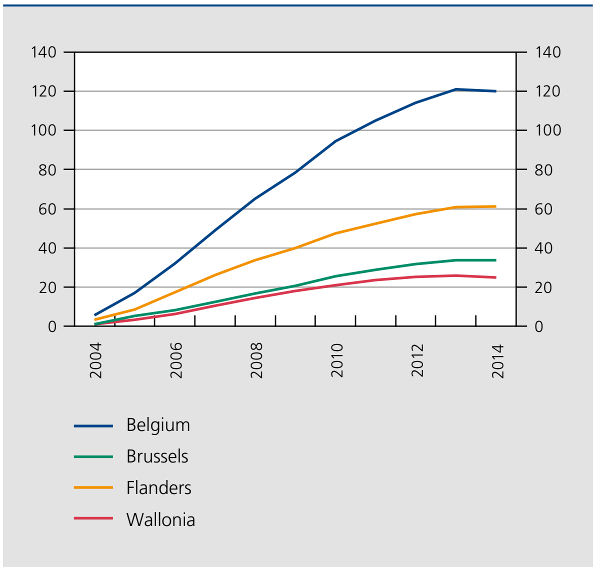
	Number of employees (annual averages, in thousands)	Price of a service voucher (on 1 January, unless otherwise stated, in €)
2004	3	6.2 – 6.7 (1)
2005	12	6.7
2006	24	6.7
2007	37	6.7
2008	56	6.7 – 7.0 (2)
2009	74	7.5
2010	90	7.5
2011	101	7.5
2012	109	7.5
2013	118	8.5
2014 e	123	9.0

Sources: NSSO, NEO, NBB.
(1) Raised in November 2004.
(2) Raised in May 2008.

The number of workers paid under the scheme has steadily risen from an average of 3 000 in 2004 to 118 000 in 2013 according to the latest data provided by the National Social Security Office (NSSO) and to 123 000 in 2014 under the NBB's forecasts, continuing the slowdown in jobs growth that started in 2010. In the early days, a large proportion of jobs thus created replaced work in the informal economy or were a conversion of services previously provided by local employment agencies, and the net effect on employment was less than it is today. Idea Consult reports that a majority of these workers are women (97 %), one-fifth are under 30 years of age and another one-fifth 50 or over. The workforce breaks down into 56 % low-skilled – a primary school certificate or lower secondary school at most – and 40 % medium-skilled. Lastly, nearly three in four workers are Belgian nationals, with 20 % nationals of another EU27 country and 8 % from outside the EU27.

The total volume of hours worked under the scheme, as measured by the number of reimbursed vouchers according to NEO statistics, has exploded since its implementation, from 6 to 121 million for Belgium as a whole in 2013, with Flanders accounting for the bulk (61 million hours). However, the rise in the volume of work has been slowing down for years, because of gradual demand saturation and the increase in the price users pay per hour. In 2014, for the first time, the number of reimbursed service vouchers even declined slightly.

NUMBER OF REIMBURSED SERVICE VOUCHERS
(in millions of units)



Source : NEO.

Following the sixth State reform, the Regions were put in charge of the service voucher scheme. They have the power to authorise the service voucher companies located in their territories, decide what activities they will allow under the scheme and set the price of the service vouchers, including the tax deduction percentage. To ensure continuity of the scheme, the NEO will run it until the Regions are operationally able to take over.

2.3 Inflation and labour costs

Consumer price trends

Inflation even slower in 2014…

During the year under review, inflation measured by the year-on-year change in the harmonised index of consumer prices (HICP) declined for the third year running, averaging 0.5 % in 2014, compared with 1.2 % in 2013 and even dipping to –0.4 % in December. Having begun in the closing months of 2011 and due mainly to the fall in energy prices, the downward trend was accelerated by moderating food prices. Underlying inflation, by contrast, went up a little on the back of higher services prices.

The fall in total inflation in Belgium is largely in line with European trends, and in the past two years it has closely mirrored those in the euro area or the average of the three main neighbouring countries, which serves as a benchmark for calculating the wage norm. However, this comparable overall figure is the result of a much sharper fall in consumer energy prices in Belgium, whereas the modest 0.1 percentage point increase in underlying inflation contrasts with an equally large fall on average in the three neighbouring countries.

…despite persistent underlying inflation trends…

While underlying inflation, as measured by the HICP excluding food and energy, has steadily moved down in the three main neighbouring countries since the last quarter of 2013, Belgium saw it accelerate in the first six months of 2014, in line with a trend that had started in the third quarter of the previous year. Underlying inflation did come down in the second half of the year, but remained quite a bit higher than the average for the neighbouring countries. Taken over the full year, these percentages worked out at 1.5 % in Belgium, compared with 1 % in the neighbouring countries. In 2013, they stood at 1.4 % and 1.1 % respectively.

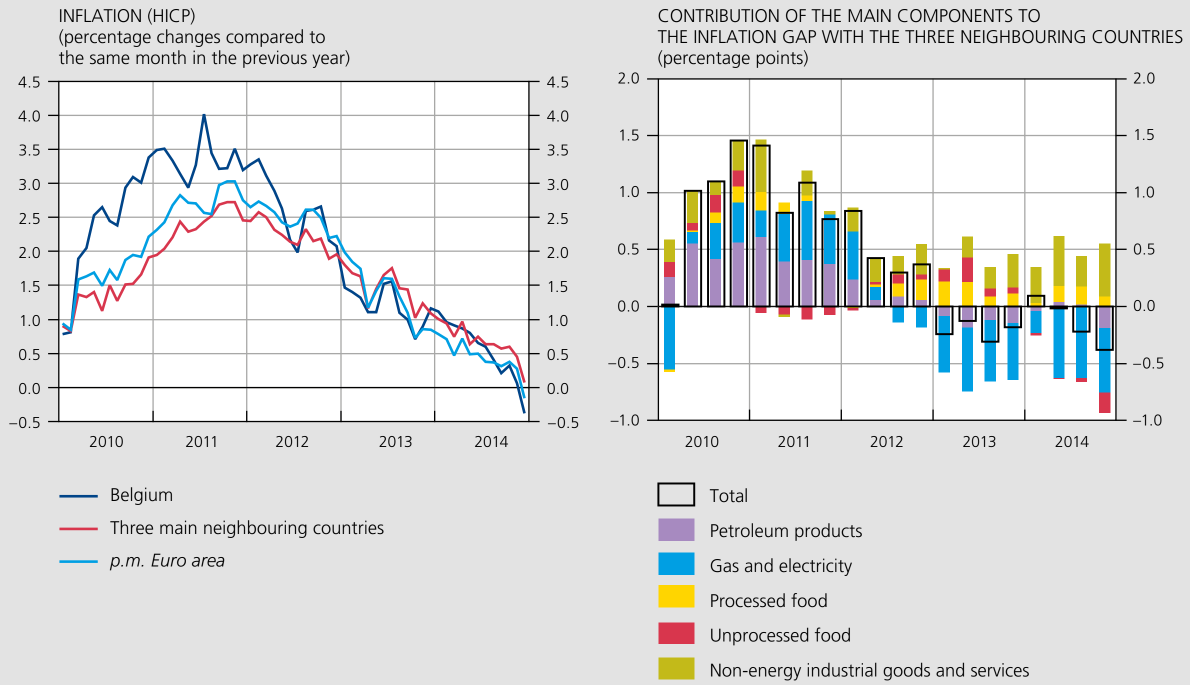
The (albeit very slight) revival of the underlying inflationary tendency in Belgium reflected rising services prices, which added 2.3 % in 2014, compared with 1.9 % in 2013. Non-energy industrial goods, by contrast, saw underlying inflation edge down to 0.5 % from 0.8 %.

TABLE 5 **HARMONISED INDEX OF CONSUMER PRICES AND LABOUR COSTS**
(percentage changes compared to the previous year)

	2010	2011	2012	2013	2014	*p.m. Three main neighbouring countries* (1) *2014*
HICP	2.3	3.4	2.6	1.2	0.5	*0.7*
Energy	10.0	17.0	6.0	–4.6	–6.0	*–1.6*
Unprocessed food (2)	3.5	0.2	3.4	4.4	–1.3	*–0.9*
Processed food	1.0	3.1	3.1	3.2	2.2	*1.6*
Underlying inflation (3)	1.1	1.5	1.9	1.4	1.5	*1.0*
Non-energy industrial goods	0.8	1.0	0.9	0.8	0.5	*0.1*
Services	1.4	1.9	2.5	1.9	2.3	*1.6*
p.m. Health index (4)	*1.7*	*3.1*	*2.7*	*1.2*	*0.4*	–
p.m. National index	*2.2*	*3.5*	*2.8*	*1.1*	*0.3*	–
Labour costs in the private sector						
Per unit of output	–0.6	2.5	4.0	2.2	0.0 e	*1.4* (5)
Per hour worked	0.8	2.3	3.2	2.4	0.7 e	*1.9* (6)

Sources: EC, OECD, CEC, DGS, NAI, NBB.
(1) As in the other tables and charts in this section: HICP, weighted average based on private consumption; labour costs, weighted average based on GDP.
(2) Fruit, vegetables, meat and fish.
(3) Measured by the HICP, excluding food and energy.
(4) National consumer price index excluding products deemed harmful to health, i.e. tobacco, alcoholic beverages, petrol and diesel.
(5) Average of the first three quarters; business sector (NACE sectors B to N); source: EC.
(6) Annualised CEC estimate.

CHART 31 INFLATION IN BELGIUM AND IN THE THREE MAIN NEIGHBOURING COUNTRIES



Sources: EC, NBB.

This latter downward movement mirrors the prevailing gloomy economic climate in Belgium and Europe, as industrial goods prices are more sensitive to international trends than services prices. These prices are a slightly watered-down reflection of lower import prices – regardless of whether imports are used immediately or serve as input for goods intended for consumption – and unit labour costs.

Slowing unit labour costs benefit service providers even more than manufacturers of goods. However, whether any cost gains are passed on to consumer prices depends on companies' approach to margins. Wage moderation can help rebuild margins, particularly if these have recently narrowed, as had been the case between 2011 and 2013. With non-energy industrial goods subject to more international competition, opportunities for bolstering margins are fewer than for services. It would seem that the latter sector is the main contributor to the rigidity of the underlying trend, coupled with wage cost trends that are more pronounced than in the three main neighbouring countries.

Services whose prices have contributed to higher underlying inflation include volatile categories such as tourist trips and hotels and restaurants, with the latter accounting for a larger weighting in Belgium's HICP than the average for neighbouring countries. In 2014, numerous councils also raised the rates of some price-regulated services, such as waste collection and waste water treatment. Meanwhile, the HICP category related to residential maintenance reflected the increased prices for service vouchers from January 2014. And then there are a lot of services whose prices are routinely linked to the general consumer price index, the health index or other benchmarks, and which reduces the transmission of price dynamics onto underlying inflation.

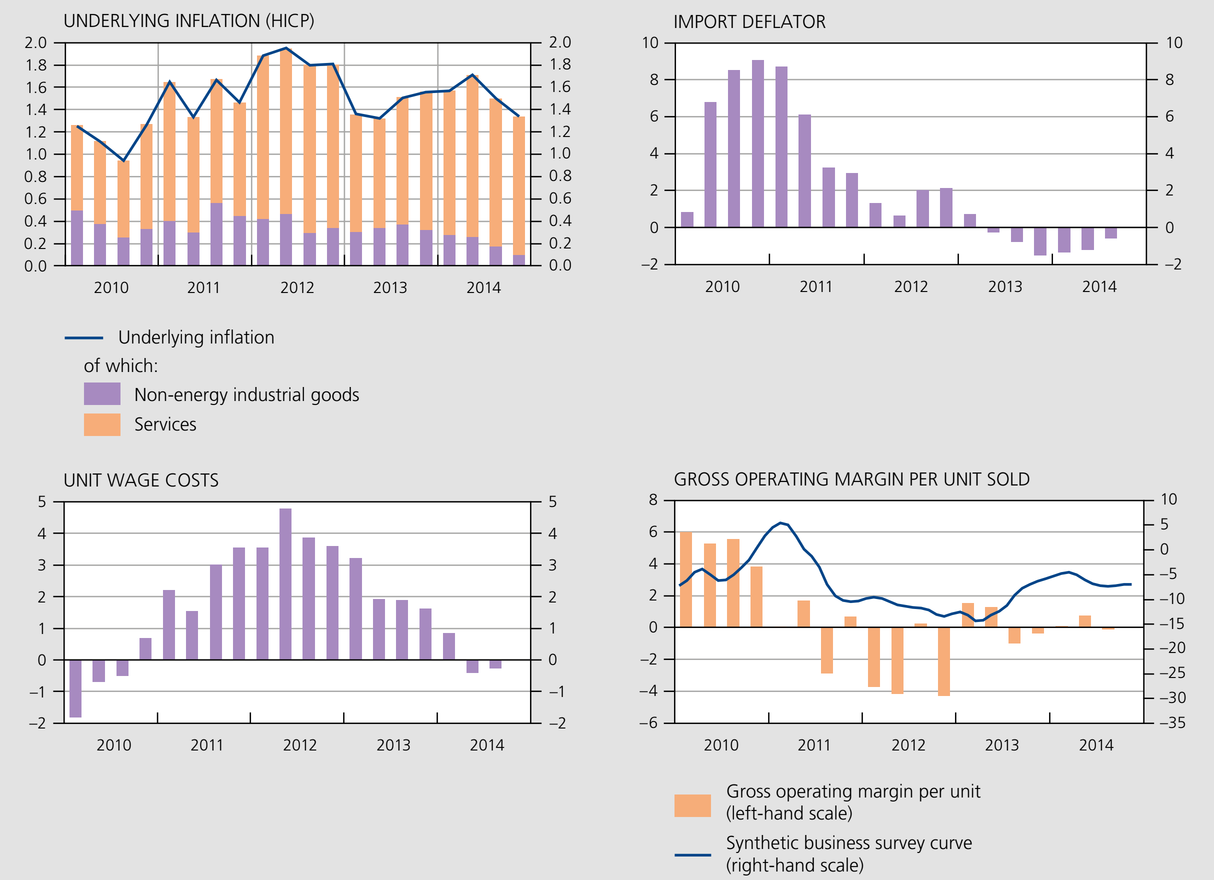
Lastly, underlying inflation was also influenced by a number of methodological changes, particularly relating to the registration of rent payments. These adjustments aim to provide a better view of implicit price increases when new leases are signed, in addition to rent being linked to the health index as is the case with existing contracts.

… related to food prices

Unprocessed food claims but a modest weighting in the HICP basket, and yet the 0.7 percentage point drop

CHART 32 UNDERLYING INFLATION AND COSTS

(percentage changes compared to the previous year)



Sources: EC, NBB.

in inflation in 2014 is mostly down to this category. Prices here fell by 1.3 % on average, compared with a hefty 4.4 % increase in 2013. Two factors came into play: supply conditions were not as dreadful in 2014 as they had been in 2013, as fruit and vegetable harvests benefited from favourable weather conditions. Secondly, a proportion of food exports intended for Russia ended up on the Belgian market because of the Russian embargo on food imports, pushing down prices.

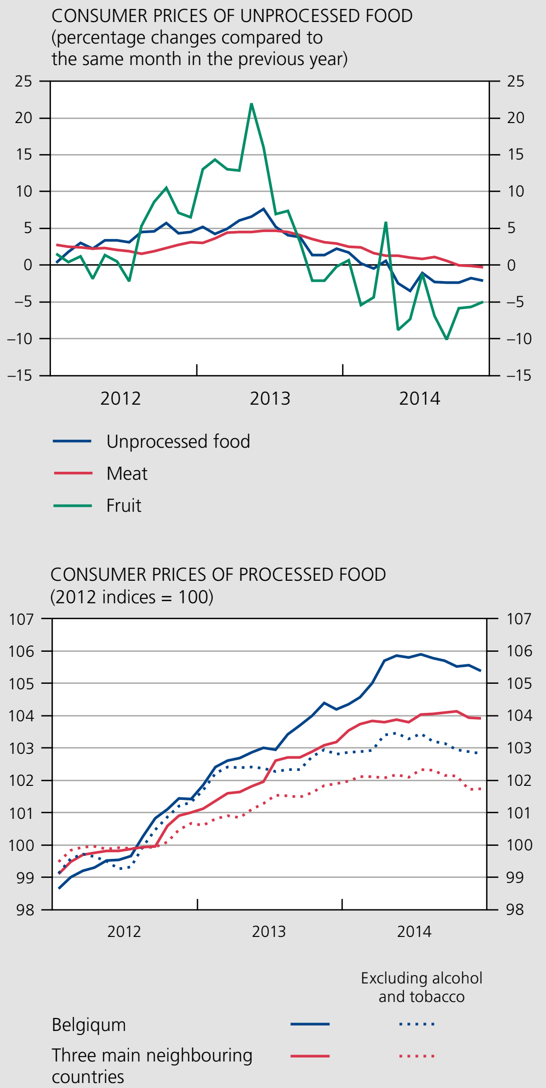
Price rises for processed food also slowed in 2014, to 2.2 % from an average 3.2 % in 2013 or, excluding alcohol and tobacco, whose prices are heavily influenced by changes in excise duty, from 2.4 % to 0.7 %. However, the pricing of processed food in Belgium continues to be asymmetrical. After the renewed upswing in international food commodity prices in 2012, Belgium had recorded steeper food price increases than neighbouring countries, adversely affecting the inflation gap in 2013. Yet the reverse did not happen when food commodity prices started to come down in the course of 2013. Ignoring alcohol and tobacco, this led to an unfavourable effect of 1.1 percentage points in 2013, while the same gap worked out at barely 0.1 percentage points in Belgium’s favour in 2014, despite lower commodity prices and the impact of base effects.

Energy prices still on a downward path…

Energy retail prices slid by a further 6 % in 2014, following a significant 4.6 % fall in 2013. In Belgium, this downward trend had been fuelled both by price swings in oil-derived products – as also seen in the neighbouring countries – and a reduction in retail prices for gas and electricity, which was more specific to Belgium.

In 2014, prices per barrel of Brent continued their downward trajectory for the second year running, falling by an

CHART 33 CONSUMER PRICES OF FOOD



Source : EC.

average 9 % (annualised) in the wake of lower US dollar prices. On average, the euro exchange rate against the dollar stayed close to its 2013 level. Prices for oil-derived energy products such as heating oil and motor fuels declined by 7.1 % and 3.7 % respectively. Consumer prices for all these products displayed similar trends in the main neighbouring countries.

However, other retail energy resources contributed greatly to narrowing the inflation gap with neighbouring countries. Retail gas prices reflected the sharp falls in market prices for gas, which since 2013 have served as the benchmark for the quarterly index-linking of variable-price contracts offered by gas suppliers. As a result, gas prices have fallen by an average 5.6 % per year, compared with barely 0.4 % in the three neighbouring countries. In its December 2013 Pact for Competitiveness and Employment, the government had moved to cut the VAT rate on household electricity to 6 % from 21 %, effective from April 2014. This measure, whose direct impact on electricity prices works out at – 12.4 %, has vastly accelerated the rate reductions linked to lower prices on the international electricity markets. Retail electricity prices nosedived by an average 9.6 % in 2014, but would have gone down by a mere 1.5 % had the old VAT rate stayed in place. In the neighbouring countries, electricity prices have gone up by 2.9 % on average – admittedly less than in 2013. Rate rises in Germany were primarily to blame, as a higher tax was levied to finance subsidies for energy generation from renewable sources.

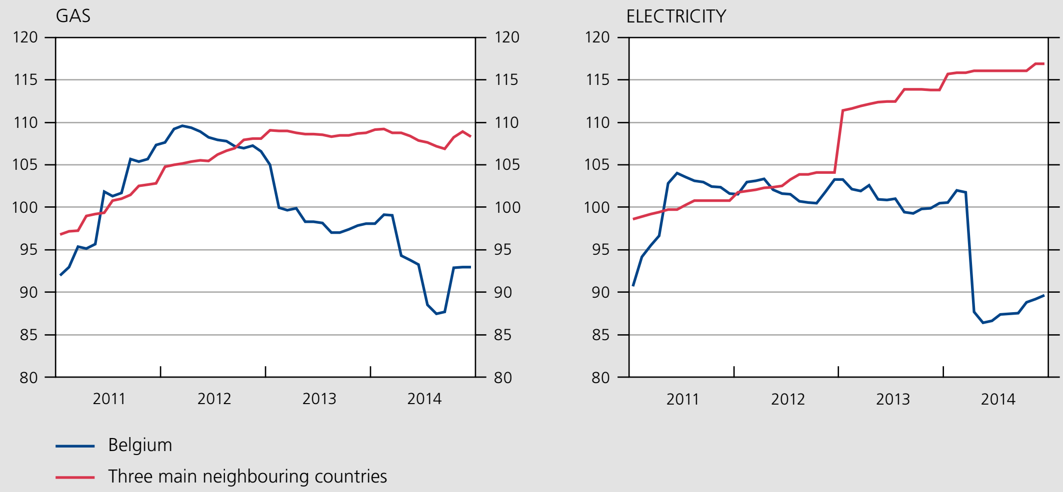
… and having a moderating effect on the health index

Although the health index basket excludes motor fuels – as it does alcohol and tobacco – in order to limit the effects of excise duties and, above all, oil shocks, it does include other energy products. As a result, the index, which is used for the automatic indexation of not just wages and social benefits and contributions but also of the prices of a number of services, remains highly sensitive to fluctuations in energy prices – all the more visible in the year under review, when gas, electricity and heating oil recorded massive price falls. On average, then, the health index barely rose, by 0.4 % on average in 2014. This compares with 1.2 % in 2013, which had already seen significant declines on the two previous years.

As it is derived from the national consumer price index (NCPI), the health index was also influenced by the methodological changes that came into effect in January 2014 as part of the complete overhaul of the NCPI. In addition to an extensive review of the basket of products and their weights to better reflect today's consumer patterns, NCPI now also factors in consumer tendencies to switch to cheaper product ranges, yet the basket of products is unchanged throughout the year. Methods for recording rent and telecom services rates were likewise adjusted. These reforms did not fail to affect the health index, particularly in the twelve months after their implementation, but their precise impact cannot be estimated on the basis of current data releases. The methodological changes are described in greater detail in an article published in the NBB's June 2014 Economic Review [1].

(1) Langohr J. (2014), "The new national consumer price index", NBB, *Economic Review*, June, pp. 45-60.

CHART 34 GAS AND ELECTRICITY CONSUMER PRICES
(2011 indices = 100)



Source : EC.

Labour costs

Nominal growth of labour costs slows

The marked decline in inflation, and more specifically the health index, had a major impact on labour costs in 2014. Hourly labour costs in the private sector recorded a much slower increase in growth to an average 0.7 % in the business sector as a whole, compared with 2.4 % in 2013 and 3.2 % in 2012. Public sector pay was much the same. With no indexation in 2014 as the key index has not been exceeded since the end of 2012, hourly labour costs rose by a mere 0.8 % in 2014, whereas they had gone up 3.1 % in 2013.

Much as in the public sector, private sector labour cost increases primarily reflect automatic indexation, which worked out at 0.7 % in 2014, below the levels of the three previous years. Given the time lags relating to the indexation mechanisms applied by the relevant joint committee, the significantly lower increase in the health index since the end of 2013 proved the key determinant for average wage indexation. And the index's more rapid slowdown since the second quarter of 2014 has yet to be fully reflected in wages.

The real agreed adjustments in the private sector are governed by a Royal Decree freezing real wage increases for 2013-2014. As had already been the case for the previous two-year period, the government pushed through the draft interprofessional agreement that some unions had refused to approve. While a margin of 0.3 % had been available in 2012 for agreed adjustments in excess of indexation, that margin was set at 0 % for 2013 and 2014, the aim being to narrow the wage gap with the three main neighbouring countries.

The "wage drift and other factors" item covers increases and bonuses granted by companies in excess of the interprofessional and sectoral collective bargaining agreements (including pay-scale increases), the effects resulting from changes in the employment structure, and measurement errors. On balance, these factors were neutral in 2014.

Employers' contributions had a similarly neutral effect on labour costs. With previously agreed measures to reduce labour costs coming into force or being expanded, the scale of cuts in social security contributions increased by nearly € 200 million to € 5.7 billion, or 3.7 % of the total private sector wage bill. Overall, these measures had a slight downward effect on labour cost trends.

With measures to reduce payroll tax not significantly different in 2014, these did not substantially affect changes in total labour costs. Accounting for € 2.7 billion or 1.8 % of the total private sector wage bill, they comprise a general reduction together with subsidies designed to

TABLE 6 LABOUR COSTS

(calendar adjusted data; percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e
Labour costs in the private sector					
Gross hourly wages	0.8	2.6	3.2	2.5	0.8
Collectively agreed wages [1]	0.7	2.7	3.0	2.0	0.7
Real agreed adjustments	0.1	0.0	0.2	0.1	0.0
Indexations	0.6	2.7	2.8	1.9	0.7
Wage drift and other factors [2]	0.0	−0.1	0.1	0.5	0.1
Employers' social contributions [3]	0.0	−0.3	0.1	−0.1	−0.1
Social security	0.0	0.1	−0.1	−0.1	0.0
Other contributions [4]	0.0	−0.4	0.1	0.0	−0.1
Hourly labour costs in the private sector	0.8	2.3	3.2	2.4	0.7
p.m. Unit labour costs in the private sector	*−0.6*	*2.5*	*4.0*	*2.2*	*0.0*
Hourly labour costs in the public sector	1.7	3.8	3.9	3.1	0.8
of which: indexations	0.5	2.7	2.5	2.3	0.0
Hourly labour costs in the economy as a whole	1.0	2.6	3.4	2.5	0.7

Sources: General notes on the budget; FPS Employment, Labour and Social Dialogue, NAI, NSSO, NBB.

(1) Wage increases fixed by joint committees.
(2) Increases and bonuses granted by companies over and above those under interprofessional and sectoral collective agreements; wage drift resulting from changes in the structure of employment, and errors and omissions; contribution to the change in labour costs, percentage points.
(3) Contribution to the change in labour costs resulting from changes in the implicit social security contribution rates, percentage points.
(4) Actual social contributions not paid to the government, including premiums for group insurance, pension funds or occupational pension institutions, and imputed contributions, including redundancy pay.

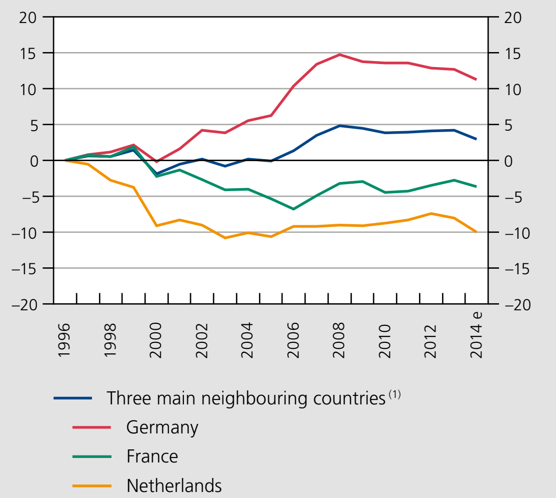
support R&D activities and certain specific forms of employment, such as shift work, night work and overtime. According to the national accounts methodology, these reductions are recorded as subsidies and are not deducted directly from labour costs.

Wage gap narrows on favourable productivity and, to a lesser degree, hourly labour cost trends

According to the technical report released by the Central Economic Council (CEC) secretariat, the wage gap with Germany, France and the Netherlands – Belgium's three main neighbouring countries and its key trading partners – narrowed to 2.9 % after having risen by 4.2 % between 1996 and 2013. This wage gap, called the "wage handicap" in Belgium, is mostly down to the cumulative difference of over 10 % compared with wages in Germany, as trends in labour costs were much less significant in Belgium than in France or the Netherlands. None of these figures – either in Belgium or in its three neighbours – allow for the effect of wage subsidies that the Belgian government will review in consultation with the social partners.

CHART 35 BELGIUM'S WAGE HANDICAP IN TERMS OF HOURLY LABOUR COSTS IN THE PRIVATE SECTOR, ACCORDING TO THE CEC

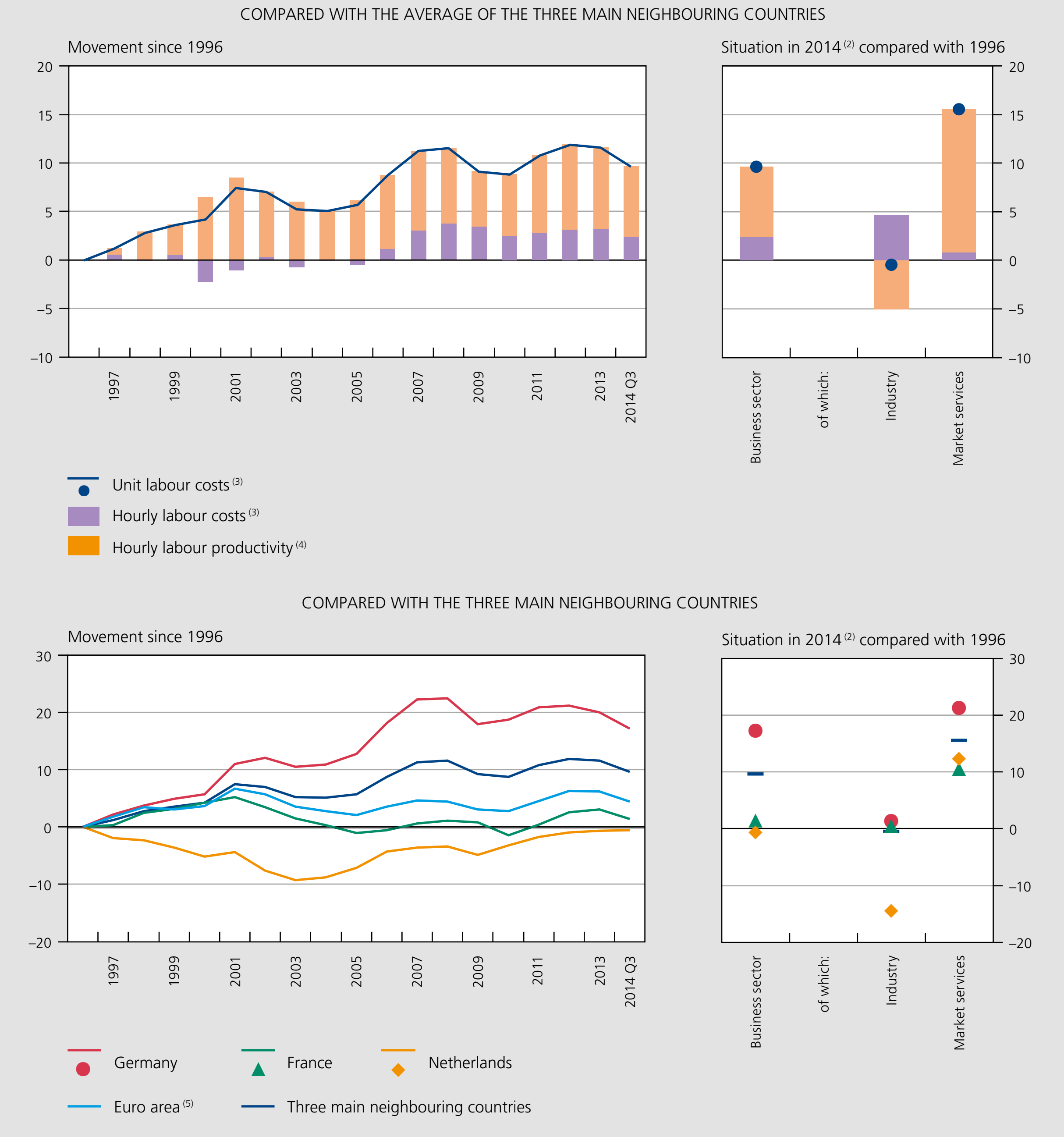
(cumulative percentage differences vis-à-vis the three main neighbouring countries, since 1996)



Source: CEC.
(1) Weighted average based on relative size of GDP.

CHART 36 UNIT LABOUR COSTS IN THE BUSINESS SECTOR IN BELGIUM

(percentage differences, cumulative since 1996)



Source: EC

(1) The business sector comprises NACE categories B to N and so includes industry, construction and market services, serving as a proxy for the private sector.

(2) Average of the first three quarters.

(3) A positive sign implies that unit labour costs and hourly labour costs are rising faster in Belgium than the average for the three main neighbouring countries.

(4) A positive sign implies that labour productivity is rising more slowly in Belgium than the average for the three main neighbouring countries.

(5) Figures for the 1996-1999 period were retropolated on the basis of the national accounts (ESA 95).

In 2014, growth in nominal wages slowed more rapidly in Belgium than in the neighbouring countries, while the country's productivity trends have been rather more favourable since 2012. The analysis of unit labour costs in the business sector, which takes account of these two factors, confirms this improvement relative to the three main neighbouring countries. In fact, the differential has narrowed from 11.6 % in 2013 to 9.6 % in the first three quarters of 2014. Over the full 18-year review period since 1996, however, the cumulative difference remains significant.

This observation is also confirmed when subsidies to help ease the cost of labour are factored in – subsidies that are not deducted from labour costs in the national accounts – such as targeted cuts in employers' contributions and reductions in payroll tax. As envisaged in the October 2014 coalition agreement, preserving cost competitiveness will require additional measures both to ensure a structural reduction of labour costs and to enhance the wage-setting mechanism, in order to strengthen the link with productivity trends.

The widening of the wage handicap at the level of the business sector since 1996 is down primarily to the market services sector, and more particularly to "trade, transport and hotels and restaurants" and "information and communication". It was largely caused by less favourable productivity trends, but hourly wages were also a contributing factor. In industry, by contrast, the productivity difference is in Belgium's favour and largely offsets the hourly labour cost-related cumulative gap, especially so in relation to Germany. For several reasons, this analysis should be interpreted with caution, as this sector is the most exposed to international competition and companies will only survive if they manage to offset cost disadvantages with greater productivity improvements. Such international competition is not limited to the three main neighbouring countries, but also includes the other countries in the euro area, including those in the periphery, some of which have greatly improved their relative labour cost positions. What is more, the services sector's lack of cost competitiveness might also weigh down on industry indirectly, as it limits synergy perspectives that enable an effective set-up of production in cross-border value chains – companies using such services as input could suffer from higher costs. But even ignoring competition effects, high labour costs directly depress job creation opportunities.

2.4 Demand and income

Growth still solidly supported by domestic demand, excluding change in inventories

In 2014, economic activity primarily expanded on the back of higher domestic demand, excluding changes in inventories; the most striking feature perhaps being the investment revival. In 2013, investment had still contracted significantly on average in volume terms, but the recovery got underway as the year progressed and pushed up gross fixed capital formation. This trend continued into 2014 and was accompanied by higher investment in residential property construction. The government then moved to scale back its investment even further, and fiscal consolidation caused public consumption to grow more slowly than it had in the previous year.

Net exports of goods and services still made a sizeable contribution to year-on-year GDP growth, even though this was solely down to a positive spillover effect from their dynamic trend at the end of 2013. In 2014, exports clearly lost momentum, with key markets weakening while imports continued to grow more strongly. The significantly negative contribution to growth by changes in inventories also tied in with the situation at the end of 2013. The absence of a reversal in 2014 suggests that companies continued to exercise caution in raising production and instead ran down their inventories in the face of a persistently challenging economy and despite rising investment.

Private consumption and household income are growing

Economic activity may have slowed in 2014 but private consumption grew steadily, if moderately. Average consumption growth in the year worked out at 1 %, quite a bit more than in 2013. Once again, consumption trends proved less volatile than GDP, and by the end of 2014 it was already 6 % higher than before the crisis – compared with a GDP increase of only 2 % – despite a brief period of negative growth during the great recession.

Households' greater willingness to consume matches the increase in their purchasing power and is also reflected in improved retail sales, which had slumped in 2013. A slight drop in joblessness fears may have something to do with this: after peaking at the beginning of 2013, this sub-indicator in the Bank's consumer survey plunged – reflecting a more positive assessment – before stabilising at around its average showing since 1998 during the larger part of 2014; to move back to just below the average since November. By then, the general synthetic consumer confidence indicator had slid down further. Statistical analyses suggest that the sub-indicator is better correlated with household consumption than the general indicator. What is more, a tentative recovery throughout the year may be gleaned from indicators in the survey measuring people's intentions to purchase consumer durables. That said, this trend is not apparent in new car registrations, which are still well below the average in recent years. More specific factors might explain these lower levels, such as early 2012 changes in the tax treatment of passenger cars – e.g. the discontinuation of subsidies

TABLE 7 GDP AND MAIN EXPENDITURE CATEGORIES
(calendar adjusted volume data; percentage changes compared to the previous year, unless otherwise stated)

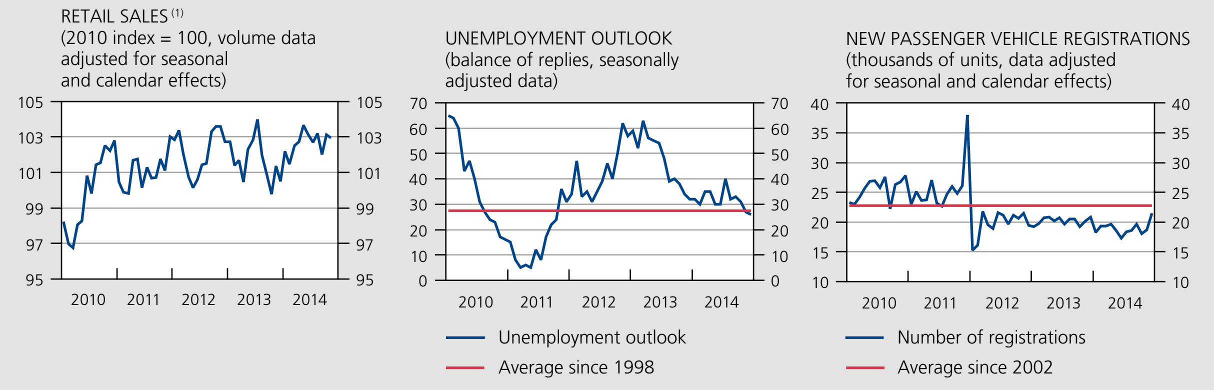
	2010	2011	2012	2013	2014 e
Private consumption	2.8	0.6	0.8	0.3	1.0
General government consumption	1.2	0.8	1.4	1.1	0.5
Gross fixed capital formation	–0.1	4.0	0.0	–2.2	4.7
Housing	3.3	1.4	–0.5	–3.5	0.9
Enterprises	–1.9	5.2	–0.3	–1.2	6.6
General government	3.6	2.5	3.4	–5.4	0.7
p.m. Final domestic expenditure (1)	*1.7*	*1.4*	*0.8*	*–0.1*	*1.7*
Change in inventories (2)	0.3	0.8	–0.8	–0.7	–1.0
Net exports of goods and services (2)	0.5	–0.5	0.1	1.0	0.4
Exports of goods and services	10.0	6.6	1.9	2.9	4.0
Imports of goods and services	9.6	7.4	1.8	1.7	3.6
GDP	2.5	1.6	0.1	0.3	1.0
p.m. Final demand	*5.4*	*4.1*	*0.9*	*0.9*	*2.2*

Sources: NAI, NBB.
(1) Excluding the change in inventories; contributions to the change in GDP compared to the previous year, percentage points.
(2) Contributions to the change in GDP compared to the previous year, percentage points.

previously granted on the purchase of environmentally friendly cars – or a change in car trade-in habits, as reflected in the steady increase in the average age of the fleet, to a little over eight years in 2013 (last available figures).

Household purchasing power is a key determinant of private consumption trends, and real gross disposable income rose by 1.3 % in 2014 – the first increase since 2009. Its slump in previous years primarily reflected shrinking capital income: in 2013, this was still more than 15 % below 2008 levels in nominal terms. Steep interest rate falls are to blame, coupled with the fact that the level of profit paid out by companies was heavily eroded by the financial crisis and the need to rebuild

CHART 37 PRIVATE CONSUMPTION INDICATORS



Sources: EC, FEBIAC, NBB.
(1) Excluding motor vehicles.

TABLE 8 DETERMINANTS OF HOUSEHOLD GROSS DISPOSABLE INCOME, AT CURRENT PRICES

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

	2010	2011	2012	2013	2014 e	*p.m. In € billion* *2014 e*
Gross primary income	2.2	3.1	2.1	1.6	1.6	*289.9*
Compensation of employees	2.0	4.4	3.4	2.1	1.1	*209.7*
Volume of labour of employees	0.9	1.9	0.1	–0.5	0.3	
Labour costs per hour worked	1.0	2.6	3.4	2.5	0.7	
Gross operating surplus and gross mixed income	2.9	1.5	1.6	2.7	2.4	
Capital income [1]	2.2	–2.6	–5.6	–3.7	4.4	*29.5*
Interest (net)	–8.3	–5.7	2.4	–15.8	–7.0	*4.4*
Dividends received	5.1	–6.3	–11.4	0.7	17.2	*15.1*
Net current transfers [1]	6.6	6.7	2.2	4.1	–0.3	*–52.2*
Current transfers received	1.7	3.3	4.7	3.7	2.0	*91.8*
Current transfers paid	3.4	4.6	3.8	3.9	1.2	*144.0*
Gross disposable income	1.3	2.3	2.1	1.0	2.1	*237.7*
p.m. In real terms [2]	*–0.4*	*–0.8*	*–0.1*	*–0.2*	*1.3*	
Savings ratio [3]	16.1	14.7	13.9	13.5	13.8	

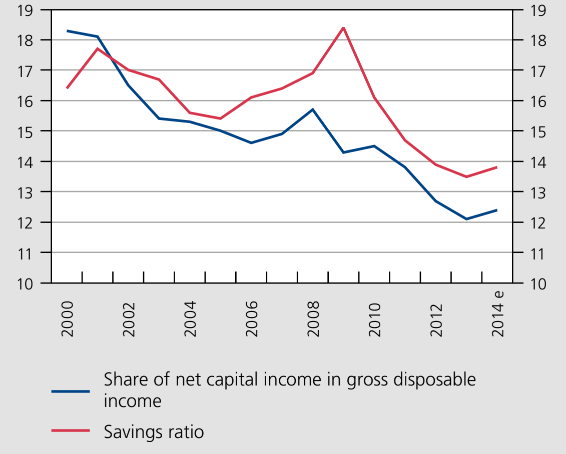
Sources: NAI, NBB.
(1) These are net amounts, i.e. the difference between income or transfers received from other sectors and those paid to other sectors.
(2) Data deflated by the household final consumption expenditure deflator.
(3) In % of disposable income in the broad sense, i.e. including changes in households' entitlements to additional pensions accruing in the context of an occupational activity.

their balance sheets. In 2014, these weaker capital income figures reversed into an increase on the back of dividends received.

Consumption profiles are more strongly influenced by labour income, however, as people put much less of their earnings towards savings. In the year under review, the wage bill rose slightly in real terms, i.e. adjusted for the private consumption deflator, as a result of as yet moderate growth in the number of employees. Since 2008, it has gone up by over 4 % in real terms, while real GDP has grown nearly 3 %. The gap widened sharply at the time of the crisis, particularly in 2009, when economic activity slumped. Lastly, other primary income, such as the earnings of self-employed people, moved ahead more rapidly, one reason being that self-employment has again risen faster than employee numbers. In terms of transfers to other sectors, with those to the government accounting for the biggest proportion by far, social benefits have grown much more than tax receipts on income or capital, so that net current transfers by private individuals have inched down.

CHART 38 SAVINGS RATIO AND CAPITAL INCOME

(in % of gross disposable income [1])



Sources: NAI, NBB.
(1) In % of disposable income in the broad sense, i.e. including changes in households' entitlements to additional pensions accruing in the context of an occupational activity.

Given that not all income immediately readjusts, rapidly falling inflation is generally also supportive of purchasing power. This includes income earned by self-employed people.

In 2014, the savings ratio edged up to 13.8 % of disposable income, in sharp contrast to the relentless falls of the past years following 2009's peak of 18.4 %. In that year, consumption contracted temporarily as uncertainty flared up, while incomes were still growing around 2 % in real terms. Over the following years, individuals did not adjust their consumption levels to negative growth in disposable income; instead, the savings ratio plumbed historic lows of 13.5 %.

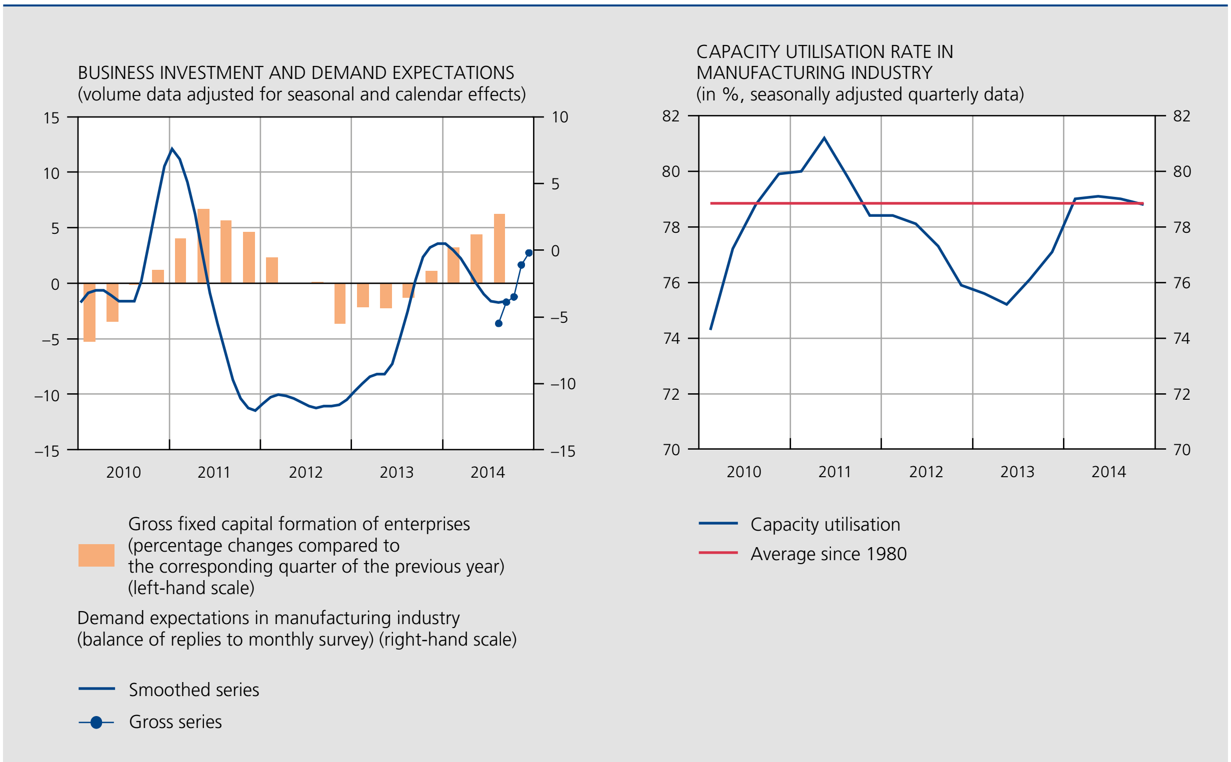
As Box 5 of the NBB's 2013 Annual Report noted, the savings ratio is largely determined by the breakdown of income and, more specifically, by the share of income from capital, as households typically save a larger proportion of property income than they do from their labour income. The past years' crumbling income from capital thus squeezed the savings ratio.

After coming down further in 2012 and 2013, much as it had done throughout the great recession, investment in housing inched back up in 2014, although volumes still languished around 10 % below those recorded before the recession.

In addition to higher disposable incomes, this tentative revival also draws on less fear among people of losing their job and its related income, while exceptionally low mortgage rates were an influence as well. Other factors were the changes in the law and tax rules related to the tax treatment of mortgage loans, which resulted from the federal government transferring authority to the Regions under the sixth State reform. When the Flemish Region announced it would sharply cut tax relief on mortgage loans – the housing bonus – from January 2015, households were quick to decide to buy homes in order to take advantage of the still existing, more favourable tax scheme. With housing construction and renovation looking at longer lead times for logistical reasons, anticipation primarily drives the secondary market. And indeed, housing investment was further bolstered by the significant increase in the number of secondary market transactions in the second half of 2014, as registration fees are stated in the national accounts on the dates of these transactions.

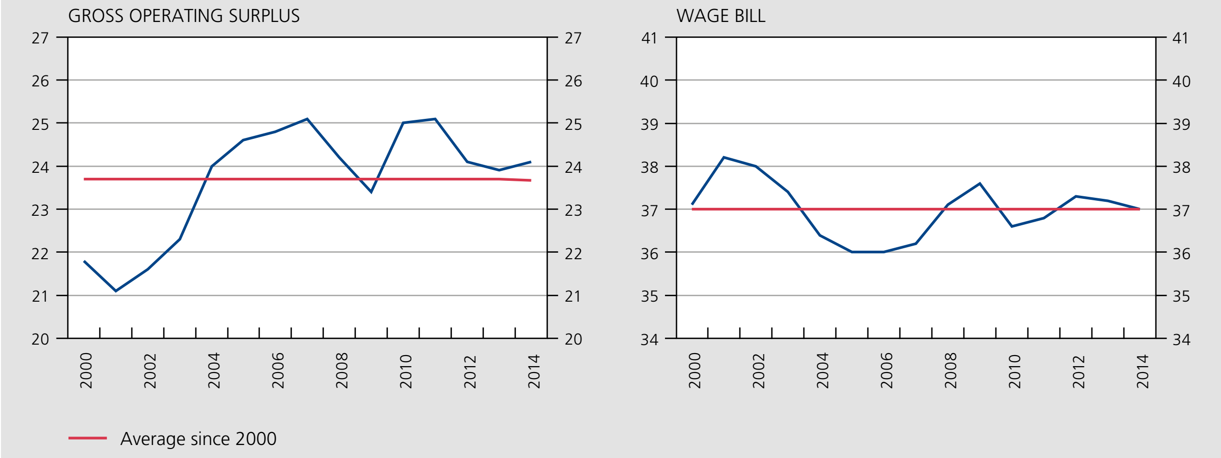
Business investment picked up strongly at the beginning of 2014 and gathered momentum from one quarter to the next, taking average growth to 6.6 % (annualised).

CHART 39 BUSINESS INVESTMENT



Sources: NAI, NBB.

CHART 40 GROSS OPERATING SURPLUS AND WAGE BILL OF COMPANIES
(in % of GDP)



Sources: NAI, NBB.

The extent to which this growth boosted economic activity has to be qualified, however, as it partly reflected specific transactions such as a big licence contract for one company and major purchases of ships abroad – which caused an equivalent increase in imports. But even ignoring this exceptional factor, business investment recovered in the year under review, on the back of improved demand forecasts. After a strong rebound in 2013, capacity utilisation in manufacturing hovered around its average showing since 1980 throughout the year. Together, these two factors could support both expansion and replacement investment. The slowdown that emerged as

TABLE 9 DETERMINANTS OF THE GROSS OPERATING SURPLUS OF COMPANIES[1], AT CURRENT PRICES
(percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e
Gross operating margin per unit of sales[2]	5.2	–0.1	–3.0	0.3	–0.2
Unit selling price	4.1	3.5	1.8	0.5	–0.2
On the domestic market[1]	3.6	2.9	2.3	1.5	0.6
Exports	4.6	4.1	1.3	–0.4	–0.9
Costs per unit of sales[1]	3.9	4.2	2.7	0.5	–0.2
Imported goods and services	6.3	5.1	1.5	–0.5	–1.0
Costs of domestic origin per unit of output[2][3]	–0.6	0.7	4.1	1.7	0.4
of which:					
Unit labour costs[4]	–1.2	1.8	3.6	1.9	0.2
Unit net indirect taxes	0.8	–1.0	7.2	0.1	0.9
Final sales at constant prices	6.1	4.5	0.9	0.9	2.3
Gross operating surplus of companies	11.6	4.4	–2.1	1.2	2.0

Sources: NAI, NBB.
(1) Private and public companies.
(2) Including the change in inventories.
(3) In addition to wages, this item comprises indirect taxes minus subsidies, and gross mixed income of self-employed people.
(4) Unit labour costs are expressed in units of value added of the business sector and are not calendar adjusted.

the year progressed appears to have had only a limited influence, either because of the time-lag between designing and implementing investment projects or because companies did not consider it a structural threat to the recovery.

Companies were able to defray their investment expenses from a solid level of own resources, coupled with favourable external financing conditions.

Funds generated through company activity rose by 2 % in 2014 and were slightly ahead of GDP growth in nominal terms, with companies' gross operating surplus accounting for a slightly higher proportion of GDP. This figure stood at 24.1 %, barely higher than the average since 2000. Conversely, wages accounted for a slightly lower share of GDP in 2014 and likewise remained a touch above the average of the past 15 years. The fact that operating surplus and wages both ended up above their average shares had more to do with tax on production less subsidies going down. Overall, as in 2013, movements in the share in income of the various factors of production – whether upward or downward – were very small in 2014, i.e. almost 0.1 % of GDP. This suggests that tighter wage restraint and falling inflation – both consumer prices and the GDP deflator – were on a similar trajectory.

The increase in gross operating surplus was primarily due to 2.3 % higher final sales volumes, including the change in inventories. This percentage does not however reflect real sales developments, as sales demand was partly met by a contraction of inventories rather than by an increase in production.

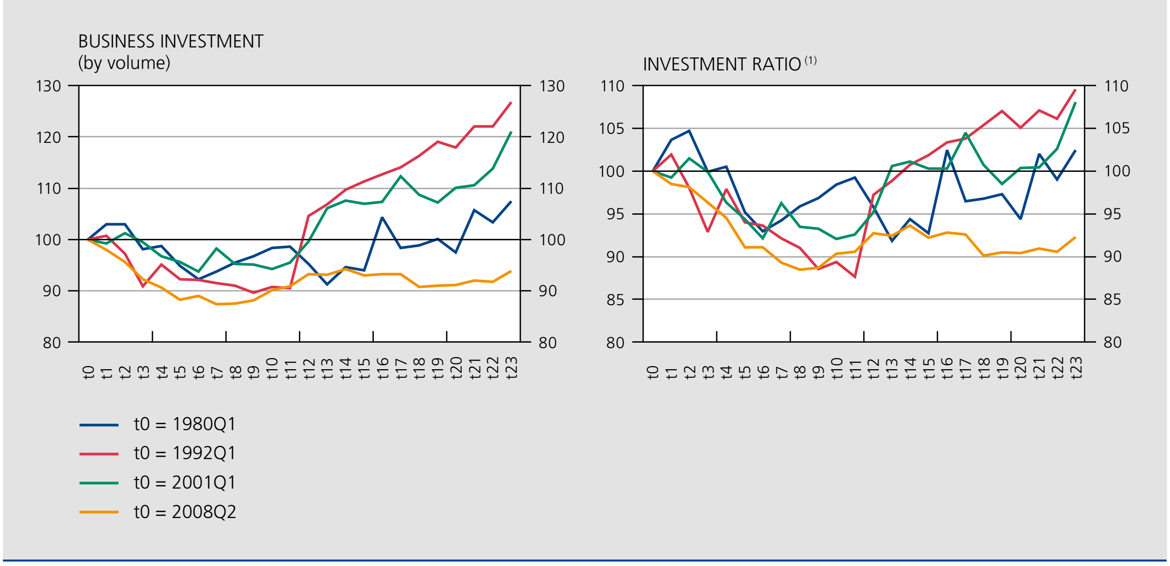
Gross operating margin per unit of sales contracted in 2014, albeit in a very minimal way. Selling prices fell, but this was exclusively down to lower export prices due to international competition in combination with lower input

Box 6 – Business investment slowly recovers

Much like the euro area at large, Belgium has seen business investment struggle to recover from the depths plumbed during the great recession. Six years after the recession took hold, investment volumes were still

BUSINESS INVESTMENT IN BELGIUM

(data adjusted for seasonal and calendar effects; indices, pre-recession high = 100)



Sources: NAI, NBB.
(1) Investment as a ratio of GDP (by volume).
ti: Quarters since the start of the relevant recession period.

around 6 % below the all-time high of the second quarter of 2008. Compared with the previous recessions of 1980, 1992 and 2001, business investment fell very hard and very fast at the nadir of the economic and financial crisis. And the decline has proved very stubborn indeed : in each of the three previous recessions, business investment exceeded pre-crisis levels within six years.

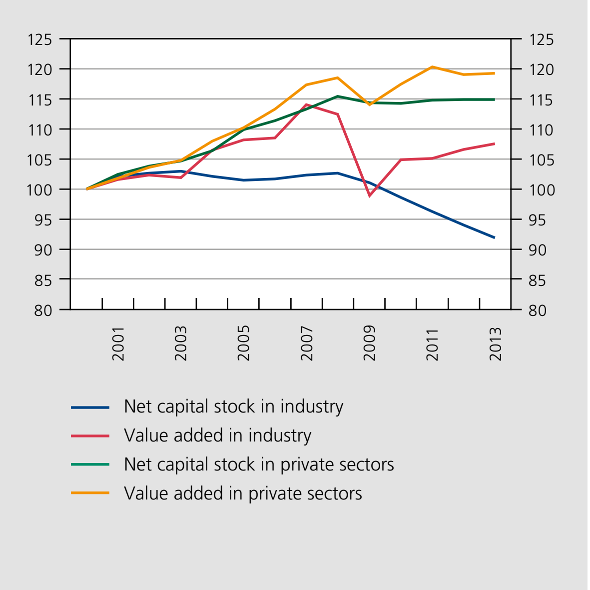
Of course, the slower revival of business investment after the latest recession period is partly down to the lacklustre recovery in economic activity. Granted, GDP has been back at pre-crisis levels since 2011 but it has hardly moved since, whereas economic activity bounced back much more strongly after earlier recessions. The tentative feel of the recovery has made investors wary of new investment projects, particularly in view of uncertain return prospects.

Today's recovery is clearly also weaker than previous post-recession recoveries when looking at the investment ratio, i.e. business investment as a ratio of real GDP. Macroeconomic uncertainty was not the only determinant of this ratio : financial conditions during the period also had a part to play. Lenders sharply tightened conditions for investment project funding during the financial crisis, while relatively high gearing levels in those turbulent days may also have squeezed investment plans. And it is always possible that companies considered it was not necessary to increase capacity to meet future demand, as growth prospects for the longer term were being revised downwards.

The languishing recovery of business investment also affects capital stock in the Belgian economy. Ignoring government and housing construction sectors, capital stock volumes grew by an average 1.9 % per year between 1995 and 2008. In the post-great-recession recovery, capital stock has virtually stagnated, as the level of investment barely offsets impairments of existing assets. The sharp contraction in manufacturing is one reason for the shortfall, as traditional industry with its extensive, capital-intensive machinery is losing ground. This is only partly offset by the increasing

NET CAPITAL STOCK (1) AND VALUE ADDED

(volume data adjusted for seasonal and calendar effects, indices 2000 = 100)



Sources : NAI, NBB.
(1) Excluding housing.

proportion of the cumulative net value of R&D investment. There are a few exceptions: in the pharmaceuticals industry, for one, innovation has been a key driver of capital stock, even during the crisis.

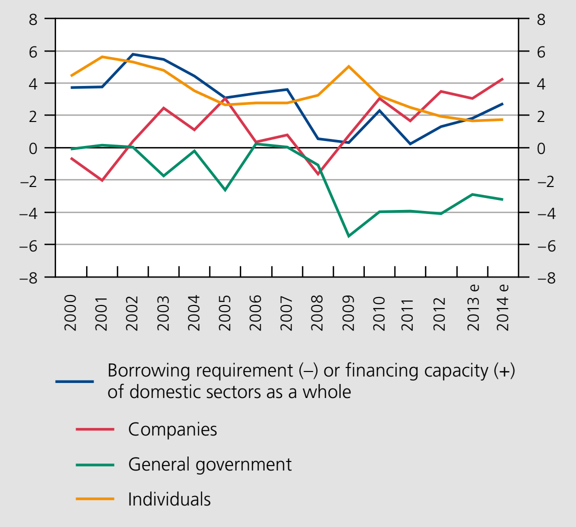
Both in manufacturing and – to a lesser degree – in market activities at large, value added has been growing a bit faster than capital stock since the great recession, also in the longer term. The shift identified earlier (from investment to other sectors and other types of assets) would appear to have had a modestly upward effect on the average productivity of capital assets.

prices, for commodities among other things. Prices of imported goods and services and, more broadly, costs per unit of sales fell even more sharply than company selling prices, lower oil prices compared with 2013 being a major factor. Domestic costs, by contrast, were up, but only moderately so. Unit labour costs recorded their lowest growth rate of the past four years, reflecting the combined influence of moderate wage growth and productivity gains.

In addition to extremely low real returns on the financial markets, which have significantly lowered break-even point for investment projects, business investment also benefited from the increase in the gross operating surplus and the relatively high level of cash held by non-financial corporations, some 29.1 % of GDP. And even ignoring lower interest rates, survey responses about lending suggest that banks also eased other credit conditions a little in the course of 2014.

CHART 41 FINANCING BALANCE OF DOMESTIC SECTORS AS A WHOLE

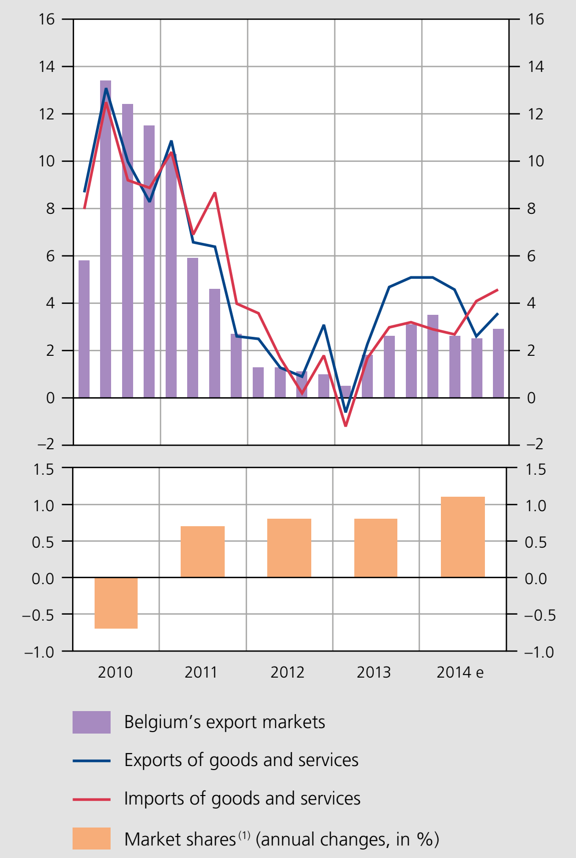
(in % of GDP)



Sources: NAI, NBB.

CHART 42 EXPORTS AND IMPORTS OF GOODS AND SERVICES, BY VOLUME

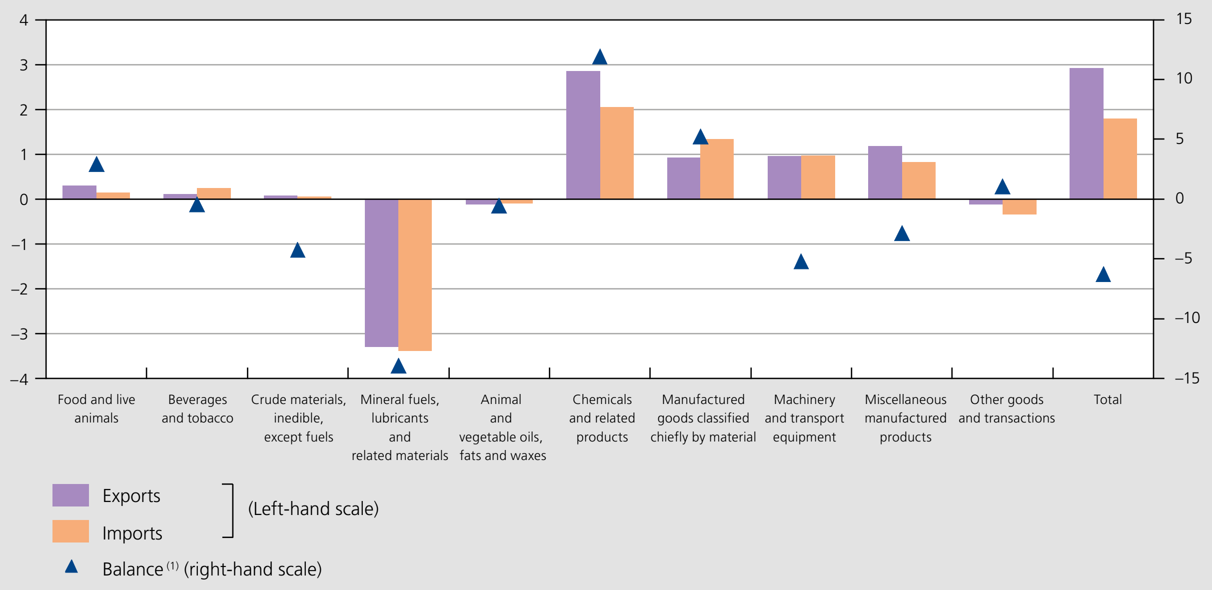
(data adjusted for seasonal and calendar effects; percentage changes compared to the corresponding quarter of the previous year, unless otherwise stated)



Sources: ECB, NAI, NBB.

CHART 43 EXPORTS AND IMPORTS OF GOODS IN VALUE BY PRODUCT CATEGORY

(national concept, in € billion, change in the first nine months of 2014 compared to the corresponding period of 2013, unless otherwise stated)



Source: NAI.
(1) Balance in € billion for the first three quarters of 2014.

TABLE 10 BALANCE OF PAYMENTS AND NET LENDING TO THE REST OF THE WORLD

(balances; in € billion, unless otherwise stated)

	2010	2011	2012	2013	2014 e
1. Current account					
Goods and services	4.3	–2.9	–3.3	–0.6	0.0
Goods	–3.8	–10.1	–10.6	–7.7	n.
Services	8.1	7.3	7.2	7.1	n.
Primary income	6.6	3.9	6.6	9.1	11.3
Earned income	4.9	5.0	5.1	5.4	5.4
Investment income	2.3	–0.5	2.1	4.3	6.5
Other primary income	–0.6	–0.7	–0.6	–0.6	–0.6
Secondary income	–5.4	–6.0	–6.7	–7.9	–7.8
General government	–4.1	–4.1	–3.8	–4.8	–4.7
Other sectors	–1.3	–1.9	–2.9	–3.1	–3.1
Total	5.5	–5.0	–3.4	0.6	3.6
p.m. Idem, in % of GDP	*1.5*	*–1.3*	*–0.9*	*0.1*	*0.9*
2. Capital account	–0.9	–0.4	2.3	–0.1	–0.4
3. Net lending to the rest of the world (1 + 2)	4.6	–5.4	–1.1	0.4	3.2
p.m. Idem, in % of GDP	*1.3*	*–1.4*	*–0.3*	*0.1*	*0.8*

Sources: NAI, NBB.

Improved current account balance

Taken as a whole, the country's economic sectors recorded a financing capacity ratio of 2.7 % of GDP in 2014, compared with an estimated ratio of 1.8 % in 2013 [(1)]. Households' net financing capacity, traditionally positive, remained stable in 2014 at 1.8 % of GDP, as individuals' gross savings increase was offset by higher capital spending, including investment in housing. As chapter 4 explained, the government's borrowing requirement rose slightly and the improved financing balance was the outcome of an increase in companies' financing capacity to nearly 4.3 % of GDP, thanks to higher gross savings derived from a slight increase in their gross operating surplus coupled with reduced inventories. All this adds up to a consistent financing capacity on the part of companies since 2009.

The increase in the economic sectors' overall financing capacity is also reflected in a higher current account surplus, which partly derives from an improved goods and services balance. Indeed, as explained earlier, annualised imports lagged behind exports in real terms, resulting in higher net exports in volume terms. Also, the terms of trade stabilised, as the improvement recorded during the last couple of months of 2014 on the back of tumbling oil prices had offset the deterioration observed at the beginning of the year.

As in the three previous years, the increase in exports was again supported by higher market share (in volume terms) in 2014. According to available estimates when this Report went to press, exports from Belgium grew faster than import demand from the main trading partners, weighted by its export structure. Belgium would appear to have won market share in markets both within and outside the euro area in the past year.

According to balance of payments data, the latest improvement in the balance of international goods and services reflected a lower goods transaction deficit coupled with an unchanged services surplus. The consolidation in services was the result of positive developments in goods for processing, construction and financial services.

As far as goods trade is concerned, foreign trade statistics for the first three quarters of 2014 reveal improved net figures for chemicals and related products on the back of a significant increase in exports. This product category alone accounted for 25 % of total Belgian exports in the nine months, and its growth mainly reflects net exports of medicinal and pharmaceutical products. Lower exports in terms of value of mineral fuels, lubricants and related materials were offset by a comparable contraction in imports. In the end, trends in this product category had only a limited net effect on the total value of goods imports and exports – which stayed negative for the first three quarters of the year under review.

Retaliatory sanctions imposed by Russia, and more specifically the import ban on most foods from Europe, have only had a slight immediate effect on the Belgian economy. Trade flows covered by the Russian embargo account for less than 0.1 % of GDP. However, individual companies and sectors have been harder hit, for example in fruit and vegetables, dairy and meat products.

Russia is in fact only Belgium's 15th largest trading partner for goods exports, accounting for € 3.3 billion or 1.4 % of total Belgian exports in 2013. As far as services are concerned, balance of payments statistics suggest that flows to and from Russia were even less significant, representing around 1 % of the total in 2012. That said, this analysis of direct trade may mask indirect economic relations, as a country can use value added created by a country that does not rank among its direct suppliers, for example if a third country acts as a broker. So Russia might well be more important to Belgium than would appear on the basis of direct export and import data.

In addition to the € 0.6 billion increase in the goods and services balance, the primary income surplus also rose in 2014, to € 11.3 billion from € 9.1 billion. This improvement can mostly be traced back to higher income from investment on the back of higher dividends received, coupled with a fall in dividends paid. Earned income, another key component of primary income, recorded a surplus of € 5.4 billion, comparable with 2013.

The secondary income deficit is reported to have narrowed a little in 2014. These transactions include Belgian contributions to the budgets of EU institutions linked to the VAT base and gross national income (GNI), international collaboration and transfers between resident and non-resident private individuals. The improvement in this item reflects the fact that, in 2014, the Belgian government paid significantly less to European institutions on balance than it had in 2013, in keeping with a lower rate of call of the GNI resource.

All in all, the balance of payments suggests that the current account continued its favourable course in 2014, with its surplus rising to € 3.6 billion in the year under review from € 0.6 billion in 2013. This is 0.9 % of GDP.

(1) To better interpret economic developments, this analysis has adjusted the NAI's national accounts data for 2013 and 2014. The adjustment mimics the effect of the new methodology for calculating income from investment in the balance of payments, which now reflects a macroeconomic approach. It applies to the accounts for corporations and for the rest of the world.

Financial developments in Belgium

3. Financial developments in Belgium

Belgium's net external position remains robust, at 35.4 % of GDP. In the persistently fragile economic climate and given the low returns on low-risk investment instruments, households have focused their investment on both liquid assets and – more than in previous years – investment funds. Net mortgage loan growth remained moderate, with the exception of refinancing transactions to take advantage of lower interest rates. The pace nevertheless picked up by the end of the year, partly in anticipation of the introduction of a less generous tax treatment of mortgage loans, particularly in Flanders. Generally speaking, household debt ratio rose further, but remained sustainable, although some categories – particularly young people – are more exposed than others. Company demand for bank loans also stayed subdued, despite lower interest rates and easier credit standards. The anaemic economy and protracted low interest rates are posing challenges to banks and insurance companies; they have to make a real effort to bolster their capital positions and make sustainable profits if they are to also meet the more rigorous solvency requirements imposed by regulators.

3.1 Overall financial position of the Belgian economy

Belgium's net external position: strong, but weakening

Belgium ranks among a small group of euro area countries – together with the Netherlands, Germany and Finland – reporting positive net financial wealth. Serving as a factor of financial stability, this net claim of all domestic sectors on the rest of the world amounted to € 142 billion or 35.4 % of GDP at the end of September 2014. This is largely down to the considerable net financial assets of Belgian individuals, the highest as a percentage of GDP (225 %) of the euro area Member States for which these data are available. Other sectors, with the exception of financial corporations, report net liabilities.

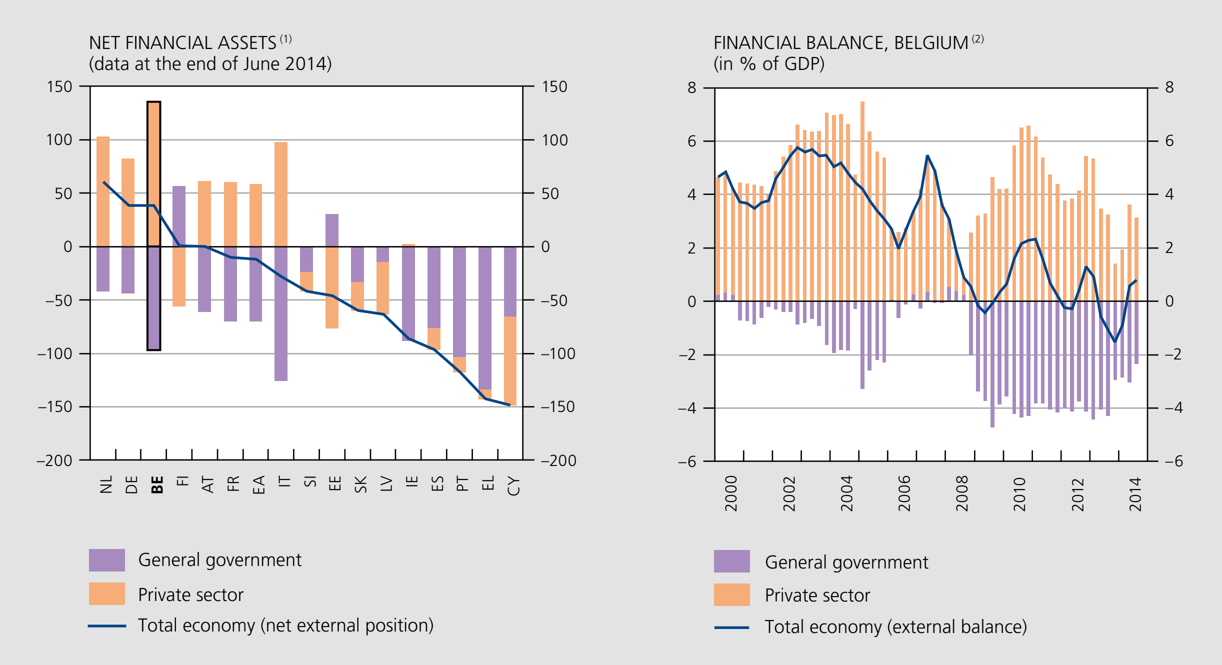
Belgium's external position may still be robust, but it has been falling since peaking at 57.6 % of GDP in 2011. This is attributable to the development of the economy's overall balance and to changes in the position primarily related to the revaluation of outstanding assets and liabilities. The downward trend persisted into the first nine months of 2014 and Belgium's net assets fell by € 25.7 billion, or 6.5 % of GDP.

Whereas Belgium had recorded major current account surpluses in the past and so built net claims on other countries, the situation has reversed since 2009. The country has from then on seen periods of current account deficits, during which it contracted net liabilities abroad. In the first nine months of 2014, the current account was positive and € 2.6 billion – i.e. 0.6 % of annual GDP – worth of net foreign assets were acquired. The positive financial balance was due to households and financial institutions, with the latter preferring to use a large part of their profits to shore up their balance sheets.

Other changes, including revaluations, amounted to a negative € 28.3 billion or –7.1 % of GDP in the first three quarters of 2014, more than wiping out the effect of the positive financial balance. Traditionally, the Belgian economy suffers negative revaluation effects when financial markets recover, primarily concentrated on non-financial corporations and the general government. Rising stock market prices in 2014 pushed up the value of non-financial corporations' outstanding liabilities, much more so than the increase in the value of their financial assets, in which equities represent a smaller share. In addition, declining yields in the secondary market for general government debt pushed up its market value, while private households as a net creditor sector enjoyed gains on their capital on the back of rising asset prices.

CHART 44 NET FINANCIAL ASSETS AND FINANCIAL BALANCE

(in % of GDP)



Sources: EC, ECB, NBB.

(1) Difference between the outstanding amount of financial assets and liabilities. Luxembourg and Malta are not included in view of the high volatility of their data.

(2) Difference between transactions in financial assets and liabilities, cumulative over four quarters.

Financial institutions also posted gains, as price effects were more significant for their assets than their liabilities.

Financial assets and liabilities turn back up, albeit moderately

For the first time since 2011, Belgium's domestic sectors taken together recorded an increase in financial assets of € 77 billion, although this was still lower than the average since 1999. The financial assets portfolio mainly grew in the financial sector (€ 67.6 billion), in stark contrast with the balance sheet contraction of the 2008-2013 period. As described in Box 7, the financial sector is defined more broadly than the sector of banks and insurance companies mentioned in section 3.4, although banks did account for three-quarters of its asset formation in the first three-quarters of 2014. Households grew their financial assets to much the same degree as in 2013, while those of non-financial corporations shrank for the second year running. The general government sector also saw financial assets come down, by € 4.5 billion.

At € 74.3 billion, growth in financial liabilities fell behind that in assets and remained below its historical average. And yet, the outstanding amount in financial liabilities reached new all-time highs in all sectors except financial services.

Gross debt ratio of non-financial private sector still inching up, but remains at sustainable levels

Against a backdrop of subdued bank lending and GDP growth, the consolidated gross debt ratio of the Belgian non-financial private sector still inched up, from 162.8 % of GDP at the end of 2013 to 163.2 % in September 2014. The debt ratio of Belgian households rose further, by 1.2 percentage points of GDP, to 57 % of GDP, while non-financial corporations reported a 0.7 percentage point fall to 106.3 % of GDP. This latter result is all down to positive GDP growth, as non-financial corporations are still actively incurring mainly non-bank debt.

In the euro area, the process of deleveraging, which had started in 2010, continued apace in the non-financial private sector, reducing the debt ratio from 139.8 % of GDP at the end of 2013 to 139 % of GDP at the end of June 2014. At that point, debt ratios of households and

TABLE 11 FINANCIAL ASSETS AND LIABILITIES BY SECTOR

(non-consolidated, in € billion, unless otherwise stated)

	Outstanding amounts at the end of September 2014			Change since December 2013			
	Assets	Liabilities	Net financial wealth	Total [1]	Transactions [2]		
				Net financial wealth	Assets	Liabilities	Financial balance
Households	1 146.6	245.6	901.0	22.1	18.7	8.0	10.7
Non-financial corporations	1 268.2	1 637.2	–369.0	–22.2	–4.8	–5.3	0.5
General government	161.2	559.2	–398.0	–42.3	–4.5	7.1	–11.7
Financial corporations [3]	2 372.2	2 364.6	7.6	16.7	67.6	64.6	3.0
p.m. Total of domestic sectors	*4 948.3*	*4 806.6*	*141.7*	*–25.7*	*77.0*	*74.3*	*2.6*
Idem, in % of GDP	*1 235.2*	*1 199.8*	*35.4*	*–6.5*	*19.2*	*18.6*	*0.6*

Source: NBB.
(1) Change over the first nine months of 2014.
(2) Cumulative flows over the first nine months of 2014.
(3) Financial corporations comprise mainly monetary financial institutions (NBB, credit institutions and monetary UCIs), non-monetary UCIs, other financial institutions (stockbroking firms, financial head offices and holding companies), in addition to insurance companies and pension funds.

non-financial corporations amounted to 62.1 % and 77 % of GDP respectively, i.e. 2.4 and 6.1 percentage points of GDP below their all-time highs of 2010. Deleveraging is mostly taking place in the periphery of the euro area, but is modest compared with previously accumulated debt. That said, most of these countries are engaged in active deleveraging and their debts are falling in nominal terms.

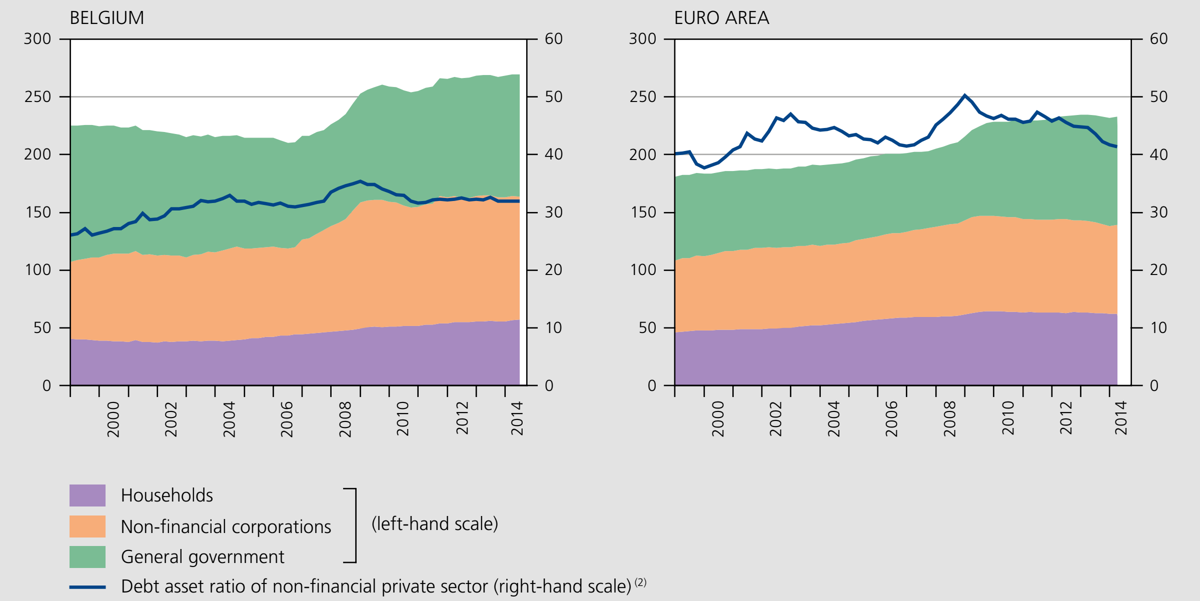
Factoring in public debt, the deleveraging process in the euro area becomes less clear-cut and the non-financial sector ends up close to its peak of 235 % of GDP, compared with 270 % in Belgium. Like net external positions, gross debt ratios, which include both the general government and the non-financial private sector, feature in the scoreboard that the European authorities use for the purpose of the macroeconomic imbalance procedure (MIP). The EC uses consolidated gross debt thresholds of 60 % of GDP for general government and 133 % of GDP for the non-financial private sector, and posits that any breach of these might suggest a macroeconomic imbalance. Belgium exceeds both threshold values: for its public and non-financial private sector debt.

However, the heavy debt level of the non-financial private sector in Belgium requires additional explanation. In reality, a large proportion of non-financial corporations' debt ratio (106.3 % of GDP) is made up of intra-company debt, even on a consolidated basis. Although funding received from other resident non-financial corporations is stripped out in line with the consolidated concept – as the counterpart assets are held by other entities in the same sector – these calculations do factor in loans by foreign affiliates, even if these frequently belong to the same group. Non-bank debt financing from abroad typically involves resources for head offices resident in Belgium and will typically also be transferred abroad, directly or indirectly. Financial flows between associated companies need to be monitored closely, of course, as significant amounts of money are involved, but these represent a much smaller risk of macroeconomic imbalances in Belgium – a fact recognised by the EC in its assessment of the Belgian economy's structural position. At the end of September 2014, foreign non-bank loans stood at € 90 billion or 22.4 % of GDP. With the implementation of new accounting rules for national accounts (ESA 2010), funding of non-financial corporations by "captive financial institutions and non-institutional money lenders" is also included in the consolidated debt ratio (see Box 7). Rather than meeting external borrowing requirements, these holding companies are incorporated in Belgium to redistribute financial resources within groups. Any funding from these holding companies will typically return to them or go to other group entities, without any net debt resulting. At the end of September 2014, loans by "other financial institutions" (OFIs), which comprise these holding companies, amounted to € 127 billion, or 31.6 % of GDP.

Setting aside these qualifications regarding non-financial corporations' debt level, various factors point to the

CHART 45 GROSS DEBT RATIO OF THE NON-FINANCIAL SECTOR (1)

(consolidated debt in % of GDP, unless otherwise stated)



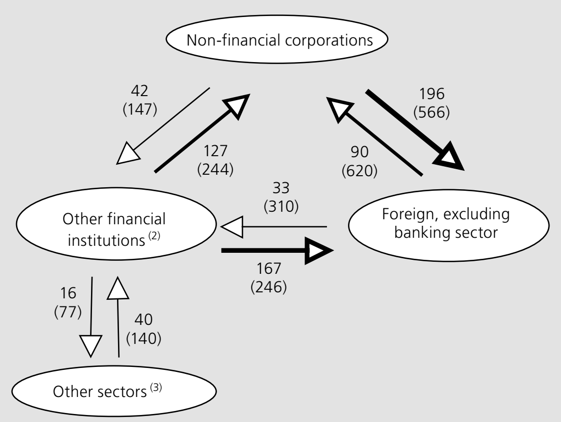
Sources: EC, ECB, NBB.

(1) Data up to the third quarter of 2014 for Belgium, up to the second quarter for the euro area. Quarterly data for the non-financial private sector debt ratio. Annual data for public debt (end of period, forecast for 2014), interpolated linearly on a quarterly basis. Euro area public debt before 2010 is defined in accordance with the ESA 95.

(2) Non-consolidated debt in %.

CHART 46 MUTUAL CLAIMS AND LIABILITIES BETWEEN NON-FINANCIAL CORPORATIONS AND (QUASI-) FINANCIAL CORPORATIONS (1)

(outstanding amount in September 2014, in € billion)



Source: NBB.

(1) The arrows indicate the amount involved in debt instruments or, in brackets, total assets held by the sectors relative to one another.

(2) Primarily "captive financial institutions and non-institutional money lenders".

(3) Households, general government, the (resident and non-resident) banking sector, non-monetary institutions for collective investment (UCIs), insurance companies and pension funds.

sustainability of private debt. At 56.5 % of GDP in mid-2014, the household debt ratio was below that for the euro area, although the gap has steadily narrowed. Looking at the relationship between the debt and the value of the financial assets held by households and companies – i.e. the debt-to-asset ratio – the non-financial private sector in Belgium has a much lower debt ratio than the euro area. And unlike debt expressed as a percentage of GDP, this ratio has remained relatively stable over the past decade. Lastly, it appears that debt service burdens – *ex ante* from the debt-service ratio and ex post from both the level and trend in arrears on loans as registered by the Central Individual Credit Register (CICR) – are manageable for most households. More generally, the financial position of households and companies in Belgium does not seem to point to any special debt sustainability issues.

Box 7 – Impact of ESA 2010 on Belgium's financial accounts

The new ESA 2010 methodology will bring numerous changes to the financial accounts. Providing a new delineation between institutional sectors, it also introduces a reclassification of and increase in the number of financial instruments. What is more, valuation effects and other volume changes in assets and liabilities will be separately recorded, alongside outstanding amounts and transactions (1).

The methodological changes have a significant effect on the financial assets and liabilities of the various sectors, as well as on various indicators of their financial position, such as the debt ratio, net assets and financial balance. With these indicators taking on a more central role in macroeconomic and prudential policies, this Box describes the changeover from the ESA 95 – the previous methodology – to ESA 2010, and the main effects of this on the key indicators.

Assets, liabilities and net financial assets of the various sectors

Assets and liabilities of the Belgian economy as a whole, as estimated according to the new methodology, were virtually unchanged compared to ESA 95. Data for the situation at end-2013 were revised by –1.1 % and –0.7 % respectively. However, the change in the definition of the institutional sectors has quite a significant impact on the size of the assets and liabilities of the different sectors. The financial sector, in particular, was expanded to include sub-sector S.127 "captive financial institutions and non-institutional money lenders" (mainly holding companies),

FINANCIAL ASSETS AND LIABILITIES PER SECTOR

(non-consolidated, in € billion, end 2013)

	ESA 2010			ESA 1995			ESA 2010 – ESA 1995 differences		
	Assets	Liabilities	Net financial assets	Assets	Liabilities	Net financial assets	Assets	Liabilities	Net financial assets
Households	1 114	235	879	1 090	220	870	24	15	9
Non-financial corporations	1 266	1 613	–347	1 936	2 295	–359	–670	–682	12
General government	162	518	–356	137	457	–321	25	60	–35
Financial corporations	2 267	2 276	–9	1 700	1 699	1	566	577	–10
of which:									
Monetary financial institutions (MFIs)	1 095	1 078	17	1 090	1 095	–5	5	–17	22
Other financial institutions (OFIs) (1)	869	908	–39	307	315	–8	562	593	–32
Insurance corporations and pension funds (ICPFs)	303	290	13	303	289	14	0	1	–1
p.m. Total of the domestic sectors	*4 809*	*4 641*	*167*	*4 863*	*4 672*	*191*	*–54*	*–31*	*–24*

Source: NBB.
(1) Including non-monetary UCIs.

(1) Please refer to the methodological note for an overview of the changes made to the national accounts.

which had previously mostly ranked in the non-financial corporations category. The change makes for a key shift in assets and liabilities from non-financial to financial corporations.

Compared with other countries, Belgium is facing a major impact from this sector shift, as many holding companies and treasury centres are incorporated in this country. Assets of OFIs, which now cover the new sub-sector S.127, were revised upwards by 140 % of GDP at the end of 2013, i.e. € 562 billion. This and other changes sparked an overall upward revision of the financial corporations sector's assets from 444 % to 573 % of GDP. By contrast, total financial assets of non-financial corporations came down to 320 % of GDP from 506 % at the end of 2013, due to this and a number of other smaller revisions.

The introduction of a new sub-sector "captive financial institutions and non-institutional money lenders" also widens the definition of the financial sector in the financial accounts, with a wider gap emerging between the credit institutions and insurance companies as discussed in section 3.4 of this Annual Report. The nine sub-sectors now making up the financial sector in the financial accounts can be broken down into monetary financial institutions (MFIs), other financial institutions (OFIs), and insurance corporations and pension funds (ICPFs). Under ESA 95, MFIs accounted for around 64 % of the entire financial sector, but their relative proportion fell to 48 %, with the share of OFIs and ICPFs now at 38 % and 13 % respectively.

Although the changes mainly affect outstanding amounts, in some cases they also provide a different take on developments. The balance sheet total of non-financial corporations, for one, edged down after touching record highs in 2011. The contraction of the financial sector's assets in the wake of the financial crisis – caused by the banking sector, in particular – looks a lot less significant, as it was not as visible in the non-banking financial sector. This also has repercussions on the EC scoreboard used for the macroeconomic imbalance procedure (MIP), one of the headline indicators being the year-on-year change in financial sector liabilities. The debt-to-asset ratio, which serves as an additional indicator, is also strongly affected.

Total assets and liabilities of the other sectors (households and general government) have been revised to a lesser extent. That said, for end-2013, the (non-consolidated) liabilities of the general government were revised upwards by 11.5 % of GDP to 130.9 % of GDP, to reflect the new boundary of general government. Differences with the Maastricht concept of debt used in the European excessive debt procedures (104.5 % of GDP) are that this debt only refers to deposits, debt securities and loans, excluding other liabilities such as tax refunds or pending invoices, and that liabilities on other entities of the general government sector are consolidated. In addition, general government debt will now be recognised in the financial accounts at market values, whereas the Maastricht definition prescribes nominal values for recognition. The slight increase in household assets and liabilities particularly reflects new basic information on non-profit institutions serving households (NPISHs).

In most cases, the impact on assets and liabilities is similar, and thus, overall the revision of the net financial assets of the various sectors is minor.

Debt ratio of non-financial corporations

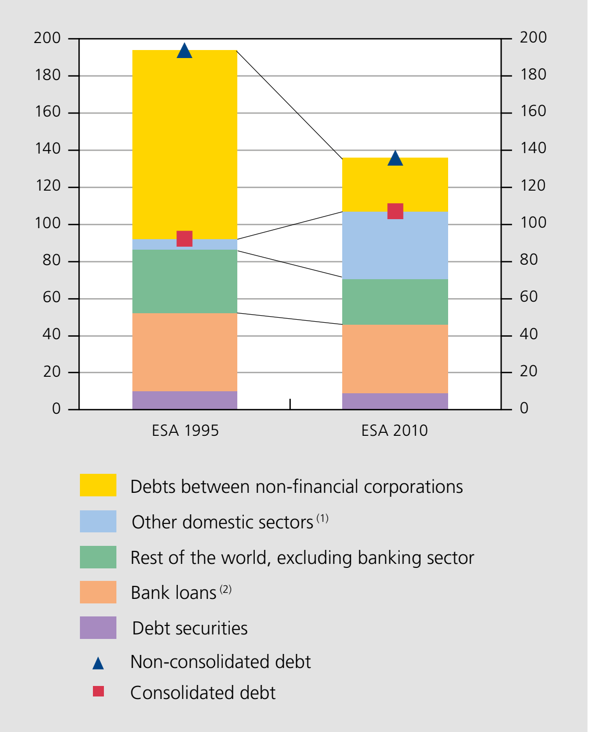
The reclassification of "captive financial institutions and non-institutional money lenders" also has a major effect on the debt ratio of non-financial corporations. On a non-consolidated basis, the debt ratio was adjusted by around 58 % of GDP, which brought it back down to 136 % of GDP at the end of 2013, the direct effect of the shift of holding companies from the financial corporations to the non-financial corporations sector.

On a consolidated basis, the reclassification of the holding companies meant that the debt ratio was increased by around 15 % of GDP. This increase stems from two opposing factors. On the one hand, any debt contracted by holding companies in other sectors is no longer recognised in the non-financial corporations sector, but on the other hand, the liabilities of non-financial corporations on holding companies are now recognised in their consolidated debt, as they relate to two different sectors, whereas these used to be consolidated.

At the end of 2013, the consolidated debt ratio stood at 107 % of GDP. Bank loans and debt securities only account for 46.2 % of this debt ratio.

IMPACT OF THE METHODOLOGICAL CHANGES ON THE DEBT RATIO OF NON-FINANCIAL CORPORATIONS

(at end-2013, in % of GDP)



Source: NBB.
(1) Households, general government, non-monetary UCIs, insurance corporations, pension funds and "other financial institutions". In ESA 2010 this latter category also includes "captive financial institutions and non-institutional money lenders".
(2) Loans granted by the resident and non-resident banking sector, including securitised loans.

3.2 Households

In 2014, the financial behaviour of households was primarily influenced by three factors. First, economic agents' confidence remained fragile and was eroded during a large part of the year, even though – unlike in the two previous years – both purchasing power and housing investment were up. Second, financial market developments have widened the gap between returns on low-risk and riskier investment instruments, which may have triggered a search for returns. Nominal interest rates on deposits and loans plunged to historic lows in the year under review, whereas returns on the equity markets held up well, even though they were volatile. Lastly, changes in a number of tax conditions – in particular the reforms of the tax treatment of mortgage loans – heavily influenced loan demand at the end of the year.

As confidence in the economy fell, the year started off with a lull in new loans taken out by households, a continuation of 2013 trends. By the second half of the year, activity picked up on the back of loan refinancing inspired by lower interest rates or early implementation of planned transactions to lock in more favourable tax treatment. In view of the economic climate, households amassed fewer financial assets than the average in the first three quarters of the years 2006 to 2012, but about as much as that observed in 2013. In terms of categories, households kept their assets very liquid in the first nine months of the year, to face down prevailing uncertainty. At the same time, though, they moved quite a significant proportion of their savings to riskier assets, particularly investment funds, in search of higher returns.

Net household wealth continues to grow at a moderate rate

Total net wealth of households, representing the sum of their financial assets and real estate, amounted to € 2 077 billion at 30 September 2014, an increase on end-2013 by € 64 billion. Both real estate and household financial assets contributed to the increase.

The increase in real estate from € 1 135 billion at the end of 2013 to € 1 176 billion on 30 September 2014 reflects net housing investment as well as higher values of land and buildings in the first three quarters of 2014. Box 8 describes the development of property prices in Belgium and the valuation methods used for its residential property market.

Financial household wealth in Belgium continued to rise in 2014. Estimated at € 1 147 billion at the end of September, compared with € 1 114 billion on 31 December 2013, this exceeds the average increase between 2006 and 2013. Belgian households have also seen their financial wealth increase as a percentage of GDP, from 268.5 % at the end of 2010 and 281.9 % at the end of 2013 to 286.1 % in September 2014. This means that they remain among the wealthiest in the euro area, which as a whole recorded households' financial wealth at 207.2 % of GDP in June 2014.

Belgium's higher household wealth showing reflects both new financial asset accumulation and other flows, including revaluations of existing assets, reclassification and other one-off adjustments. These other flows, which between them amounted to € 13.5 billion, were driven by favourable financial market trends.

TABLE 12 HOUSEHOLD ASSETS AND LIABILITIES
(in € billion)

	Outstanding amount		Change from December 2013		
	End of 2013	End of September 2014	Total	Transactions	Other flows [1]
Real estate	1 134.7	1 176.3	41.6	25.4	16.1
Financial assets	1 114.4	1 146.6	32.2	18.7	13.5
of which:					
Notes, coins and deposits	347.4	353.5	6.2	8.9	–2.7
Debt securities	87.4	81.4	–6.0	–6.5	0.5
Equities	268.7	275.0	6.3	0.9	5.4
Investment fund units	125.9	144.7	18.7	10.7	8.0
Insurance products	269.1	275.7	6.5	4.4	2.1
Other	15.9	16.4	0.5	0.3	0.2
Financial liabilities	235.4	245.6	10.2	8.0	2.3
of which:					
Mortgage loans	181.8	185.5	3.8	3.8	0.0
Other loans	38.9	42.6	3.7	3.5	0.2
Other liabilities	14.7	17.4	2.7	0.7	2.0
Total net assets	2 013.7	2 077.3	63.6	36.2	27.3

Source: NBB.
(1) Other flows comprise both "valuation effects" and "other volume changes". Amongst those, one-off elements such as reclassification of transactions with regard to other sectors may be included.

Box 8 – Valuation of Belgium's residential property market

In Belgium, nominal residential property prices have practically doubled since the beginning of the century, and the drop seen during the great recession was very limited in both scale and duration compared with that in many other euro area member countries. However, the pace of the increases has slowed down markedly in the past two years, and the rise in property prices over the first three quarters of 2014 was only 0.4 % compared with the same period of the previous year. In real terms, prices have come down slightly.

Against this backdrop, the affordability of housing improved somewhat in 2014, as measured by the indicator developed by the NBB and presented in Box 4 of its 2012 Annual Report. After all, the debt service burden on mortgage loans as a part of household disposable income generally eased during the year under review, as both property prices and mortgage rates fell.

The empirical literature describes a range of methodologies for assessing property market valuations, which roughly break down into two categories. The first comprises traditional indicators, i.e. simple ratios of macroeconomic variables expressed as the deviation from their long-term average. Two of the most commonly used – price-to-income and price-to-rent – compared property price developments with household incomes and rents, and both ratios typically point up a strongly overvalued Belgian property market. OECD figures put this overvaluation in the third quarter of 2014 at 50.2 % and 55.3 % respectively.

These yardsticks, which are relatively easy to apply, have their limitations and their outcomes need to be interpreted with caution. The theoretical concept of equilibrium underlying this method of valuing the property market is approached on the basis of the indicators' long-term averages. This is a weighty hypothesis, as it presumes that the equilibrium value is constant over time, whereas it fluctuates in line with changes in the fundamental determinants of property prices, such as interest rate levels, demographics, the preferences of economic agents, mortgage contract features and applicable tax treatment.

VALUATION OF THE BELGIAN RESIDENTIAL PROPERTY MARKET

(percentage deviation from the long-term average,
in the third quarter of 2014, unless otherwise stated)

Indicator	Value
Ratio price-to-rent	55.3
Ratio price-to-income	50.2
Interest-adjusted affordability index	28.0
Econometric regression (1)	3.6

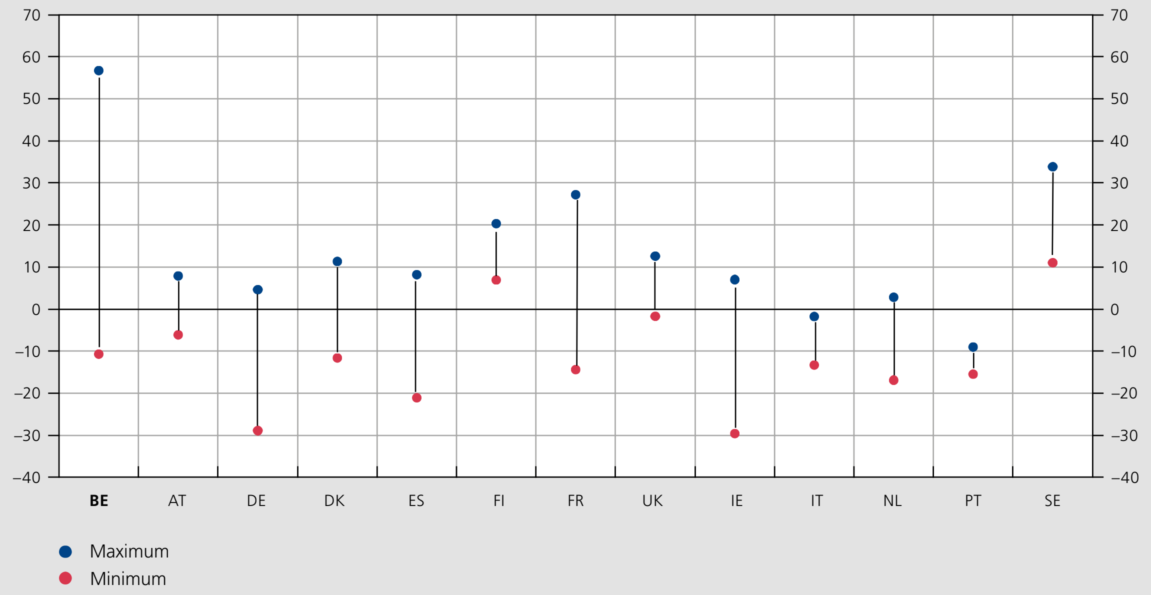
Sources: OECD, NBB.
(1) Percentage deviation from the equilibrium value as estimated by the model.

In the case of the price-to-rent ratio, there is a key conceptual difference in that house prices (in the numerator) are based on new secondary market transactions and therefore reflect market conditions, while rents (in the denominator), which in Belgium correspond to the rent component of the consumer price index, usually reflect the rents under existing leases rather than new leases. In addition, as rents in Belgium are subject to various legal rules restricting increases over time, such as (non-obligatory) annual indexation on the basis of the health index, the results obtained essentially reflect those index movements. Lastly, Belgium's relatively small rental market also detracts from the relevance of the price-to-rent ratio.

The price-to-income ratio is then adjusted for movements in mortgage rates, a major influence on household borrowing capacity, giving "interest-adjusted affordability". This indicator – which is invariably expressed relative to a long-term average – suggests that the Belgian housing market was 28 % overvalued in the year under review.

The second approach for assessing property market valuation is based on econometric techniques, the aim being to use fundamental determinants to fix an equilibrium price which can then be taken as the benchmark for measuring deviations in recorded prices. More specifically, this indicator corresponds to the residuals from the regression of a series of fundamental determinants of residential property prices, i.e. average household income, mortgage interest rates, the number of households plus a binary variable to help take account of changes in 2005 to the tax treatment of mortgage loans. This approach would put the Belgian property market at near-equilibrium, a stark contrast with the outcome of the traditional approach.

RESIDENTIAL PROPERTY MARKET VALUATIONS IN A SELECTION OF EUROPEAN COUNTRIES (1)
(in %)



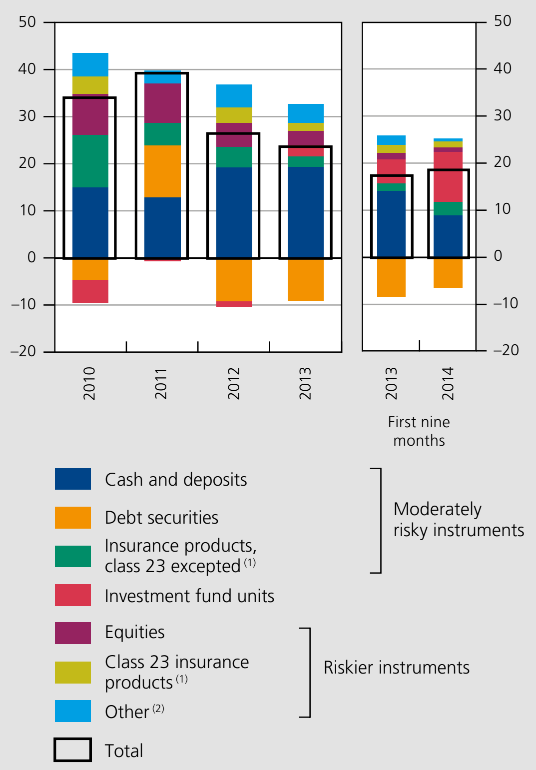
Source : ECB.
(1) Estimates reflecting four different approaches, i.e. price-to-rent, price-to-income and two indicators based on econometric regressions. Minimum and maximum points reflect the lowest and highest estimates of the four methods. For more information, refer to Box 3 of the June 2011 Financial Stability Review (ECB).

As in the case of financial assets, assessment of the fundamental value of property remains a perilous exercise, and the results must be viewed with caution. Despite its unmistakable advantages – factoring in fundamental market determinants and not establishing the market's equilibrium value on the basis of a long-term average – the econometric approach is not without its flaws. The gap between recorded prices and the equilibrium price might be down to the omission of one or more fundamental determinants, or to the explanatory variables deviating from their own long-term equilibrium values, as is the case with abnormally low mortgage rates. Another example would be the announcement – and in the case of the Flemish Region the early implementation – of measures reducing tax relief on mortgage loans, a decision that could significantly depress house prices in 2015.

The analysis for the euro area countries as reported by the European Systemic Risk Board reveals that major valuation gaps between methods are no typically Belgian phenomenon. However, price-to-rent and price-to-income are completely out of step in Belgium.

In the first three quarters of 2014, Belgian households accumulated new financial assets worth € 18.7 billion (compared with € 17.5 billion in the same period of 2013). That said, their new liabilities also exceeded those in the first nine months of 2013, at € 8 billion. Overall, the balance of households' financial transactions contributed € 10.7 billion to the increase in their net financial wealth between January and September – slightly down on the € 12.1 billion recorded in the same period of 2013.

CHART 47 FORMATION OF FINANCIAL ASSETS BY HOUSEHOLDS: BREAKDOWN BY ASSET CLASS
(in € billion)



Source: NBB.
(1) These items comprise the net claims of households on technical insurance reserves and on standardised guarantee schemes.
(2) This item comprises households' pension entitlements and, insofar as they have been recorded, export credit as well as miscellaneous claims on general government and financial institutions.

The financial liabilities of households comprise mainly mortgage loans. In net terms, refinancing of current loans are not included, as these do not affect total volumes of household liabilities. Like their assets, households' total net financial liabilities continued to rise in 2014 to reach € 245.6 billion at the end of September, compared with € 235.4 billion in the comparable nine-month period.

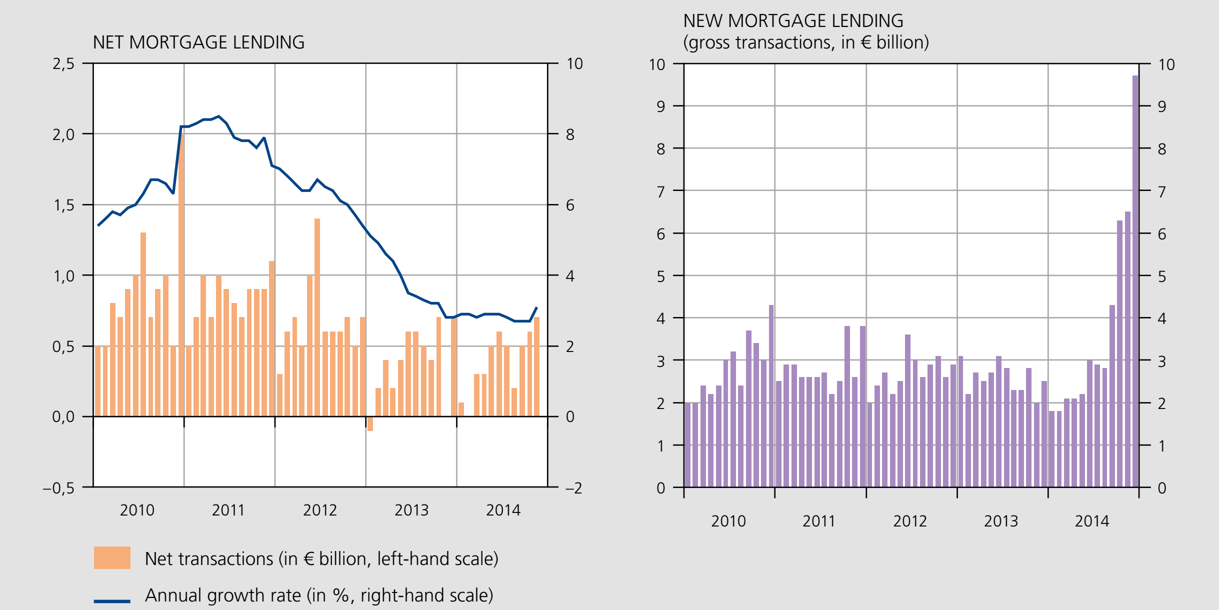
Households partially refocus new investment to riskier assets

In 2014, households redirected a greater proportion of their savings to investment products than in 2013. Falling consumer confidence and continued fragile economic prospects have led households to retain a significant amount of precautionary savings: short-term liquid assets accounted for a large proportion of savings in the first six months of the year.

The financial assets acquired by households can be divided into three categories of instruments, according to the nature of the associated risk: assets bearing a low risk, including cash, deposits, debt securities and insurance products (except class 23); higher risk products such as equities and class 23 insurance products; and finally, units in investment funds, which combine moderately risky products (bond UCIs) with other, riskier products (equity UCIs, mixed funds and funds of funds). According to data from the Belgian Asset Management Association, it was mainly the latter that attracted the interest of investors in 2014, which is why these are ranked among equities and class 23 insurance products in this Report.

According to this breakdown, riskier instruments would seem to account for a large proportion of new investment

CHART 48 MORTGAGE LENDING



Source: NBB.

in financial assets by Belgian households in the first nine months of 2014 (€ 13 billion, compared with € 8.2 billion in the comparable period of 2013). Although cash and deposits remain sought-after instruments, claiming € 8.9 billion of new investment, households have also invested in investment fund units and equities, for a total amount of € 11.6 billion.

As for moderately risky assets other than cash and deposits, € 2.8 billion of household savings went into insurance products, class 23 products excluded. This compares with € 1.6 billion in the first three quarters of 2013.

As in previous years, households completely ignored debt securities. Sales and redemptions of these instruments exceeded purchases and subscriptions by € 6.5 billion, compared with a € 8.4 billion negative flow in the first nine months of 2013.

Investment in investment fund units was sharply ahead of the 2013 figures: € 10.7 billion in the first three quarters of 2014, compared with € 5.2 billion in the same period of the previous year. Virtually all investment went into non-monetary investment funds.

Households invested a little less in equities than they had in 2013, with net equity investment amounting to € 0.9 billion in the first nine months of 2014, compared with € 1.3 billion from January to September 2013.

Class 23 insurance products, the other instruments in the riskier category largely linked to individual life insurance, attracted € 1.3 billion, one-third of total new insurance product transactions. These instruments had accounted for € 1.7 billion in the first three quarters of 2013.

Mortgage loans see moderate net growth despite intensive refinancing activity

Various factors influenced the growth of new household loans in the year under review, and more specifically the signing of new mortgage contracts, as the deteriorating economic climate of the spring of 2014 affected the formation of new financial liabilities by households. Specific developments such as the ongoing fall in mortgage rates and changes in the tax treatment of property loans (tax rebates on mortgage interest) sharply pushed up (gross) demand for loans. The demand spike was particularly noticeable in the second half of the year and took the shape of a significant increase in refinancing volumes – which did not affect net demand – and higher levels of new loans for the new construction, purchase and/or renovation of homes. As a result, annual growth rates of property loans remained moderate – and relatively steady – in 2014, at around 2.8 %. This percentage shot up to 3.1 % by the end of the year, as households anticipated changes in the law on mortgage interest relief.

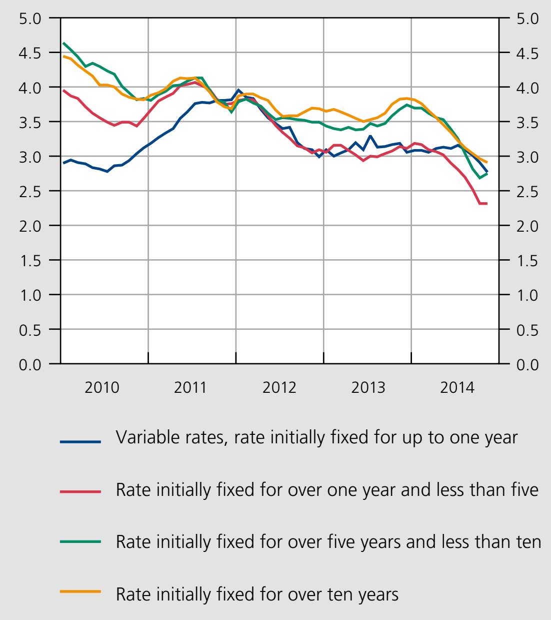
In the first nine months of 2014, net volumes of new loans contracted by households – both mortgage loans and consumer credit – rose from € 5.3 billion in the comparable period of 2013 to € 7.9 billion. On the one hand, new mortgage loans edged down from € 4.2 billion in 2013 to € 3.8 billion in the first nine months of 2014, reflecting households' wait-and-see attitude in the period. Taking account of reclassification and other adjustments, households' total mortgage debt came to € 185.5 billion by September 2014, compared with € 181.8 billion at the end of 2013. On the other hand, the total increase in new financial liabilities was partly attributable to new long-term non-mortgage loans, the net volume of which amounted to € 1.7 billion in the first nine months of 2014, compared with a slightly negative figure of € 0.1 billion in the same period of last year. Higher new financial liability volumes have further pushed up households' debt ratio, to 103.5 % of their disposable income in September 2014, as against 101.1 % at the end of 2013.

Housing investment and new mortgage contract growth remained subdued in the wake of restrictive bank lending conditions (disregarding interest rates) and the greater challenge for households to financially secure their new loans due to the rather limited rise in disposable incomes. The bank lending survey found that banks further tightened their mortgage lending criteria in the second and fourth quarters of the year in view of general economic conditions and housing market-related risk trends. Mortgage lending criteria remained fairly tough in 2014: banks have yet to ease mortgage loan conditions tightened up in 2012 during the sovereign debt crisis.

However, in the second half of the year, households were keen to lock in persistently falling mortgage rates, which have plumbed historic lows, particularly by refinancing. In keeping with benchmark rates, mortgage loans recorded uninterrupted falls in interest rates as the year progressed. Loans with original maturities of over ten years came down by 93 basis points to 2.9 % between December 2013 and November 2014.

From September 2014, the CICR recorded a significant increase in new mortgage loans: between September and December an average 67 300 mortgage contracts were agreed, compared with an average 22 000 a month between January and August. The amounts involved were also slightly higher. However, the overall number of loans has failed to keep up with this pace, suggesting that part

CHART 49 MORTGAGE LOAN COSTS
(in %)



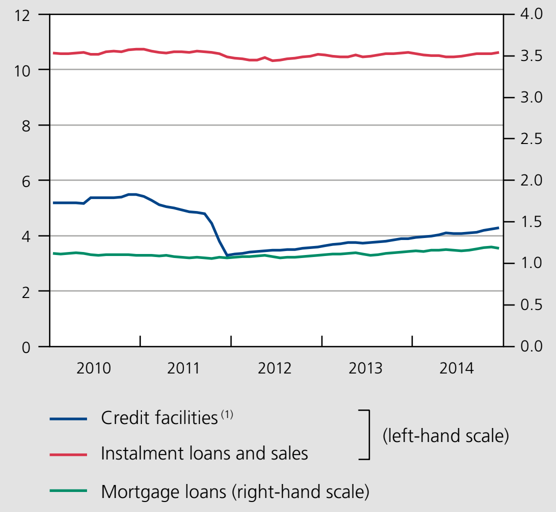
Source: NBB.

of the upturn was down to refinancing. But even ignoring any refinancing effect, the home loan market has become more dynamic since September. The situation may reflect some front-loading related to tax treatment reforms introduced by the Flemish government, which has decided to cut the maximum mortgage rate reduction for would-be buyers from 2015, from € 2 280 to € 1 520 (amounts increased by € 760 in the first ten years). Starting in 2015, the tax break will be reduced to 40 % in Flanders. The number of residential building permits, an indicator anticipating the start of construction work roughly three months before, reached record highs in March and April of 2014, exclusively due to figures from Flanders.

Risks related to private individuals' debt limited on balance, if a heavier burden on some categories

Statistics from the CICR reveal an upward trend in the number of non-regularised defaults on mortgage loans since mid-2012, amounting to 1.2 % of total loans outstanding at the end of November 2014, the highest level since 2007. Though this low percentage is no cause for concern, this indicator should be closely monitored, particularly in the event of economic stagnation. As Box 9 shows, some categories, including the young, those on the

CHART 50 NON-REGULARISED DEFAULTS
(in % of the number of current loans)



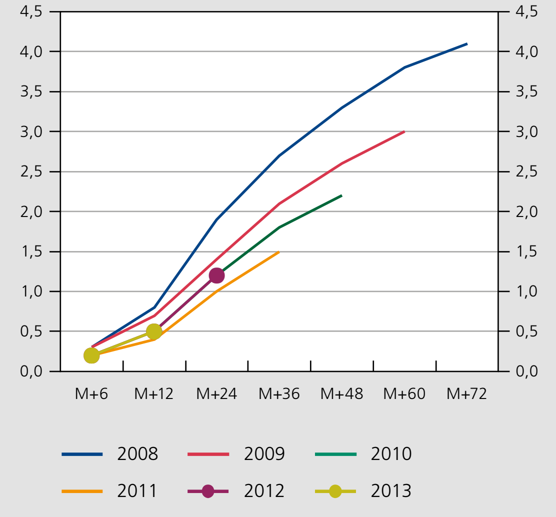
Source: NBB.
(1) Credit facilities showed a statistical break at the end of 2011, which was due to the Central Individual Credit Register's increased scope. Since the end of 2011, authorised current account overdrafts have needed to be recorded in the Register, whereas this did not previously apply if the facility was less than € 1 250 and was repayable within three months.

lowest incomes and highly leveraged households, are more at risk. Lastly, the average level of arrears and amounts due rose to € 38 400 at the end of November 2014 from € 36 400 at end-December 2013, a 5.5 % increase.

In the case of revolving credit facilities – which since end-2011 include current accounts allowing overdrafts – defaults continued to rise in 2014: defaults recorded on this type of loan amounted to 4.3 % of all contracts in November, an increase of 0.4 percentage point on the end-2013 figure. The amounts involved are smaller than in the case of mortgages: an average of € 1 700 per default. Default rates on instalment loans and sales held steady in the year under review, accounting for 10.7 % of the total number of loans outstanding at the end of 2014. Default amounts stood at nearly € 1 200 for instalment sales and at around € 7 800 on instalment loans.

An analysis of annual default ratios for a range of credit types might show up changes to credit conditions imposed by banks or any post-financial crisis intensification of repayment problems. Instalment sales excepted (an unusual category anyway, as contracts have slumped in the past years), no significant increase in default rates has been recorded since the economic and financial crisis first took hold. In fact, for mortgage loans successive cohort curves fundamentally declined in the 2008-2011 period, which points to an improved – and downward – trend in defaults between these two years. Default rates edged back up from these record lows in 2012 and 2013, but have remained low.

CHART 51 DEFAULTS ON MORTGAGE LOANS (1) BY YEAR OF GRANTING (2)
(in % of the number of loans)



Source: NBB.
(1) A default is recorded if the sum due remains fully or partly unpaid three months after due date, or if the sum due remains fully or partly unpaid after a demand by registered letter, or if the sum is fully or partly unpaid a month after formal notice has been served by registered letter.
(2) Loans are grouped according to the year of origination. For each year, the curves show defaulting loans as a percentage of the original total number of loans after a certain number of months from the date the facility is granted. Any loan regularisations are disregarded.

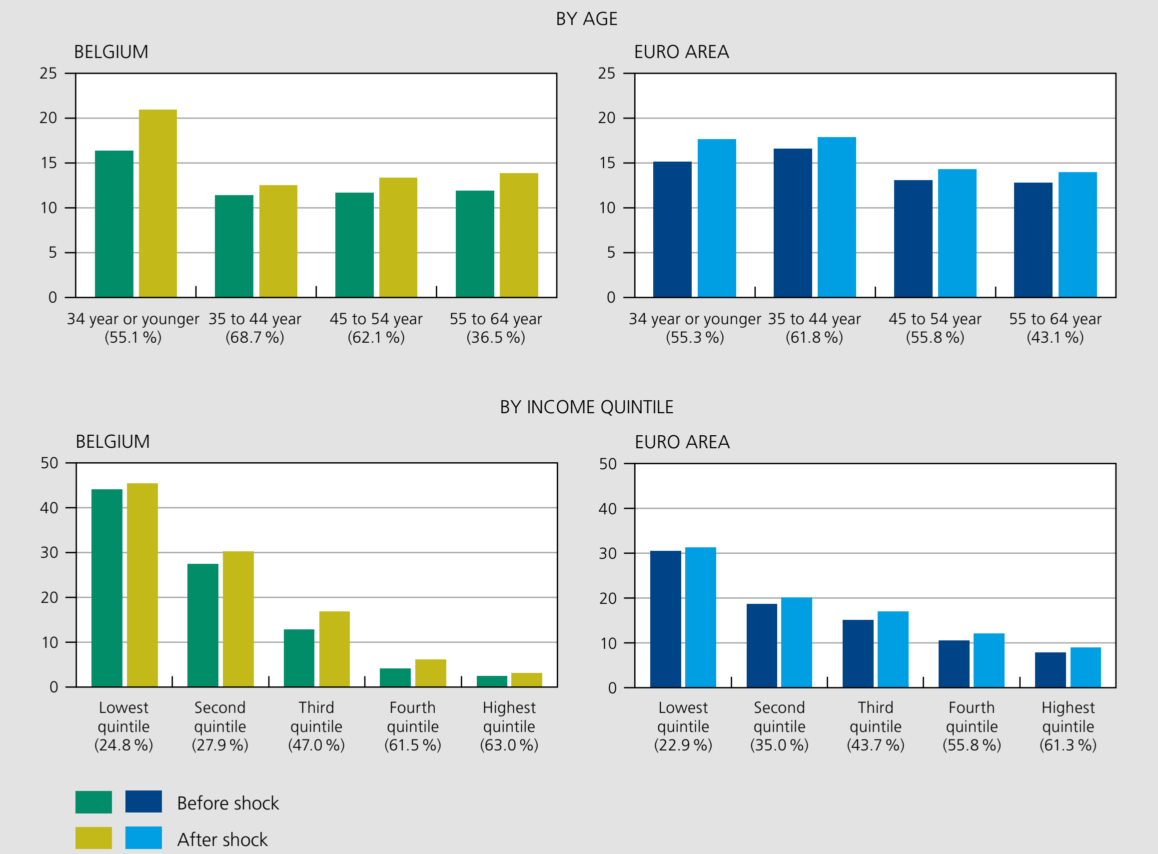
Box 9 – Household debt sustainability: effect of income shocks on the repayment capacity of Belgian households

The financial accounts data show total debt to be pretty favourable for Belgian households. However, these aggregate statistics provide a total debt overview for all households taken together, regardless of their levels of indebtedness, and do not enable deeper research into the borrowing capacity of specific groups or individual households. And so it is useful to estimate the effect of macroeconomic shocks on the debt sustainability of individual households based on microeconomic data. Using data derived from the Household Finance and Consumption Survey (HFCS) for 2010, this Box investigates the effects on household sustainability and, more specifically, on the repayment capacity of households.

HFCS data show that less than half of all Belgian households are indebted, by mortgage loans or otherwise. Participation in the credit market is 44.8 % in Belgium, compared with 43.7 % in the euro area. Belgian household

SENSITIVITY OF DEBT-SERVICE-TO-INCOME RATIO TO AN INCREASE IN UNEMPLOYMENT (1) (2)

(number of households with a debt-service-to-income ratio of over 0.3, in % of indebted households)



Sources: ECB, NBB (HFCS).

(1) In the simulated income shock, employees stand a 5 % chance of losing their jobs and income from employment (10 % for employees under 35 and over 55), after which they will have to draw unemployment benefit.

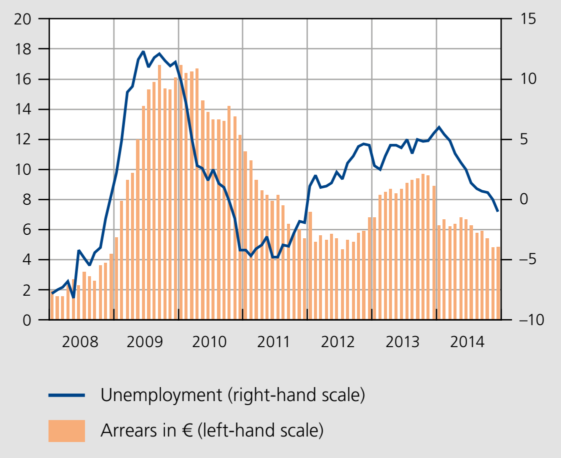
(2) In brackets: indebted households in % of total households of the comparable group.

debt can be analysed more closely by breaking down households into age groups and income quintiles (1). Credit market participation exhibits a hump-shaped age profile both in Belgium and in the euro area, with participation initially rising with age, from 55.1 % for the youngest households (in which the reference person is under 35) to a peak of 68.7 % for the 35-44 age group, and then coming down again. Credit market participation increases with income, from 24.8 % in the lowest income quintile to 63 % for the highest. Households with higher incomes find it easier to get and repay loans. Outstanding loans typically exhibit age and income profiles similar to the participation rate.

Total outstanding debt levels for households provide no information on the repayment capacity of individual households. A frequently used indicator in this context is the debt-service-to-income ratio, which measures the proportion of income that is needed to repay the debt and meet interest payments. Academic studies suggest that households which spend more than 30 % of their income on servicing debt potentially run higher liquidity risks. According to HFCS data, the proportion of households with a debt-service-to-income ratio of over 0.3 stood at 12.9 % of all indebted households in Belgium, compared with 14.1 % for the euro area.

Not all household categories run the same risk of too high a debt-service-to-income ratio. Indebted young families potentially run a slightly higher risk, and the share of households with problem debt ratios also falls with income levels. Belgium's age and income profiles related to potential debt service issues are both slightly more pronounced than in the euro area: although the proportion of households with problem debt-service-to-income ratios is smaller in Belgium on average, the share of youngest households (16.3 %) exceeds the figure for the euro area (15.2 %). In the lowest income quintile, 44.2 % of Belgian indebted households exhibit debt-service-to-income ratios of over 0.3, compared with 30.6 % for the euro area. The share of indebted households with problematic

UNEMPLOYMENT AND HOUSEHOLD DEFAULT
(annualised percentage changes)



Sources: NEO, NBB (CICR).

debt ratios is bigger for Belgium's lowest income quintiles than for the euro area. Belgium's more pronounced age and income profiles – accounting for a relatively higher risk than in the euro area for the youngest households and households in the lowest income group – reflect different patterns in property ownership and related mortgage

(1) Du Caju Ph. (2013), "Structure and distribution of household wealth: An analysis based on the HFCS", NBB, *Economic Review*, September, pp. 41-63.

loans. Unlike the euro area, Belgium typically has the highest loans in the youngest indebted households, reflecting faster and more general access to home ownership: 46 % of households with a reference person under the age of 35 own their own home, compared with only 31.9 % in the euro area.

Drawing on HFCS data, a simulation can be used to gauge the effects of an income shock on the debt sustainability of households and their capacity to keep repaying their debts. More specifically, it analyses the consequences of an upturn in unemployment that threatens to destroy the jobs of 10 % of employees under the age of 35 and over the age of 55, with 5 % of employees in the middle age brackets hit (1). After all, youth unemployment tends to be more cyclical and corporate restructurings typically end in older employees being made redundant. All other things being equal, the shock would push up unemployment by nearly 4 percentage points. This static simulation does not factor in any behavioural adjustments, changes in the the labour force or feedback effects.

Loss of income from employment and its replacement by unemployment benefits can turn a family's debt position into a problem. The chances of this happening depend on their basic financial situation before the shock, the amount of outstanding debt and other sources of income. Under this simulated unemployment shock, the share of families with a debt-service-to-income ratio of over 0.3 would rise from 12.9 % to 14.9 % in Belgium and from 14.1 % to 15.5 % in the euro area, with the relatively stronger impact in Belgium affecting mostly young families. The share of indebted families in the under-35 bracket and with a debt-service-to-income ratio of over 0.3 would climb from 16.3 % to 20.9 % in Belgium and from 15.2 % to 17.7 % in the euro area. The unemployment shock's impact on household debt sustainability would be fairly evenly distributed across the income groups (quintiles). Belgian families in the lowest and middle income groups prove more vulnerable than those in the euro area. Middle incomes in Belgium have a lot of double-income, steeply mortgaged couples whose outstanding debt is generally higher than in the euro area.

The outcomes of these simulations are broadly confirmed by trends in arrears as registered with the CICR (2). Between 2008 and 2014, changes in the number and size of arrears in Belgium closely mirrored unemployment trends, with CICR data confirming that younger people struggle more with arrears on their loans. A more pronounced correlation between repayment problems and unemployment rates is also noted, with most of the defaults concerning non-mortgage loans.

(1) Du Caju, Ph., F. Rycx and I. Tojerow. Unemployment risk and financial fragility: a microeconometric perspective. NBB Working Paper, forthcoming
(2) Du Caju, Ph., Th. Roelandt, Ch. Van Nieuwenhuyze and M.-D. Zachary (2014). "Household debt: Evolution and distribution", NBB, *Economic Review*, September, pp. 65-85.

3.3 Non-financial corporations

In the first three quarters of 2014, the financial transactions of non-financial corporations were heavily influenced by historically low interest rates coupled with a fragile and tentative economic climate. Despite better funding conditions, corporations took on fewer new financial liabilities, although the net fall was not as steep as in the comparable period of 2013 and was the outcome of trends pulling in many different directions. Bank lending to large companies fell further, as they increasingly tapped the capital markets by issuing bonds and equities. By contrast, bank lending to small and medium-sized enterprises (SMEs) picked up slightly in 2014. As loan conditions have eased, the overall drop in total external funding would appear to point to ongoing relatively weak investment demand, possibly caused by increased uncertainty, sluggish final demand and a deteriorating outlook for economic growth. These factors also partly explain why corporations piled up liquid assets in anticipation of future investment.

Companies see their net financial liabilities increase on the back of rising stock market prices

In the first nine months of 2014, the financial liabilities of non-financial corporations grew by € 24.5 billion in total, whereas their assets added only € 2.3 billion, taking their net financial liabilities € 22.2 billion higher to € 369 billion (or 92.1 % of GDP) by the end of September 2014. As in 2013, the balance of financial transactions was negative in

TABLE 13 FINANCIAL ASSETS AND LIABILITIES OF NON-FINANCIAL CORPORATIONS
(in € billion)

	Outstanding amount		Change from December 2013		
	End of 2013	End of September 2014	Total	Transactions	Other flows [1]
Financial assets	1 265.9	1 268.2	2.3	–4.8	7.1
of which:					
Cash and deposits	112.2	116.6	4.4	1.5	3.0
Debt securities	20.2	11.6	–8.6	–8.4	–0.2
Listed shares	89.9	90.5	0.5	0.5	0.0
Unlisted shares and other equity	405.1	417.8	12.7	11.5	1.2
Loans	363.4	371.0	7.6	5.2	2.4
Trade credit	146.2	135.2	–11.1	–11.3	0.3
Other assets [2]	128.7	125.5	–3.2	–3.7	0.4
Financial liabilities	1 612.6	1 637.2	24.5	–5.3	29.9
of which:					
Debt securities	37.9	40.8	2.9	2.3	0.6
Listed shares	199.1	229.0	29.9	3.3	26.7
Unlisted shares and other equity	717.3	717.5	0.2	–5.4	5.6
Loans	499.8	504.5	4.7	6.0	–1.3
Bank loans	147.1	146.5	–0.5	–0.3	–0.2
Non-bank loans	352.7	358.0	5.2	6.3	–1.0
Trade credit	134.3	120.7	–13.6	–12.2	–1.3
Other liabilities [3]	24.3	24.7	0.4	0.7	–0.3
Net financial assets	–346.8	–369.0	–22.2	0.5	–22.7

Source: NBB.
(1) Comprising both "valuation effects" and "other volume changes".
(2) Primarily statistical adjustments.
(3) Almost exclusively other debt, with the exception of trade credit.

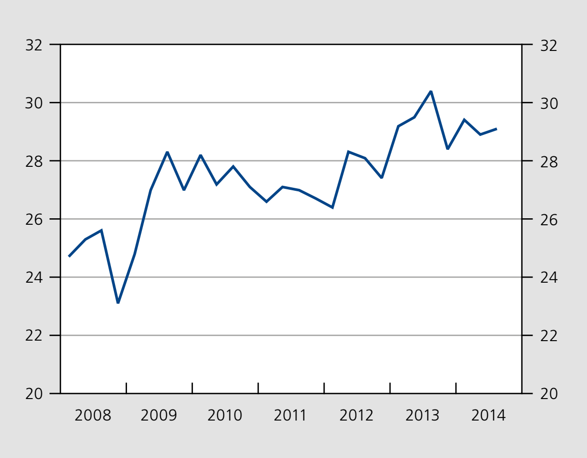
the first three quarters of 2014, both for liabilities and for assets. The shortfall was more than offset by positive changes in corporate financial positions on the back of rising stock market prices and a number of reclassifications.

Total financial assets and liabilities of non-financial corporations mainly reflect cross-balance-sheet positions: almost one-fourth of non-financial corporations' liabilities are held by other resident non-financial corporations, often in the shape of inter-company positions, and about half by foreign companies and holding companies, which will henceforth be recognised under the financial sector (see section 3.1). Around 30 % of total financial assets of non-financial corporations have resident non-financial corporations as their counterparty; foreign companies and holding companies account for 60 %. It is of course quite likely that not all transactions with foreign companies or holding companies are inter-company transactions, but these figures probably serve as a reasonable approximation of such transactions. Instruments used in cross-positions are primarily unlisted equities and other equity, as well as non-bank loans.

Total financial liabilities grew less robustly than in the comparable period of 2013, and mostly advanced as listed shares, non-bank loans and debt securities. The € 29.9 billion surge in listed shares mostly reflects rising stock market prices and only slightly the net issuance of new shares. Outstanding debt securities at the end of September 2014 recorded a total value nearly € 3 billion up on the end of 2013, on the back of positive net issuance. Outstanding loans also increased, by € 4.7 billion, but these were exclusively facilities furnished by sectors other than MFIs. All in all, corporations tapped the financial markets for their external funding and relied less on bank loans, while also using less trade credit.

CHART 52 CASH AND DEPOSITS HELD BY NON-FINANCIAL CORPORATIONS

(outstanding amount, in % of GDP)



Source: NBB.

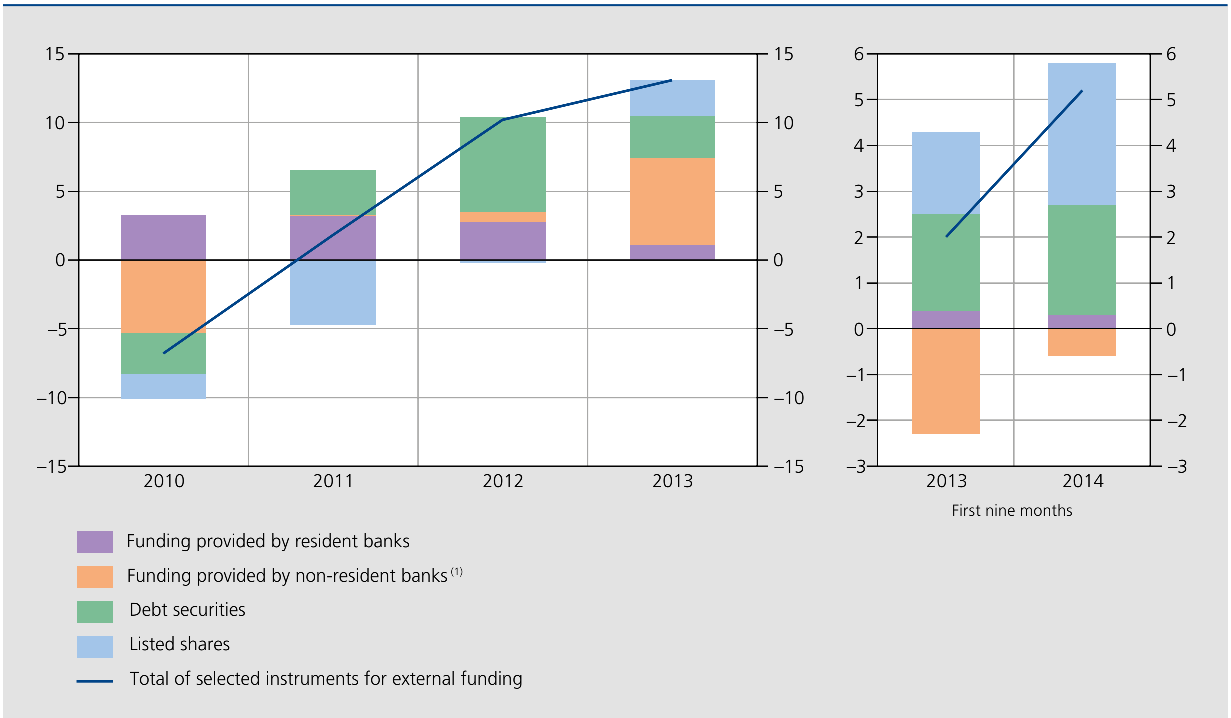
On the assets side, non-financial corporations' balance sheets recorded positive developments for unlisted shares and other equity, lending and cash & deposits. Conversely, they furnished fewer trade loans and held fewer debt securities.

Corporations continue to enjoy ample financial reserves

Recording a further increase of around € 4.4 billion in the first nine months of the year under review, cash and deposits outstanding at non-financial corporations amounted to € 116.6 billion by the end of September 2014, or 29.1 % of GDP – a hefty cash reserve when compared with the average since 1999 of 24 % of GDP. Non-financial corporations have been improving their profitability since 2013, but a dearth of attractive real and financial investment opportunities has kept them from dipping into their financial reserves. They will be able to draw on these reserves to complement external funding when implementing investment projects as soon as the economic recovery gathers momentum.

CHART 53 SELECTION OF NEW FINANCIAL LIABILITIES OF NON-FINANCIAL CORPORATIONS

(consolidated data, in € billion)



Source: NBB.

(1) Whereas net lending by non-resident banks was negative for the first nine months of 2013, the positive full-year figure reflected an exceptional transaction in the fourth quarter.

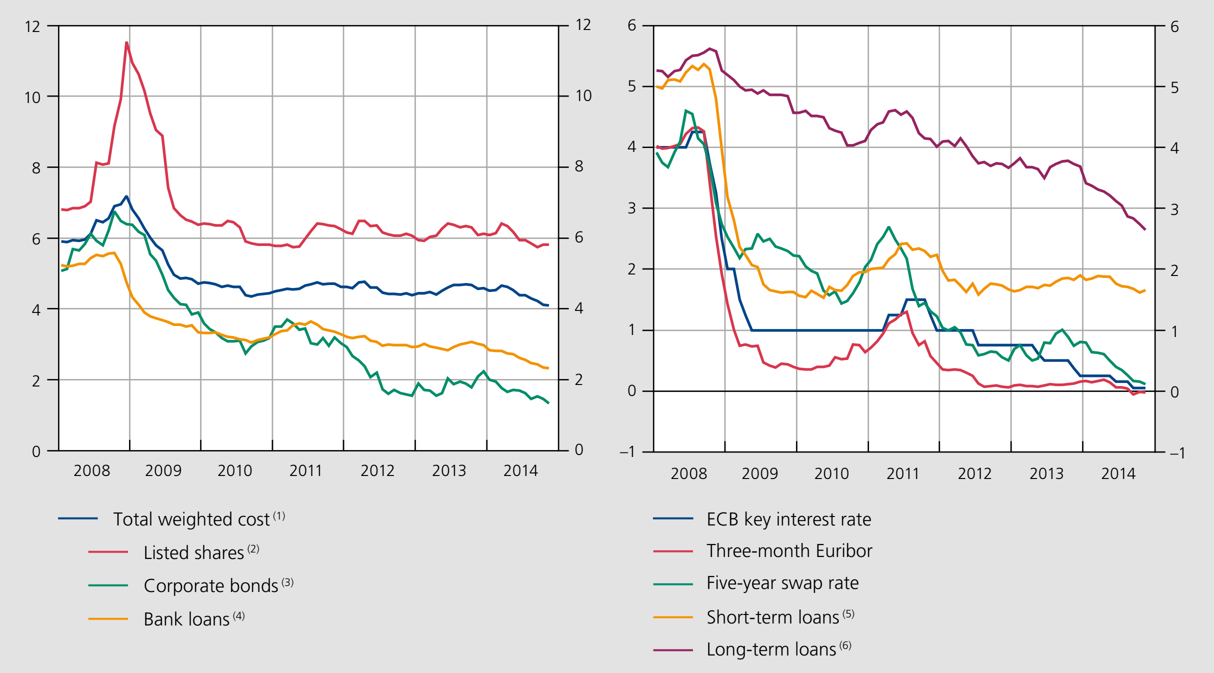
Companies used more long-term market instruments to finance their operations

Funding transactions will now be reviewed on a consolidated basis and so ignore funding from other resident non-financial corporations. What results is still an unavoidably distorted view, however: the figures are not adjusted for any funding provided by holding companies and associated companies incorporated abroad, as sufficiently detailed information is lacking.

The consolidated data show corporations to have reduced their total financial liabilities by € 0.6 billion in the first three quarters of the year under review, compared with a net increase of € 5.1 billion in the comparable period of 2013. The figures primarily reflect a net € 7.1 billion fall in unlisted shares and other equity. A large proportion of this may well be down to cross-holdings within the same group, as holding companies and foreign companies together account for around 90 % of the fall. Non-financial corporations did tap the markets more in the first nine months of the year under review, using long-term market instruments in particular. They did not just increase the issuance of listed shares – the very embodiment of long-term financing – but also issued more debt securities, particularly long-term ones.

Corporations again borrowed less from banks in the first three quarters of 2014, but the net € 0.3 billion fall was wholly attributable to short-term credit trends. Resident banks granted as many short-term loans as there were repayments, but short-term lending by non-resident banks continued to decline. The same was true for their long-term loans, but this was offset by non-financial corporations drawing on more long-term credit from resident banks. Besides, non-financial corporations also issued new debt securities in the first nine months of the year under review. Consolidated net debt securities issuances totalled € 2.4 billion, compared with € 2.1 billion in the comparable period of 2013, breaking down into long-term debt securities at € 1.9 billion and short-term issuance worth only € 0.5 billion. For corporations able

CHART 54 EXTERNAL FUNDING COSTS OF NON-FINANCIAL CORPORATIONS
(monthly data, in %)



Sources: Barclays Capital, Thomson Reuters Datastream, NBB.

(1) Obtained by weighting the cost of funding by listed share issuance, bond issues and bank loans according to their respective share in the total outstanding amount of these financial liabilities.

(2) Estimated on the basis of a dividend discount model (see Box 19 in the 2005 Annual Report).

(3) Return on an index of euro-denominated bonds issued by Belgian non-financial corporations, with maturities of more than one year and with a rating in excess of Baa; the index is weighted according to the outstanding amounts.

(4) Weighted average rate applied by resident banks to business loans. The weighting is based on the outstanding amount of the various types of credit.

(5) Interest rate on new bank loans of more than € 1 million at variable rates, initially fixed for up to one year.

(6) Interest rate on loans of € 1 million or less, with a rate initially fixed for more than five years.

to issue bonds, this type of market funding was again relatively attractive when compared with bank loans, as interest charges on bank lending are invariably higher (see below). And although the issuance of listed shares comes at a steep cost, corporations increasingly draw on these instruments too: on a consolidated basis, they issued € 3.1 billion in listed shares, compared with € 1.8 billion in the comparable period of 2013.

Funding environment for corporations improved significantly

On the whole, non-financial corporations saw their funding environment improve massively from the end of 2013, which was reflected in lower costs of a range of external funding sources. A number of surveys of banks and entrepreneurs also found that general funding conditions – price and non-price – have improved both for large companies and to a lesser degree also for SMEs.

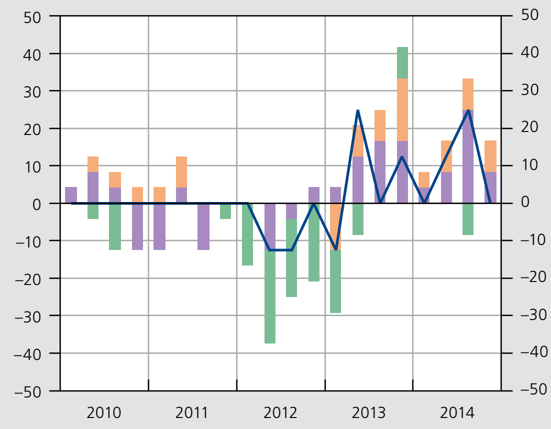
Corporations' total financing costs – calculated by weighting the nominal cost of each funding source according to its respective share in the total outstanding amount of its financial liabilities – fell further in the year under review, to historic lows. The average financing costs of all non-financial corporations taken together were estimated at 4.1 % in November 2014, compared with 4.6 % in December 2013. Note that this average masks sizeable differences between funding sources, with costs ranging between 1.3 % for corporate bonds and 5.8 % for listed shares. And although costs came down sharply in 2014 for all types of external funding, long-term bank loans and corporate bonds fell the hardest, by 105 and 90 basis points respectively.

In part, these reduced costs reflect accommodating monetary policies set by the ECB, which cut its key interest rate further and confirmed its forward guidance, sparking an immediate further drop in money market rates – and especially the long-term ones. The three-month swap rate fell by 18 basis points compared with end-2013, to –0.02 % in November 2014, while five-year swap rates were 70 basis points lower at 0.1 %. Effective interest rates on new bank loans to corporations also followed the downward trend: interest rates on short-term loans for amounts in excess of € 1 million fell from 1.9 % at the end of 2013 to 1.7 % in November 2014, while long-term loans initially fixed for more than five years dropped 105 basis points to 2.6 %.

The improved funding environment for non-financial corporations did not just reflect external borrowing costs but also non-monetary conditions. In a range of

CHART 55 CREDIT STANDARDS AND DETERMINANTS ACCORDING TO CREDIT INSTITUTIONS

(weighted net percentages of the responses by credit institutions (1))



Source: NBB (Eurosystem bank lending survey).

(1) The responses are weighted according to their distance from the "neutral" response: mention of a "considerable" change in the lending criteria is accorded double the weighting of a "slight" change.

(2) The degree to which lending criteria were eased (+) or tightened (–).

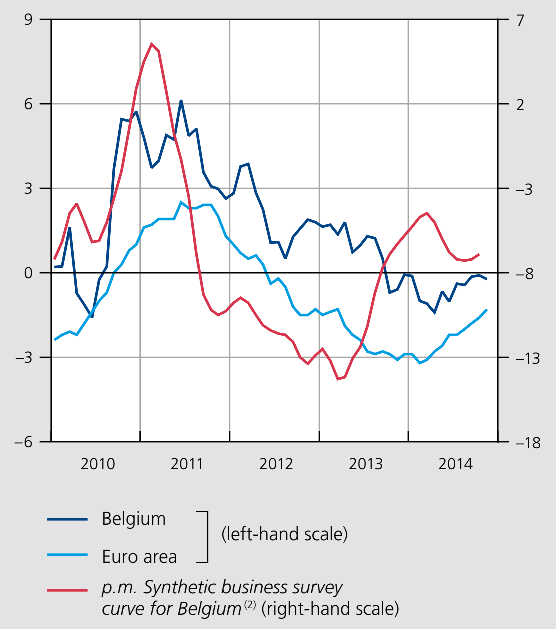
(3) A positive (negative) net percentage corresponds to a factor contributing to easing (tightening) the lending criteria. Average of net percentages for the various sub-questions.

qualitative surveys both banks and entrepreneurs agreed that the availability of external funding, and in particular of bank loans, had improved in the course of 2014. The Eurosystem's bank lending survey found that Belgium's four resident major banks had further eased their credit standards for corporate loans in the second and third quarters of 2014, as they had seen their own financing costs and balance sheet restrictions relax and competition pick up, although risk perceptions had heightened again and affected credit standards in the third quarter. This easing of borrowing conditions primarily showed up in improved monetary conditions – lower margins on corporate loans with average risk profiles – but banks also proved more relaxed about term to maturity, volumes and clauses in loans agreed. Better non-monetary conditions generally benefited large companies more than they did SMEs.

Another NBB survey revealed that business leaders also took a favourable view of general conditions for new bank loans in the second and third quarters of the year under review – for the first time since the second quarter of 2011. Positive sentiment primarily reflected a more favourable perception of bank lending rates, while views

CHART 56 LENDING BY RESIDENT BANKS TO RESIDENT NON-FINANCIAL CORPORATIONS [1]

(end-of-month data; annualised percentage changes, unless otherwise stated)



Sources: ECB, NBB.
(1) Including securitised loans.
(2) Smoothed indicator, balance of responses.

of non-monetary conditions continued to deteriorate, albeit to a lesser degree. The total net percentage score assigned to loan volumes came to –6 % in the third quarter of 2014 for all companies together, compared with –26 % in the first quarter of 2013, while the percentage had already turned positive for very large companies. Both surveys point to significant across-the-board improvements for large companies, while small and medium-sized enterprises mainly benefited from lower interest rates but not (yet) so much from easing of non-monetary criteria. These findings are corroborated by a third qualitative annual survey, the Survey on the Access to Finance of small and medium-sized enterprises in the euro area (SAFE), in which Belgian SME respondents reported easier access to bank loans between April and October 2014, for the first time since the survey was launched in 2009. SMEs with robust balance sheets, in particular, appeared to encounter fewer challenges in attracting outside funding, despite the subdued general economic climate. Lower interest rates were primarily cited, but far fewer SMEs reported that their loan applications were wholly or partly rejected by their banks.

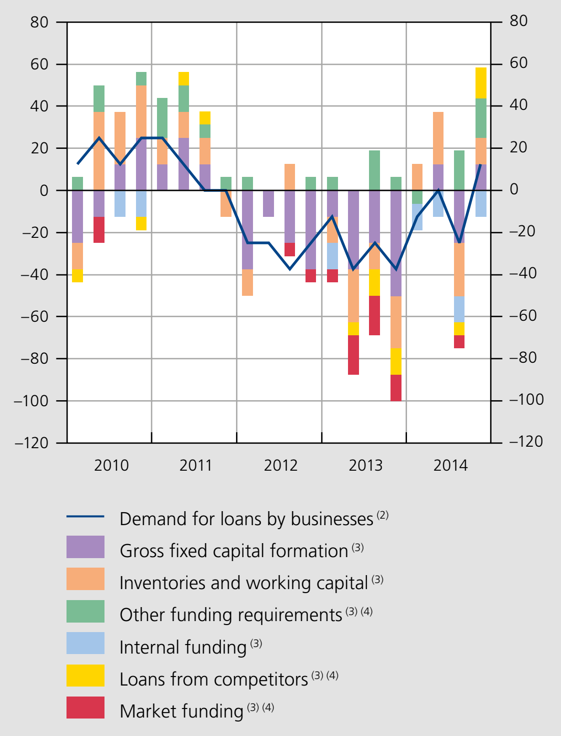
Weak bank loan growth mainly demand-related

Despite this robust improvement in the funding environment, bank lending to non-financial corporations continued to grow at a glacial pace in the first three quarters of 2014. With bank loans virtually the only source of debt financing for SMEs and given these companies' crucial role in Belgium's economy, the importance of stable bank lending cannot be underestimated.

According to resident banks' monthly statistics – still drawn up in keeping with the ESA 1995 definition of non-financial corporations – the annual percentage change in loans to corporations stayed negative in 2014. That said, the recent downtrend that started in May 2013 would now appear to have ended: by April 2014, the percentage change had plumbed an all-time low of –1.4 %. By November 2014, growth was at an annualised –0.2 %, comparable

CHART 57 LOAN DEMAND AND DETERMINANTS ACCORDING TO CREDIT INSTITUTIONS

(weighted net percentages of responses by credit institutions [1])



Source: NBB (Eurosystem bank lending survey).
(1) The responses are weighted according to their distance from the "neutral" response: mention of a "considerable" change in borrowing demand is accorded double the weighting of a "slight" change.
(2) The degree to which borrowing demand went up (+) or down (–).
(3) A positive (negative) net percentage corresponds to a factor contributing to borrowing demand going up (down).
(4) Average of net percentages for the various sub-questions.

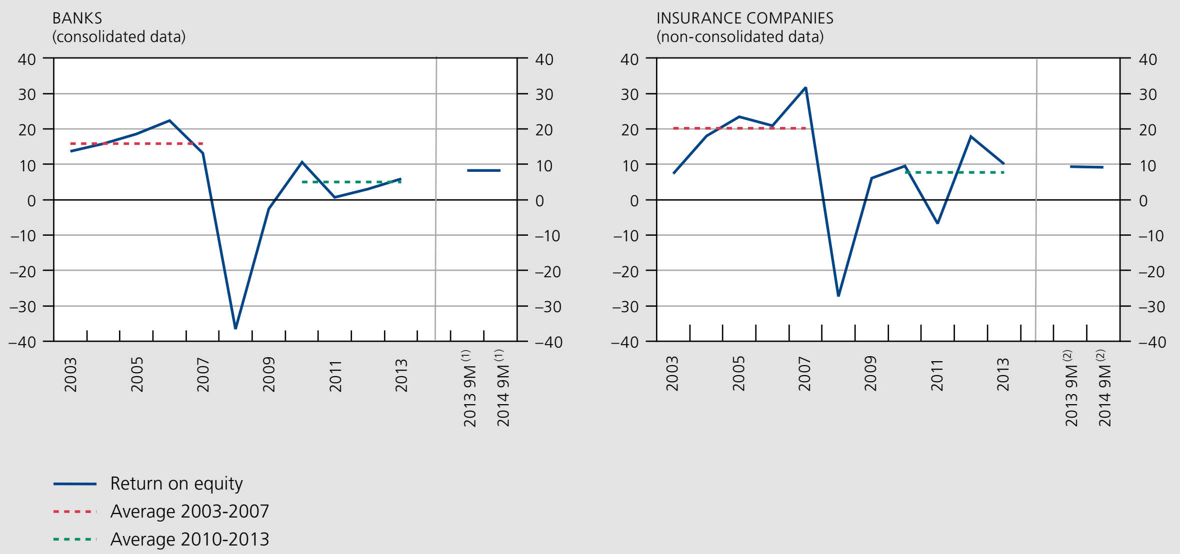
to end-of-2013 levels. More relaxed loan criteria notwithstanding, loans provided by resident banks to non-financial corporations continued to exhibit very subdued growth, underlining the key influence of sluggish demand.

Two factors of a very different nature could explain the sluggishness: continued reticence on the part of corporations to launch investment projects and corporations increasingly tapping non-bank funding sources, such as corporate bonds or equities. In the latter case, subdued bank loan growth need not be regarded as acting as a brake on future investment, but rather as a positive trend towards a more diversified financing structure and a more robust financial base for non-financial corporations. What is more, this would give the banks more room to lend to SMEs, which are typically too small to tap resources in the equity or bond markets. It is important to establish whether subdued bank credit growth is down to substitution by large companies or to a dearth of suitable investment projects.

According to the Eurosystem bank lending survey, Belgium's four resident major banks did indeed report that the demand for loans remained very weak and that it has consistently fallen since the beginning of 2012, only starting to pick up again in the fourth quarter of the year under review. Initially, it was only loan demand by large companies that contracted, but SME demand has also been declining since the end of 2012. The situation for large companies improved in 2014, but for SMEs, the net percentage has again remained negative since the third quarter. The banks blame corporations' weak demand for loans in recent years both on reduced gross fixed capital formation, inventories and working capital, and on increased use of alternative funding. Both factors showed similar trends in 2014, but banks would appear to have attached more importance to alternative funding, primarily internal resources, as the year progressed. Unfortunately, the data do not enable a breakdown into large companies and SMEs.

However, the available figures do allow for a breakdown by company size, and Central Corporate Credit Register data – still drawn up in keeping with the ESA 95 definition of non-financial corporations – suggest that credit expansion contracted much more sharply for large companies than for SMEs. Large companies saw annual growth come down from 13% in the 2005-2008 period to –4.4% between 2009 and the third quarter of 2014. For SMEs, the trend was much less marked, with average growth figures of 9.7% and 3% respectively. All things considered, these data present a somewhat clearer picture of the negative loan growth at resident banks: the contraction is

CHART 58 RETURN ON EQUITY
(in %)



Source: NBB.
(1) Annualised.
(2) Annualised based on quarterly reporting. Quarterly figures do not completely coincide with the annual figures, as they do not take account of any dividend payments to shareholders and insurance policy-holders.

mainly attributable to large companies, which have mostly swapped bank loans for bond issuance. This is not to say that lacklustre borrowing requirements did not have a key part to play: both lending to SMEs and debt financing of large companies merely edged up compared to their long-term averages.

3.4 Financial institutions

Profitability vulnerable at financial institutions

In the first nine months of 2014, Belgium's banking and insurance sectors returned profits of € 3.6 billion and € 1 billion respectively, comparable to the same period of 2013. Return on equity at Belgian financial institutions remained significantly lower than before the financial crisis.

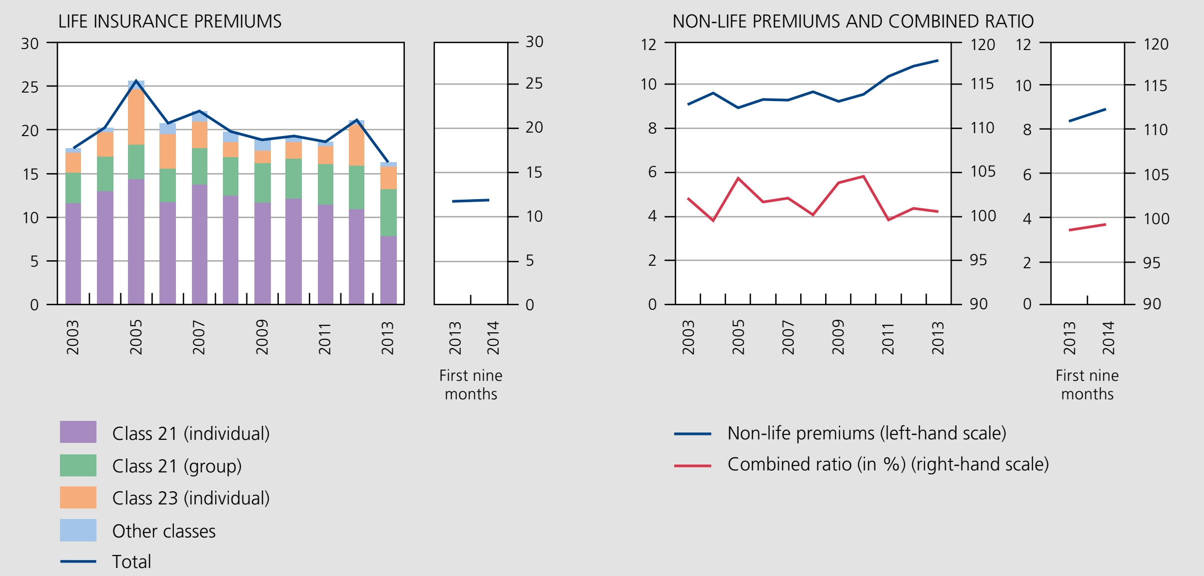
Economic conditions in Belgium and in the rest of the euro area – low interest rates coupled with weak economic activity – are squeezing the profitability of both banks and insurance companies. And although both have taken measures to combat their economic impact, continued poor conditions cannot be ruled out and financial institutions might feel compelled to adjust their business models and cost structures even further.

Weak economic growth curbs activity at banks and insurance companies

Recent sluggish economic trends have combined with the gloomy outlook to curb demand for core banking and insurance products. Weak loan demand has squeezed banks' net interest income, although some of them have been able to offset the shortfall with repo operations (loans collateralised by temporary transfer of securities), but repo-derived margins are typically much slimmer than those on traditional financial intermediation services. Against this backdrop, there was hardly any need for Belgium's banks to raise more funds via the Eurosystem in 2014, and their rather extensive call on the second targeted longer-term refinancing operation (TLTRO) was mostly prompted by the rollover of the three-year longer-term refinancing operations maturing at the beginning of 2015. Although banks tapped the two TLTROs to the tune of € 6.3 billion cumulative, total funding provided by the NBB as part of its monetary policy transactions fell from € 16 billion at the end of 2013 to € 11.7 billion at the end of 2014.

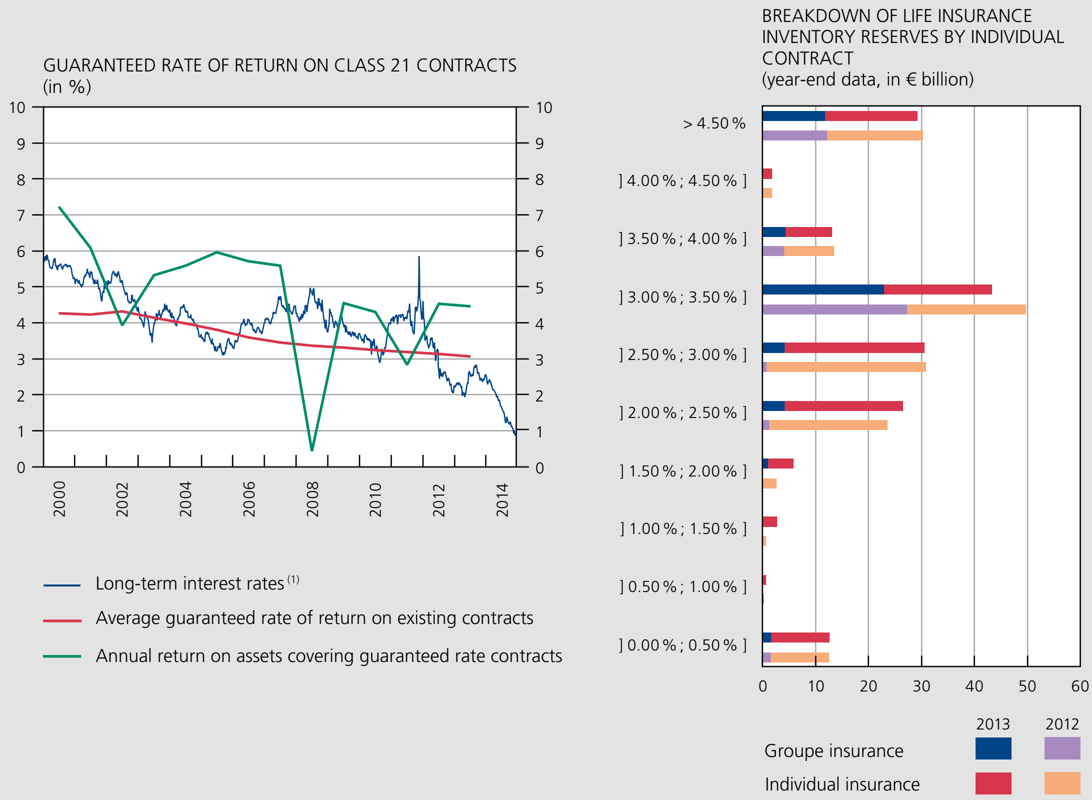
Flat macroeconomic conditions continued to hit demand for life insurance products from insurers, as households preferred to keep their assets liquid. The massive fall in 2013 premium income can largely be explained by the increase in the tax on premiums paid on life insurance

CHART 59 INSURANCE COMPANIES: PREMIUM INCOME AND COMBINED RATIO (1)
(non-consolidated data; in € billion, unless otherwise stated)



Source: NBB.
(1) The combined ratio is the ratio relating the sum of the cost of claims plus operating expenses to net premium income.

CHART 60 GUARANTEED RATES OF RETURN AND BREAKDOWN OF LIFE INSURANCE COMPANIES' INVENTORY RETURNS



Sources: Thomson Reuters Datastream, NBB.
(1) Secondary market yields on ten-year Belgian government loans (OLOs), weekly data.

products to 2 % at the beginning of that year, while anticipatory buying had caused a temporary spike in 2012. No one-off factors explain why 2014 premium income languished at the unusually low levels of the previous year, with this rather reflecting a fundamental downward trend that had got underway in 2008 and now appears to have accelerated. Given Belgium's *bancassurance* model, this general climate may have inspired banks to move household savings to more profitable investment instruments rather than to life insurance contracts.

Non-life insurance tends to be less sensitive to macroeconomic conditions than life insurance, with profitability generally satisfactory and some insurance companies preferring non-life operations anyway. In 2014, premium increases could not absorb the effects of higher storm-related claims in the first half of the year. Having recorded a steady upward trend since 2008, non-life results were slightly down in the year under review. The combined ratio, which reflects the sum of claims and operational costs as a ratio of net premium income, slid from 98.6 % in the first nine months of 2013 to 99.3 % in the same period of 2014.

Negative impact of low interest rate environment on profitability at banks and insurance companies offset by 2014 measures

Overall, the repercussions of the economic slowdown were cushioned by low interest rate levels – both short-term and long-term – thus supporting the activity of the financial sector and the broader economy. That said, low interest levels also affect the financial sector in a more specific way.

A long period of low interest rates does not benefit the insurance sector, particularly life insurance as its liabilities typically have longer maturities than its assets and it is also facing high interest rates guaranteed in the past. Annual returns on assets covering guaranteed-return contracts have dipped below guaranteed returns three times in the past, in 2002, 2008 and 2011, i.e. the years of the financial crises and the sovereign debt crisis in the euro area. In 2013, the effective return on class 21 contracts (4.44 %) made it possible to cover interest rates guaranteed in the past. However, effective investment returns are showing a clear downward trend in line with financial markets and if current low interest rates are here to stay, significant amounts of high-rated securities (AAA or AA) will have to be replaced by lower-yielding investments. There is a real risk, then, that the effective return on assets will not be enough to cover the guaranteed interest rates on contracts entered into earlier.

The outstanding total of life insurance contracts with guaranteed return and the actual rates paid on them are therefore very important risk parameters for insurance companies in times of falling interest rates on risk-free investments.

Total inventory reserves related to guaranteed return contracts rose only slightly between end-2012 and end-2013, from € 165.6 billion to € 166.3 billion, on the back of group insurance growth at over 6 %. By contrast, individual insurance products contracted by nearly 2 % (€ –2.1 billion). This decrease only concerns guaranteed-return contracts of over 2 %. Inventory reserves of guaranteed-return contracts of up to 2 % added 33 %, albeit from a fairly low base.

Contracts agreed in the past whose guaranteed returns on future premium-based reserves exceeded 4.5 % accounted for € 29.2 billion – i.e. 17.5 % of inventory reserves, compared with € 30.2 billion in 2012 – € 26.1 billion of which related to contracts with guaranteed returns of 4.75 %, the legal maximum for this type of contract up to June 1999. This legacy of contracts with high guaranteed returns that cannot currently be funded profitably is the biggest risk currently facing the Belgian insurance sector.

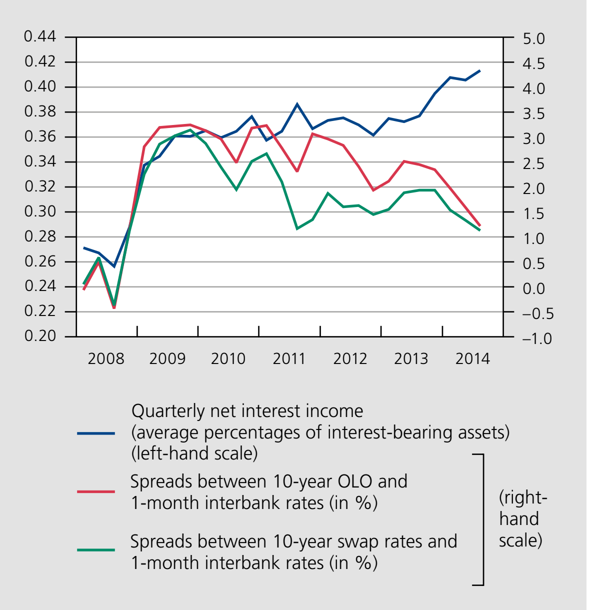
Persistently low interest rates are forcing insurance companies to offer contracts more in line with market conditions, taking the average guaranteed return of class 21 agreements down from 3.12 % in 2012 to 3.04 % in 2013 – which is the last year for which aggregate data are available – and also encouraging them to promote class 23 agreements that are linked to investment funds and offer no guaranteed return. What is more, some class 21 contracts impose time limits on guarantees and specify that the reserve built up will technically be considered a new premium after the agreed period, with guaranteed returns in line with market conditions that apply by that time. Meanwhile, insurance companies have also developed hybrid products to help reduce their risks, consisting of a guaranteed-return life insurance product (class 21) coupled with another life product in class 23, whose returns reflect the performance of an investment fund. Options to shift lower returns to those paid out to policy-holders are limited by intense competition between insurance companies and from other savings products. If returns stay too low, insurance companies run the risk of contracts getting taken over.

To support their net profits, insurance companies also made capital gains of € 1.3 billion in the first nine months of 2014. At times of low interest rates, prudential rules oblige insurance companies to include additional annual provisions in their accounts. These provisions, for which no exemptions were forthcoming in 2013 and which stood at a cumulative total of € 3.8 billion by the end of that year, made the sector less profitable and translated into the need to constitute a higher solvency margin.

Persistently low interest rates also depress total interest margins generated by Belgium's banks, against a backdrop of intensified competition as a result of banks refocusing their business on a highly saturated domestic market. Credit institutions have seen an erosion of the gains from very cheap resources, such as sight deposits, on which remuneration is only partly linked to market rates. At the same time, high-yield securities or loans reaching maturity had to be replaced with others offering

CHART 61 **BELGIAN BANKS' NET INTEREST INCOME AND YIELD SPREADS**

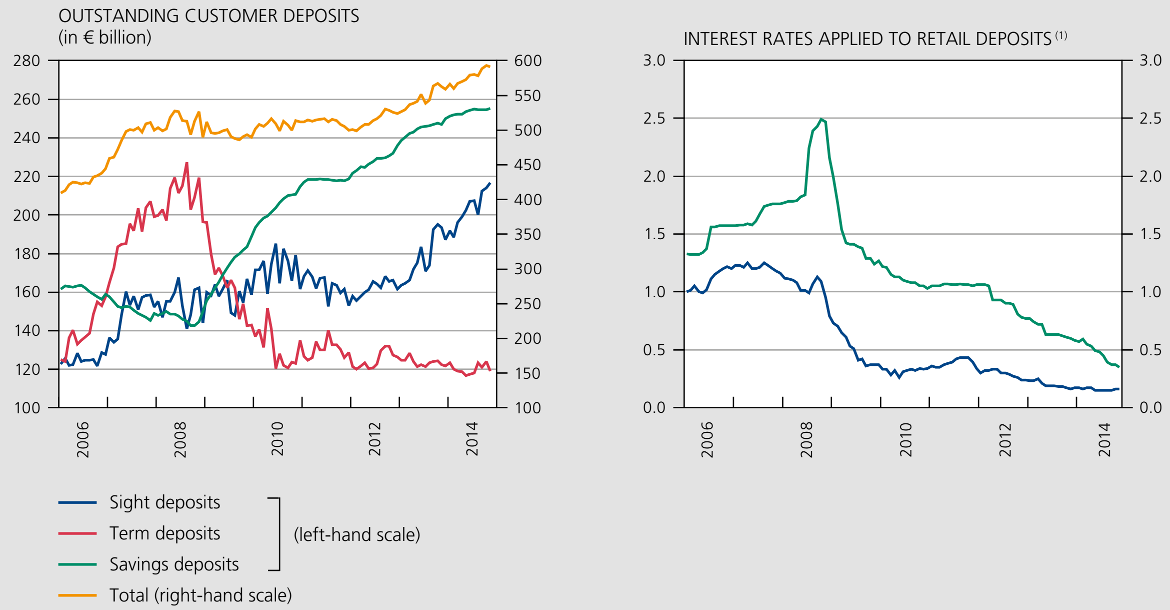
(quarterly data, on a consolidated basis)



Sources: Thomson Reuters Datastream, NBB.

CHART 62 **BELGIAN BANKS' CUSTOMER DEPOSITS: OUTSTANDING AMOUNTS PLUS APPLIED INTEREST RATES**

(non-consolidated data)



Source: NBB.
(1) New deposit data taken from monthly MIR survey.

lower yields, while lower interest rates also entice borrowers to refinance their mortgages.

Belgian banks were able to take temporary measures to offset the negative impact on their profitability and prepare for this impact to continue over the next few years.

On the other hand, Belgian banks in general kept their commercial margins on new loans at a high level, despite intensified competition in this market. Positive effects on total margins tend to be greater as the share of new business – which commands steeper commercial margins – in total outstanding loans increases. In the teeth of challenging conditions, Belgian banks still managed to increase their net interest income in 2014, both in absolute terms and as a percentage of interest-bearing assets.

Nevertheless, most of these effects are usually temporary. With balance sheets typically having more short-term liabilities relative to longer-term assets, banks benefit from falling interest rates, as the costs of their liabilities adjust more quickly to the new situation than do the returns on their assets. Although the intermediation interest rate structure continued to be favourable in 2014 – albeit it less so than in previous years – borrowing costs are not likely to come down any further, as interest rates offered on savings deposits have hit new lows while, conversely, returns on assets should gradually contract. A lengthy period of persistently low interest rates would pare down the interest income received by Belgian banks, which is precisely their most important source of net income. Return on equity, which averaged 8.2 % in the first nine months of 2014, might therefore come under pressure in the future.

Other factors also had positive or negative effects on bank profitability. In 2014, Belgian banks no longer notched up massive gains on financial instruments, unlike in 2013, when such gains were booked when selling securities. Loan loss provisions totalled € 1 billion in the first nine months of 2014, remaining below the figure for the same period of 2013. This was largely due to the slowing of the deterioration in the quality of certain foreign portfolios, such as Irish portfolios. Conversely, unexpected provisions were required in the Hungarian retail loans portfolios, in the wake of measures announced by the government in Budapest in the first half of 2014 which promised borrowers repayment of a proportion of amounts collected and in due course also the conversion of foreign currency-denominated loans into Hungarian forints.

Limited refocusing on investment policies

The current climate and pressures on their profitability might induce financial institutions to redirect their investment policies to higher-yielding asset classes. However, there were no clear signs of such a shift in Belgium by the end of September 2014, either at its banks or at its insurance companies.

Banks saw a minor rebalancing of their balance sheets in favour of foreign claims in the first nine months of 2014, but nowhere close to pre-crisis levels. More Italian and Spanish government bonds were taken on at the expense of Belgian ones, reducing the high concentration of government paper owned by Belgian banks that had been built up since the start in of the sovereign debt crisis in the euro area in 2011-2012.

Belgian insurance companies saw the outstanding amount in their government bond portfolios decline by 2.2 % in the course of 2014, as a result of the sale of bonds – creating capital gains – and because of the fact that they were compelled to change their investment strategies and focus on riskier asset classes to maintain return levels. Low-yielding fixed-income investments prompted some of them to redirect their assets to longer-term alternatives, such as corporate bonds or UCI units. Such alternatives promise higher yields but also imply greater credit and liquidity risks.

These changes in insurance companies' investment strategies are already partly dictated by the new prudential solvency rules due to come into force in January 2016. Class 23 products will be subject to more favourable capital requirements under the new rules. These products, which are less risky for insurance companies, have flourished since 2012.

Adjusting cost structures

To cope with the current flat economic climate – which is likely to last for a while longer – and with the repercussions for asset quality of any further deterioration of economic conditions or financial market corrections, financial institutions will have to bolster their profit-generating

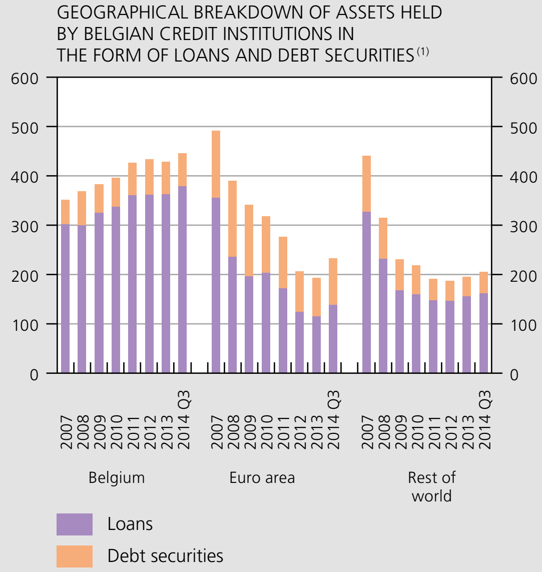
TABLE 14 INCOME STATEMENT OF BELGIAN CREDIT INSTITUTIONS
(consolidated data; in € billion, unless otherwise stated)

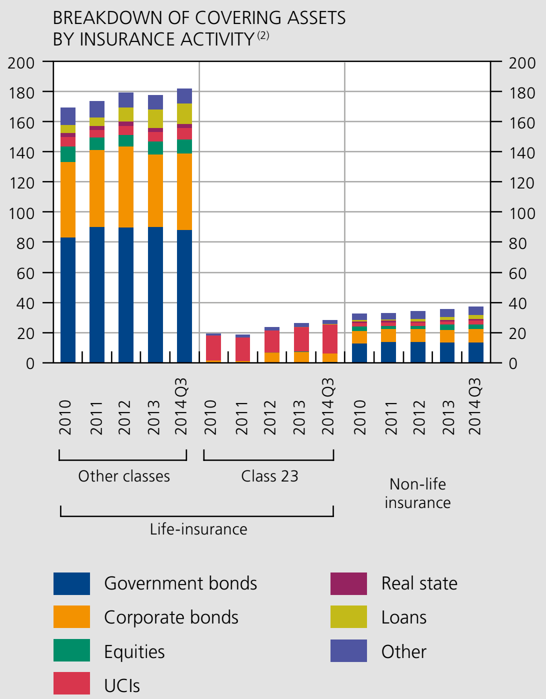
	2010	2011	2012	2013	First nine months 2013	First nine months 2014	In % of operating income
Net interest income	13.8	14.0	13.6	13.3	9.9	10.8	68.4
Non-interest income	5.6	4.8	4.5	7.0	5.9	5.0	31.6
Net fee and commission income (including commission paid to agents)	4.3	4.4	4.5	5.0	3.9	4.1	26.1
(Un)realised gains or losses on financial instruments (1)	0.0	–0.8	0.0	0.8	1.1	0.3	
Other non-interest income	1.3	1.2	0.0	1.3	0.9	0.6	
Operating income	19.3	18.7	18.1	20.3	15.8	15.8	100.0
Operating expenses	–12.5	–12.3	–13.0	–12.4	–9.4	–9.6	60.8 (2)
Gross operating result	6.9	6.4	5.0	8.0	6.4	6.2	
Impairments and provisions	–1.8	–5.0	–2.6	–3.0	–1.4	–1.0	
Impairments on loans and receivables	–1.8	–3.0	–2.0	–2.3	–1.2	–1.0	
Impairments on other financial assets	–0.1	–1.4	0.8	0.0	0.0	0.0	
Other impairments and provisions	–0.2	–0.6	–1.5	–0.6	–0.2	0.0	
Other components of the income statement	0.5	–1.0	–0.8	–1.8	–1.5	–1.6	
Net profit or loss	5.6	0.4	1.6	3.3	3.5	3.6	

Source: NBB.
(1) This item also includes the net realised gains (losses) on financial assets and liabilities not measured at fair value through profit or loss, the net gains (losses) on financial assets and liabilities held for trading and designated at fair value through profit or loss, and the net gains (losses) from hedge accounting.
(2) Cost/income ratio of the Belgian banking sector.

CHART 63 LOANS AND DEBT SECURITIES HELD BY CREDIT INSTITUTIONS AND INSURANCE COMPANIES' COVERING ASSETS

(end-of-period data ; in € billion)





Source : NBB.
(1) Data obtained from the consolidated financial reporting of Belgian credit institutions. Breakdown in line with FINREP prudential reporting.
(2) Non-consolidated data.

capacity. This will require a review of business models, cost structures and consolidations. As described in the "Prudential regulation and supervision" part of this Report, the review was one of the focal points of the NBB's macroprudential policies.

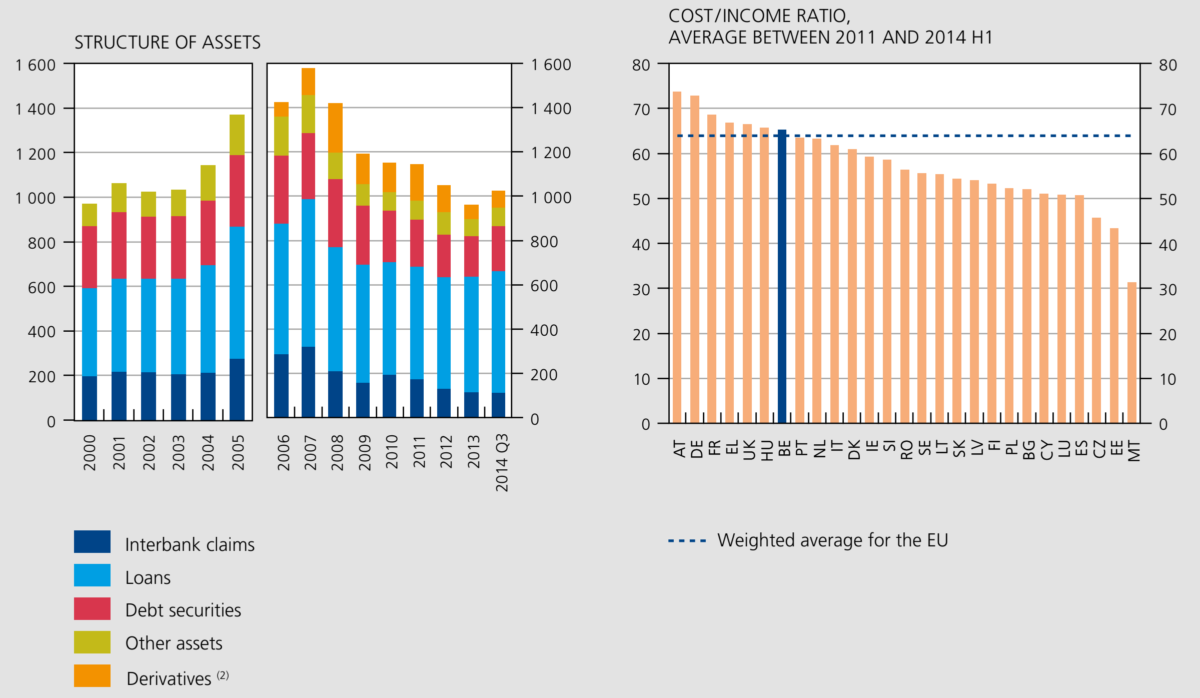
Between 2008 and 2013, Belgian banks significantly reduced the scope of their activities, particularly abroad, but they have yet to prune costs to the same degree. The country's major institutions have announced restructurings and have made a start on actually implementing them, but have so far failed to control operating costs : these added 2 % in the first nine months of 2014 compared with the same period of 2013. The increase largely reflects changes in the consolidation scope of a major bank and is thus also partly offset by the consolidation's positive effects on operating income. The cost/income ratio of the Belgian banking sector amounted to 61 % in the first nine months of 2014, dipping under the ratios observed in 2011 and in 2012. The average ratio between 2011 and the first half of 2014 puts Belgium among the highest in Europe, even though other banking sectors are facing similar challenges, in both big and smaller countries.

Insurance companies saw the ratio of operating expenses to technical result in non-life decline in 2014, continuing the steady downtrend since 2009. In life insurance, by contrast, the ratio increased in the wake of rising costs coupled with a weaker technical result.

Transition to new solvency framework

The new EU solvency regulations for insurance companies, known as Solvency II, which come into force on 1 January 2016, present a massive challenge for Belgium's insurance industry. Under Solvency I, solvency requirements are linked to insurance business as measured by premium income, claims numbers and technical reserves. By contrast, Solvency II imposes a calculation based on the risks of both the assets and the liabilities side of the balance sheet, at market values. The riskier the assets (equities, hedge funds, etc.), the bigger the required regulatory capital is likely to be. One of the first effects of the new rules is already visible : a shift from the most capital-intensive assets (equities) to assets that are much less capital-intensive (bonds) and a preference for liquid assets

CHART 64 BELGIAN BANKS' BALANCE SHEET (1) AND COST/INCOME RATIOS



Sources: ECB, NBB.
(1) Data compiled according to Belgian accounting rules until 2005 (Belgian GAAP) and in line with IAS/IFRS standards since 2006.
(2) Derivatives are recorded at their market values, including – from 2007 – income receivable and charges payable (which are not included in the data relating to 2006).

over long-term investments which are less favourable in terms of capital requirements. Capital requirements under Solvency II will be eased by a correlation matrix between different securities, measured by asset class, and insurance companies will do well to diversify their assets more. With assets no longer recognised at historical values, solvency margins will be much more sensitive to fluctuations in the interest rate and equity market movements, as well as to margin risks.

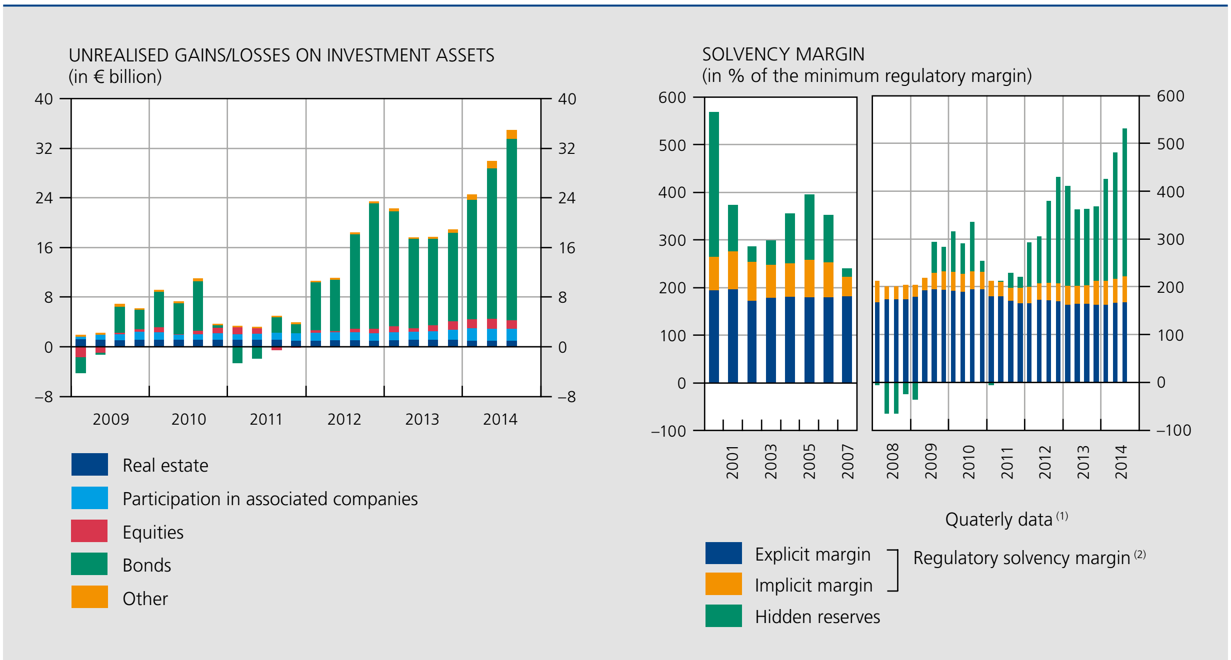
Interest rate falls pushed the solvency margin upwards in 2014 on the back of higher market values for the bond portfolio, and even more for much longer-dated bonds. The unrealised gains reached new highs in September 2014 at € 34.9 billion, 84 % of which derived from bond holdings. If approved by the NBB in its capacity as prudential regulator, these unrealised gains are recognised in the implicit component of the solvency margin, thus strengthening it. Factoring in the stability of the explicit component, which essentially includes own funds and subordinated debt, the regulatory solvency margin advanced by 4 % in the year.

In the life insurance business, slightly better solvency margins were attributable to the implicit margin, which has been stable since 2013. In non-life, which is better placed for the transition to Solvency II, the solvency margin is bolstered by the explicit margin, which has recorded an upward trend since June 2014.

Belgium's banks have also been subject to a new regulatory framework since 1 January 2014, known as Basel III. The transition to the new framework, of which the most recent developments are discussed in section A.1.4 of the "Prudential regulation and supervision" part of the Report, has led to an increase in risk-weighted assets. Credit-risk-related assets were up in the first nine months of 2014 as a result of the higher weighting assigned to exposures to credit institutions and because some banks were no longer able to apply a – more favourable – standard approach to sovereign debt exposures rather than an approach based on internal models. Basel III also introduces the Credit Valuation Adjustment (CVA), which aims to serve as a better hedge for the counterparty risk related to derivatives transactions, adding € 9 billion to risk-weighted assets. The decline in assets weighted for

CHART 65 UNREALISED GAINS/LOSSES AND SOLVENCY MARGIN OF BELGIAN INSURANCE COMPANIES

(non-consolidated data)



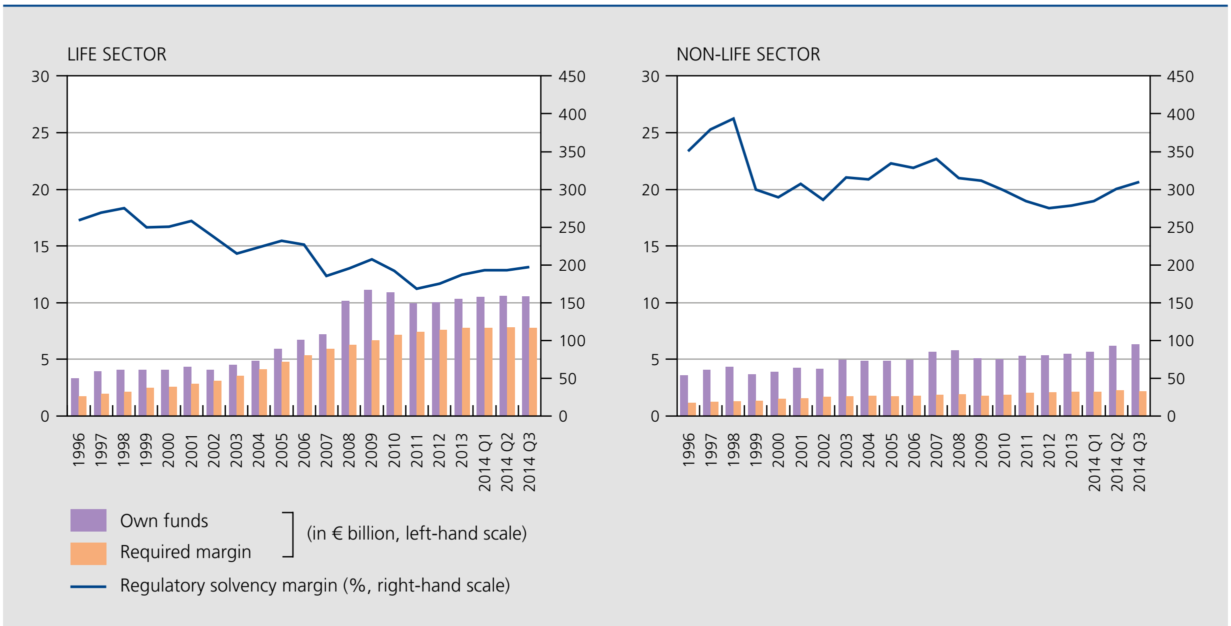
Source: NBB.

(1) The figures reported quarterly are not entirely comparable with the final annual figures. In particular, they take no account of any distribution of profits to shareholders and policy-holders.

(2) This margin is composed of an explicit margin including own funds, subordinated debt and selected other balance sheet items and an implicit margin which, subject to NBB's approval, comprises certain other specific elements, the principal one being a part of the unrealised gains on investment portfolios.

CHART 66 OWN FUNDS, REQUIRED MARGIN AND REGULATORY SOLVENCY MARGIN OF BELGIAN INSURANCE COMPANIES

(non-consolidated end-of-period data)



Source: NBB.

TABLE 15 BREAKDOWN OF TIER 1 CAPITAL AND RISK-WEIGHTED ASSETS

(end-of-period data, on a consolidated basis, in € billion, unless otherwise stated)

	2009	2010	2011	2012	2013	September 2014
Tier 1 capital	53.9	57.9	56.5	55.9	55.6	54.9
of which:						
common equity Tier 1	–	–	–	–	–	51.9
Risk-weighted assets	407.5	372.5	373.8	352.7	339.4	349.6
of which:						
Credit risk	352.3	322.8	312.9	301.0	287.7	289.4
Market risk	16.1	10.7	21.9	16.6	9.9	7.4
Operational risk	38.8	35.1	35.2	35.0	34.2	34.6
CVA	–	–	–	–	–	8.9
Other	0.2	3.9	3.8	0.1	7.6	9.3
Tier 1 ratio (in %)	13.2	15.5	15.1	15.9	16.4	15.7
Common equity Tier 1 ratio (in %)	–	–	–	–	–	14.9

Source: NBB.

market risk seen since the end of 2011 is primarily down to reduced securities trading by Belgian banks.

With capital relatively stable in 2014, the increase in risk-weighted assets caused the Belgian banking sector's solvency ratios to come down. Those ratios are much higher than the minimum requirements imposed by Basel III (4 % for common equity Tier 1 and 5.5 % for Tier 1 in 2014). These minimum requirements will gradually be raised and be linked to buffers, so that the new Basel III solvency standards will be in full force from 2019.

In the course of 2014, the ECB extensively tested banks' capacity to keep their solvency margins sufficiently high as part of its comprehensive assessment, consisting of an asset quality review and stress tests. This exercise is described in more detail in the "Prudential regulation and supervision" part.

The solvency position of Belgian banks is generally comfortable, but their average levels of return need to go up, particularly at institutions that have reported extremely weak returns on equity. This should enable them to achieve the best possible positions in a sector being restructured as part of regulatory framework changes, intensified competition and subdued profit generation.

Public finances

4. Public finances

The general government deficit ended 2014 at 3.2 % of GDP, up from 2.9 % in 2013. The modest consolidation that started in 2011 failed to keep going and the benefits of reduced interest charges were lost in a climate of low interest rates. So, the deficit moved into "excessive" territory by breaching the 3 % ceiling. Government debt climbed 1.9 percentage points to 106.5 % of GDP, its acceleration due to both the deteriorating primary balance and GDP's subdued nominal growth. The Belgian government's budget plan is focused on achieving structural balance by 2018, and the European Commission will investigate in March whether it meets the requirements of the Stability and Growth Pact prior to implementation of the budget and the proposed structural reforms. In this particular context, Belgium faces extremely high fiscal and parafiscal pressure on labour income, and a shift to other tax bases would benefit job creation as well as competitiveness.

4.1 Overview of fiscal policy

Deteriorating nominal and structural overall balances have put a stop to the modest improvement of the previous few years

The Belgian government ended the year 2014 in the red to the tune of 3.2 % of GDP, a deepening of the deficit by 0.3 percentage point compared with 2013. A combination of lower revenues and a higher ratio of primary expenditure to GDP was to blame, while interest charges came down further.

It was the reversal of a recent trend: the fiscal consolidation that had got underway in 2011 was stopped in its tracks. Belgium's structural overall balance as measured by European Commission (EC) methods – which adjust the budget for the effects of cyclical and temporary factors – worsened by 0.1 percentage point of GDP, whereas it had improved by around 1 percentage point between 2011 and 2013. Non-recurrent factors had put a 0.3 % positive shine on nominal deficit levels – tax regularisation revenues being the key factor – but their total effect was 0.3 percentage point less than in 2013. The business cycle proved a neutral force, as economic activity roughly kept pace with the economy's growth potential in 2014.

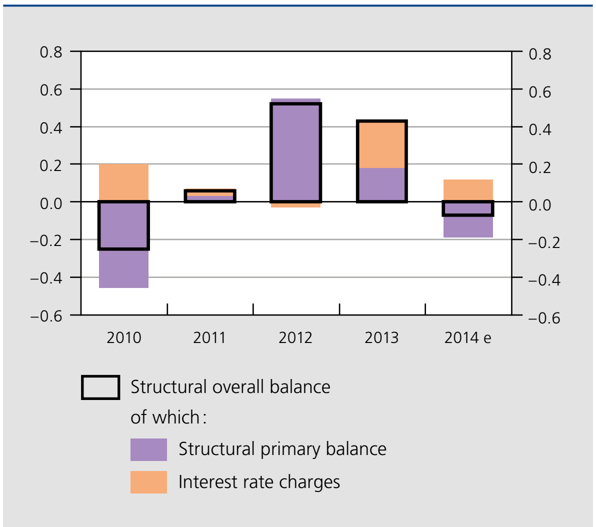
TABLE 16 GENERAL GOVERNMENT ACCOUNTS
(in % of GDP)

	2000	2011	2012	2013	2014 e
Revenue	48.6	49.3	50.7	51.5	51.2
Primary expenditure	42.2	49.8	51.4	51.2	51.4
Primary balance	6.4	–0.5	–0.7	0.3	–0.2
Interest charges	6.5	3.4	3.4	3.2	3.0
Budget balance	–0.1	–3.9	–4.1	–2.9	–3.2
p.m. Effect of non-recurrent factors	*–0.2*	*–0.2*	*–0.4*	*0.6*	*0.3*

Sources: EC, NAI, NBB.

CHART 67 DETERMINANTS OF THE CHANGE IN THE GOVERNMENT'S STRUCTURAL OVERALL BALANCE

(changes compared to the previous year, in percentage points of GDP)



Sources: EC, NAI, NBB.

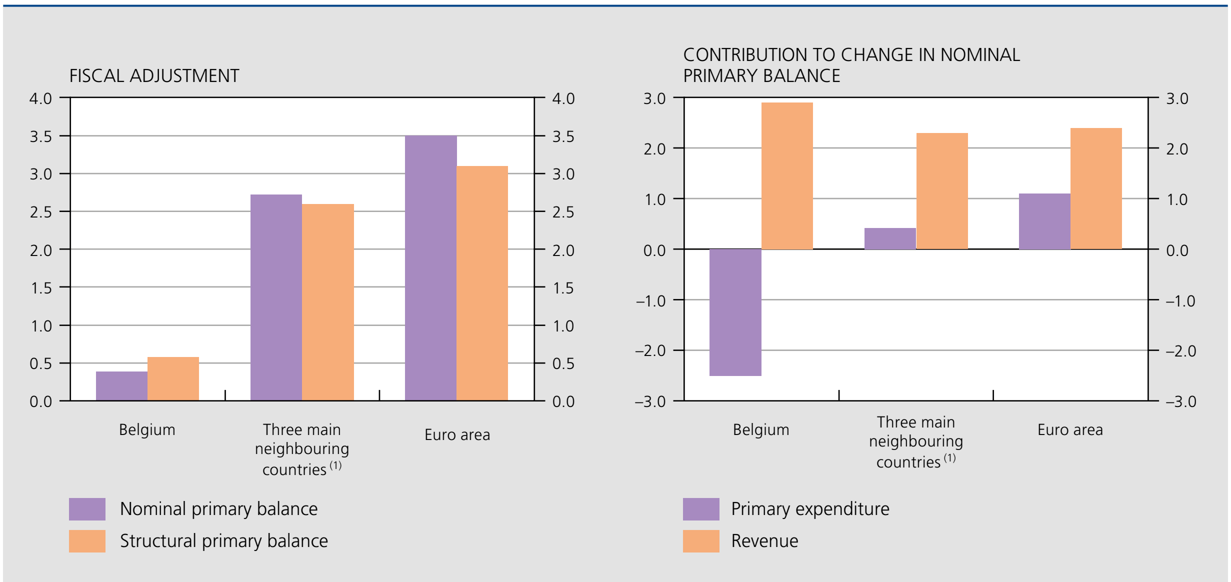
In addition to its interrupted consolidation, Belgium may also be observed to have trodden relatively lightly on austerity compared with measures taken in its three main neighbouring countries and elsewhere in Europe, particularly in the peripheral countries. Measured by the structural primary balance, which ignores interest charges, non-recurrent factors and cyclical effects, Belgium's fiscal consolidation worked out at 0.6 % of GDP between 2010 and 2014, as against 2.6 % of GDP for the three main neighbouring countries – with Germany notching up a 2.2 % improvement, France 2.6 % and the Netherlands 3 % – and compared with 3.1 % of GDP for the euro area at large. France, the Netherlands and Germany – if by a very small degree – had bigger deficits than Belgium in 2010, as did the euro area as a whole, but have managed to shrink them significantly in 2014, France excepted. Germany returned to a balanced budget in 2012.

The contrast with the approach to fiscal consolidation is also striking: throughout the euro area, both the expenditure and revenue levers were applied at the same time, but in Belgium expenditure has gone up as a percentage of GDP, which has not helped to make public finances any healthier as it required offsetting by significantly higher revenues.

The budgetary deterioration of 2014 prevented Belgium from meeting its target as set in its October 2013 draft budget, i.e. a structural balance improvement of 0.6 % of GDP. On the basis of calculations made at the time, this target was in line with a nominal deficit of 2.1 % of GDP, a norm also included in the April 2014 stability programme. Belgium's failure to achieve the structural

CHART 68 SIZE AND BREAKDOWN OF FISCAL CONSOLIDATION

(changes between 2010 and 2014, in percentage points of GDP)



Sources: EC, NAI, NBB.
(1) Unweighted averages.

TABLE 17 INTERNATIONAL COMPARISON OF OVERALL BALANCE AND PUBLIC DEBT

(in % of GDP)

	Overall balance					Consolidated gross debt
	2010	2011	2012	2013	2014 e	2014 e
Belgium	–4.0	–3.9	–4.1	–2.9	–3.2	106.5
Three main neighbouring countries (1)	–5.3	–3.4	–2.9	–2.1	–2.2	79.9
Germany	–4.1	–0.9	0.1	0.1	0.2	74.5
France	–6.8	–5.1	–4.9	–4.1	–4.4	95.5
Netherlands	–5.0	–4.3	–4.0	–2.3	–2.5	69.7
Euro area	–6.1	–4.1	–3.6	–2.9	–2.6	94.7

Sources: EC, NAI, NBB.
(1) Unweighted averages.

balance improvement as envisaged in its budget was the main reason for its non-compliance with its nominal target. Plus which, the review of the general government accounts in the wake of the transition to ESA 2010 caused a negative effect on the overall balance of nearly 0.3 % of GDP [1].

Belgium needs to bring its fiscal policy in line with the European governance framework

The April 2014 stability programme also set out a budget path based on the recommendations of Belgium's High Council of Finance in March 2014, which envisaged a structurally balanced budget by 2016. This was never a formal commitment, however, as it noted in the run-up to the general elections of 25 May 2014 that both these fiscal targets and their breakdown across the various entities were indications only and could well be changed by future federal, community and regional governments. As it turned out, such adjustments were indeed agreed during the coalition negotiations and the achievement of a structural balance was pushed back by two years, to 2018.

The federal government agreement also provides for new pension reforms, their main aspects being an increase in the statutory retirement age to 66 in 2025 and to 67 in 2030, tighter early retirement conditions, changes to civil

(1) See Methodological Note.

TABLE 18 TARGETS FOR THE OVERALL BALANCE OF BELGIAN GENERAL GOVERNMENT

(stability programme targets, unless otherwise stated; in % of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018
Nominal balance								
April 2011	**–3.6**	–2.8	–1.8	–0.8	0.2			
April 2012		**–2.8**	–2.15	–1.1	0.0			
April 2013			**–2.5**	–2.0	–0.5	0.4		
April 2014				**–2.1**	–1.4	–0.4	0.6	
October 2014 (draft budget)				–2.9	**–2.1**	–1.3	–0.4	0.0
Structural balance								
April 2014				–1.4	–0.7	0.0	0.75	
October 2014 (draft budget)				–2.0	–1.3	–0.6	–0.1	0.0

Sources: FPS Budget and Management Control, FPS Finance.

servants' pension calculations and an increase in the age at which people are eligible for survivor pensions. It is too early to say if these reforms will enable Belgium to ease its medium-term target – which is currently a structural surplus of 0.75 % of GDP – as it has not yet been possible to estimate accurately the extent to which these reforms will curb the budgetary cost of ageing in Belgium.

A revised budget path was included in the draft budget plan for 2015, as submitted to the EC and the Eurogroup on 22 October. On 28 November 2014, the EC found that the draft budget risks falling short of the requirements of the Stability and Growth Pact, in view of inadequate improvements to the structural balance in 2014 and 2015. It urged the Belgian authorities to take the necessary measures to bring the 2015 budget into line with the requirements of the Pact as part of its national budgetary process, while also encouraging Belgium to pursue its efforts in the structural arena of the EU Council's public finances recommendations. In early 2015, the EC will review the situation in light of the completion of Belgium's fiscal laws and the implementation of the structural reforms announced by the authorities.

Although the Ecofin Council decided on 20 June 2014 to end the excessive deficit procedure (EDP) against Belgium that it had opened in December 2009, the country's nominal overall balance worsened in 2014 and the latest estimates suggest that it again breached the reference threshold of 3 % of GDP. At the end of March 2015, the NAI will make its first submission to Eurostat of the official general government accounts for the year 2014.

Box 10 – European fiscal rules for Belgium

The fiscal policies of EU Member States are required to comply with all European fiscal rules, whose aim is to avoid flawed policies and undesirable outcomes. The Treaty on the Functioning of the European Union (TFEU) and the Stability and Growth Pact underpin these rules, whose application has been fleshed out by the European Commission [1]. It has put in place both preventive measures – to ward off any emergence and/or development of untenable budgetary situations – and corrective recovery action for Member States that run into particularly severe difficulties in terms of their public finances.

This Box provides an overview of the key rules that Belgium is expected to comply with. Following the Ecofin Council's decision on 20 June 2014 to lift the excessive deficit procedure embarked on in December 2009, Belgium is now subject to the preventive arm of the Stability and Growth Pact, while also needing to comply with the transitional arrangements relating to the corrective arm's debt criterion.

Preventive measures

The medium-term objective

Setting and achieving a medium-term objective (MTO) is the very essence of the preventive arm, this being a country-specific reference value of the overall balance as expressed in structural terms, i.e. adjusted for cyclical influences and excluding temporary factors. The Member States themselves choose their own medium-term objectives in their stability or convergence programmes, although their MTOs should meet a minimum standard taking into account public debt and the expected budgetary cost of ageing, as forecast by the EC's Ageing Working Group. In 2012, the EC put the required minimum for Belgium at 1.3 % of GDP. However, the minimum may not exceed an upper limit, which for Belgium is currently set at a maximum of 0.75 % of GDP. It is thus the highest of all the euro area countries, reflecting the high debt level and the significant budgetary cost of population ageing in Belgium.

(1) EC (2013), *Vade mecum on the Stability and Growth Pact*, EC Occasional Paper 151, May.

Convergence towards the medium-term objective

Countries that have yet to achieve their medium-term objective – like Belgium in this instance – are expected to converge on their MTOs at an appropriate pace along an adjustment path. Progress is assessed by analysing two indicators, namely the structural balance and real government expenditure. The required improvement in the structural balance is determined on the basis of the economic cycle and the public finances of the Member State. Based on the European Commission's guidance on the practical application of the Stability and Growth Pact rules for the 2014 European Semester, and given its 13 January 2015 Communication for the 2015 European Semester, these improvements can be summarised in the following table:

DETERMINING THE REQUIRED STRUCTURAL BALANCE IMPROVEMENT

(in percentage points of GDP)

Economic conditions	Gross debt < 60 % and no risk pertaining to the sustainability of public finances		Gross debt > 60 % of GDP or sustainability of public finances at risk	
	Semester 2014	Semester 2015	Semester 2014	Semester 2015
Exceptionally poor:				
real growth < 0 % ou	No adjustment			
output gap [1] < –4 %				
Very poor:				
–4 % ≤ output gap < –3 %		0.0		0.25
Poor:	> 0.0		≥ 0.5	
–3 % ≤ output gap < –1.5 %				
a) real growth < potential growth		0.0		0.25
b) real growth > potential growth		0.25		0.5
Normal:				
–1.5 % ≤ output gap < 1.5 %	0.5	0.5	> 0.5 [2]	> 0.5 [2]
Good:				
output gap ≥ 1.5 %	> 0.5 [2]		> 0.5 [2]	
a) real growth < potential growth		> 0.5 [2]		≥ 0.75
b) real growth > potential growth		≥ 0.75		≥ 1.0

Source: EC.
(1) The output gap equals the difference between actual GDP and its potential level and is expressed as a percentage of the latter.
(2) An improvement in the structural balance by over 0.5 percentage point of GDP is conventionally considered as at least equal to 0.6 percentage point of GDP.

In July 2014, the Ecofin Council recommended an improvement in Belgium's structural balance by 0.5 percentage point of GDP in 2014, and by 0.6 percentage point of GDP in 2015, taking into consideration the EC's recommendations and the rules as set out in the above schedule. The required minimum improvement is higher for 2015 as the EC forecast a negative output gap of below 1.5 % of potential GDP and debt exceeding 60 % of GDP. The requirements do not change under the Commission's new interpretation for the 2015 European Semester.

To pinpoint the permitted annual change in real government expenditure [1] a benchmark was created for all Member States based on potential GDP growth in the medium term. Countries like Belgium, which have yet to

(1) Government expenditure does not include interest charges, cyclical unemployment benefit expenditure and all expenditure on EU programmes funded by the EU. Government expenditure is also adjusted for the budgetary impact of discretionary reveneu measures..

hit their medium-term objectives, have reference values below the benchmark, enabling them to converge to the objective. For Belgium, this implies a real annual change of 0.2 % in 2014 and 0 % in 2015.

Compliance monitoring

Every spring, the EC assesses countries' performances on the basis of data submitted, more specifically identifying any significant deviations from medium-term objectives or convergence paths. Deviations are found to exist if the two conditions below are met, or if one of them is met and a more general analysis establishes that the other is met to a limited degree:

– The deviation between structural balance developments and the pre-agreed path amounts to no less than 0.5 percentage point of GDP in any one year or an average 0.25 percentage point of GDP per annum in two successive years;
– Government expenditure deviates from the agreed objective, affecting the government balance by at least 0.5 percentage point of GDP in any one year or cumulative in two successive years.

Temporary deviations from the adjustment path to the medium-term objective are possible, for instance if there are unusual events outside the control of the Member State which have a major impact on its financial position, in periods of severe economic downturn for the euro area or in the EU as a whole, or to combat negative short-term effects of significant structural reforms which have a verifiable positive fiscal effect in the longer term, provided that this does not jeopardise the sustainability of public finances in the medium term.

If it identifies a significant deviation, the EC will notify the Member State, under Article 121 (4) of the Treaty on the Functioning of the European Union. A decision by the Ecofin Council on a significant deviation from the adjustment path to the medium-term objective will trigger the preventive arm procedure as laid down in the Stability and Growth Pact, and sanctions may be imposed.

The corrective arm

The general government overall balance

A country's general government deficit cannot be greater than 3 % of GDP in nominal terms.

Public debt

General government outstanding debt should not exceed 60 % of GDP or, failing that, it should be approaching the reference value at a satisfactory pace. The general rule is that Member States reduce their debt-to-GDP ratios each year, measured as an average over a period of three years, by one-twentieth of the difference between the initial debt ratio and the reference value.

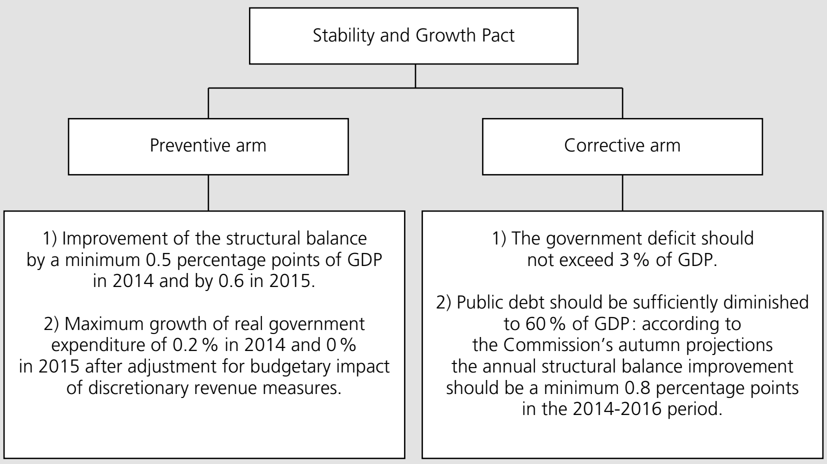
Since the measure was only adopted fairly recently, several euro area countries – including Belgium – are nevertheless put under a transition regime after closure of the excessive deficit procedure against them. For Belgium, this transition period runs from 2014 to 2016, during which time sufficient progress needs to be made towards respecting the general rule. This progress is measured by the change in the structural balance, also called the 'minimum linear structural adjustment'. Based on the EC's autumn projections, Belgium currently needs to notch up a minimum improvement of 0.8 percentage point of GDP per year, whereas the spring projections were still pointing to 0.3 percentage point of GDP. This clear tightening directly ties in with the country's higher debt ratio and fiscal deficit in 2013, but primarily also with the downward revision of nominal GDP growth, which caused a deterioration in the debt-to-GDP ratio. On 8 December 2014, the Eurogroup nevertheless said it was aware that poor economic conditions and extremely low inflation have made it difficult to meet the debt reduction criterion and acknowledged that Belgium currently faces a real challenge meeting it.

In order to ensure continuous and realistic progress towards compliance with the debt rule by the end of the transition period, a Member State should respect two conditions: the annual adjustment of the structural balance should not deviate from the required improvement by more than 0.25 percentage point of GDP, and the remaining annual structural improvement should not exceed 0.75 percentage point of GDP at any time during the transition period. A larger annual effort put into meeting the first condition may mean that the second condition does not apply.

Breaching the criteria

If the figures show a Member State not to have met the criteria or if the forecasts suggest a risk of non-compliance, a Commission report under Article 126 (3) of the TFEU will consider all the relevant factors to see whether an EDP needs to be launched. If, on the basis of the Commission's opinion, the Ecofin Council decides that an excessive deficit exists, it sends a recommendation to the Member State to absorb the deficit within a set period and may even impose sanctions.

SUMMARY OF EUROPEAN FISCAL RULES THAT BELGIUM IS REQUIRED TO COMPLY WITH IN 2014 AND 2015



Source: EC.

4.2 General government revenue, expenditure and overall balance

Falling revenue after four years of consistent increases

In 2014, total government revenue declined to 51.2 % of GDP, mainly in the wake of lower non-fiscal revenue, while fiscal and parafiscal revenue stabilised. Belgium's revenue ratio remains high, both historically and compared with other European countries.

Levies on earned income dipped slightly under last year's levels, while the relationships between the various components remained unchanged.

Income tax held more or less steady as assessments developed favourably and offset lower payroll tax revenues, which were hit by the slighter share of wages in GDP as a result of meagre improvements in employment and the freezing of real negotiated wages. These effects were compounded by slower inflation, as indexation fed into wages much less than into tax brackets, which are index-linked to inflation in the previous year. These negative factors were only partly offset by higher social security benefits on which payroll tax is due, as the number of claimants increased. Lastly, the structural measures related to tax on income from employment had a slightly negative impact.

Social security contributions have barely come down from the previous year, despite wage restraint and the rather negative effect of the wider cuts in social contributions – and particularly the structural component granted to employers, as well as fresh tax reductions for the accommodation and food services sector, as long as employers register their employees on a daily basis.

TABLE 19 GENERAL GOVERNMENT REVENUE
(in % of GDP)

	2010	2011	2012	2013	2014 e
Fiscal and parafiscal revenue	42.3	43.0	44.1	44.8	44.8
Levies weighing chiefly on earned income	25.2	25.5	25.8	26.2	26.1
Personal income tax (2)	11.2	11.4	11.4	11.7	11.7
Social contributions (3)	14.0	14.1	14.4	14.4	14.4
Taxes on company profits (4)	2.5	2.8	3.0	3.1	3.1
Levies on other incomes and on assets (5)	3.6	3.7	4.0	4.4	4.4
Taxes on goods and services	11.0	10.9	11.3	11.1	11.2
of which:					
VAT	6.9	6.8	6.9	6.9	7.0
Excise duties	2.1	2.1	2.1	2.0	2.1
Non-fiscal and non-parafiscal revenue (6)	6.0	6.3	6.6	6.7	6.4
Total revenue	48.4	49.3	50.7	51.5	51.2

(1) In line with ESA 2010, total revenue of general government does not include the proceeds of customs duties transferred to the EU nor the revenues levied directly by the EU.
(2) Mainly payroll tax, advance payments, assessments and additional percentages on personal income tax.
(3) Including the special social security contribution and the contributions of people not in work.
(4) Mainly advance payments, assessments and withholding tax.
(5) Mainly withholding tax on income of individuals, withholding tax on income from immovable property (including the proceeds of additional percentages), inheritance taxes and registration fees.
(6) Income from assets, imputed social contributions, current transfers and capital transfers from other sectors, plus sales of goods and services produced, including revenues on guarantees granted by the State on interbank loans.

Box 11 – Fiscal and parafiscal levies on labour and tax shift options

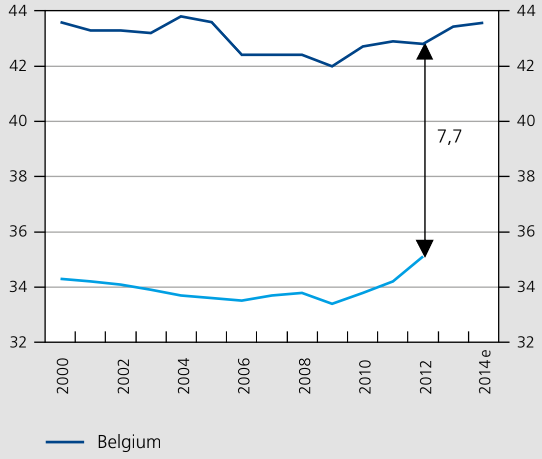
The general level of taxation in Belgium is high, with the tax burden on labour being among the highest in the euro area. The most recent EC statistics show that the implicit tax rate on labour is 7.7 percentage points higher than the euro area average in 2012, despite the strong rise there in 2010. And with the Belgian rate increasing further in recent years, the country's tax burden has again reached a level similar to that seen in 2000. On top of this, marginal rates have hit a record high: in Belgium, about two-thirds of pay rises go towards paying fiscal and parafiscal levies, irrespective of levels of income and family situations.

Although heavy taxation of labour income is used to fund a large proportion of social security costs and other public spending, it is clear that it has a discouraging effect on labour supply and demand. It might therefore be desirable to make the tax system more efficient, which would imply reducing the tax burden on labour and shifting it to less distorting tax bases. As the need for fiscal consolidation remains, a rebalancing of this kind would mean giving greater weight to consumption – in particular consumption with an adverse environmental footprint – and to capital as a basis for taxation. Corporation tax, on the other hand, is also generally felt to have an unfavourable impact on growth, so reforms to shift the tax burden onto corporations would not offer a good alternative to levies on labour.

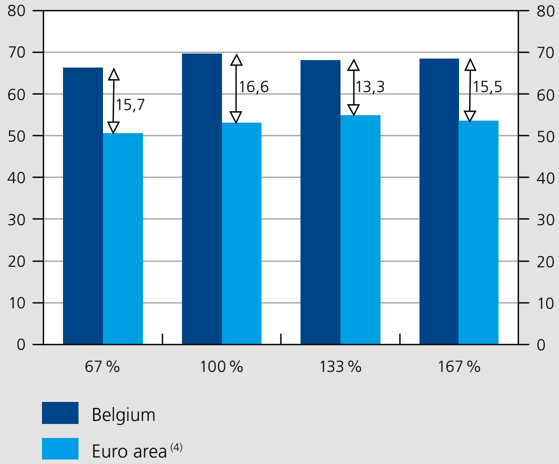
On 2 June 2014, the Ecofin Council recommended that Belgium should try to restore equilibrium in its tax system and improve its overall fairness in the 2014-2015 period, as well as preparing far-reaching tax reforms. This would, at the same time, pave the way for reducing the tax burden on labour income by shifting the tax base towards levies that would promote growth, simplify the tax system, put an end to tax abuse, improve VAT efficiency, broaden the tax base, lower tax expenditure and gradually abolish environmentally unfriendly subsidies.

LABOUR TAXATION

IMPLICIT RATE OF TAXATION ON LABOUR (1)
(as a % of labour costs)



MARGINAL FISCAL AND PARAFISCAL RATES ON LABOUR FOR A SINGLE EMPLOYEE WITHOUT DEPENDENT CHILDREN FOR VARIOUS INCOME LEVELS (2)
(as a % of labour costs, 2013)



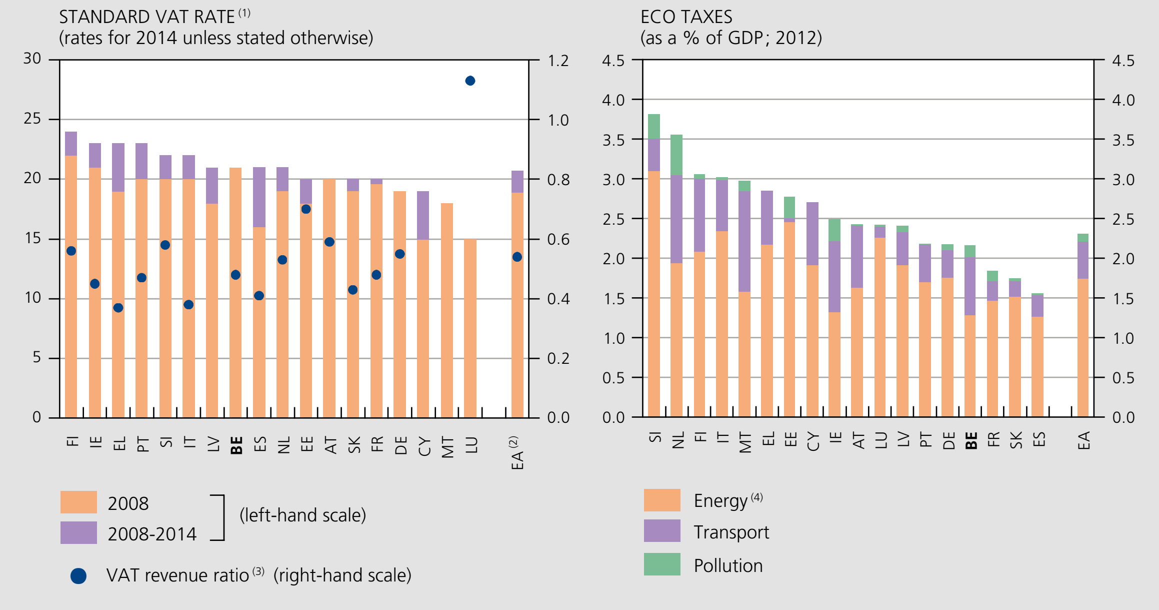
Sources: EC, OECD, NBB.
(1) Defined as total levies on labour income paid to the government, divided by the wage bill. Calculated on the basis of the national accounts.
(2) Expressed as a percentage of the average wage.
(3) Unweighted averages.
(4) Unweighted averages, except for Cyprus, Malta and Latvia.

The standard VAT rate in Belgium is close to the average for the euro area, particularly since most Member States recently raised their rates. However, the VAT revenue ratio, which measures the difference between effective revenues and the theoretical revenues that would have been collected if the standard VAT rate had applied to total consumption, shows that this difference is fairly large in Belgium. It has even risen in recent years, partly in response to the fact that the lowered rates were applied to accommodation and food service activities and to electricity consumption. Some thought should be given to using lowered rates for a significant proportion of the consumer basket.

At the same time, Belgium has a real opportunity to raise revenues from environmental levies. Expressed as a percentage of GDP, these levies are among the lowest in the euro area. Belgium's revenues from levies on energy are amongst the smallest, an average half a percentage point of GDP lower than the average for the other Member States. Excise duties in Belgium are also fairly low compared with most other countries in the euro area, for example on diesel and domestic heating oil. Moreover, the tax treatment of company cars and fuel cards is very generous.

Belgium could use additional levies in the form of indirect taxes and eco taxes to lower the tax burden on labour while at the same time encouraging more sustainable consumption patterns. Note in this regard that such a tax shift will have the best possible effect on Belgium's competitive position and employment if the impact on prices does not lead to wage increases.

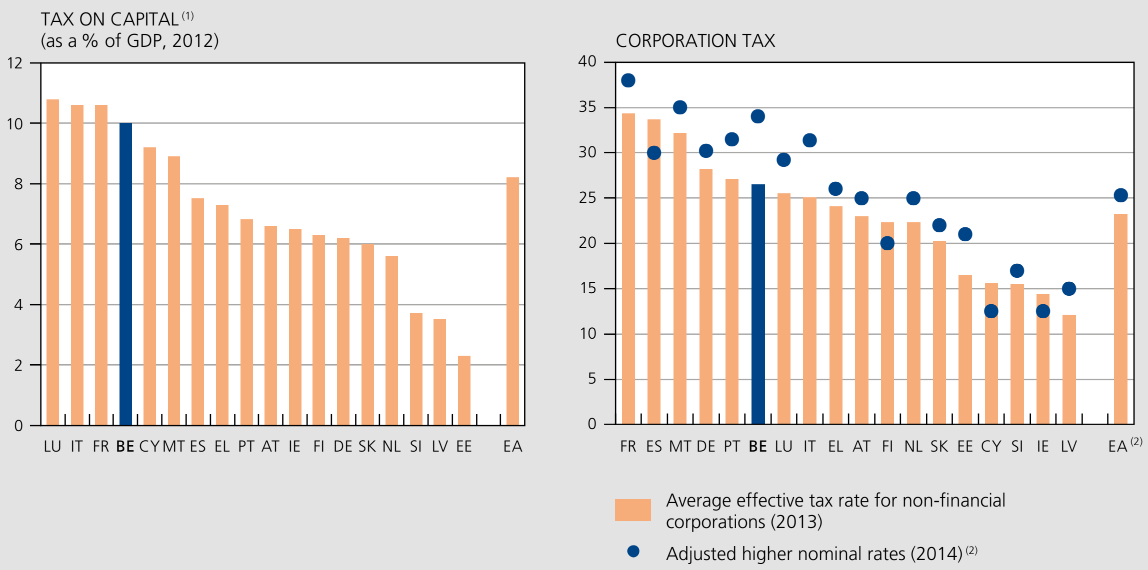
VAT AND ENVIRONMENTAL LEVIES



Sources: EC, OECD.
(1) If two rates apply in a given year, the rate that applied on 1 July is used.
(2) Unweighted averages.
(3) Calculated by the OECD, 2012 data.
(4) These taxes include excise duties on fuel.

Capital is more heavily taxed in Belgium – where tax on capital amounts to 10 % of GDP – than in the euro area, where the average amounts to 8.2 % of GDP. Corporation tax adds to the relatively high tax burden, giving Belgium one of the highest nominal tax rates in the euro area. Tax deductibles for companies – including tax allowances for venture capital – are very generous in Belgium, bringing the effective tax rate to 26.5 %. This tax rate is higher than in most European countries, but does not exceed the rate in France and Germany, for example. Capital transfer taxes, such as inheritance taxes and registration fees, are also substantial. Whereas annual capital income used to be only moderately taxed in Belgium, the situation changed as a result of withholding tax increases between 2012 and 2014. Capital gains realised by private individuals are barely taxed, however, whereas they are subject to taxation – in a variety of ways – in several European countries, including Belgium's neighbours. Note also that the effective tax rate is very unevenly distributed across the various types of assets. Some are heavily subsidised through personal income tax allowances, for example within the context of pension savings schemes. Other assets, such as interest income from savings, are exempt from the 25 % general withholding tax. This different tax treatment can lead to imbalances between types of savings. Besides the conversion of labour income into corporate revenues leads to distortions. Remedying these distortions could generate additional revenues, which could also be used to shift the tax burden.

TAX ON CAPITAL AND CORPORATION TAX



Sources: EC, ZEW.

(1) In Belgium, examples of capital taxation include, notably, corporation tax and tax paid by the self-employed, inheritance and gift taxes, tax paid on long-term savings, proceeds from tax regularisations, property tax, road tax paid by companies and rent payments by the nuclear power supply company.

(2) Unweighted averages.

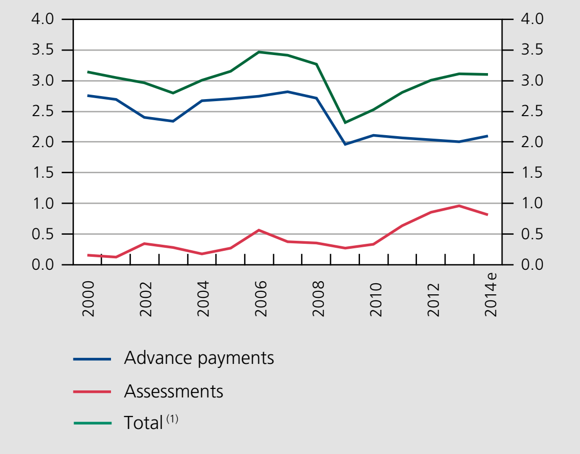
(3) If different tax rates exist, only the highest base rate applies; any additional levies and the average of local taxes are then added.

The tax burden on labour could also be relieved by improving tax administration procedures and combating tax fraud and tax evasion. This requires cross-border cooperation and the effective international exchange of tax information. In any case, recent decisions in this area are encouraging. In addition, various forms of fraud could be more efficiently tackled by making optimum use of the technical resources available to determine all incomes and the financial position of private individuals.

Tax revenues on company profits were virtually unchanged at 3.1 % of GDP in 2014. Assessments were negatively affected by a temporary factor, as last year's revenue had reflected a settlement with a company in the diamond sector involved in a massive international fraud. In addition, the 'fairness tax', a new measure that was supposed to bring in more tax revenue – applicable to certain companies whose distributed profits exceed the basis of assessment for corporation tax – did not yield as much as had been hoped, while the budgetary gains of other decisions were modest. Equally modest was the effect of measures reducing tax collection, such as higher tax allowances for investment – SMEs are granted tax exemptions for creating investment reserves and enjoy a 4 % allowance rate for their investment expenditure. However, the rise in advance tax payments almost made up for reduced assessment revenues, and 2014 would appear to have seen fewer companies shift to collection via assessments than in previous years. The tax surcharge due in the event of insufficient advance payments was unchanged, but a lot higher than market rates, so it may be cheaper to take out a loan to finance the advance payments than pay the penalty. That said, the increase was more modest than might be expected given the steady upward trend in gross operating surplus and the lower reference interest rate used to calculate the tax allowance for risk capital and the limited possibilities for transferring it.

Levies on other incomes and on assets held steady at 4.4 % of GDP, after having risen for four successive years – temporary factors being a key influence in recent fluctuations. For one thing, the increase in withholding tax on liquidation gains, raised from 10 % to 25 % in October 2014, had boosted revenues by around € 600 million in 2013 on the back of a transition measure, rising further to around € 660 million in the year under review. What is more, the third tax regularisation operation, heralded as people's last chance for tax forgiveness, was a resounding success. Files submitted in this third tax amnesty operation were dealt with in the course of 2014, and, together with the final stage of the second operation, generated around € 480 million more in tax revenues than in 2013, with the proportion related to inheritance tax falling to the Regions. Registration fees benefited from structural measures, primarily on long leases, to the tune of nearly € 100 million. Together, these favourable measures conspired to cushion the impact of lower inheritance taxes due to faster processing and the drop in withholding tax,

CHART 69 CORPORATION TAX
(in % of GDP)



Sources: NAI, NBB.
(1) Including other taxes, the main component of which is withholding tax.

TABLE 20 MAIN FISCAL AND PARAFISCAL MEASURES (1)
(in € million, differences compared to the previous year)

	2012	2013	2014
Structural fiscal measures	3 663	1 677	612
Federal government and social security	3 550	1 650	562
Personal income tax	1 330	461	–56
Corporation tax	1 087	552	327
Levies on other incomes and on assets	81	71	131
Taxes on goods and services	1 052	566	166
Communities and Regions and local authorities	113	27	44
Structural parafiscal measures	81	–121	–194
Non-recurrent measures	1 236	1 091	–140
of which:			
Liquidation gains	0	600	60
Tax regularisation	0	668	477
Late payment of the 2011 nuclear rent	500	–250	0
Inheritance taxes: filing deadline shortened by one month	80	40	–120
Early collection of the advance levy on life insurance	200	–200	0
Tax agreements and court decisions	300	–52	–248
Total	**4 980**	**2 647**	**278**
p.m. In % of GDP	*1.3*	*0.7*	*0.1*

Sources: Budget documents, NBB.
(1) This generally concerns the presumed influence of the measures according to the budget documents. The final impact may be different.

which reflected low interest rates and a shift of a proportion of savings to instruments taxed less heavily or later.

Taxes on goods and services rose by 0.1 percentage point of GDP, as the tax base remained robust. Private consumption virtually kept pace with GDP, but private investment – which is also subject to VAT – was relatively dynamic, while various indirect tax measures were also supportive. For instance, higher excise duties on tobacco and fuels (with a total impact of over € 330 million), the increase in annual taxes on credit institutions and a higher monopoly rent paid by the Loterie Nationale/Nationale Loterij (Belgium's national lottery) more than made up for the nearly € 400 million fall in VAT on electricity consumption and banks' lower contributions to the deposit guarantee scheme.

Non-fiscal and non-parafiscal revenues inched down in 2014, from 6.7 % to 6.4 % of GDP, in part because revenue-enhancing elements from 2013 had run their course, such as the Bank's record payments to the State or the refunds of excess customs duties levied by the EU. However, the main reason was the further erosion of interbank guarantee fees paid by financial institutions and the drop in dividends paid, totalling over € 600 million. After all, the Belgian State has fewer holdings in these institutions and the federal and Flemish governments also made fewer loans to some of them.

Continued high levels of primary expenditure

The government's primary expenditure, i.e. spending excluding interest charges, amounted to 51.4 % of GDP in 2014, a slight increase on the previous year, taking the increase in expenditure volumes, which is 1.3 %, a touch higher than the 1% real GDP growth rate.

To obtain a true picture of the fundamental trend in fiscal policy, the growth of expenditure should be adjusted for temporary factors as well as for cyclical factors and indexation effects. Non-recurrent factors, which include one-off refunds of unlawfully levied corporation tax, have fuelled expenditure in 2014 by 0.2 percentage point of GDP. Unemployment benefits show up the impact on primary expenditure of the economic cycle and stayed below their average pace of growth in 2014, with the cyclical component shaving a total 0.1 percentage point off primary expenditure in the year. Lastly, factors relating to indexation exerted more downward pressure on spending in 2014, estimated at 0.3 percentage point. After all, civil service pay and social benefits were not index-linked in the year – as the key index on which this mechanism is based has not been exceeded since the end of 2012 – while general price levels went up further.

At the end of the day, primary expenditure recorded adjusted growth of 1.5 % in 2014, and so exceeded GDP growth. This acceleration in real terms of general government's adjusted primary expenditure masks divergences between the various sub-sectors. The federal and local governments were expected to post a new drop in their

TABLE 21 GENERAL GOVERNMENT PRIMARY EXPENDITURE

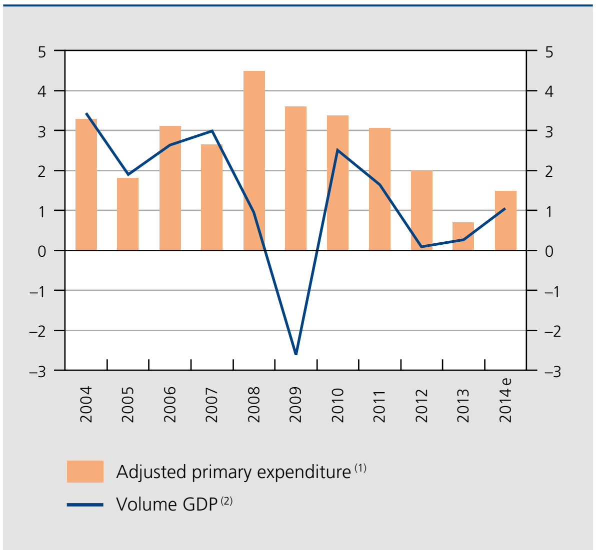
(deflated by the GDP deflator, percentage changes compared to the previous year, unless otherwise stated)

	2010	2011	2012	2013	2014 e	Average 2000-2013
Level recorded (1)	48.9	49.8	51.4	51.2	51.4	46.3
1. Real recorded growth	1.1	3.6	3.2	0.0	1.3	2.9
2. Influence of non-recurrent or fiscally neutral factors (2)	–1.3	0.6	0.8	–1.1	0.2	0.1
3. Influence of cyclical factors (2)	–0.1	–0.3	0.1	0.1	–0.1	0.0
4. Indexation effect (2) (3)	–0.9	0.3	0.3	0.4	–0.3	0.0
5. Adjusted real growth (1 – 2 – 3 – 4)	3.4	3.1	2.0	0.7	1.5	2.8

Sources: DGS, NAI, NBB.
(1) In % of GDP.
(2) Contribution to real recorded growth of primary expenditure.
(3) Effect caused by the difference between, on the one hand,the actual indexation of public sector wages and social security benefits and, on the other hand, the rise in the GDP deflator. The other effects due to differences between inflation measured by the GDP deflator and the movement in price factors influencing other expenditure categories – whether these are attributable to the indexation mechanisms or to divergent patterns in the prices of certain expenditure categories – are not adjusted, owing notably to the absence of sufficient information.

CHART 70 PRIMARY EXPENDITURE OF GENERAL GOVERNMENT AND GDP

(percentage volume changes compared to the previous year)



Sources: NAI, NBB.

(1) Primary expenditure deflated by the GDP deflator and adjusted for cyclical and non-recurrent or fiscally neutral factors, and for the indexation effect. The latter is caused by the difference between, on the one hand, the actual indexation of public sector wages and social security benefits and, on the other hand, the rise in the GDP deflator.

(2) Calendar adjusted data.

adjusted expenditure, whereas spending on social security and spending by the Communities and Regions was estimated to have exceeded economic activity by 1 and 2 percentage points respectively.

Various budget items contributed to more moderate adjusted federal government expenditure in 2014. For instance, a further marked reduction in the number of public sector workers led to a fall in remuneration, while purchases of goods and services by the federal government held steady in real terms. Conversely, the volume of subsidies to businesses increased, mainly comprising lower payroll tax and subsidies to the national railway company (SNCB/NMBS), Infrabel and bpost.

In 2014, growth of adjusted social security expenditure stayed firmly below the average in the past decade, and this related to the main social security benefits categories. Health care spending, which represents just over a third of the social security budget, increased by 1.3 % in real terms, a fairly similar trend to the previous year, which itself had been considerably below trend growth in the past. The target for real growth of health care expenditure, set at 3 % for 2014, was amply met.

Pension expenditure increased by 2.6 % in real terms, which was below the average since 2000 and reflected slowdown in the growth of the number of pensioners in 2014. That said, the pensions bill continued to grow faster than average economic activity, while benefits paid under the sickness and disability scheme shot up to well above the long-term average in real terms. By contrast, cyclically adjusted unemployment benefits fell in real terms on the back of the labour market reforms introduced by the previous federal government, such as making unemployment benefits more degressive over time, and raising to 60 the age up to which unemployed people must be available for work.

TABLE 22 ADJUSTED PRIMARY EXPENDITURE BY GENERAL GOVERNMENT SUB-SECTOR (1) (2)

(deflated by the GDP deflator, percentage changes compared to the previous year)

	2010	2011	2012	2013	2014 e	Average 2000-2013
Entity I	4.6	3.5	2.1	0.6	1.4	2.8
Federal government	8.2	4.9	0.2	−1.4	–0.4	2.5
Social security	3.1	2.9	3.0	1.5	2.2	2.9
Entity II	1.4	2.3	1.7	0.9	1.6	2.7
Communities and Regions	2.2	1.8	0.5	2.0	2.9	2.9
Local authorities	0.1	3.3	4.0	−1.0	–0.8	2.3
Total	3.4	3.1	2.0	0.7	1.5	2.8

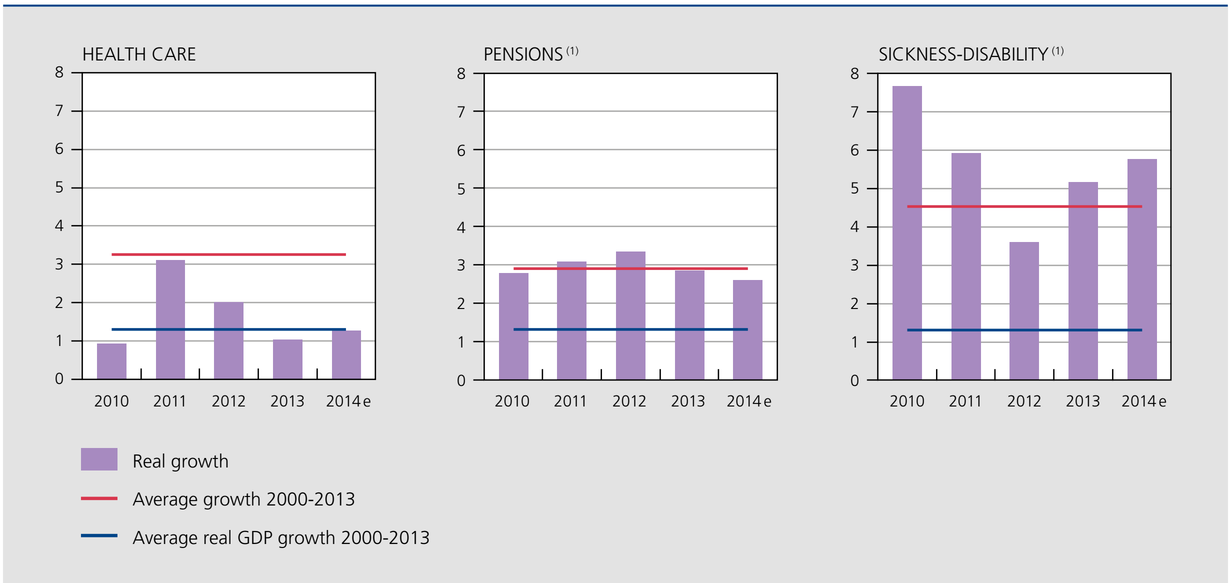
Sources: NAI, NBB.

(1) The expenditure of the general government sub-sectors does not include mutual transfers.

(2) Primary expenditure deflated by the GDP deflator and adjusted for cyclical and non-recurrent or fiscally neutral factors, and for the indexation effect. The latter is caused by the difference between, on the one hand, the actual indexation of public sector wages and social security benefits and, on the other hand, the rise in the GDP deflator.

CHART 71 PUBLIC EXPENDITURE ON HEALTH CARE, PENSIONS AND SICKNESS AND DISABILITY BENEFITS

(deflated by the GDP deflator, percentage changes compared to the previous year, unless otherwise stated)



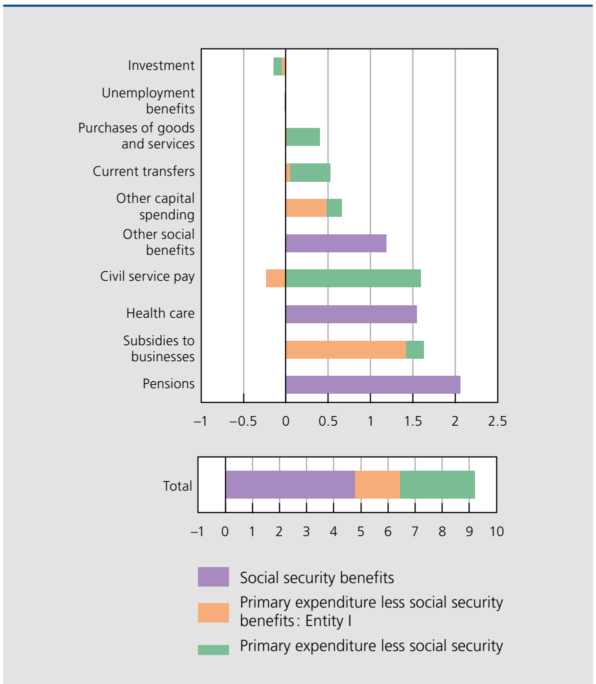
Sources: Budget documents, NAI, NBB.
(1) Expenditure adjusted for the indexation effect, caused by the difference between, on the one hand, the actual indexation of public sector wages and, on the other hand, social security benefits and the rise in the GDP deflator.

The Communities and Regions reported a 2.9 % increase in adjusted primary expenditure, the big-ticket items being subsidies to businesses, current transfers and investment. Lastly, adjusted expenditure by local government came in 0.8 % lower as a result of reduced government investment, which traditionally drops back in the two years that follow local and provincial elections.

Taking a long-term perspective, however, primary expenditure has staged a significant 9 percentage point average upturn since 2000, this being mostly down to three key expenditure categories: social security benefits, civil service pay and subsidies to businesses. First, social security benefits added 4.8 percentage points of GDP, climbing much faster than economic activity. The category saw pensions and health care spending add 2.1 and 1.5 percentage points between 2000 and 2014. Second, civil service pay was up 1.4 percentage points in the same period, all of this attributable to the Communities and Regions, and local government. The last contributor, subsidies to businesses, accounted for 1.6 percentage points of GDP in the period, which is attributable to the federal government (payroll tax reductions) and to social security (the service voucher scheme and employment activation programmes).

CHART 72 PRIMARY EXPENDITURE BY CATEGORY AND BY ENTITY

(changes between 2000 and 2014, in percentage points of GDP)



Sources: NAI, NBB.

Investment, which is considered productive public spending as it bolsters the economy's growth potential, was the only category to decline relative to GDP, from 2.3 % in 2000 to 2.1 % in 2014. The election cycle's influence on local government spending offers only part of the explanation, and relative government expenditure levels are well below the average in the euro area.

Interest rate falls push interest charges down further

In 2014, interest charges fell by 0.2 percentage point to 3 % of GDP, in line with the ongoing downward movement in the interest charges-to-GDP ratio since the early 1990s. This steep fall was due mainly to the steady reduction in the implicit interest rate on the public debt, down from 10.1 % of GDP in 1990 to 3 % in 2014. Up to 2007, the fall in interest charges was also caused by the significant decline in the debt ratio, but the rise in the debt ratio has slowed the reduction in interest charges since the end of 2008.

The year under review was no different and the further decline in interest charges mirrored the exceedingly low interest rates on new securities and government loans, both short-dated and longer-dated paper. In fact, ten-year rates kept coming down throughout the year and even dipped below the 1 % threshold by the end. Most countries in the euro area saw similar movements. The spread on Belgian government paper against Bunds halved to around 30 basis points by the end of 2014, which is similar to the spread observed for French government loans.

Overall balance of the general government sub-sectors

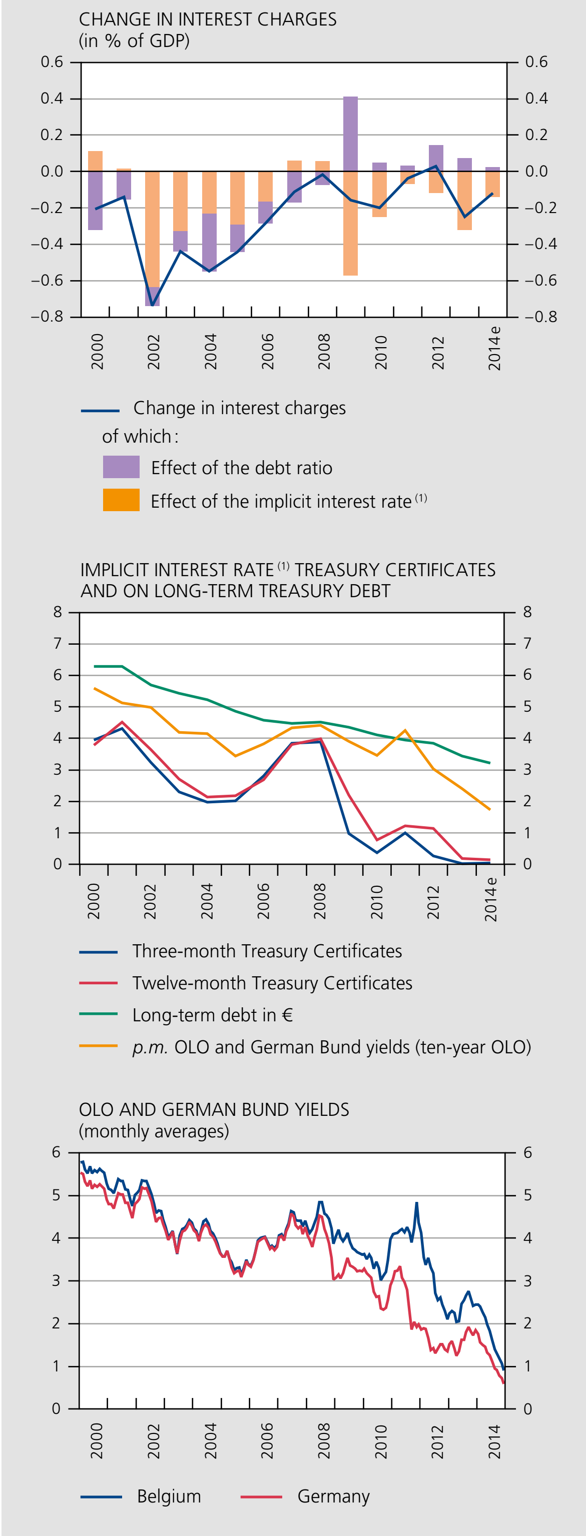
Despite a minor fall in interest charges, the federal government deficit climbed to 2.6 % from 2.4 % of GDP in 2013. This deterioration was caused by a fall in both non-fiscal and fiscal revenues that are retained at the federal level of power after transfers to all other sub-sectors. In this respect, transfers rose faster than the revenues collected by FPS Finance.

The additional revenue received from the federal government partly went towards social security; as in previous years, it helped to pay for the sudden increase in social security benefits. After a small deficit in 2013, social security spending was in balance again in 2014.

The Communities and Regions saw their deficit widen further, to 0.5 % of GDP. The Flemish Community, the Walloon Region and the French Community ended the 2014 fiscal year on significant funding shortfalls, while the Brussels-Capital Region was predicting a virtually balanced

CHART 73 TEN-YEAR GOVERNMENT BOND YIELDS AND BREAKDOWN OF CHANGES IN INTEREST CHARGES

(in %, unless otherwise stated)

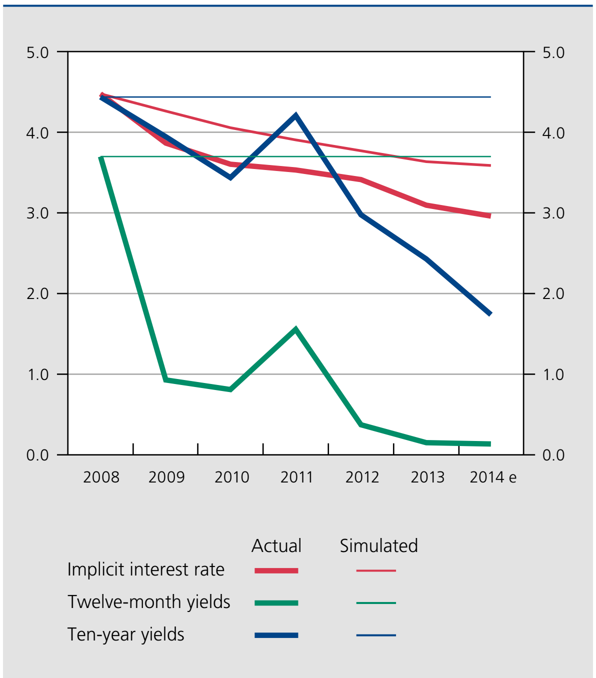


Sources: FPS Finance, NAI, Thomson Reuters Datastream, NBB.
(1) Ratio between interest charges in the current year and debt at the end of the previous year.

Box 12 – Lower interest rates and their effect on government interest charges

The fall in interest rates over the past few years has sharply reduced the interest charges paid by the Belgian State. To get an idea of the amounts actually saved by the Treasury, this Box compares paid interest with the interest bill it would have had to pay if rates had stayed at their average market levels since the outbreak of the financial crisis in 2008. At the time, Treasury bills were looking at three-month rates of 3.7 % and ten-year linear bonds (OLOs) at 4.4 %. These theoretical levels can be tested against effective rates, which fell by 3.6 and 2.7 percentage points respectively between 2008 and 2014. These projections suggest that the implicit interest rate, i.e. total interest charges relative to outstanding debt, will continue to decline despite constant market rates, as previously taken out higher-rated loans mature and are refinanced with cheaper loans.

BELGIAN GOVERNMENT YIELDS, ACTUAL AND SIMULATED
(annual averages)



Source: NBB.

The simulation shows that the Treasury would have had to pay € 2.9 billion more in interest charges in 2014 if Belgian public debt securities had been issued at average conditions prevailing in 2008. Over one-third of this would be attributable to lower short-term yields, and nearly two-thirds to falling long-term yields. This saving, which gradually rises from 2008 onwards, would have implied a windfall gain for the budget in 2014 of 60 basis points in terms of the implicit interest rate on Belgian government debt, taking the saved amount, which rises steadily in the simulation period, to 0.7 % of GDP. All in all, lower interest rates would have saved a total € 11.2 billion over the projection period, with cumulative cost-cutting since 2008 taking 2.8 % off the debt ratio. And if market rates remain low, the positive effects would be even greater in future.

Falling interest rates, the result of the ECB's accommodating monetary policies among other things, have thus somewhat eased the fiscal restrictions faced by the government. But although low interest rates have in fact kept interest charges in check, they are caused by an economic climate not beneficial to public finances. These two effects, lower interest charges and pressure on the primary balance related to unfavourable economic conditions, are pulling in two different directions. By the same token, the burden carried by debt-laden entities – such as the government – in a low-inflation environment is lessened by the falling nominal interest rates resulting from this environment, albeit that the offset is only partially due to the inertia of the implicit interest rate.

Lower interest charges present an opportunity the government should jump at to reduce its deficit. It needs to preserve the sustainability of public finances, and not just because of the effect of rising implicit interest rates on public debt, but also because of the rapidly growing costs of ageing, a trend that has already got underway.

INTEREST-RATE REDUCTION AND ITS EFFECT ON GOVERNMENT INTEREST CHARGES
(data concerning 2014)

	Implicit interest rate (1)	Interest charges	
		(in % of GDP)	(in € billion)
1. Actual levels	3.0	3.0	12.2
Short-term debt	0.1	0.0	0.0
Long-term debt	3.2	3.0	12.2
2. Simulated levels (2)	3.6	3.8	15.1
Short-term debt	2.8	0.3	1.1
Long-term debt	3.7	3.5	14.0
3. Difference (1 – 2)	–0.6	–0.7	–2.9
Short-term debt	–2.7	–0.3	–1.1
Long-term debt	–0.5	–0.5	–1.8

Sources: NAI, NBB.
(1) Relationship between interest charges in the current year and debt at the end of the previous year.
(2) The simulation assumed unchanged figures for the government's funding structure and primary balance levels; only outstanding debt was influenced by the change in the interest charge amount.

budget. Primary expenditure caused the increased deficit in the Communities and Regions as a whole, which saw their own revenues fall in the wake of fewer tax receipts and an absence of a dividend payment to the Flemish Community by KBC (unlike the previous year). The overall fall exceeded the additional tax revenues allocated by the federal government under the old Finance Act, last applied before the sixth State reform – as announced on 6 January 2014 – came into force.

Local government saw its deficit come down to 0.1 % from 0.2 % of GDP. Revenues stagnated, while expenditure dropped on the back of investment cuts in keeping with its typical electoral cycle.

In its April 2014 stability programme, the federal government proposed a breakdown of the budget target across the sub-sectors, in addition to outlining the fiscal path for government as a whole, assuming a deficit of 2.1 % of GDP for 2014. The objectives for fiscal 2014 were in line with the July 2013 cooperation agreement, which had envisaged a surplus for local government reflecting its elections-related investment cycle. Between them, the Communities and Regions were supposed to strike a nominal balance, in

TABLE 23 OVERALL BALANCE OF GENERAL GOVERNMENT AND BY SUB-SECTOR

(in % of GDP)

	2010	2011	2012	2013	2014 e	Target in 2014 (1)
Entity I	–3.1	–3.4	–3.6	–2.5	–2.6	–2.3
Federal government	–3.0	–3.5	–3.4	–2.4	–2.6	–2.3
Social security	–0.2	0.1	–0.1	–0.1	0.0	0.0
Entity II	–0.8	–0.5	–0.5	–0.4	–0.6	0.1
Communities and Regions	–0.7	–0.3	0.0	–0.2	–0.5	0.0
Local government	–0.1	–0.2	–0.5	–0.2	–0.1	0.1
Total	–4.0	–3.9	–4.1	–2.9	–3.2	–2.1

Sources: FPS Finance, NAI, NBB.
(1) Targets from the April 2014 stability programme, determined on accounts drawn up in accordance with ESA 95.

accordance with the recommendations of the High Council of Finance's Public Sector Borrowing Requirement section. Entity I, which comprises the federal government and social security, was to limit its deficit to 2.3 % of GDP, a figure in line with the objective imposed on the federal government, assuming that it would keep social security in balance.

On the basis of the most recent data under ESA 2010 – which entail an increase in the deficit of nearly 0.3 % of GDP compared with ESA 95, in use when the stability programme was drawn up (see Methodological Note) – the fiscal targets of the Stability Pact were not achieved for either Entity I or Entity II, with both the Communities and Regions and local government responsible for the latter.

4.3 Public debt and government guarantees

Debt ratio back up

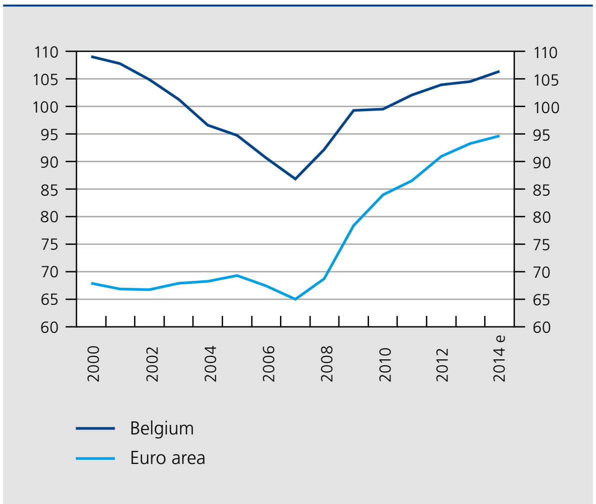
The Belgian government's debt ratio came to 106.5 % of GDP at the end 2014, compared with 104.5 % a year earlier. A range of methodological changes introduced by the NAI in the course of 2014 – partly due to the transition to the ESA 2010 methodology – led to a total upward revision of the ratio by 4.5 percentage points of GDP. The revision was mainly the result of the inclusion of institutional entities in the public sector and the rearrangement of transactions that used to be recognised differently in the accounts (see Methodological Note).

There was no change, then, in the upward debt ratio trend that started in 2008, when the government first injected capital into various ailing financial institutions. Belgium has seen its debt ratio add nearly 20 percentage points of GDP since 2007, while public debt in the euro area rose by close to 30 percentage points of GDP. In contrast with the previous two decades, however, the debt ratio gap between Belgium and the euro area widened in the year under review.

Endogenous factors underlay much of the 2014 rise in the Belgian debt ratio, accounting for 1.6 percentage points of GDP. Their impact is determined partly by the gap between the implicit interest rate on the public debt and nominal

CHART 74 CONSOLIDATED GROSS GOVERNMENT DEBT IN BELGIUM AND IN THE EURO AREA

(in % of GDP)



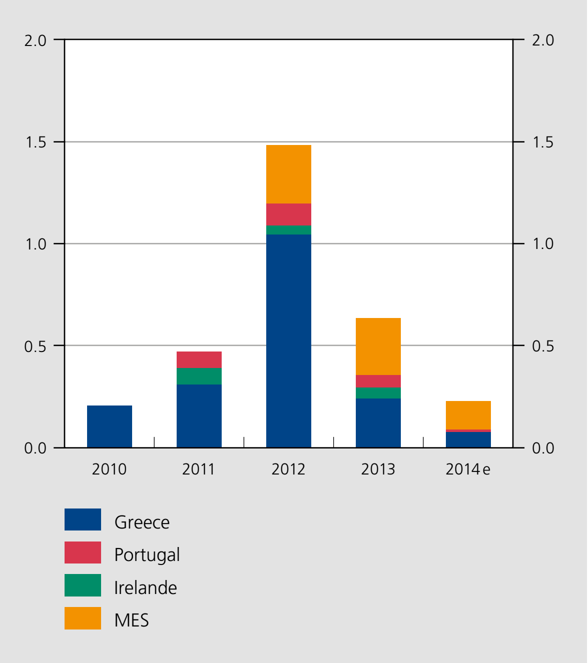
Sources: EC, NAI, NBB.

GDP growth, and partly by the level of the primary balance. With both real GDP and the GDP deflator barely moving, nominal GDP growth was relatively subdued and stayed well below the implicit interest rate on public debt. The primary balance, which reversed into a deficit of 0.2 % of GDP in 2014, was unable to stop the domino effect.

Exogenous factors, so named because they have an impact on the public debt but not on the overall balance, had an unfavourable influence of 0.3 % of GDP on the debt in 2014. Once again, Belgium's federal debt was directly affected by Europe's sovereign debt crisis, as aid to Greece, Ireland and Portugal via the European Financial Stability Facility (EFSF) and the capital contributions to the ESM increased the debt by nearly 0.2 % of GDP. The cumulative effect of the aid to European countries in difficulty, granted by Belgium since 2010 in the form of bilateral loans and via the EFSF and the ESM, comes to 3 % of GDP. In 2014, the debt ratio also added nearly 0.1 % of GDP as a result of the integration of Dexia NV, the holding company of the Dexia group, within the general government boundary, following the sale of Dexia Asset Management at the beginning 2014. Two temporary factors also weighed on the debt ratio. First, the Flemish municipalities acquired Electrabel's stake in the Flemish mixed (public and private) distribution system operators for gas and electricity, after receiving a bridging loan from Eandis for this purpose, pending an equally large sum from a planned capital reduction. And second, corporation tax receipts lagged behind assessments in the year under review. By contrast, other factors helped relieve debt, one being the repayment by KBC of the capital injection received from the Flemish Community, worth 0.1 % of GDP. Moreover, actual debt management also pushed GDP down by 0.5 %, owing to hefty issue premiums. With coupons on general government debt exceeding market rates, issue values were higher than their nominal values – the benchmark for what is known as the Maastricht debt. This effect will peter out as higher coupons are paid.

CHART 76 DIRECT IMPACT OF THE SOVEREIGN DEBT CRISIS ON BELGIAN PUBLIC DEBT [1]

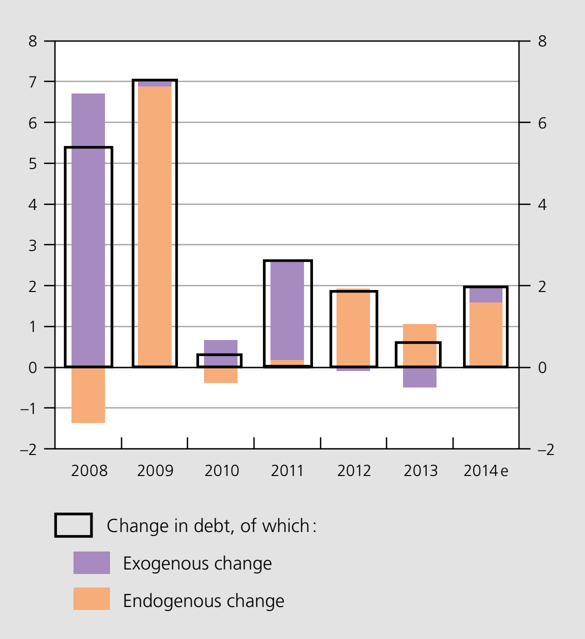
(in % of GDP, end-of-year data)



Sources: EFSF, ECB, NBB.
(1) Direct impact of the loans to other euro area countries (bilateral loans to Greece and loans via the EFSF) and capital injections into the ESM.

CHART 75 DETERMINANTS OF THE CHANGE IN THE CONSOLIDATED GROSS DEBT OF GENERAL GOVERNMENT

(in % of GDP)



Sources: NAI, NBB.

Treasury debt management again benefited from favourable conditions

In 2014, the gross balance to be financed by the Treasury stood at € 38.2 billion, which is below the € 40.4 billion figure recorded in 2013. The federal government's growing fiscal deficit was amply offset by steep falls in medium- and long-term loans maturing – the outcome of the steady increase in maturities in the past few years – and by the smaller amount of outstanding loans bought back compared with the previous year.

Unlike in the 2011-2013 period, the Treasury increased short-term financing by issuing Treasury bills in 2014, in order to boost the instrument's liquidity. Combined with a lower gross borrowing requirement, this resulted in a sharp reduction in medium- and long-term refinancing, particularly by way of OLOs. And yet, the Treasury issued more loans than it had planned towards pre-funding expected 2015 requirements, which were adjusted upwards as the year progressed. Solid debt management kept the average maturity of the Treasury's debt portfolio virtually unchanged at 7.8 years, whereas it had continuously risen in the previous few years. A longer average maturity typically reduces refinancing risks.

2014 confirmed the upturn in foreign demand for Belgian government securities, first observed in 2013, and the share of debt held outside Belgium rose to 50 % by the end of the third quarter. This was solely due to renewed investor interest from outside the euro area. In the context of investors' search for yields in the financial markets, robust foreign demand and shrinking spreads between Belgian interest rates and core euro area countries also reflect confidence in the Belgian markets.

TABLE 24 FINANCING REQUIREMENTS AND RESOURCES OF THE FEDERAL GOVERNMENT

(in € billion)

	2012	2013	2014 e
Gross balance to be financed	40.5	40.4	38.2
Gross financing requirements	33.5	33.0	32.8
Budget deficit (–) or surplus (+) (1)	8.0	5.7	10.5
Medium- and long-term debt maturing during the year	25.6	27.3	22.4
In euro	25.6	27.3	22.4
In foreign currencies	0.0	0.0	0.0
Buy-backs (securities maturing the next year or beyond)	7.0	7.4	5.3
Other financing requirements	0.0	0.0	0.0
Funding resources	48.0	46.7	35.7
Linear bonds (OLOs)	43.0	42.3	31.8
State notes and others	5.1	4.4	3.8
Net change in the short-term debt in foreign currencies	0.0	0.6	–0.6
Change in the outstanding amount of Treasury Certificates	–3.4	–7.1	1.8
Net change in other short-term debts in € and in financial assets	–4.1	0.1	1.4

Source: FPS Finance.

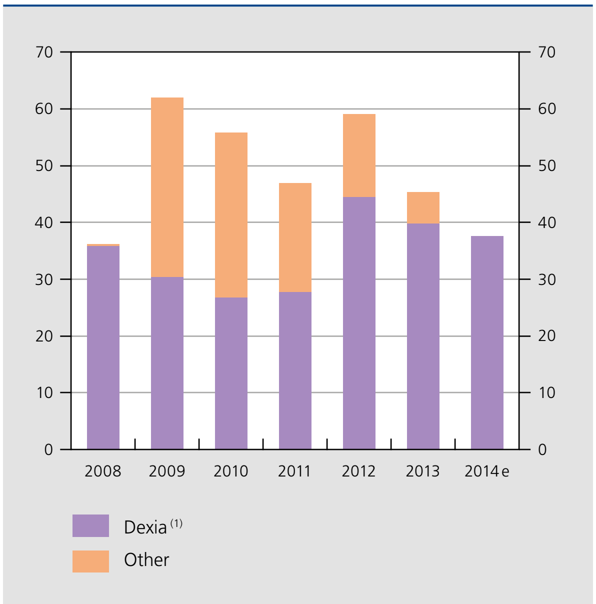
(1) The overall balance is calculated on a cash basis and takes account of financial transactions which are not included in the overall balance of general government which, in accordance with ESA 2010, is calculated on a transaction basis.

Further reduction in guarantees granted to financial institutions

Against the backdrop of the financial crisis, the Belgian government, principally the federal State, granted guarantees to financial institutions, which do not affect the budget balance or the debt unless they are called on. At the end of 2014, the only remaining guarantee was the Dexia interbank funding that had been agreed in December 2011. Federal government guarantees for KBC ended, as in 2014 the bank wound down the CDOs they underpinned. Remaining guarantees for Fortis were also lifted at the start of 2014, and the total amount of guarantees – ignoring the deposit protection scheme – declined by € 7.8 billion to € 37.6 billion at the end of 2014. Despite this, guarantees granted to the financial sector still constitute a major potential commitment, accounting for 9.4 % of GDP, and comprise the vast majority of all general government guarantees. Recent NAI figures put other guarantees at nearly 1.8 % of GDP. These were granted by the federal government as well as the Communities, Regions and the local government.

CHART 77 GUARANTEES GRANTED TO FINANCIAL INSTITUTIONS

(in € billion)



Sources: NAI, FPS Finance, NBB.

(1) Guarantees relating to the 2008 and 2011 schemes. For 2014, only the 2011-related guarantees apply.

Placing the economy on a broader footing

5. Placing the economy on a broader footing

Like many other European countries, Belgium is facing significant challenges, specifically related to its steep government debt levels, the budgetary costs of population ageing, its low employment rate and the marked slowdown of productivity gains. Key measures have been implemented since 2011 and the newly elected government announced further steps after the May 2014 elections, with pension reform again claiming a central position. More generally, job creation in the market sector and productivity enhancements should help assure a sustainable consolidation of public finances. Eight out of ten jobs created between 2000 and 2013 are mainly paid from government resources and labour costs in Belgium are higher than in neighbouring countries, particularly due to very high fiscal pressure. These costs affect the demand for low-skilled labour and hamper the transition to paid work. To improve this transition, the country needs to introduce appropriate financial incentives, coupled with education and activation policies to help reduce labour market mismatches. Smoothly functioning product and labour markets should also encourage a reallocation of production factors to the most efficient companies, and serve as an important source of productivity gains in the economy, notably in the services sector. However, Belgium is struggling with thin business creation. Meanwhile, long-life-cycle investment is required to prevent looming shortages in electricity supplies, for which a stable and predictable regulatory framework is a prerequisite.

5.1 Major challenges

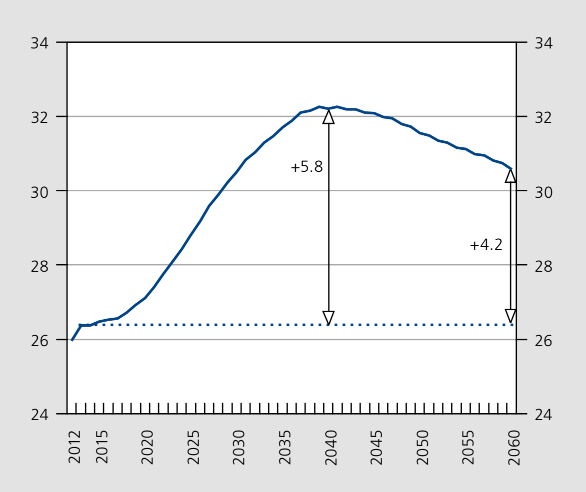
In 2014, the Belgian economy again performed less well than expected, as was generally the case elsewhere in Europe. Yet the rate of fiscal consolidation slowed, monetary policy remained accommodating and financial conditions were favourable. This underlines the need to reinforce the economy's ability to boost economic activity and employment on a long-term basis. There is a need to strengthen the economy's resilience to strong cyclical fluctuations and, at the same time, in combination with Belgium's fiscal policy, to safeguard prosperity and consolidate support for the social protection of today's and future generations.

In this respect, Belgium faces the same challenges as most other European countries. It should therefore follow the shared European strategies and comply with the recommendations that have been drawn up. In doing so, it will contribute to the proper functioning of the Economic and Monetary Union (EMU), which brings major benefits for the country. That said, Belgium has specific characteristics that require special treatment and priorities in order for the economy to be able to perform optimally.

Characteristics that are specific to Belgium are the high (and still rising in 2014) level of public debt, the budgetary costs of ageing, the low employment rate and the sharp downturn in productivity gains.

High public debt reduces the scope of budgetary policy to help cushion cyclical downturns and makes the economy more vulnerable to increases in financing costs, especially if these continue to rise. What is more, the budgetary costs of ageing are very high in Belgium, and accelerating fast. According to the most recent forecasts from the Belgian Study Group on Ageing (July 2014), the weight of benefits as a percentage of GDP will add 5.8 % between 2013 and 2040 if policies are left unchanged; and the European Commission is predicting an even stronger increase on the basis of other macroeconomic hypotheses and different expenditure parameters.

CHART 78 BUDGETARY COSTS OF AGEING
(in % of GDP)



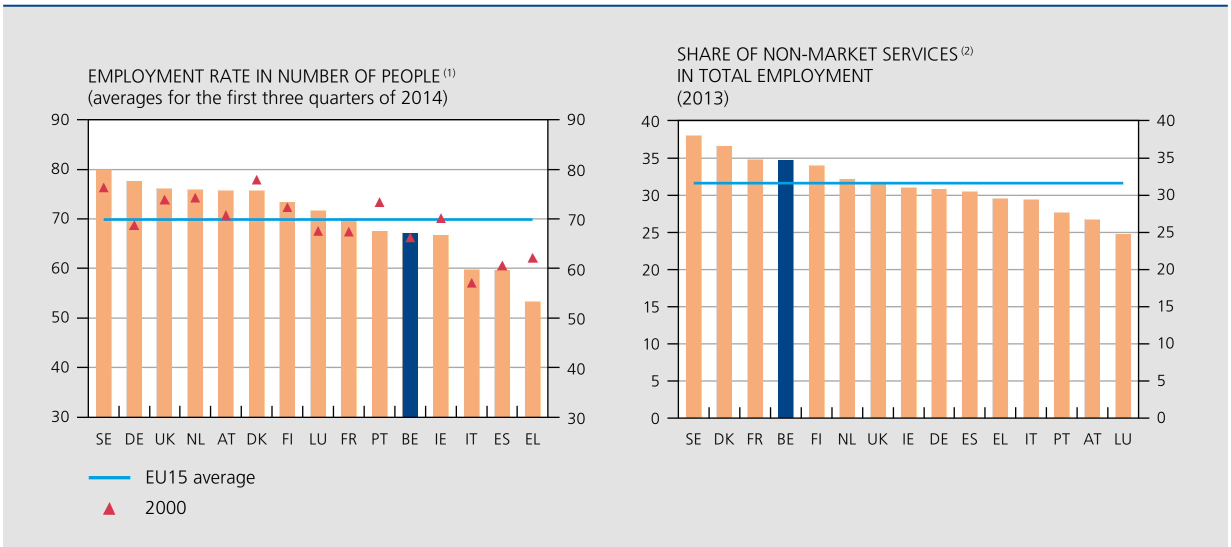
Source: Study Group on Ageing.

Since the previous government had launched an initial range of measures – whose effects were factored into the Study Group on Ageing forecasts – the newly elected federal government has announced it will tighten up the age and minimum career length conditions for early retirement, raise the statutory pension age to 66 in 2025 and 67 in 2030, and review the parameters for calculating civil servants' pensions. With no precise implementing details available at this stage, it is not yet possible to estimate the effects of these reforms on the cost of an ageing population. It will take a more detailed assessment to work out to what extent these new measures might reduce these costs, especially in the early stages when they will grow the fastest.

The employment rate amongst people aged 20-64 years averaged 67.2 % in the first three quarters of 2014. Not only is this 2.6 percentage points below the EU15 average and nearly 13 percentage points lower than in Sweden, it is well below Belgium's own objective of 73.2 % set in the context of the Europe 2020 strategy. The economic crisis has undoubtedly squeezed the employment rate, but does not entirely explain why Belgium is falling behind, as demonstrated by the modest difference between the unemployment rate of 8.6 % on average in 2014 and the structural unemployment rate of 7.8 % according to EC estimates.

The employment rate for the 55-64 age bracket is clearly too low (42.3 % compared with an average 53.8 % for the EU15), although it has risen significantly since 2000. The same applies to low-skilled workers (46.5 % of those who have not obtained a certificate of higher secondary education or the equivalent are in employment, against 52.8 % for the EU15). Employment is particularly low among nationals from outside the EU, only 41 % of

CHART 79 INTERNATIONAL EMPLOYMENT COMPARISON



Source: EC.
(1) As a % of the population aged 20-64 years.
(2) As a percentage in line with the national accounts. The non-market services comprise public administration, national defence, education, health care, social services and other services.

TABLE 25 EMPLOYMENT TRENDS BY MAIN BRANCH OF ACTIVITY

(in thousands of people)

	Change	Level
	2000-2013	2013
Domestic employment	429	4 543
Market activities [1]	159	2 966
Non-market services	270	1 577
p.m. Service vouchers	*118*	*118*
p.m. Jobs largely funded by the government [2]	*352*	*1 659*

Sources: NAI, NSSO.

(1) Agriculture, industry, construction, trade, transport, hotels and restaurants, information and communication, financial and insurance activities, real estate activities and business services.

(2) Jobs in non-market services and estimated share of service-vouchers based employment in market activities.

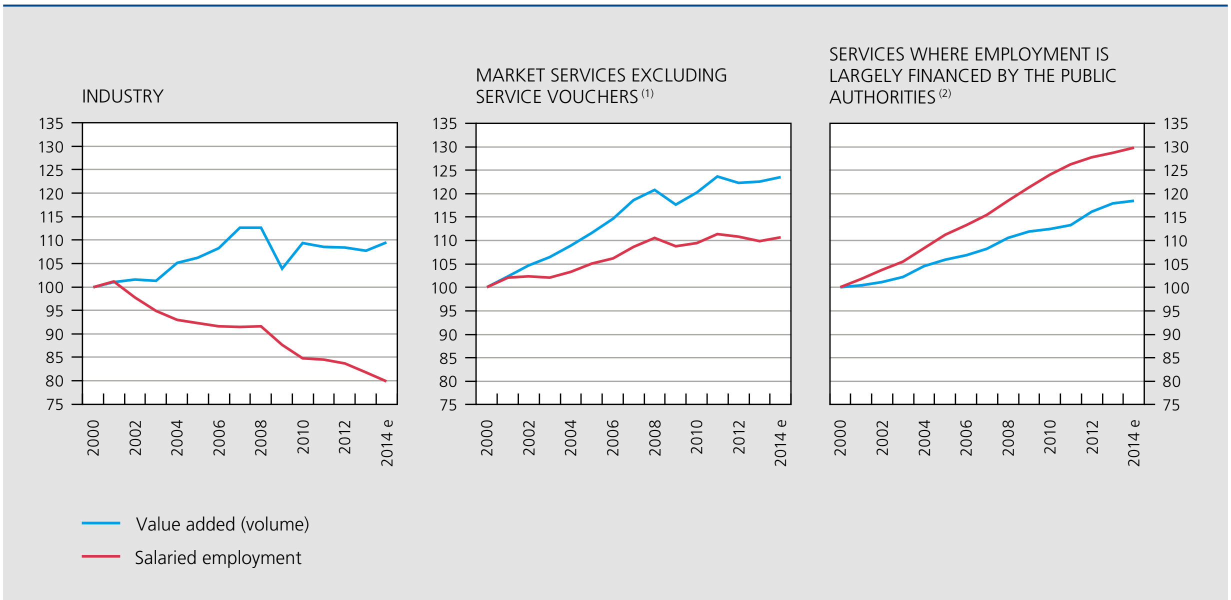
whom are in work – i.e. almost 30 percentage points less than Belgian nationals. Other categories, such as women and the under 30s, also have a lower probability of being employed, while regional differences are also very marked, with the employment rate in Flanders over 10 percentage points higher than in Wallonia (71.8 % as against 61.7 %) and Brussels (58.4 %).

What is more, the percentage of jobs in the non-market sector is relatively high in Belgium, standing at 34.7 % in 2013 compared with an average 31.6 % in the EU15. In fact, employment growth in Belgium since the early 2000s has been mostly on the back of the net creation of jobs that are partly or wholly funded by the government. And this does not just concern additional people in public administration and education, who saw their numbers swell by 100 000, but primarily around 170 000 extra workers in health care and social services and people who work for private sector employers under the service voucher scheme. In all, an estimated eight out of ten jobs created between 2000 and 2013 primarily rely on government funding.

Value added and employment trends vary widely from one sector to the next. In industry, growth in economic activity was rudely interrupted by the great recession, the lingering effects of which had still not disappeared by the end of 2014. The sector's value added increase is in stark contrast with its falling employee numbers, and reflects an accumulation of significant productivity gains. These are much more modest in market services, where value added growth more closely reflected employment,

CHART 80 EMPLOYMENT AND VALUE ADDED IN THE MAIN BRANCHES OF ACTIVITY

(data adjusted for seasonal and calendar effects, indices 2000 = 100)



Sources: NAI, NBB.

(1) Trade, transport, hotels and restaurants, information and communication, financial and insurance activities, real estate activities and business services, disregarding service-voucher jobs from market activities.

(2) Non-market services, including service-voucher-related employment in market services.

while the crisis had much less of an impact and proved more temporary than in industry. By contrast, non-market services hardly felt the recession at all: employment was up sharply and staged the highest growth in the economy, with economic activity trailing slightly behind.

Public services and personal service activities undoubtedly contribute to community well-being, and respond to the needs of a society whose socio-demographic make-up and lifestyles are changing. By providing education and health care, in particular, these services also support growth potential. But these trends also imply risks – to the sustainability of public finances in particular – if they do not coincide with sufficient job creation in the market sector. Sustainable public finances can only be secured if the economy has a sufficiently wide range of income-generating activities, as non-market services that weigh on the primary balance are not neutral for government budgets.

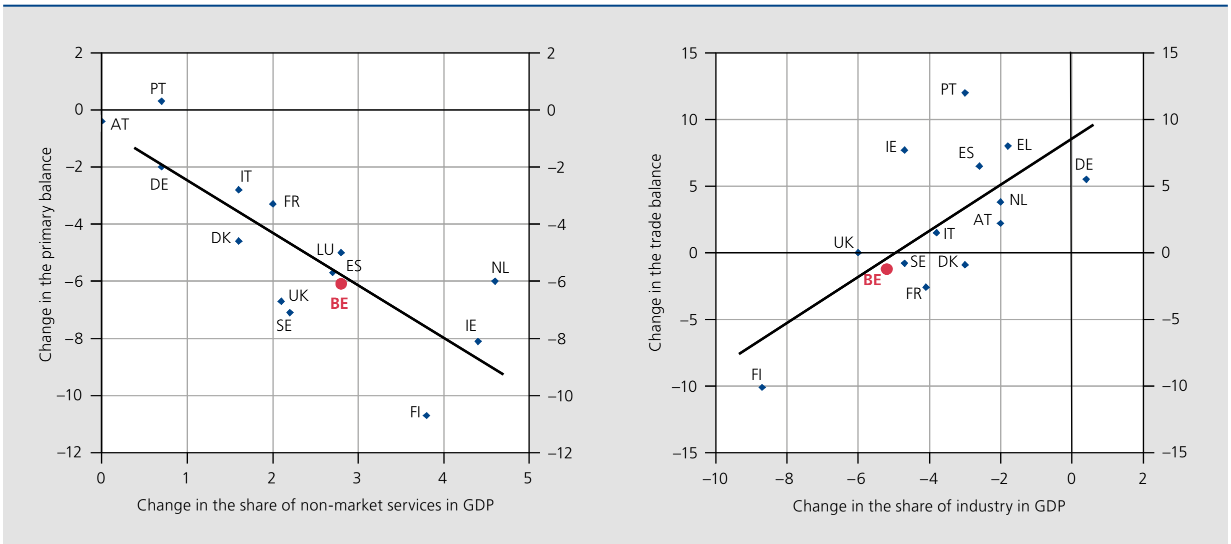
While the Belgian economy was changing in structure, its trade balance also deteriorated, from a surplus of 2.9 % of GDP in 2000 to a deficit of 0.2 % in 2013 according to the balance of payments. Broadly speaking, a decline in the relative weight of market activities – and industry in particular – erodes an economy's ability to export goods and services. The 2002-2013 period witnessed net annual destruction of jobs in the manufacturing industry, which lost a total of no less than 117 000 jobs.

To a degree, the decline ties in with restructuring of production processes in industry itself: jobs that were previously done within the sector have been transferred to service suppliers to create greater flexibility and improve cost control, and research into the production process underlying exported goods has shown that part of their value lies in services sectors providing intermediary services to the manufacturing industry, such as legal and accounting services, management, services from architects and engineers, supervision, technical analysis and so on. Service suppliers increasingly also operate as commercial go-betweens, taking care of re-exported goods, or acting as an intermediary in the export of Belgian-made goods. That said, de-industrialisation has also brought a discontinuation of certain product lines that have only partly been replaced by new chains. With industry remaining the gateway to the global economy and the first to flag up new demand, a declining industrial sector weighs down on the trade balance.

More so than services, industry is a key source of productivity gains in the economy. Estimates show potential growth – and more specifically total factor productivity (TFP) – to have slowed in Belgium since the 2008-2009 economic recession. An international comparison flags up barriers that curb TFP growth, both in industry and in services – the latter typically known for weaker TFP figures.

Companies typically develop on their own merits and qualities, conquer positions in global value chains and

CHART 81 PUBLIC FINANCE AND TRADE BALANCE CHALLENGES
(changes between 2000 and 2013, in percentage points of GDP)



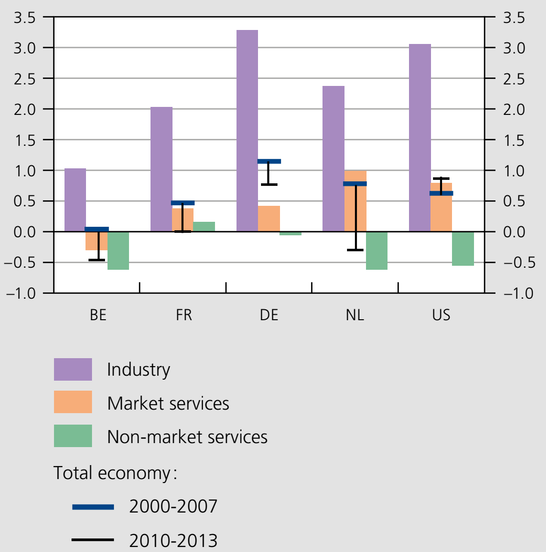
Source : EC.

so support productivity and employment, and some companies in Belgium are outstanding at doing just that. However, an analysis of the makings of a successful process reveals that the government also has a role to play, by taking measures to enhance intangible capital, channel resources to the most productive companies, encourage the implementation and spread of innovation, provide effective infrastructure and facilitate appropriate funding. More broadly, the government should create the conditions that help the economy create more jobs. All other things being equal, costs will be a decisive factor for where the different stages of the value chains will be based, both industrial production and its related services. And incidentally, this also applies to activities that focus on domestic demand, such as construction.

At the end of 2011, Belgium launched a series of key measures to address the structural problems vexing the domestic economy. New federal, community and regional governments took office in October 2014 and are planning their next moves in this direction. In view of the challenges and the feedback loops between them, these measures and their effects will demand close and constant scrutiny, as it would appear essential to operate the levers of employment creation and productivity development that will help achieve a sustainable consolidation of public finances.

CHART 82 TOTAL FACTOR PRODUCTIVITY (TFP)

(average annual growth between 2000 and 2007, in %, unless otherwise stated)



Sources: Conference Board, EU KLEMS.

5.2 Boosting job creation in the market sector

Creating more employment by encouraging job growth in the market sector means striking a better balance between supply and demand in the labour market. To that end, the labour market must operate flexibly in order to allow more robust demand from employers to match an appropriate supply of labour of the right quality. The World Economic Forum puts Belgium in 18th position among the 144 countries it compares in its Global Competitiveness Index (7th among EU15 countries). However, it performs worst on labour market efficiency, where it ranks 60th (10th among EU15 countries). This indicator draws on actual data (participation of women, redundancy costs) and on the annual WEF Executive Opinion Survey. There are five factors executives identify as hampering the labour market in Belgium: the effect of taxation on incentives to work (141st out of 144 countries), its strict hiring and firing practices (139th), its centralised wage negotiations (129th), the weak link between wages and productivity (100th) and, lastly, the lack of cooperation between social partners (78th).

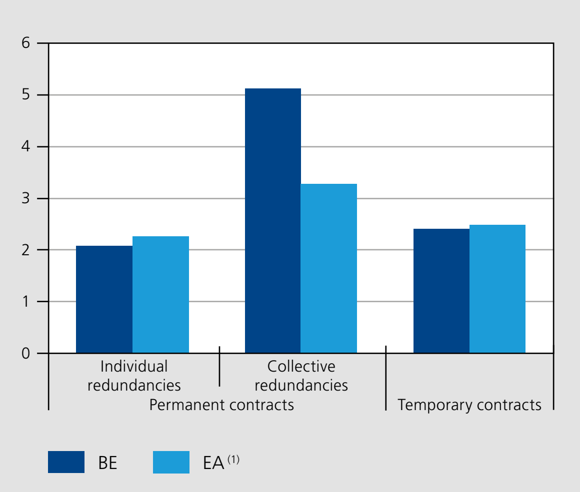
This perception of Belgium's executives matches earlier empirical findings, such as the importance of fiscal and parafiscal pressure on income from employment and the rather loose correlation between productivity and labour costs.

OECD data suggest that employment protection rules governing temporary contracts and individual redundancies of people on permanent contracts in Belgium are not really any more rigorous than in other euro area countries. By contrast, collective redundancies are subject to much stricter rules. Available indicators for an international comparison relate to the situation as at 1 January 2013. Two important developments have taken place since then. The first is the harmonisation of the status of blue-collar and white-collar workers; some points still have to be firmed up but blue-collar workers will be offered wider protection. And the second is the simplification of company closure and collective redundancies procedures (Renault Law), planned by the government, particularly by shortening them.

Many European countries have taken a range of measures concerning the functioning of the labour market, more particularly countries that were faced with dramatic increases in unemployment in the wake of the 2008 economic and financial crisis and the social repercussions of greater joblessness. Their implementation is in many cases so recent as to make it impossible to gauge their outcomes. A common trend would appear to be greater flexibility in terms of working hours (easier

CHART 83 **EMPLOYMENT PROTECTION LEGISLATION**

(indices, scale of 0 to 6, from less to more restrictive, situation in 2013)



Source: OECD.
(1) Data not available for Cyprus, Latvia and Malta.

to work overtime or change hours to fit demand on companies' output) and tighter early retirement access rules. In the case of temporary contracts or fixed-term contracts, opposing measures have been taken – and sometimes even in the same country – to prevent a two-tier labour market and at the same time encourage labour market participation.

Demand for labour

Of all the factors influencing the demand for labour, the most challenging are linked to wage-setting mechanisms and, more specifically, to wage levels. Belgium is among the countries with the highest hourly wage costs, which is very detrimental to employees whose productivity does not reflect or no longer reflects the labour costs for their employer, as may be the case for the lower-skilled – including younger people – or for some older employees.

Labour costs higher in Belgium than in neighbouring countries

Despite recent favourable labour cost trends compared to Belgium's three neighbouring countries – as described in section 2 – a comparison of wage levels reveals that significant differences remain. In 2013, hourly labour costs in the broader business sector amounted to over € 40 in Belgium, compared with € 35 for France and around € 32 for the Netherlands and Germany – and the differences are even more marked when compared with the average for the euro area. Of course, this average is heavily influenced by the countries of Southern Europe, whose standard of living, productivity and costs are clearly below average. Some of them however, are true competitors in the export markets.

Belgium's steep wage levels are the result of a combination of high net wages and an exceptionally heavy tax charge on labour (including employer and employee social security contributions and personal income tax). Average net hourly wages in Belgium – excluding levies – are estimated at € 24, which is about the same as in Luxembourg but exceeds the nearly € 20 in Belgium's three main neighbouring countries.

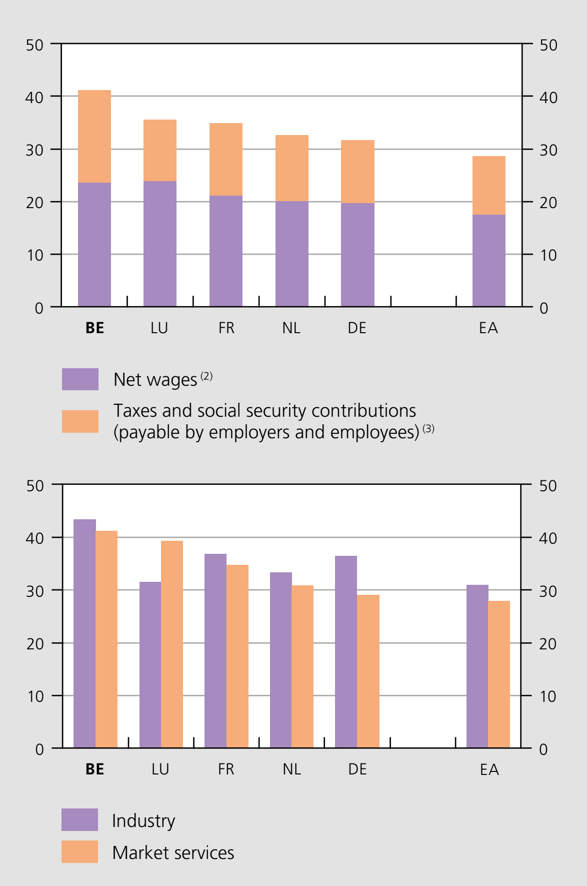
The € 960 million measures announced by the government to help reduce labour costs in 2016, particularly by reducing employer contributions, should help narrow the gap in hourly labour costs with neighbouring countries. These fresh measures will come on top of similar but less far-reaching ones in 2013 and 2014. What is more, any shift of the fiscal pressure on labour to other tax bases could also help improve companies' competitiveness, depending on how it is applied (see Box 11).

Both in industry and in market services, Belgium has the second heaviest hourly labour costs in the EU, hard on the heels of Sweden. And this continues to be the case at a less aggregated level, for instance when wage subsidies are taken into account, so the difference for all Belgian companies as a whole cannot be solely attributed to the structure of the economy.

High labour costs can get in the way of preserving and improving an economy's competitiveness. In Belgium, these are at least partly offset by equally high productivity levels at the aggregate level, but broken down by sector the offset may be stronger or less strong, in some sector even reversing into a drag on productivity. Analyses in 2013 of data drawn up in line with ESA 95 found that, in Belgium, unit labour costs were below those in its three main neighbouring countries in ten of the sectors surveyed while they were higher in the other eleven. However, this does not lead to an unambiguous conclusion as to whether higher productivity levels are a cause or an effect of higher labour costs. Where there are substitution options, high labour costs typically require companies to find capital or tap external resources, but they will translate into fewer jobs if there are financial restraints.

CHART 84 HOURLY LABOUR COSTS IN THE BUSINESS SECTOR [1] IN 2013

(in €)



Source: EC.

(1) Companies with ten or more employees.

(2) Labour costs less estimated fiscal and parafiscal levies.

(3) Estimated by applying the implicit rate of tax on labour (employers' and employees' social security contributions and personal income tax) in 2012 to hourly labour costs in 2013.

Labour costs affect demand for low-skilled labour

For economic reasons, employers will only take on more employees if the value generated by these exceeds their costs. Low-skilled young people, who lack experience to make up for any gaps in their initial training, will be the first to suffer from an unfavourable cost-to-productivity ratio. Other factors may also come into play, of course, but there appears to be a negative correlation between wage levels for young employees and the age group's employment rate. To prevent any distortions from differences in general wage levels between countries, the analysis uses the Kaitz Index, i.e. the lowest gross wages for unskilled youngsters as a ratio of median gross wages in the economy.

High minimum wages may help to reduce the likelihood of poverty for employees and – given relative benefit levels for people out of work – avoid any curbs on labour supply, but they do raise labour costs for low-skilled employees, who risk being pushed out of the labour market altogether. People with real or perceived extra productivity constraints, such as young people, older people or low-skilled workers of foreign origin, are likely to be hit hardest.

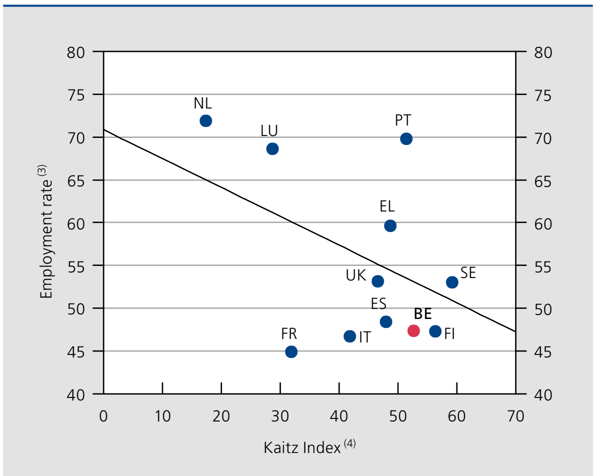
Only a few European countries impose a minimum wage that applies to the entire economy, and Belgium's is on the high side in an international perspective, while sector-wide agreements typically go higher still. What is more, Belgium has phased out lower minimum wages for young people, which often serve to mitigate the dangers of labour market exclusion and which have been implemented in nearly half of the OECD countries concerned. Sectoral agreements will still be able to set lower minimum wages for young people, but they will not be allowed to dip below the national statutory minimum wage.

Wages and seniority

Just like in other countries, wages in Belgium typically rise with age. In theory, pay-scale increases should reflect the declining effect of experience acquired in a specific position, that is, starting off high, then levelling off and

CHART 85 WAGES AND EMPLOYMENT OF LOW-SKILLED YOUNG PEOPLE [1] IN EU15 [2] IN 2010

(in %)



Source: EC.

(1) Non-student 15-29 age group without secondary level qualifications.

(2) No data available for Austria, Denmark, Germany and Ireland.

(3) In % of the corresponding population.

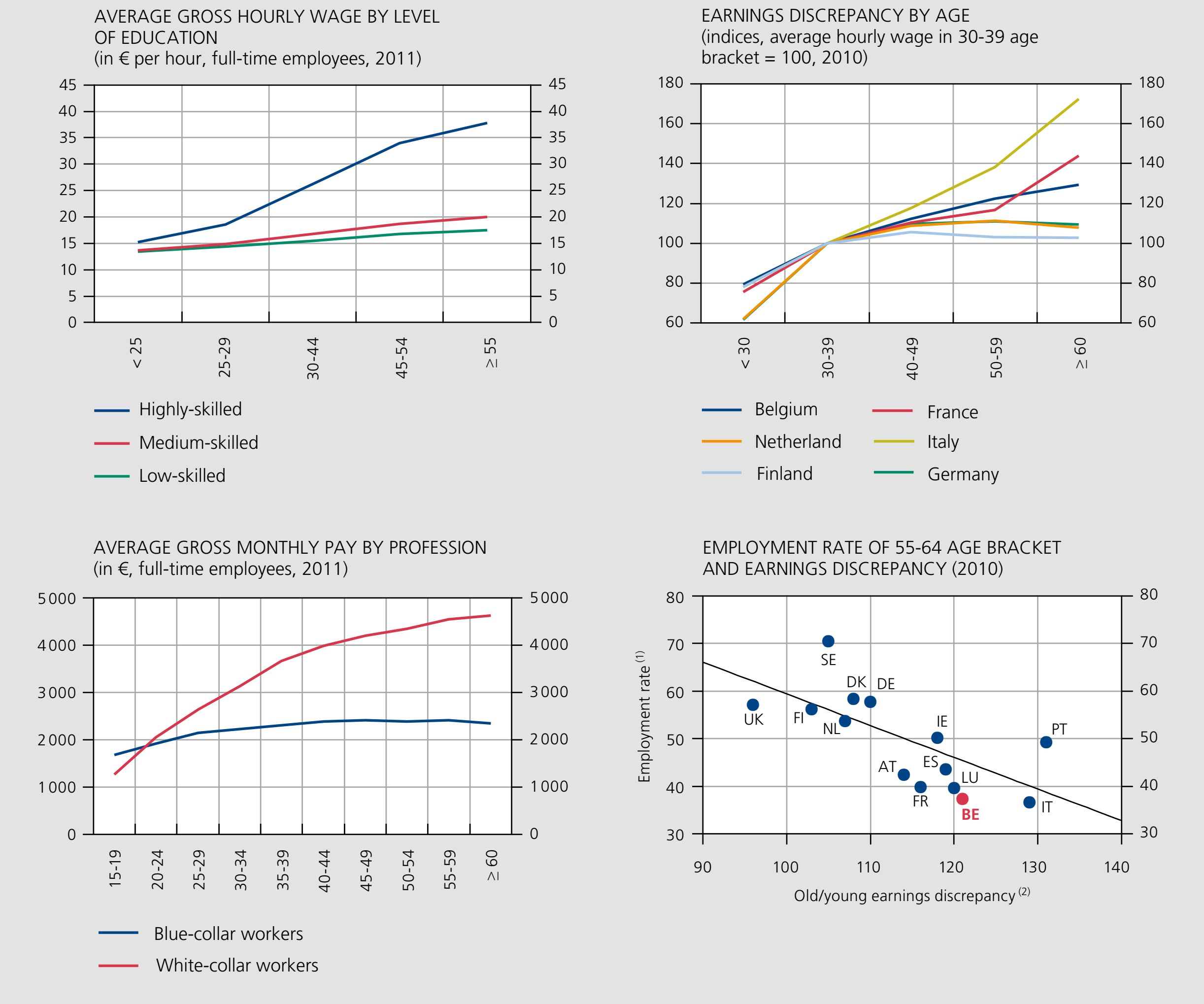
(4) Ratio for each of the countries between the fifth percentile of the distribution of gross wages of low-skilled young people and the total median gross wage, in %.

eventually ceasing altogether. It is typic ally Belgian that these pay-scale increases – at least for white-collar workers – do not slow down towards the end of people's careers. This causes the differences between wages and productivity to widen, and the resultant higher relative cost of older employees erodes their position in the labour market.

International comparisons based on such aggregate data should nevertheless be interpreted with caution, as these are prone to composition effects. For example, in terms of education levels, the composition of employees changes in the oldest age groups in Italy, Belgium and France – the number of highly-skilled workers increases; the low-skilled (who often earn below-average wages) more often drop out of the labour market via early retirement schemes. And Belgium's age-related wage profile is largely explained by early retirement – at the initiative of either the employees and/or the employers – and not just by seniority-related differentials. By contrast, countries working with apprenticeships typically have lower average wage levels for young people.

Although the low-skilled tend to leave the labour market prematurely more often than other groups, there is still a notable employment rate difference between the over-(55s) and the middle-aged group in Belgium. Generally speaking, there is a clearly negative correlation between seniority-related wages and the employment rate of older workers.

CHART 86 WAGES BY AGE [1]



Sources: EC, DGS.
(1) Ratio of workers aged between 55 and 64 to the total population in this age bracket, in %.
(2) Ratio of average monthly pay of employees between 50 and 59 to monthly pay of employees between 30 and 39, with wage levels of this latter group set at 100.

Incidentally, technology-related changes and longer working lives than currently will also require changes to the way labour is organised and human resources are managed. Lifelong learning typically contributes to professional development and so preserves productivity that matches wage development.

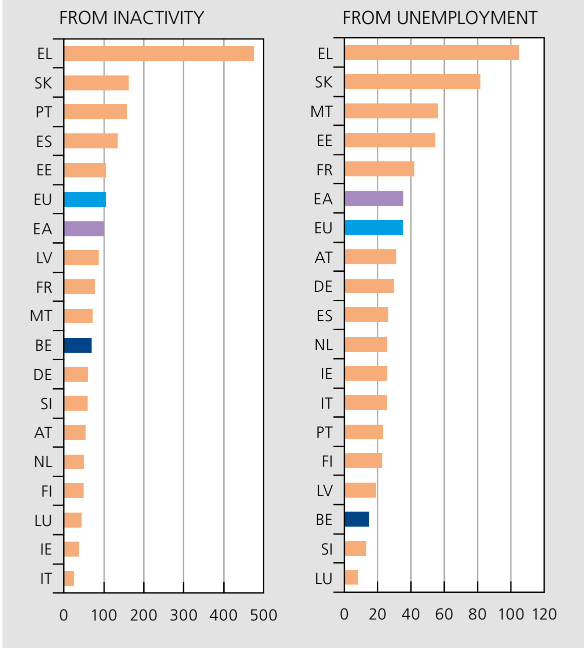
Labour supply

Appropriate financial incentives for transition to employment

To promote the supply of labour, work should be more appealing – not least financially – than unemployment or inactivity. The gap between net wages and social security benefits should be sufficiently large to make up for the expenses of having a job, such as the cost of transport, clothes and child care, but also the loss of the financial advantages of being a benefit claimant (income taxes, child allowances, access to certain government services). Most potential employees do not face this problem, as their expected earned income is significantly higher than social benefits. However, for the low-skilled, the difference between the two is sometimes too small to serve as a real incentive to accept a job that matches their skills and therefore will be low-paid.

CHART 87 FINANCIAL INCENTIVE TO ACCEPT A LOW-PAID JOB [1]

(net increase in disposable income, in %, situation in 2013)



Source: EC.
(1) Job remunerated at 67 % of the average wage for employees. Average situation for six types of households.

The financial incentive in Belgium appears to be on the low side when compared with the other euro area countries and the European average. From an inactivity baseline, a job earning 67 % of the average wage makes for a net income increase of around 70 % in Belgium, as against a European average of 100 %. Yet the advantage is still substantial and subsistence benefit does not appear to serve as a financial employment trap. Things are different for low-skilled job-seekers, though. In the euro area, they can look forward to an improvement in

TABLE 26 EXPENDITURE ON ACTIVE LABOUR MARKET POLICIES IN 2012

(in € per unemployed job-seeker in the relevant Region, unless otherwise stated)

	Brussels	Flanders	Wallonia	German-speaking Community	Federal	Belgium
Total (in €)	1 594	4 472	1 030	1 938	3 032	5 430
In % of the total per Region						
Labour market services	44.9	21.0	14.2	43.0	29.1	26.4
Training	31.2	24.4	28.0	13.1	13.3	18.9
Employment incentives	0.0	3.1	5.0	7.7	48.3	28.3
Supported employment and rehabilitation	14.5	41.9	46.0	35.8	0.2	17.4
Direct job creation	9.2	9.6	6.8	0.4	8.6	8.8
Start-up incentives	0.2	0.0	0.1	0.0	0.5	0.3

Source: FPS ELSD.

their net incomes by 35 %, but in Belgium this is a mere 15 %. Only in Slovenia and particularly Luxembourg can an even smaller difference be found. In November 2012, this state of affairs in Belgium prompted the implementation of degressive benefits over time, in a move to gradually step up the financial incentive while at the same time offer job-seekers an income that gives them enough time to find a position that matches their expectations and skills.

Job-seekers in Belgium do not receive unemployment benefit unconditionally, and have to prove they are doing whatever is necessary to find a job, in which they are supported by regional employment services. Following the sixth State reform, these organisations are now also responsible for checking job-seeker availability. A large number of other competences – like economic migration, target group policies, service vouchers and outplacement – were also decentralised on 1 July 2014. The federal government remains in charge of labour and social security legislation, including rules on unemployment.

Active labour market policies to support job-seekers

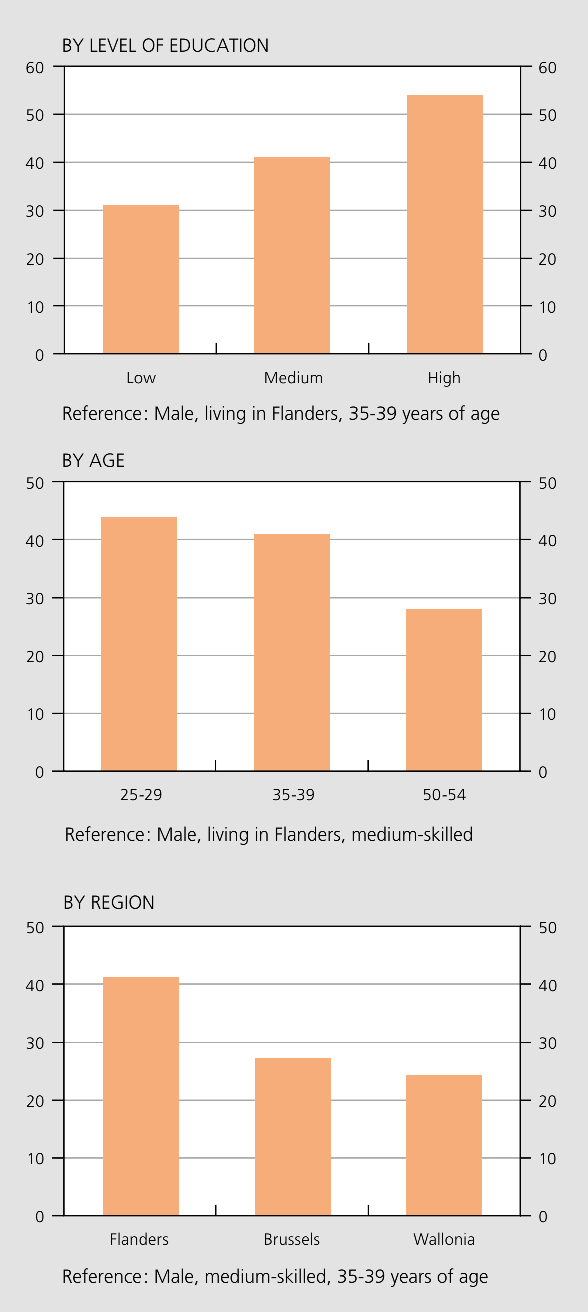
Drawing on a set of measures to activate job-seekers, the authorities can tailor their actions to the characteristics of the unemployed population and labour demand in their own Regions. The most recent data refer to 2012 and thus do not reflect the new division of competences. At the time, an average of € 5 400 per year was spent per unemployed job-seeker. Employment incentives were a largely federal matter, while supported employment and rehabilitation measures for the disabled were mainly drawn up by the Regions and the Communities. Ignoring the federal level, a comparison of the regional authorities gives some idea of the resources used and the choice of the specific measures selected at the time. Flanders spent nearly € 4 500 per job-seeker, significantly more than the other two Regions and the German-speaking Community. The latter's average budget was around € 1 900, compared with nearly € 1 600 in Brussels and just over € 1 000 in Wallonia. Relative to total resources used, Brussels and the German-speaking Community focused more on job-seeker guidance, while Flanders and Wallonia devoted more resources to work for the disabled, mainly in sheltered environments. Training expenses take second place in employment activation policies.

Slower transition from unemployment to work for some categories of job-seekers

An analysis of survey data, which factors in residence, gender, level of education and age, reveals major differences in the chances of finding employment in Belgium. In the bracket 'male, 35 to 39 years old and living in

CHART 88 **TRANSITION FROM UNEMPLOYMENT TO WORK** (1)

(transitions within a year, in %, situation in 2013)



Sources: DGS, NBB.

(1) Results based on a multivariate analysis, from which the effect of a variable can be measured while controlling for the effects of other available covariates.

Flanders', a little more than 30 % of the low-skilled will find a job within the year, compared with nearly 55 % of highly-skilled workers. Comparable gaps are found in other sections of the population. In other words, unemployment spells among the low-skilled are significantly longer.

Age is another key determinant in finding work. The reference group's job-seekers between 50 and 54 have only a one in four chance of finding a job within the space of one year, while the percentage is 41 % in the 35-39 age bracket. One possible explanation of this lower return-to-work rate from the age of 50 could be the notion of the reservation wage, which posits that job-seekers turn down jobs commanding lower wages than what they think they should earn. Job-seekers might be pegging their reservation wage too high because they compare their current situation with what they used to be paid, without allowing for the fact that a proportion of this former wage paid them for specific skills at their former employer that are not necessarily useful in a new position. And employers might have various reasons – for some of which there are no objective grounds – not to hire older job-seekers, perhaps because they fear older workers will have a harder time adjusting to a new workplace or will be absent more frequently for health reasons.

Region also has a part to play : irrespective of level of education, gender or age, job-seekers in Flanders move more quickly out of joblessness and into work than those living in Brussels or in Wallonia, with the transition percentage for medium-skilled men between 35 and 39 at 41 % in Flanders, 27 % in Brussels and barely 24 % in Wallonia. This regional variable is down to a range of factors, the most important of which is more plentiful employment opportunities in Flanders than in the other Regions. Of course, it might also reflect other differences ignored in the model, such as perhaps Flemish job-seekers doing better on average in terms of characteristics such as experience or language skills, or perhaps also the resources Flanders uses to get people back into work.

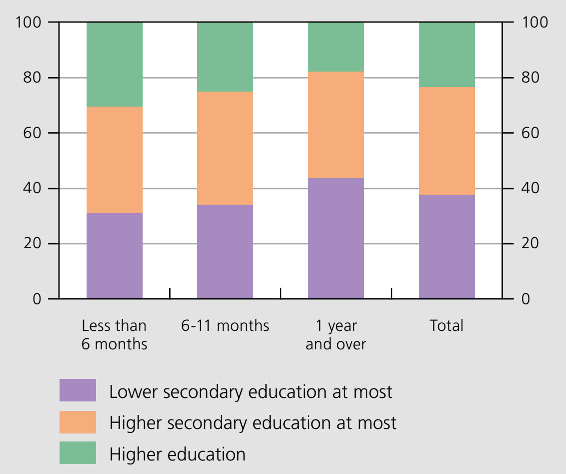
Skills mismatch

A low level of education reduces employment opportunities, as elementary occupations that do not require high skill-sets account for barely 10 % of total employment, a proportion that has been fairly stable since early 2000. By contrast, highly-skilled jobs such as managers and professionals have risen to 45 % of the total, and now claim as large a share of employment as medium-skilled jobs such as administrative personnel, salespeople or skilled blue-collar workers, a group that has proportionately been on the decline.

These are the hallmarks of a labour market transitioning to a knowledge economy – a trend visible to a greater or lesser extent depending on the sector. In industry, low- and medium-skilled jobs have been lost, partly because they have been outsourced, while highly-skilled jobs have been created. That said, this is still a sector with mainly medium-skilled, typically technical jobs. In services – and particularly in market services – elementary jobs have increased both in numbers and in their relative share of total employment, although this is still no more than 12 %. This is partly explained by the transfer of low-skilled jobs from industrial companies to the services sector, as well as by the development of the service voucher scheme, which primarily employs low-skilled workers. Non-market services, by contrast, have a high concentration – i.e. six out of ten – of highly-skilled jobs, such as intellectual and scientific professions.

This qualification-based employment structure does not match the skill-sets of job-seekers, three-quarters of whom were low-skilled or medium-skilled in 2013, which is to say that they had a certificate of secondary education at most. What is more, early school-leavers are over-represented among the long-term unemployed. Nearly one in four job-seekers does have a certificate of higher education – university degree or equivalent. This goes to show that some tertiary education courses are less well rewarded and their graduates run into problems when entering the labour market – which is obviously not the case for engineers and graduates from scientific disciplines.

CHART 89 BREAKDOWN OF UNEMPLOYMENT BY DURATION AND LEVEL OF EDUCATION
(in % of the total, situation in 2013)



Source : DGS.

In the 18-24 age group, a total of 11 % had not completed secondary education in 2013 and were not enrolled in a training course of any kind. This breaks down into 7.5 % in Flanders, 14.7 % in Wallonia and 17.7 % in Brussels, taking Belgium's proportion of early school-leavers to just below the European average. The Belgian government has made a commitment to reduce this percentage to 9.5 % by 2020.

In this context, there has been too little focus on technical and vocational training, and in particular on apprenticeships and internships. The number of apprentices between the ages of 15 and 29 is reported to be below 1 % in Belgium, compared with an average of 3.7 % in the EU (boosted in particular by Germany's large proportion). The new transition internship scheme for young job-seekers in Belgium has seen limited succes : it has brought only 3 000 contracts since its launch in 2013. Nevertheless, such schemes offer real employment opportunities for young people who are put off by the idea of excessively formal training. More generally, specific attention needs to be focused on the situation of young people of foreign origin, both in terms of their school careers and their entry into the labour market.

Greater need for lifelong learning as careers last longer

The recurrence of numerous jobs in the lists of critical occupations released each year by the public employment services proves the structural problem of filling specific profiles – technical in Flanders and Wallonia, and administrative in Brussels. Although few new occupations have emerged in recent years, many jobs have become more complex, and employers increasingly insist on people complementing their formal training and professional skill-sets with "transversal" competences.

Lifelong learning makes it easier to match labour supply and demand, and supports economic growth by enabling a better allocation of resources. As the population ages and measures are taken to lengthen careers, and as the work environment keeps changing and shifting, skills will need to be developed and updated throughout people's working lives, to bolster both the productivity and employability of workers and the competitiveness of companies.

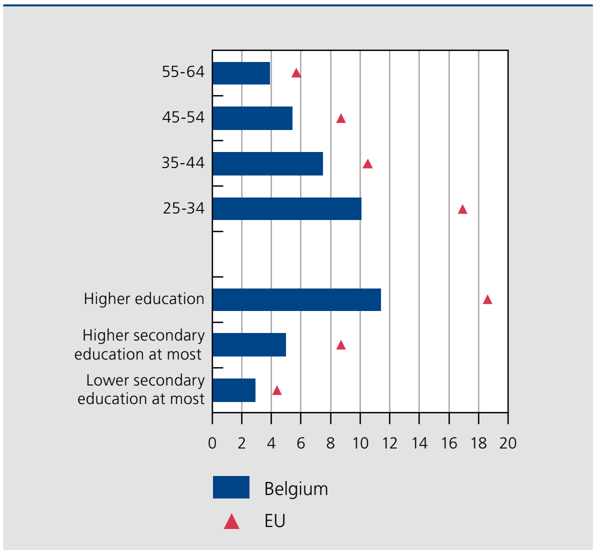
However, access to lifelong learning remains fairly limited in Belgium, and barely 6.7 % of the population between the ages of 25 and 64 were enrolled in some kind of course or training in 2013 – nearly four percentage points below the European average. Comparatively more job-seekers were taking courses, principally under the guidance of the regional public employment services.

Also, the proportion of training participants increases in step with the initial level of education : 11 % of highly-skilled adults received education or training, compared with 3 % of people who never finished their secondary education. And this is a phenomenon noted in all European countries. In terms of age, too, access to education is unevenly distributed : In Belgium, only 4 % of the 55-64 age group had followed a training course, compared with 10 % of the 25-34-year-olds – a negative average correlation found across the EU, including the Nordic countries which are generally considered as role models in vocational training. Investment in further training was long considered unnecessary, as these people were known to drop out of the labour market well before reaching the statutory retirement age.

With all the measures taken to make people work longer, this 'end-of-career' effect should become a lot less significant, and those in work should start to think differently about the value of further training. However, there is a risk that they will not, if they consider themselves sufficiently capable of handling their daily duties, if the training courses on offer do not help improve the quality of their daily work or their career opportunities, or if these courses do not match their learning skills and capabilities.

CHART 90 ACCESS TO LIFELONG LEARNING

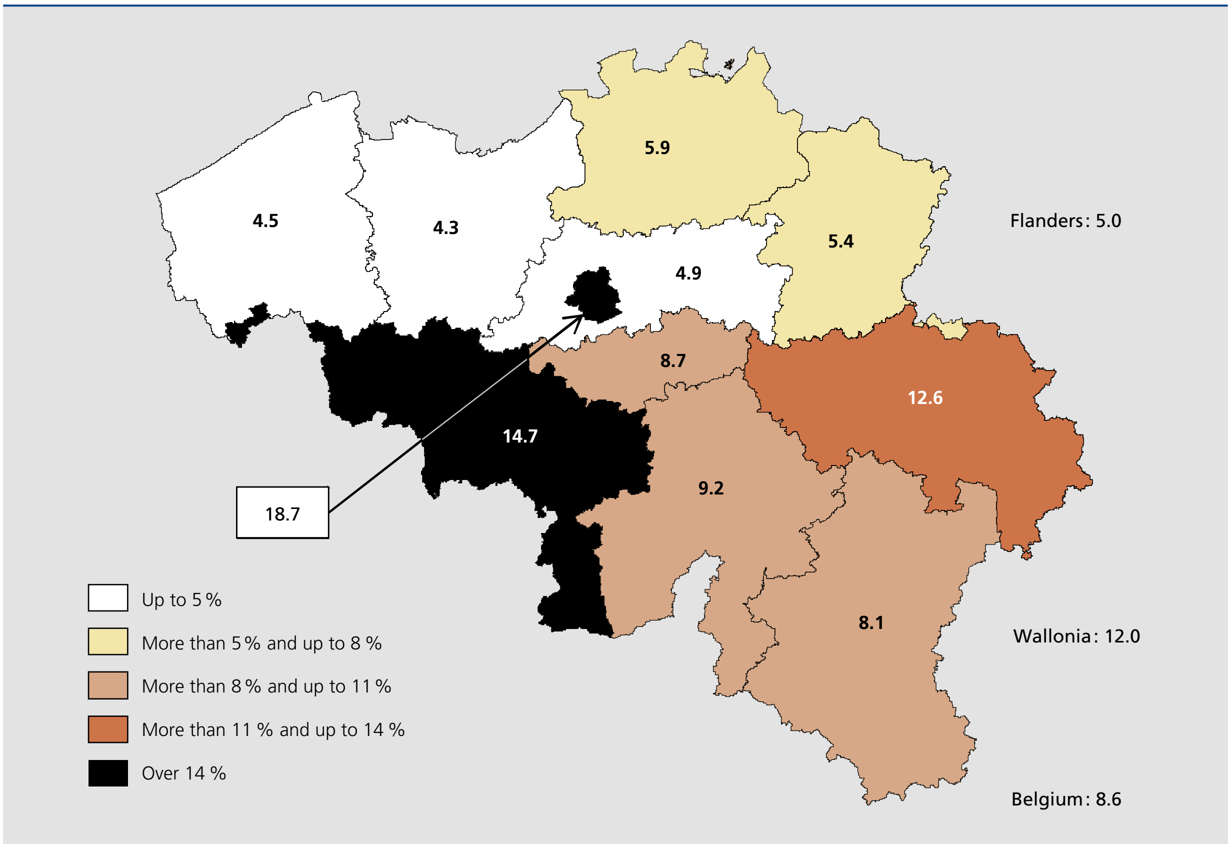
(percentage of the 25-64-year-olds, in %, who report having received education or training in the four weeks prior to the survey, situation in 2013)



Source : EC.

CHART 91 UNEMPLOYMENT IN GEOGRAPHIC PERSPECTIVE

(in % of the labour force aged 15 to 64, average of the first three quarters of 2014)



Source : DGS.

Persistent geographic mismatches

Divergent transition opportunities from unemployment to employment as broken down by Region (place of residence) are inevitably visible in the unemployment figures as well. On average, 8.6 % of the Belgian labour force was looking for work in the first three quarters of 2014. There were major differences between the Regions and even between neighbouring provinces: in Flanders, 5 % of the labour force was out of work, compared with 12 % in Wallonia and even 19 % in Brussels, which is facing specific big-city issues in terms of matching labour supply and demand. At the provincial level, the unemployment rate stood at 4.3 % in East Flanders and at 14.7 % in the Hainaut. Antwerp was the Flemish province returning the highest unemployment figure, at 5.9 %, and was still ahead of the province in Wallonia that registered the lowest joblessness figure: Luxembourg, at 8.1 %. The intra-regional differences are also markedly bigger in Wallonia: the unemployment rate spanned a range of nearly 7 percentage points, as against less than 2 percentage points in Flanders.

A proportion of vacancies in low unemployment provinces might be filled by job-seekers from other Regions. Increased job mobility could therefore help boost economic growth – a process in which the government has significant leverage, as it sets the rules for suitable work for job-seekers. Given the ongoing regionalisation of labour market powers, regional public employment services should work closely together, as in fact they already do when exchanging job offers, or organising language training.

5.3 Towards a more dynamic and flexible economy

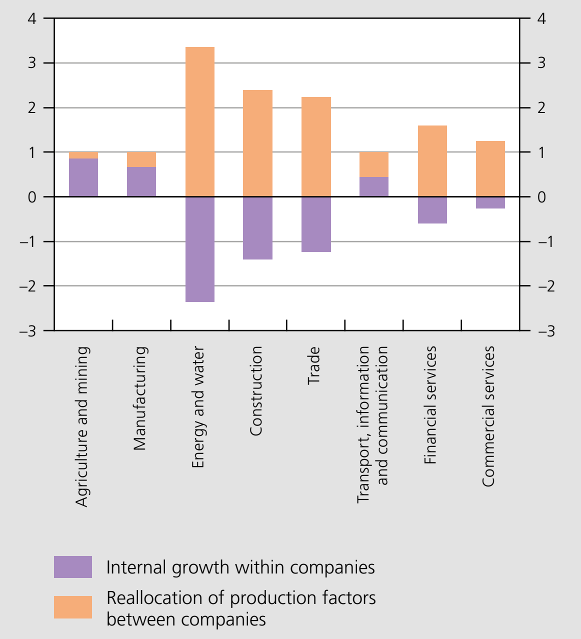
Shifts in activities and jobs to support growth

Although efficient labour markets are a necessary condition for more employment in the market sector, sustainable numbers of new jobs can only emerge in an environment based on solid activities. Entrepreneurial dynamism acts as a catalyst for total factor productivity, or TFP. As highlighted at the October 2014 international conference held by the Bank, and further illustrated in the introduction to this section, TFP growth in advanced economies has seen a major slowdown over the past two decades. With the services branches of activity known for their relatively modest TFP gains, the shift to services in the economy has been an important contributory factor. Moreover, industry and the services sector have their own dynamics when it comes to productivity gains. In manufacturing, these are achieved by existing companies through R&D investment among other things, while the services sector records generally low – or even negative – productivity gains in its companies, the ICT sector being the only notable exception. The same is true for non-market services, which are traditionally characterised by very low productivity gains. By contrast, reallocation of production factors to the most efficiently operating service companies has proved a key source of aggregated growth, achieved by creating new companies or by growing the most productive ones at the expense of the most outdated.

The economic dynamics, with some activities or companies rising and growing while others are falling, of course make for a constant flow of job creation and destruction.

CHART 92 SOURCES OF INTERNAL AND EXTERNAL TFP GROWTH

(contributors to TFP growth of 1 % between 1998 and 2009, in percentage points)



Source : Van Beveren and Vanormellingen (2014).

Between 2006 and 2013, the Belgian economy saw an average of 209 000 new jobs created per annum, nearly 6 % of the existing total. At the same time, no less than 185 000 jobs have disappeared, an average 5 % of the number of people in work. One-fifth of new jobs were created in new companies, underlining the importance of a dynamic business environment. In a labour market characterised by high adjustment costs and asymmetric information, the extent of these workforce movements shows how big the challenges are and how essential a properly functioning market is to economic growth, by ensuring a smooth reallocation of workers between different jobs, both within the same sector and between different sectors.

The trade, transport, accommodation and food service activities accounted for a little over 30 % of all jobs created and destroyed in the Belgian economy. The accommodation and food service activities branch is particularly notable for its high churning rate, due to both its high numbers of start-ups and closures and to its wide use of temporary contracts and less favourable labour and wage conditions. The biggest number of jobs created by new companies is found in trade. Job creation and destruction were roughly balanced in commercial services, in industry and energy and in construction, while health care and social services saw many more jobs created than there were lost, as evidenced by the high share of this sector in net job creations in the economy as a whole.

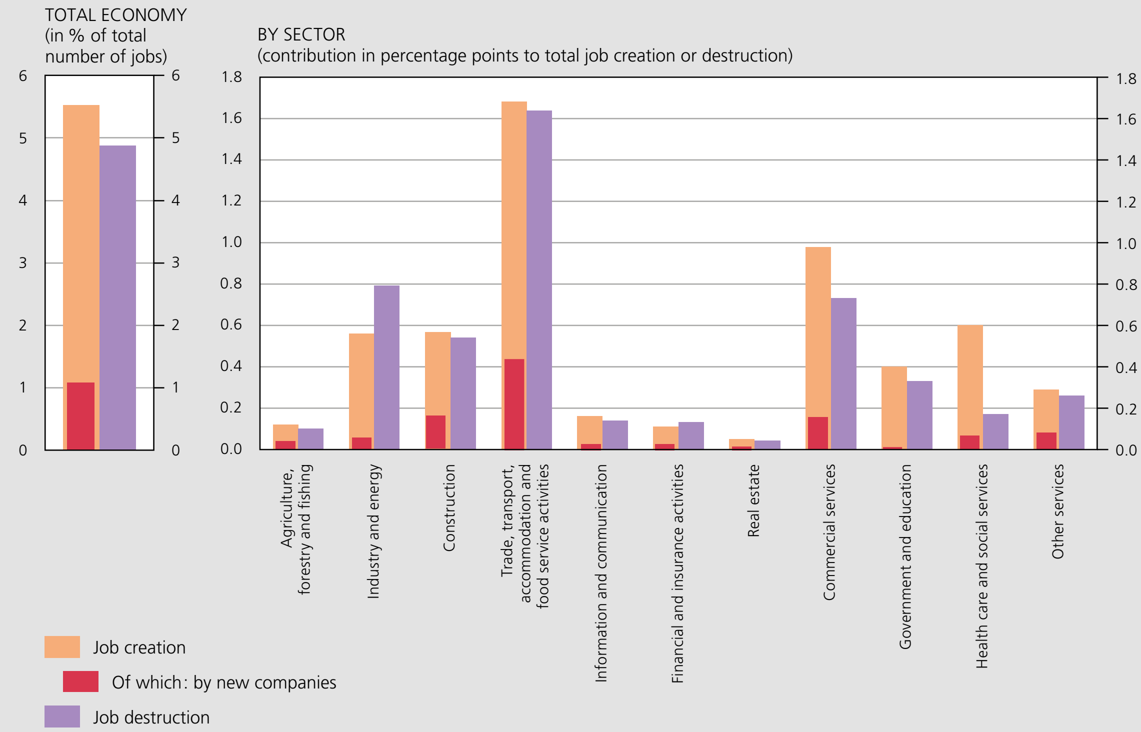
Low start-up ratio depresses economic dynamism

European Commission data show that there are fewer newly established companies in Belgium than in the other European countries, both in industry and in market services. This trend is unlikely to reverse any time soon, as fewer people have recently started a business or are planning to do so in the next three years.

There are likely to be a plethora of reasons behind this reluctance on the part of potential entrepreneurs to start a business. OECD indicators of Product Market Regulation (PMR) and the World Bank's Doing Business indicators suggest that entrepreneurship in Belgium is hampered by administrative, legal and tax constraints. The formalities and costs linked to registering ownership, tax charges, the cost of setting up a business and minimum capital requirements are all greater in Belgium than on average in the EU.

Not all indicators are flashing red for Belgium, though. The time required for setting up a business is comparatively

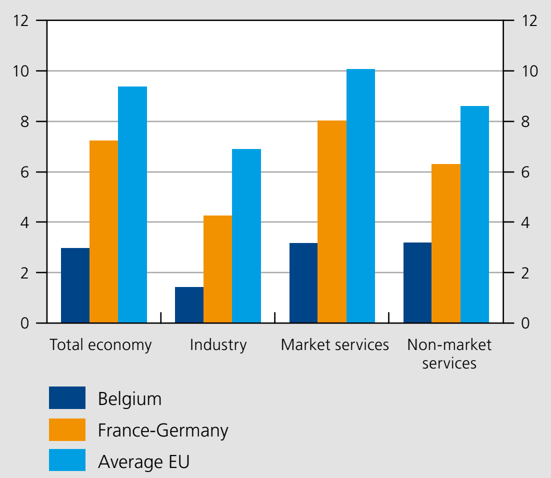
CHART 93 JOB CREATION AND DESTRUCTION IN THE 2006-2013 PERIOD



Source : DynaM-Belgium.

CHART 94 BUSINESS START-UPS [1]

(in % of the number of companies active in 2012)



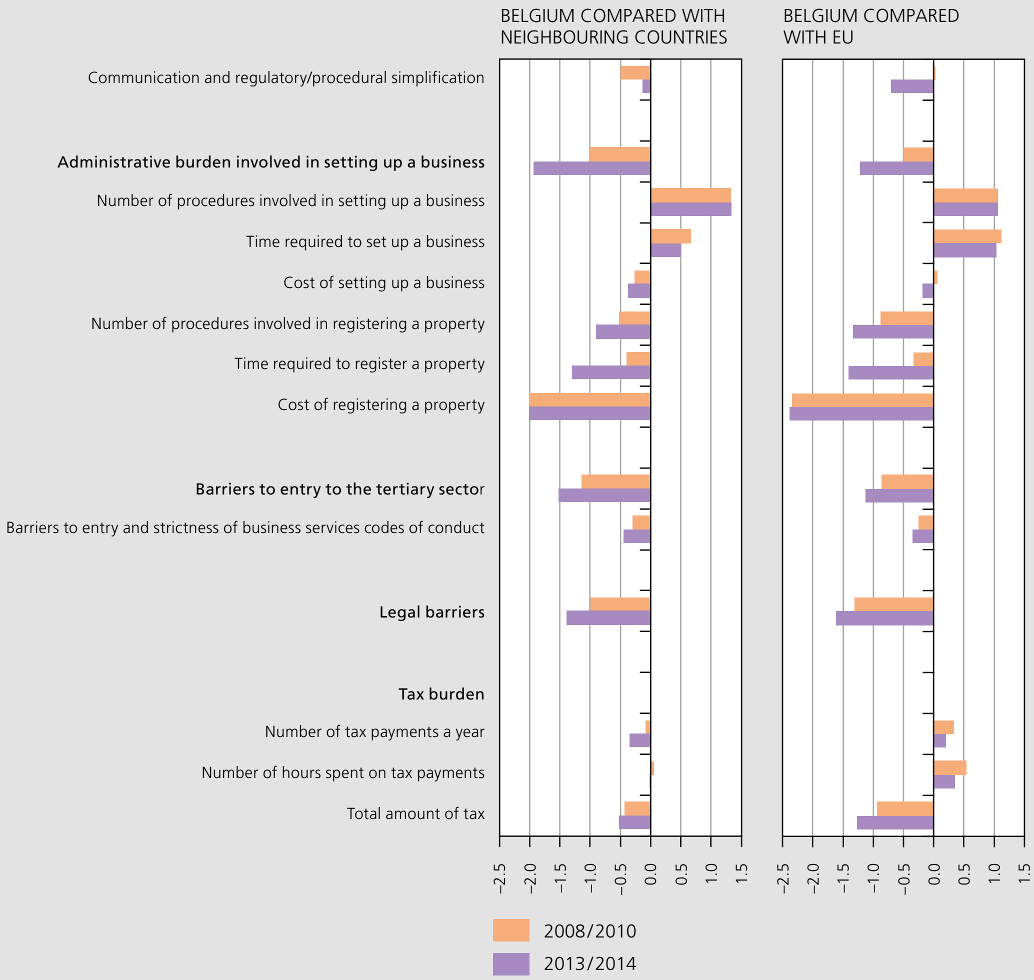
Source: EC.

(1) Start-ups are defined as new companies that have used new production factors, particularly new jobs. Start-ups do not include mergers or company restructurings, nor dormant companies that resume their activities within two years.

short, tax is collected fairly efficiently and the execution of contracts is less expensive and less subject to disputes. However, on a very large number of indicators, Belgium saw its relative position deteriorate compared with the EU and its neighbouring countries, between the 2008-2010 period and the more recent 2013-2014 period. In this regard, efforts in other countries have been more extensive or have produced better results than they have in Belgium.

Ignoring all these barriers, it is generally entrepreneurial spirit that needs strengthening in Belgium. Paradoxically, the Community Innovation Survey (CIS) considers the opportunities for starting a business in the current general economic climate more favourable in Belgium than elsewhere. It would seem that psychological barriers, such as relative risk aversion, play a part, as Belgians report a greater fear of bankruptcies than do other nationalities and potential entrepreneurs feel their knowledge and competences are inadequate for starting a business. Media images of entrepreneurs are less favourable than in neighbouring countries and in the EU as well, with company success stories enjoying less media exposure.

CHART 95 ADMINISTRATIVE BARRIERS
(standardised differences between Belgium and the reference area)



Sources: World Bank (Doing Business indicators, 2010 and 2014), OECD (PMR indicators, 2008 and 2013).
Note: A negative value indicates a more difficult situation in Belgium than the average in the reference area.

When looking at the alternatives, aspiring entrepreneurs might also feel their potential income is too low and end up preferring other professions.

Diverging outcomes on innovation

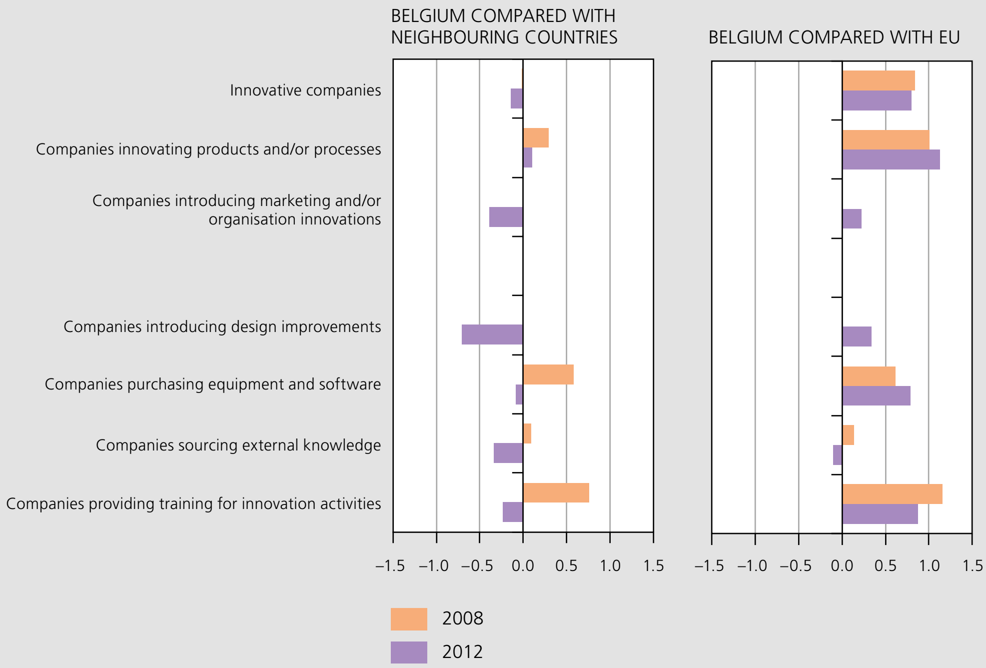
To foster the positive dynamics of new start-ups, conditions need to be in place to help them develop and flourish, with innovation one of the key ways to achieve this in a highly competitive world. Innovation can take many shapes and forms, ranging from fundamental research into the adoption of new management techniques to adjusting production or sales processes.

Despite all government efforts to encourage innovation, the R&D spending that is so seminal to the expansion of industry in Belgium lags below the average in advanced countries and is mainly limited to industrial multinationals. According to the OECD, Belgium's relative R&D weakness is attributable to the structure of its economy, which is more services-focused. Service companies typically spend less on R&D and acquire new technologies from external sources.

To encourage more R&D, different policy echelons have put in place measures and practical recommendations to help SMEs innovate. Specifically, regional government offers hands-on support by funding projects in areas of

CHART 96 INNOVATION

(standardised differences between Belgium and the reference area)



Source: EC (Community Innovation Survey).

growth. The federal government chips in by alleviating the cost of R&D investment, by offering tax relief to researchers and tax deduction on patent income.

Economic growth does not depend exclusively on R&D expenditure, especially in an economy focused on providing services. The OECD's Oslo Manual, which proposes guidelines for collecting and interpreting technological innovation data, describes innovation as a much wider concept that also includes later stages of development and testing, as well as new production processes, marketing new products, training employees, design, etc.

Belgium has about as many innovative companies as its main neighbouring countries, but their results on innovation in its broadest sense show moderate progress on design, marketing or organisational aspects. This is a general observation that applies to both industry and market services, and specifically to small companies, which tend to have a harder time innovating.

The main reason Belgian companies cited for innovation weaknesses – in a survey conducted by the OECD – was difficulties in freeing up funds. In 2013, only 2.3 % of GDP was invested in venture capital in Belgium, only 30 % of which was earmarked for financing the later development stages of the companies, compared with an EU15 average of 2.9 %. This is not just a Belgian phenomenon, it is an EU-wide problem: even the three EU15 countries scoring highest – i.e. Ireland, Finland and Sweden – are trailing over 11 percentage points behind the United States, where this type of financing accounts for 17.5 % of GDP.

In addition to funding, companies mentioned a shortage of capable employees. Although Belgium has a large number of people taking long higher education courses, the number of students in scientific or technical fields is low compared with the rest of the EU and neighbouring countries. And this is precisely the employee profile companies are looking for when trying to encourage innovation.

Business environment curbs services activities

Service activities deserve a special mention, in view of their importance in the functioning of advanced economies, as well as the characteristics of the production and trade methods in this area. What is more, in Belgium, these activities are marked by higher and more persistent increases in consumer prices than in the main neighbouring countries, and by relatively unfavourable productivity trends, as demonstrated in the discussion on prices and labour costs in section 2.3.

The heavy regulatory framework that characterises the services sector can act as a brake on growth. And although a majority of the European countries face similar problems, Belgium has a specific set on its own. For one thing, its liberal professions are more rigorously regulated than in the neighbouring countries or on average in the EU. Except for engineers, Belgium's other liberal professions accountants, lawyers and architects are bound by strict rules governing their entry to the market and the way they carry out their profession. There is undoubtedly a need for a framework addressing market imperfections – e.g. the problems clients may experience in evaluating the quality of proposed services ex ante – but this should be set up in such a way that it does not impede the development of these activities. Retail trade is also more highly regulated in Belgium than in the rest of the European Union,

Box 13 – Regulating service activities at European level

Market services are a dominant economic sector in Europe, accounting for 50.7 % of total value added and 43.2 % of employment in the economy as a whole. Moreover, other economic sectors that use services in their production processes benefit from productivity gains in market services. Services are particularly important for global value chains, as exporting industries typically outsource many of the services relating to their activities – such as transport, marketing, accountancy, financial, technical and other specialist services – either to businesses in their own countries or to companies in other European countries.

In general, however, productivity gains in the European services sector are limited. The OECD attributes this to a number of factors, including the rigidity of market regulations. Indicators of Product Market Regulation (PMR), for example, show that professional services tend to be most highly regulated in the countries of Europe, with the exception of the United Kingdom and the Nordic countries of Sweden, Finland and Denmark.

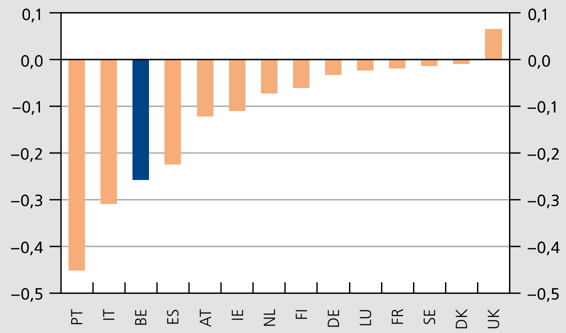
Although stringent regulations may be introduced with a specific goal, such as defending the public interest, protecting consumers or monopoly control, they may also shelter companies from international competition. It will hardly come as a surprise, then, that the services sector is among the least efficient of all sectors in terms of the allocation of means of production. An analysis of the indicator for 'allocative efficiency', which sheds light on the relationship between productivity and market share, shows that – unlike production in the manufacturing industry – production in the services sector is not necessarily generated by the most productive groups of companies.

However, relaxing regulations governing services activities could generate growth potential and productivity gains. This would, moreover, offer the best guarantee that the labour market reforms in most European countries will produce optimum results. As competition may erode any benefits gained, it would raise the chance of these reforms resulting in a fall in prices, productivity gains and the creation of employment rather than in higher profits for the companies protected. EC estimates show that a decline in the PMR indicator in the professional services sector would facilitate business start-ups and lead to an improved allocation of the means of production.

It is against this background that the EC sought to relax the regulatory framework in its economic policy. It urged Member States to transpose the Services Directive into national law by 2009. The purpose of this Directive was to remove legal and administrative barriers. Despite the efforts made by many countries, a large number of barriers are currently still in place, five years after the Directive entered into force. Most progress made in this area to date has resulted only in the partial removal of these barriers.

In accordance with another aspect of its economic policy under the European Semester, the EC also draws up specific recommendations for Member States, including recommendations for market regulation. In 2014, for

MEASURING THE EFFICIENCY OF THE ALLOCATION OF PRODUCTIVE RESOURCES [1] IN PROFESSIONAL SERVICES [2]



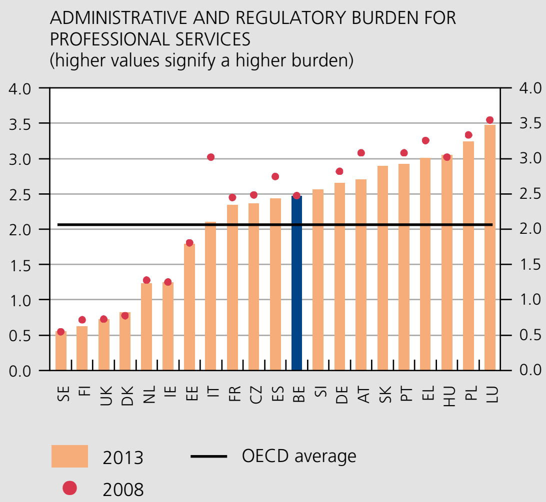
Source : EC.

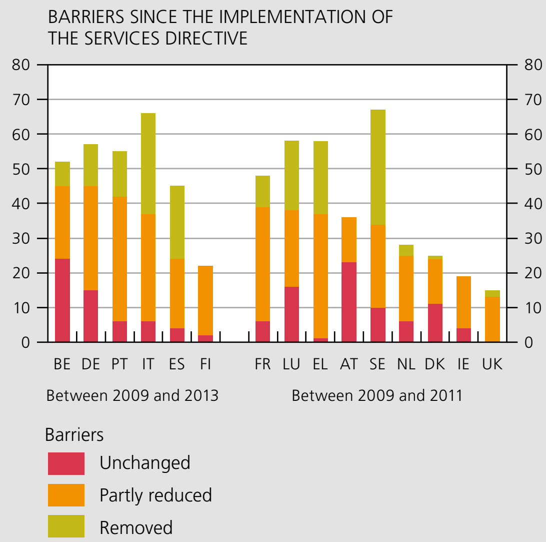
(1) A value of the indicator of -0.2, for example, indicates that actual labour productivity is 20 % lower than the calculation based on a baseline scenario in which means of production are randomly allocated to the various company size categories using a uniform distribution. A positive value means that actual productivity is higher than in the base scenario.

(2) Professional, scientific and technical activities.

example, Belgium, Denmark, Germany, Estonia, Finland, France, Hungary, Ireland, Italy, Austria, Poland, Portugal, Slovenia, Spain and the Czech Republic were urged to simplify the procedures in their services sectors or to remove access barriers in an effort to strengthen competition. These recommendations applied not only to professional services but also to network industries and to the construction industry.

CHART 97 REGULATORY FRAMEWORK FOR SERVICES ACTIVITIES





Sources: EC, OECD.

including standards governing seasonal sales, market impediments to protect existing companies and licences required to start a trading company.

The OECD's PMR indicators suggest that Belgium has made little progress on simplifying its administrative procedures since 2008. And it also happens to be among the countries that have made the least headway on implementing the Services Directive.

In view of the fact that a large number of services, principally network industries, professional services and distribution, have remained overprotected, the EC, OECD and IMF have recommended that Belgium encourage competition by removing legal and administrative barriers. After all, for professional service providers, sheer cost and excessive regulation prevent innovative business models from emerging and curb investment. The retail trade sector has also come in for closer scrutiny as prices have remained higher than in neighbouring countries. More specifically, the rules on seasonal sales and opening hours need some easing.

Moving beyond services, international institutions have repeatedly urged Belgium to do something about the risk of additional increases in energy distribution costs. Its power distribution rates are still among the highest in Europe and the regionalisation of these powers has only served to increase uncertainty over future price trends. Regionalisation of a set of economic powers is typically a cause for concern anyway: though facilitating greater flexibility, it increases the risk of uncoordinated action and could affect economic activity. Close cooperation at all policy levels and with the social partners is advisable in these circumstances.

These same institutions have suggested other measures as well, such as simplifying the complex regulatory framework of the network infrastructure industries by putting into place one regulator per sector across the country. They have also urged Belgium to restructure public service obligations, for public procurement for example. In 2013, Belgian legislation in this area was changed: the ceiling was raised on negotiated procedures without prior notice and electronic procedures were simplified, while the scope of public procurement legislation was expanded to include private social institutions such as hospitals, colleges of higher education and universities, etc.

Infrastructure

In addition to the intangible assets, the actual quality of network infrastructure improves an economy's production capabilities, particularly when it comes to information and communication technologies, transport and energy. Even ignoring the short-term effect on economic activity, investment in network infrastructure supports economic production in the longer term by enabling the economy to work efficiently.

Optimum use of extensive, high-grade and low-cost information and communication networks boosts an economy's potential and facilitates connectivity between people and companies. Remarkably, whereas the economic and financial crisis has only exacerbated the TFP slowdown in Europe, the United States has been notching up TFP gains since 2010 similar to those at the start of the millennium, mainly thanks to its investment in ICT. The European economies, on the other hand, have found it much more difficult to benefit from the digital revolution. And this is not about the contribution of the telecommunications sector to total TFP growth – which is significant – but about the lack of productivity gains that ICT has brought to other sectors of the economy.

In the 2010-2013 period, nearly 92 % of Belgian companies on average had broadband internet access, but a mere 38 % of companies employing ten people or more had access to a mobile broadband network (3G or 4G), compared with an average 45 % in the EU and 69 % for the three most advanced European countries in this respect. In terms of economic activity, Belgian companies generated only 15 % of their sales through e-commerce, compared with 21 % in the three best performing European countries. Belgium has principally fallen behind them in sectors of specialist, scientific and technical services, in addition to administrative and support services.

Quality of transport is also a key contributor to growth, as efficient transport networks ensure productivity gains by bringing down logistics costs and enabling better market integration. Between 1995 and 2011, State-held net capital stock in transport infrastructure has declined and capital investment has been insufficient to address wear in the existing network. The current situation is a worrying, as Belgium is the most congested country in Europe, and INRIX puts Brussels, Antwerp and Ghent in the Top 20 of most traffic-jam-prone cities. Research by the Belgian Federal Planning Bureau shows that congestion would be even worse by 2030 in the event of no policy changes, and that average driving speeds would fall even further, by 29 % during rush hour and by 16 % at other times.

However, the OECD noted that any expansion of the already dense road network would be expensive and an additional source of pollution, without necessarily solving the problem of traffic jams. The efficiency and planning of investment needs to be improved by better use of cost-benefit analyses and coordination between the various policy remits. To influence use of different modes of transport, Belgium should ensure their externalities are more appropriately reflected in their costs, net of subsidies or tax relief.

Security of power supply and risk of shortages

Energy is another key to a smoothly functioning economy. In 2014, the issue of having adequate infrastructure to guarantee energy provision, and electricity in particular, became a genuine concern.

Fear of power shortages …

Adverse events have dragged down the performance of the Belgian electricity generation capacity (fleet) in the past two years and fuelled fears of power shortages – a tricky situation both for residential users, for whom this is considered as a public service, and for professional users, who need power as an essential input in their production processes, with cost and security of supply being key influences on competitiveness.

In the absence of major storage facilities to help manage temporary imbalances, the security of power supply issue should also be assessed in the light of available production capacity and its flexibility to respond to peaks and troughs in demand, as well as the capability of transmission and distribution networks to ensure stability. In this context, the increasing integration of decentralised and intermittent power generation from renewable energy sources (RES) requires even more flexible means. In this respect, demand-side measures are equally relevant, both to adjust demand profiles and to reduce demand levels, but their implementation turns out to be a more delicate business, as power consumption is spread out over time and space.

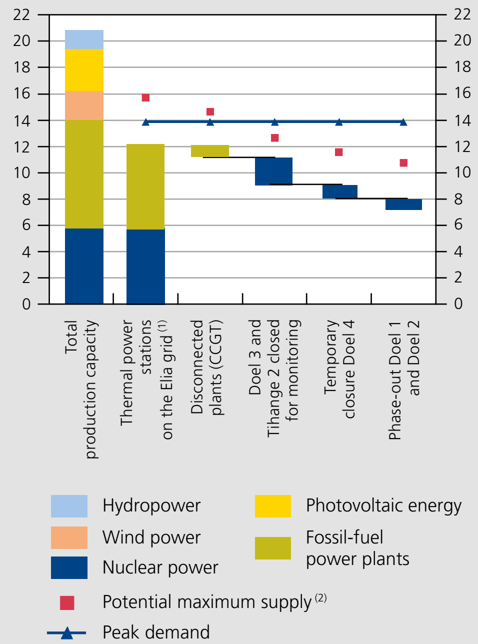
In the event of a failure in the power grid, the production-consumption adjustment should be immediate. In this case, any room for manoeuvre is at the consumption end, in the form of power outages, as measures to recover production would be too slow to restore the grid immediately.

… when markets take an unexpected turn

Boasting a total capacity of almost 21 GW in 2014, Belgium's power generation fleet has nevertheless quickly evolved into a situation where the available capacity became insufficient to meet the peak demand traditionally seen at the end of a winter's day. 3 GW worth of photovoltaic solar power capacity is obviously not effective at that moment, and the risk of under-capacity increases if the dangers of the loss of 1.7 GW in wind power capacity under harsh weather conditions are likewise factored in. In these circumstances, the production capacity from fossil-fuel-fired and nuclear power plants that grid operator Elia can call on amounts to 12 GW, compared with a total generation capacity of 15.3 GW connected to the grid.

Power shortage concerns emerged in the course of 2014, when the owners of two combined cycle gas turbines (CCGT) power plants decided to switch them off, as recent relative price trends compared with gas and coal and carbon prices did not move in their favour; these shutdowns were temporary in the case of one plant and until further notice for the other, involving 485 MW and 385 MW respectively. This was exacerbated by the unexpected unavailability – for an indefinite period – of two nuclear units (Doel 3 and Tihange 2 – 2 014 MW), as these had failed technical tests. At the start of the winter

CHART 98 POTENTIAL ELECTRICITY SUPPLY DEPENDING ON THE UNAVAILABILITY OF PRODUCTION PLANTS
(capacity in GW, in 2014)



Sources: DG Energy, Elia.
(1) Thermal power stations running on fossil fuels and nuclear fuels, excluding producers on the distribution grid.
(2) Remaining domestic production capacity after unavailability, plus maximum import capacity.

of 2014-2015, Belgium was facing a significant 25 % fall in the available minimum capacity to meet peak consumption, estimated at 13.9 MW. And the situation even got worse when another unit (Doel 4 – 1 039 MW) had to be shut down temporarily due to deliberate damage.

Belgium has interconnected transmission infrastructure in place (maximum capacity : 3.5 GW) to import power to make up for the shortfall, provided neighbouring countries' production capacity and connection capabilities allow them to supply the power, which depends on their own domestic demand. Yet, operational margins for running the Belgian power grid are growing increasingly thin, and without any guarantees regarding the availability of electrical energy to import.

The immediate challenge is to prevent any power outages, for the benefit and convenience of the general public and smooth operation of economic activities. In addition to the cost of interruptions in terms of activity adjustments, a perceived deterioration in the quality of the electricity supply damages a country's reputation and appeal as a location to develop new business activities. To date, Belgium's power system is considered very reliable in terms of power cuts and voltage stability – the country scores 6.4 on scale of 1 to 7, claiming 16th position among 144 countries. However, the World Economic Forum's executive opinion survey has pushed it down three places when compared with the 2009-2010 league table.

A European agenda …

Long-life-cycle investment will have to go into any solutions considered and/or agreed to address the stability issues currently hitting the electricity system, but swift and timely investment must also be tailored to future energy needs. All these decisions need to be grounded in a stable and predictable regulatory framework, involving numerous policy-makers and various pieces of legislation, from the EU down to the Regions and local governments.

At the European level, cross-border interconnection of network infrastructure is an essential component of a liberalised Single Market, facilitating transactions and competition between operators and contributing to secure supplies. In the past, security of supply was the responsibility of one national actor, which planned and developed the relevant infrastructure accordingly, but market liberalisation has changed all that and security of supply is no longer the sole domain of a single operator. Unbundling of production-transmission-sales activities, together with restructuring of the sector and its expected development into an integrated European market open to new entrants, have spread this role across a set of actors, where necessary requiring a joint approach headed up by national authorities. After all, the interests of the various operators do not necessarily go hand in hand with a country's security of supply, but rather depend on their main generation options and on making their investment pay, also at European level.

The approval of a European low-carbon economy strategy in 2008 has had implications for the way electricity systems work and are developed, at the level of both production and transmission. Of the renewable energy sources on offer to power vehicles and produce electricity and heating, wind and photovoltaic power have proved most popular, with their respective capacity in the EU having increased by as much as half and by a factor of four between 2009 and the end of 2013 while their share in total output went up to 6.2 % and 2 % respectively in 2012. This has affected how electricity systems work in three distinct ways. First, the RES-related intermittent production pattern implies alternate and flexible production units that can step in and take over when one of them goes down, requiring greater flexibility of the system, at the international level too. Second, this flexibility structure also concerns transmission, as national grids – historically designed and established on the basis of centralised production units – need to be adapted to cope with decentralised production flows. Finally, given the steep start-up capital costs involved, renewable energy has been supported through subsidy mechanisms varying from one Member State to another, depending on the energy mix and political choices about allocating the cost of subsidisation. This massive growth in – subsidised – RES, which have virtually no marginal cost of production and to which the system gives priority access, has eroded the profitability of fossil-fuel-fired power plants, and these are used less as a result.

… and Belgian political choices …

In view of this European agenda, margins are limited for a small, densely populated country with few fossil fuel resources. Moreover, regarding its energy mix, Belgium has made the sovereign choice to stop using nuclear power plants by 2025, while it has become effectively impossible to operate coal-fired power plants as local authorities refuse to grant environmental licences. Obviously, the transition to an electricity system guaranteeing power at an affordable price and under environmentally sustainable circumstances is not an easy one, and will have to take on board all these decisions.

… plus a range of challenges in terms of long-term solutions

If there is no policy change, the power production fleet will have to undergo significant adjustments to meet the aims of a low-carbon economy and low-carbon electricity generation, with only a limited possible choice of production systems in view of decisions made by the authorities. On Federal Planning Bureau projections, capacity needs to be boosted to 27 GW by 2030, from 20 GW today, once all these decisions have fully played out, while ensuring continued investment in replacing obsolete and dismantled production plants and in adjusting the grid. In financial terms, investment in production capacity has been estimated at around € 31 billion between now and 2030.

Finally, recent developments have thrown into sharp relief a number of shortcomings in the way the market currently functions. The current framework does not guarantee the continued operation of gas-fired plants, which might cause supplies to fall short in the event of peak demand. This market, which is subject to frequent changes in the regulatory climate, looks poorly suited to properly address the problem of security of supply and to provide encouraging and timely signals to generate the necessary investment. Other Member States have run into similar difficulties, albeit over different issues, and this has required the authorities to step in by launching tendering procedures to install capacity.