# Foreword

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At 3.3 %, global growth once again fell short of expectations. Mounting geopolitical tensions in the Middle East and Ukraine are only part of the reason. The global economy is in fact struggling to leave the crisis behind and is still battling with excess capacity, or in other words under-employment, seven years after the crisis began. So is the global economy, or part of it, facing secular stagnation owing to a persistent mismatch between savings and investment ?

In the advanced economies, the risk of stagnation appears to be lowest in the United States and the United Kingdom, as the recovery has made most progress there. Monetary policy – which played a key role in bringing about the recovery – is now embarking on a gradual normalisation. That is in stark contrast to the situation in Japan which has been suffering from stagnation for a long time now, and where deflation is entrenched in the economy so that the policy of quantitative and qualitative easing had to be further reinforced.

In 2014, growth slowed in many emerging economies. In 2013 and early 2014, some countries faced a sudden reversal of capital flows, while others suffered from the slump in commodity prices, particularly crude oil prices. In China, growth dropped to 7.4 %, against the backdrop of a property market correction and heightened risks to financial stability. All the same, the intrinsic growth potential of the emerging economies remains considerable, despite some loss of momentum in recent years, and the associated scope for investment could, in principle, mobilise the surplus savings of economies with an ageing population. This global dimension is important in the secular stagnation debate, as the balance between savings and investment has to be achieved at global level.

The euro area – where the recovery faltered again from the second quarter, so that growth in 2014 came to only 0.8 % and the unemployment rate remains at 11.5 % – appears to be showing some symptoms of stagnation. It will take a comprehensive policy mix to overcome that, combining a macroeconomic policy to support demand with structural reforms to boost supply and a policy that facilitates the financing of the economy.

On the demand side of the economy, monetary policy must prevent an excessively long period of low inflation from impeding the recovery. Low inflation hampers the process of debt reduction and slows the adjustment of competitive positions between euro area countries. In addition, lower inflation expectations drive up real interest rates, leading to increased savings and weaker investment. The size and composition of the central bank balance sheet and its rate of expansion are policy parameters that can still be used even though the key interest rates reached their floor in the summer of 2014. In January 2015, the ECB Governing Council started down that road by launching an expanded programme of asset purchases amounting to € 60 billion per month.

Under the Stability and Growth Pact, which offers a degree of flexibility, fiscal consolidation must continue in a manner conducive to growth in the countries where the sustainability of public finances is compromised. However, where scope exists, it is equally necessary to adopt a more expansionary fiscal stance.

Above all, structural reforms are needed in two areas. First, the productivity and growth potential of the economy must be enhanced by encouraging innovation and reforming the labour and product markets. Such reforms will be beneficial in bolstering demand. Next, the economy must be financed more efficiently, both by facilitating market financing and by reaping the benefits of the substantial progress achieved in 2014 with the creation of the banking union. The single supervisory mechanism was launched in November 2014, following the successful completion of the comprehensive assessment, while the single resolution mechanism also took shape. These combined reforms will increase the return on investment and reduce the associated funding costs. That could give a significant boost to the expenditure component which has so far been the main factor behind the shortfall in demand in the euro area. The stimulation of demand and support for supply cannot be substituted for one another, as they are complementary. The euro area must grow and reform simultaneously.

Although the downbeat economic environment requires an accommodative monetary policy, the very low nominal interest rates could give rise to renewed excesses on the financial markets and depress the profits of financial corporations. That implies a challenge for the central banks, which need to encourage economic risk-taking while ensuring that the financial risks do not become excessive. This context has led the authorities to extend their range of instruments by implementing a macroprudential policy. That enables monetary policy to focus on its primary objective – the maintenance of price stability – which also has positive spillover effects on financial stability first of all, while macroprudential policy can curb the side effects of the accommodative monetary policy and the accompanying risks. Pursuant to the Law of 25 April 2014, the Bank is responsible for conducting this new policy in Belgium.

Six Belgian banks took part directly in the comprehensive assessment, while a number of subsidiaries of foreign groups were assessed via their parent company. The asset quality review confirmed that the accounting practices of the Belgian banks were generally prudent, as was evident in particular from the adequate credit risk provisions. The banks all stood up to the baseline scenario in the stress tests, although AXA Bank Europe and Dexia did not meet the required conditions in the second, much more adverse, scenario. However, a capital contribution from the parent company enabled AXA Bank Europe to meet the required solvency ratio, while Dexia is a special case since the bank is undergoing orderly dismantling and is backed by State guarantees, so that there is no need for additional measures.

It also became clear that the burdens of the past were still denting the banks' profitability. The Belgian banks are trying to focus on their traditional activities and their domestic market. Key features of that market are the considerable investments accumulated by Belgian households and disparities in the tax rules applicable to the various types of income from movable property. That tax wedge interferes with the business models of Belgian financial intermediaries because it encourages banks to concentrate their liabilities on savings deposits while also inhibiting the 'life' business of insurance companies. Moreover, it is part of the reason for the development of *bancassurance* groups, another specific feature of the Belgian financial landscape. Harmonisation of the tax on income from movable assets could neutralise these effects on the market structure.

The reversion to traditional lending, where default rates are currently modest, is no guarantee for the future. That is why the ECB stress tests allowed for a possible steep decline in house prices. Although the Belgian banks stood up well to that extreme scenario, the Bank remains vigilant about the consequences of any property price correction ; for that reason it increased the risk weighting applicable to mortgage loans in the banks' internal models. Moreover, it is necessary to monitor the impact of low interest rates on the profitability of financial institutions and on their risk-taking. The insurance sector, which is preparing for the introduction of the new "Solvency II" rules on capital requirements in 2016, proved very sensitive to the low interest rate environment in the stress tests. The guaranteed rates on life insurance contracts will have to be adjusted to the new market conditions. The prudential authorities could assist here by lowering the legal maximums currently in force for these guaranteed yields. Finally, the financial sector must endeavour to secure lasting profitability, either by cutting operating expenses, possibly via consolidation, or by applying realistic margins and systematic charges for the services offered.

In Belgium, economic growth also slowed from the second quarter. Annual growth came to 1 %, and the expansion of employment by 15 000 units was not enough to prevent the unemployment rate climbing to 8.6 %. Inflation dipped to 0.5 %, and the rise in hourly labour costs in the private sector subsided to 0.7 %. As well as facing a hesitant recovery, the Belgian economy has to contend with significant structural challenges, relating mainly to progressive globalisation and population ageing. Those challenges require strategic responses to strengthen not only demand but also supply in the economy.

On the demand side, Belgium is benefiting from the ECB's accommodative monetary policy, the impact of that policy on interest rates relevant to the real economy being less distorted in Belgium than in some other euro area countries. There is also a need for gradual but resolute fiscal consolidation conducive to growth. After the budget deficit was cut to 2.9 % in 2013 under the previous administration, it expanded again to 3.2 % in 2014, an election year. The new government has opted for a path leading to a structural balance by 2018. In that respect, it is necessary to ensure that the structural budgetary efforts conform to the Stability and Growth Pact, and that they are then actually implemented. If adjustments are needed, they will have to be made at the time of the March 2015 budget review. Fiscal consolidation must be based primarily on controlling expenditure, and there is some scope available for shifts on the expenditure side and more prioritisation to provide greater support for growth. Efforts to enhance the efficiency of public services and to steer consumption of those services more effectively by making wider use of price signals can create the scope necessary for such shifts without further expansion of the already particularly large public sector.

On the subject of structural reforms, new measures are being taken to support growth potential. Efforts are being made to restore competitiveness, extend working life and to create jobs by improving the efficiency of the labour market. These action points had already spearheaded the reforms initiated at the end of 2011. They will help to improve the labour supply, reduce the budgetary costs of ageing and eliminate the wage handicap, which diminished in 2014 for the first time since 2010.

All the same, there is still a lot of work to be done. Between now and the end of the wage freeze, it is necessary to examine with the social partners how wage-setting can best be linked to the movement in productivity so as to promote job creation. Hourly wage costs in Belgium are amongst the highest in the euro area and, not by chance, the domestic employment rate is one of the lowest. To foster employment, charges on labour need to be substantially reduced by switching to levies on consumption, pollution, wealth, capital gains or property incomes. Such a tax shift is essential to reduce the level of labour costs in Belgium and to make work financially attractive. An effort must be made to reform product markets, to encourage innovation, to attract foreign investment and to facilitate reallocation of resources, in order to boost productivity growth which, in the long term, is the main source of income creation.

There are strong interactions between these various spheres. The high level of public spending which, leaving aside interest charges, amounted to over 51 % of GDP in 2014, makes it hard for the economy to create jobs, because it is accompanied by severe fiscal and parafiscal pressure which, moreover, has a disproportionate impact on the factor labour. In addition, some of that expenditure discourages participation in the labour market, or even rewards early departure. The inability to create sufficient jobs and growth – primarily in the private sector – undermines the economic basis necessary for maintaining a high degree of social protection and a wide range of public services. If nothing is done, that interdependence could lead to an untenable situation. Conversely, resolute action in each of the spheres mentioned could trigger a self-perpetuating positive spiral giving rise to sustainable growth, job creation in the private sector, and sound public finances, thus opening the way to a high standard of living and safeguarding the Belgian social model.