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

In this report, published on behalf of the Council of Regency, the Governor discusses the main economic and financial developments of 2018 and the policy challenges which they revealed. The first chapter deals with the normalisation of monetary policy in the euro area. The process began in 2018 against the backdrop of growing uncertainty in the global economy. The second chapter discusses the situation in the European and Belgian financial sector and explains how prudential policy and regulation can ensure that the sector remains robust. These two chapters therefore focus on the main tasks of the National Bank of Belgium. The Bank performs some of those tasks – such as monetary policy and banking supervision – as a faithful partner in the Economic and Monetary Union (EMU), while other tasks remain entirely or primarily a national responsibility. The third chapter takes a closer look at economic developments in Belgium, and the issues which may hamper stronger and more inclusive growth, before proceeding to examine the consolidation of public finances. Finally, the fourth chapter sets out the conclusions. The rest of the National Bank of Belgium's Annual Report provides more detailed information and analysis on each of these subjects.

1. Normalising monetary policy in the euro area while the uncertainty surrounding the global economy increases

Main aspects of the normalisation of monetary policy

1. Ten years after the eruption of the crisis, the ECB Governing Council has begun to normalise the euro area's monetary policy. At its meeting on 13 December, it decided to end the net asset purchases in 2019, so that the quantitative easing launched in 2015 will no longer be reinforced. This decision reflects the Governing Council's confidence in sustained convergence of inflation towards the price stability objective. Such confidence is based on the expectation that the euro area's economic recovery and the resulting stronger pressure on prices will continue even after the net asset purchases have ended.

2. Nonetheless, the Eurosystem will maintain the size of its balance sheet by reinvesting the equivalent amount of the securities redeemed at maturity. That will perpetuate the purchase programme's downward influence on long-term interest rates. The Governing Council intends to maintain that reinvestment policy until well after it begins raising the key interest rates. Those rates will be held at their present level until at least through the summer

* Two Regents are not able to endorse the Report in its entirety.

of 2019, and in any case for as long as necessary to ensure the sustained convergence of inflation towards levels that are below, but close to, 2 % in the medium term. Safeguarding price stability remains the chosen course of monetary policy to steer the euro area's economy through the crisis.

3. This framework does not only establish the sequence of the various normalisation stages : first, the end of the net asset purchases, then the start of key interest rate rises, and finally the termination of the reinvestment policy. It also indicates that normalisation will be a very gradual process, the pace of which is not fixed in advance. The indications concerning the interest rate path and the accompanying reinvestment policy confirm that ample monetary stimulus is still needed to continue rekindling inflationary pressure. In addition, the pace of normalisation will depend on the strength of the reflation that has begun, which in turn depends largely on the continuation of economic growth in the euro area. The normalisation framework thus provides a buffer against the uncertainties and risks surrounding growth which emerged in 2018.

Normalisation will be a very gradual process, the pace of which is not fixed in advance

Growth and inflation in the euro area

4. Compared to 2015, the year when the asset purchases began, not only has the deflation risk faded, but the euro area's growth has exceeded its potential ever since, while the drift in inflation expectations has gone into reverse, thereby fulfilling the aims of quantitative easing. In the meantime, inflation itself increased to 1.8 % in 2018. Admittedly, that acceleration mainly reflects the movement in crude oil prices, which maintained a predominantly upward trend until October. At that time, the price of Brent crude oil had reached around $ 85 per barrel, its highest level in four years, partly owing to fears that the mounting geopolitical tensions would have an adverse impact on supplies. However, towards the end of the year, those fears waned and oil prices also subsided as a result of concern about a global growth slowdown. Inflation thus dipped to 1.6 % in December.

5. If the more volatile price components are excluded, then core inflation in the euro area came to barely 1 % in 2018. But unemployment continued to decline, dropping to 7.9 % at the end of the year. Since the start of the recovery in the euro area, more than 9 million jobs have been created. That therefore supports the belief that domestic price pressures are beginning to build up. There are increasing signs of labour market shortages, particularly in the countries where the recovery is farthest advanced. Wage cost rises therefore gathered pace in 2018. That process could be further intensified as underemployment continues to fall and the legacy of low inflation ceases to hold back wage-setting. The maintenance of strong monetary stimulus even now that net asset purchases have ended will be a contributory factor.

Domestic price pressure is beginning to build up

6. Although the economic recovery continued in the euro area in 2018, it lost momentum. Growth declined from 2.4 % in 2017 to 1.9 %. To some extent, that reflects a number of temporary factors, such as a sharp but probably short-term contraction of activity in the German car industry. More fundamentally, however, following an exceptionally strong 2017, exports produced significantly weaker growth. As a result of less dynamic global trade, European export markets also contracted. International trade ran out of steam, even though the global economy's growth rate was still almost as high as in 2017, at 3.7 %. The direct impact of the worsening protectionist pressures on world trade seems to have been limited in 2018. But, owing to the close interlinking of production chains at global level, the effects could extend beyond the products or countries initially concerned. It is also possible that businesses across the world have

already scaled down their investment plans somewhat in view of the mounting uncertainty, whereas capital goods are particularly trade-intensive.

7. While exports from the euro area weakened significantly, domestic demand remained robust up to the third quarter of 2018 – the latest quarter for which data were available when this report went to press. The growth of domestic demand was almost as strong as in 2017, supported by both investment and private consumption. The latter consists mainly of services which are very job-intensive. Consequently, employment in the euro area was up by 1.4 %. The deteriorating external environment and growing uncertainty during the year had little impact on this domestic dynamism in the euro area in 2018. Conversely, financial market volatility increased considerably during the fourth quarter. The fall in stock market prices reflected fears of a growth slowdown, which depressed profit expectations and drove up risk premiums. This could result in tighter financing conditions, although – partly thanks to the maintenance of a substantial monetary stimulus – those conditions remained favourable in the euro area in 2018.

Numerous uncertainties which could reinforce one another call for caution

8. The uncertainty originates primarily from the United States' fiscal and trade policies. Among all the advanced economies, the United States alone recorded stronger growth of almost 3 % in 2018, thanks to its massive fiscal stimulus package. However, as unemployment had since fallen to less than 4 %, there were fears that, sooner or later, the Federal Reserve would have to abandon its policy of gradual interest rate rises in order to prevent the economy from overheating. But that was certainly not the case in 2018, as inflation remained in the region of the 2 % target. The Federal Reserve was therefore able to continue raising its key interest rate in a predictable manner in four stages by 25 basis points at a time, to a range of 2.25 % to 2.5 %. The Federal Reserve also stated that, consequently, the key interest rate was no longer far off its neutral level. Nonetheless, in February 2018, fears of speedier interest rate hikes had triggered a sharp rise in long-term interest rates in the United States and caused the dollar to appreciate. Moreover, the US budget deficit reached 4.7 % of GDP and the public debt expanded to 106.1 % of GDP, without any clear sustainability plan.

The uncertainty originates primarily from the fiscal and trade policies of the United States

9. The US fiscal stimulus also implies more imports and a deterioration in the current account; but that deficit is specifically one of the main factors behind the policy of raising import duties. Instead of the current account being seen as the result of saving and investment in the economy, a mercantilist vision is gaining ground in the United States, putting excess emphasis on bilateral trade deficits. The focus here is on China and the euro area, particularly Germany. Thus, in 2018, the United States put up the import duty on a range of products representing imports totalling around $ 300 billion. The biggest share of that figure concerns imports from China, a country which is accused of unfair trade practices and infringements of intellectual property rights, and is increasingly considered a rival which could threaten the United States' position as a world power. The trading partners, especially China, retaliated by raising their customs duties on a range of products representing imports worth over $ 130 billion. In addition, the United States threatens to impose supplementary duties on car imports and on some still exempt imports from China. That would triple the scale of the tariff increases, inevitably implying the risk of further retaliatory measures by the countries concerned.

10. According to OECD and IMF simulations, the tariff increases already approved – which currently only concern around 3 % of world trade – will reduce economic activity in the United States and China by 0.2 % to 0.3 % of GDP between now and 2020-2021. That estimate takes no account

of the impact on confidence, while a further escalation of the trade war could clearly cause growth to slow more sharply. In general, the higher customs tariffs also have an adverse effect on third countries, although the impact is smaller. At this stage, Belgium's direct exposure is still fairly limited, but the situation would be very different in the event of supplementary levies on imports of cars into the United States, as many Belgian firms supply parts for car assembly. Moreover, the European Union as a whole is vulnerable to such levies. Not only does the tendency towards less openness impede access to foreign markets, it also entails reorganisation of production processes and damages confidence. Furthermore, in the longer term, it has an adverse effect on productivity growth, because openness to both trade and direct investment is a powerful driver of innovation and its widespread dissemination.

11. While growth in China only slowed slightly from 6.9 % to 6.6 %, the country has numerous vulnerabilities. The trade war with the United States is only one of them. China still also faces the difficult challenge of making economic activity less dependent on investment and exports and basing it more on domestic consumption. That transformation implies the risk of a sharp slowdown in growth, while the scope for supporting growth is becoming smaller. Moreover, public enterprises are burdened with heavy debts, and the allocation of resources has not always been ideal in the successive rounds of economic stimulus. In addition, significant risks have built up in the shadow banking sector, while a very substantial proportion of private capital is invested there. These vulnerabilities have already caused a depreciation of the renminbi in 2018.

12. Other emerging economies would also be vulnerable in the event of a further escalation of the trade disputes. Moreover, owing to the key interest rate rises in the US, some of them had already faced capital outflows and tougher financing conditions in 2018. The appreciation of the US dollar also made it harder to repay loans contracted in that currency. The effect was particularly marked in certain countries, such as Argentina and Turkey, but was limited in 2018 in the case of countries with sound fundamentals and a credible economic policy framework.

The uncertainty over Brexit and turbulence on the sovereign bond market in the euro area are risks closer to home

The risk of a no-deal Brexit has increased considerably

13. Following a protracted negotiation process, the British government and the European Commission (EC) reached a withdrawal agreement which the European Council approved on 25 November. However, the British Parliament rejected the agreement on 15 January 2019, thereby considerably increasing the risk of a no-deal Brexit. Even if the agreement were to be approved, many points still remain to be settled. That would mean the start of a transitional period from April 2019 to December 2020, which could perhaps be extended by a maximum of two years. That period was deemed necessary to reach agreement on future relations between the United Kingdom and the EU. The initial positions in that respect were defined in the political declaration accompanying the withdrawal agreement, but it is unclear exactly what direction that might take. This uncertainty has already depressed business investment in the UK. The ultimate economic impact of Brexit will depend on the type of future trading relationship between the UK and the EU. If the least open model is adopted, it could amount to 1 % of GDP for Belgium in the long term. A no-deal Brexit will also have supplementary short-term consequences.

14. In addition, the Italian sovereign bond market experienced turbulence in 2018. While monetary policy measures protected the euro area's long-term risk-free interest rates from the upward trend on the American bond market, the spread on Italian government bonds widened significantly from May onwards; the markets were worried about the fiscal expansion announced by the new government when it took office, as Italy's public debt was already hovering around

130 % of GDP. Those fears proved justified in the autumn when an expansionary budget was unveiled, which according to the EC would imply a stimulus of an estimated 1.2 % of GDP. The EC considered that the draft budget was contrary to the requirements of the Stability and Growth Pact. In November, it therefore took the first step towards reinstating an excessive deficit procedure, on account of insufficient progress in reducing the public debt. In the end, that caused the Italian government to make some adjustments to its budget. According to the EC, Portugal, Slovenia, Spain, France and Belgium are similarly at risk of failing to comply fully with the requirements of the Stability and Growth Pact in 2019. At the end of the year, France announced a number of measures aimed at supporting purchasing power. Those measures could well cause the deficit to exceed the draft budget figure in 2019.

15. The developments in Italy again highlighted the vicious spiral between sovereign debt and the still predominantly national banking systems. The payment default insurance premiums of Italian banks are still closely correlated with those for the Italian public debt. The sovereign debt portfolio held by the banks began expanding again in 2018 after contracting somewhat in the two preceding years. While the cost of issuing bonds or shares rose sharply for the banks, the effect on the overall funding cost remained small, because Italian banks have a large deposit base and also enjoy low-cost Eurosystem financing in the form of the targeted long-term refinancing operations (TLTRO). But there is still a risk that bank lending rates will go up in Italy, which would be detrimental to the country's already fragile economy. While that calls to mind the 2012 sovereign debt crisis, there were no contagion effects on other euro area countries this time. The developments in Italy had no adverse effect on either the spreads on government bonds or the cost of market financing of the banks. Following the adjustment to the budget, the Italian spread narrowed slightly at the end of the year.

Unlike what happened during the 2012 sovereign debt crisis, the contagion did not spread to other euro area countries

Monetary policy can form a buffer against the risks but cannot eliminate them: other policy areas must come into play

16. If the aforesaid risks were to materialise, monetary policy could limit their impact on the business cycle in the euro area, and hence on the inflation path. The possibility of delaying a rise in key interest rates can act as an automatic stabiliser, and the effect is further reinforced by the fact that the Governing Council has linked the duration of the reinvestment policy to the timing of that rate rise. However, monetary policy cannot remove the risks in themselves. For example, it cannot avert the detrimental effects on growth potential due to increasing protectionism or Brexit, nor can it offer a solution for the sustainability of public finances in the euro area countries or provide a substitute for deeper EMU. Other policy areas must come into play.

17. Take the example of the rejection of globalisation and the tendency towards protectionism, which have already marked a break with the past for several years now. There are many factors behind this, some of which extend beyond the purely economic sphere. For example, national democracies find it difficult to entrust certain powers to supranational bodies and to strengthen multilateral cooperation. In addition, broad sections of society are plagued by a feeling of loss of control or identity. From an economic point of view, the unequal distribution of the net benefits of globalisation is also a factor. In many advanced economies, income inequality has escalated in recent years, and large sections of the population have seen hardly any real increase in their income. It is true that this trend is less pronounced on the European continent and especially in Belgium, where social adjustments to the market economy are in fact more prevalent than in the Anglo-Saxon countries. This growing inequality is one of the factors weakening the social consensus in favour of free trade. To reverse that trend, the respective national economies

therefore need to implement an economic policy mix conducive to both stronger and more inclusive growth. That requires not only an adequate social safety net, but also and above all a policy which can seize all the growth opportunities, spearheaded by education, training, labour market support and empowerment, so that everyone can enjoy the benefits of economic progress. That is the way to once again generate greater support for a multilateral approach. Such an approach is necessary not only in the trade sphere but also in regard to such matters as financial regulation, the proper allocation of the tax base of multinational companies, intellectual property rights, attenuation of the impact of global warming, migration flows, or cybersecurity and privacy protection. It is beyond question that the need is more pressing than ever in a multipolar world. Developments in the past year are particularly clear evidence of that.

18. In the euro area, the Stability and Growth Pact and the procedure for preventing macroeconomic imbalances must genuinely prompt the Member States to pursue appropriate policies. That should encourage growth potential via structural reforms, make the Member States more resilient and encourage them to form fiscal buffers, particularly in countries with a high level of public debt. Developments in some euro area countries show that full compliance with the Stability and Growth Pact – one of the cornerstones of EMU – is vitally important. It is essential both for the stability of the Member States and for the cohesion of Monetary Union. The formation of fiscal reserves will act as a buffer against future shocks. In addition, compliance with the rules could boost the mutual trust needed for taking new steps towards deeper EMU. Further work on that subject took place in 2018. For instance, the December Euro Summit gave the go-ahead for reform of the European Stability Mechanism (ESM), implementation of the common backstop for the Single Resolution Fund (SRF), and development of a budgetary instrument for strengthening convergence and competitiveness in the euro area. However, the progress achieved fell short of the original ambitions, especially as regards the completion of the Banking Union and the Capital Markets Union. Nonetheless, progress in those areas remains necessary to strengthen EMU.

Full compliance with the Stability and Growth Pact – one of the cornerstones of EMU – is vitally important

2. A robust European and Belgian financial sector

Financial stability can never be taken for granted: on the contrary, it requires close monitoring of the risks and refinement of the regulatory and prudential framework

19. Alongside price stability, financial stability is a precondition for achieving and consolidating sustainable economic growth and welfare. A lack of financial stability – particularly in the banking sector – not only disrupts financial services which are vital for the economy, but also undermines the essential confidence of producers, consumers and investors; in extreme cases, it may even lead the economy on a deflationary path. In that context, the highly accommodative monetary policy pursued by the ECB in recent years has proved appropriate. It not only halted the mutually reinforcing downward feedback loop between macroeconomic and financial instability, but also helped to restore the bank lending channel, thus opening the way to the economic recovery and gradual convergence of inflation towards the target.

20. However, in the current economic situation, there is a danger that the objectives of price stability and financial stability are no longer perfectly aligned. The monetary stimulus provided through the low interest rate policy remains necessary to shore up prices and to anchor inflation and inflationary expectations, in line with the ECB's aim. However, this low interest rate environment also encourages households and businesses to continue accumulating debt and leads to more

risk-taking and a search for yield in the financial sector, where profitability is under pressure. As a result, it could foster systemic risks. Although those risks are only building up gradually, and only in a limited number of European financial markets and euro area countries, we must not forget the lessons of the financial crisis and financial stability should rank high on the prudential policy agenda. The European and national prudential authorities – both the microprudential and the macroprudential authorities and those responsible for crisis management and resolution – play a key role in maintaining financial stability. That is particularly true in the European Monetary Union, where the common monetary policy is geared primarily to price stability and is also less capable of resolving financial stability problems on fragmented markets or in specific countries.

The gradual build-up of systemic risks requires national and European supervisory authorities to monitor closely macrofinancial developments

21. Although the European regulatory and supervisory framework within which the supervisory authorities operate has been markedly redesigned and reinforced, it is still incomplete in some important respects, and its effectiveness throughout the system has yet to be tested. That framework still requires further refinement and completion in order to consolidate the now restored financial stability. Inadequate or incomplete regulation could lead to insufficient hedging of the risks incurred or a transfer of the risks to less strictly regulated market segments and compromise the sector's stability owing to inordinate leverage on the balance sheet or excessive maturity or liquidity transformation. In these circumstances, the remaining risk limitation measures under the Basel III agreement, and particularly those restricting the use of banks' internal risk models, need to be promptly and fully transposed into European legislation. In the Belgian context – with the presence of major subsidiaries of international banking groups – the maintenance of sufficient capital and liquidity buffers for all banks operating in Belgium, as specified in the latest revision of the European banking regulations, is also essential to safeguard the resilience of the Belgian banking sector in the as yet incomplete Banking Union.

22. Finally, in a sector that depends on confidence, financial stability requires an efficient crisis management and resolution framework. Such a framework gives the authorities the powers to intervene swiftly if banks or major investment companies are in trouble, in order to restructure them efficiently and strengthen them by using domestic instruments. Swift and effective intervention is actually crucial to prevent any contagion and preserve confidence in the financial sector. As resolution authority, the Bank advocates a sound regulatory framework for the resolution of all banks, combined with a coherent and effective prudential policy. Orderly resolution can only be achieved if the structure of the institutions' liabilities in terms of quantity and quality does not hinder the application of the resolution procedure and access to the Single Resolution Fund, and preserves the option of State intervention in extreme cases. Although the latest revision of the European banking regulations deepened and reinforced the resolution framework in this direction, not all risks are covered – particularly since, as also pointed out by the IMF in its recent FSAP report, the regulations only provide for liquidation according to normal insolvency procedures for non-systemic banks. Although this strategy would probably cause little if any market disruption in the event of an idiosyncratic failure – due to firm-specific non-systemic factors –, the liquidation of a non-systemic bank in a period of systemic financial events or instability could still have a serious adverse impact on the financial system. In such cases, the best way to preserve financial stability is to apply the resolution framework including, if justified, the option of government intervention – albeit as a last resort – to protect depositors and avoid a wave of contagion triggered by a loss of confidence.

The Bank advocates a sound regulatory framework for bank resolution accompanied by an effective and coherent resolution policy, including for non-systemic banks

The financial sector has become more robust overall, but the vicious feedback loop between banks and public debt is still cause for concern, and sustainable profitability remains a point for attention, particularly in a low interest rate environment

23. Ten years after the crisis, Belgian and European banks are once again in a sound solvency and liquidity position. The excessive dependence on short-term funding has been reduced to some extent. With significant banks currently having a core equity (CET1) ratio of 14.5 % of their risk-weighted assets, 4 percentage points higher than in 2010, the European banking sector has become much more resilient. The Belgian banking sector which, as a result of state aid, had to undergo restructuring and has focused more on its core business in its strategic markets, has largely recovered, with a solvency ratio now standing at around 15.5 %. That robust starting position – confirmed, moreover, by the microprudential and macroprudential stress tests conducted by the European Banking Authority (EBA) and the IMF – implies that the banks are generally equipped to ensure the continuity of their services to the economy, even in these uncertain times of high macroeconomic and financial risks and (geo)political tensions, both within the EU and elsewhere.

The developments in Italy highlight the vicious spiral between banks and sovereign debts – and the associated risks to financial stability

24. Nevertheless, the European banking sector remains vulnerable and the legacy issues have not all been resolved. For instance, the stock of non-performing loans, the persistence of a strong home bias in bond portfolios, and exposures to a number of emerging countries continue to represent risks which, in extreme cases, could also have an impact on the sector as a whole. The severe losses on Italian bank shares, in particular, as a result of tensions on the Italian bond markets not only illustrate these vulnerabilities, but they also give a clear signal that, in extreme situations, the negative feedback loop between banks and sovereign debt remains a concern for the stability of the sector as a whole. Despite the substantial progress in certain areas such as the significant reduction in non-performing loans, the European regulatory and prudential framework in its current form seems inadequately equipped to deal with all these concentration risks – and especially the home bias in government bond holdings – and to limit their systemic impact. The reduction of these vulnerabilities could also act as a powerful catalyst in the completion of the Banking Union, for which it is desirable to lower the risks further before the entry into force of the common deposit guarantee system (EDIS).

The European financial sector has regained its resilience, but the lack of profitability still needs to be watched

25. Persistently low profitability – which, with an average return on equity estimated at 7 %, is insufficient in relation to capital costs – remains a considerable challenge for the European banking sector and could ultimately disrupt the smooth functioning of financial intermediation. There is also a risk of a divided European banking landscape in which the more profitable banks seek and secure cost savings and economies of scale by means of substantial investment – e.g. in digitisation and IT – and in the long run threaten the business models of more fragile, often smaller, banks. The profitability of the Belgian banking sector – which is well above the European average with an estimated return on equity of 8.6 % – is under mounting pressure. Here, too, high investment costs and ever-increasing charges weigh on profitability, and the low interest rate environment and fiercer competition also pose a growing threat to net interest income, the Belgian banks' primary income source. Yet it remains vital to restore the structural profitability of the European banking sector to a level commensurate with market requirements in order to safeguard the continuity and stability of financial services. However, numerous simulations demonstrate that the current economic recovery might be insufficient for that purpose, and that there is a need for more ambitious structural measures generating substantial efficiency gains. Various strategies might be envisaged, such as securing economies of scale via acquisitions, implementing supplementary cost-cutting rationalisation

measures, or applying more flexible and diversified business models. Finally, part of the gap between capital costs and returns achieved could disappear if the financial markets start taking into account the strengthening of bank balance sheets and the stricter regulatory and prudential framework and reduce risk premiums and capital costs.

26. Like the Belgian banking sector, the insurance sector has also embarked on significant structural adjustments, bringing the capital requirements more into line with the inherent risks and aligning the maturities of assets and liabilities. These adjustments have culminated in a reduction in the sector's duration gap and improved the matching of incoming and outgoing cash flows. The stress tests conducted by the IMF, the European Insurance and Occupational Pensions Authority (EIOPA) and the Bank confirm that the sector is resilient and can cope with the impact of a prolonged low interest rate environment.

27. However, in the current low interest rate environment, there is mounting pressure on insurers' profitability and on their business models, especially for those that focus on life insurance. These companies have to redirect their investment towards riskier assets and adapt their products to the new market environment. As regards investment, there is a tendency, on the one hand, to make greater use of riskier assets, or on the other hand, of less liquid instruments such as property. In that context, the recent adjustments to the regulations, bringing the capital requirements for infrastructure investment more closely into line with the inherent risks, do open the way to longer-term investment and further diversification of the investment portfolio. At the same time, the interest rate guarantees on life insurance contracts are being phased out and a shift is taking place in the market segments in which insurers operate, in particular a shift from class 21 to class 23 and/or non-life business.

Increasing accumulation of debt in the private sector and accelerating credit cycle in the euro area and Belgium

28. The acceleration of the financial cycle in numerous EU countries is a warning that an accommodative monetary policy can also have unintended spillover effects harmful to financial stability. In that context, it is important to distinguish between productive and risky lending, and if necessary to take appropriate action. This cycle can in fact go off the rails if, as it did in the run-up to the financial crisis, the banks and the shadow banking sector – driven by fierce competition or an irresponsible search for yield – proceed to fund too many unproductive or insufficiently productive investment projects on over-generous terms.

29. In the light of the accelerating credit cycles, it is all the more important for the banking sector to form additional capital buffers in good times. Now that economic uncertainty and financial market volatility are increasing, and signs of a weakening of the business cycle are emerging, it is especially important to ensure the resilience of the banking sector so that, even in a recession, it can absorb loan losses and preserve stable lending to the real economy. Various EU countries, including France, Ireland and Sweden, have already taken specific measures in that regard, such as activating a countercyclical buffer requirement, while others are considering introducing supplementary measures in the near future. Here, it is very important to strike the right balance between the small but visible short-term costs of additional capital buffers and the substantial – but less obvious – long-term advantages gained by preventing a possible financial recession and the accompanying high social costs.

30. In this context, the Bank, as the macroprudential supervisory authority, keeps a close watch over the Belgian property and credit markets. In contrast to the debt reduction trend in the euro area, the debt ratio of Belgian households is still rising steadily, and at around 60 % of GDP, it

In view of the further easing of credit conditions and the rising debt ratio, the Bank has reinforced the prudential measure for property risks

now exceeds the average debt ratio in the euro area. This points to a further increase in the systemic risks in the current credit cycle, especially as the Belgian banks are still expanding their mortgage loan portfolios, sometimes on terms which no longer cover the credit and liquidity risks or no longer ensure an adequate profit margin. In these circumstances, the Bank introduced a new and stricter macroprudential measure in 2018, whereby the Belgian banks using internal models to determine their capital requirements must build up capital buffers in proportion to the risk, sufficient to absorb loan losses on the mortgage portfolio in the event of a property crisis and to limit the potential consequences of such a crisis for the real economy. The Bank is keeping a close eye on this measure's impact on mortgage lending and might consider supplementary measures if the risks continue to build up.

31. However, for the first time since the financial crisis, the credit cycle is also accelerating for Belgian non-financial corporations, as firms are tending to opt for debt financing instead of increasing their equity, and there has recently been a surge in credit expansion. With growth of around 7 % – well above the euro area average of 4 % – the provision of business loans by Belgian banks is among the most dynamic in the EU. The Bank is therefore monitoring the situation closely and – like some other EU countries – might consider activating the countercyclical capital buffer for the Belgian banks so as to guarantee sufficient absorption capacity and the continuity of lending to the Belgian economy.

The financial sector on the verge of a radical, structural transformation

32. Having only just recovered from the crisis and adapted to the new, more stringent regulations and supervisory regime, the financial sector faces new structural challenges. Some of those challenges concern more general trends in society, such as digitisation or climate change, and the transition to a low-carbon economy. Others are specific and relate to political decisions such as Brexit or the Capital Markets Union. These challenges undoubtedly create significant new opportunities for the financial sector, but they also imply threats to the sector owing to the far-reaching implications of these trends and the substantial associated investment.

33. The progressive digitisation and digital interlinking of society implies escalating cyber risks and operational IT risks, and the monitoring of those risks in the financial sector – a strategic sector for cyber security – is an absolute priority for the Bank. For example, the Bank devotes particular attention to the cyber security of financial market infrastructures and systemic banks. As it presides over the Financial Sector Cyber Council (FSCC), acting jointly with the financial sector, it endeavours not only to improve the regulatory framework but also to strengthen vigilance and cyber resilience in general. In that connection, the Bank is deploying TIBER-BE, an operational framework for ethical hacking in the financial sector.

Monitoring cyber risks for financial market infrastructures and systemic banks is a priority for the Bank

34. This digital transformation is accompanied by risks, but at the same time, it offers the financial sector significant new opportunities. As well as broadening the financial landscape with the advent of new financial service providers – FinTech and BigTech –, the digital transformation offers incumbent institutions – and particularly the banks – new technologies for improving the organisation and supply of services and expanding the product range. In various financial sector segments, new FinTech applications are appearing – such as crowdfunding, peer-to-peer lending, alternative payment services, robot advice or new electronic trading platforms. They enhance customer satisfaction, reduce transaction costs and expand the product range, often in market segments where little or no service was previously available. The second European Payments Directive (PSD2), which notably provides for banks to allow third parties to have access to

information about bank accounts – with the account holder's consent –, is a major step towards open banking and the further integration of FinTech and BigTech into the European payment services market. For established financial institutions, the digital transformation also offers the opportunity – perhaps in cooperation with FinTech companies – to make structural adjustments to the business processes and infrastructure, thereby cutting costs and achieving economies of scale, or responding better to customers' needs by means of detailed analysis based on Big Data or artificial intelligence. Finally, the transition to the "new normal" of a digitised financial sector is proceeding apace, and in the short term requires financial institutions to make substantial efforts and invest heavily in order to achieve the necessary transition to the digital age in good time.

35. Brexit will considerably reduce the size of the European internal capital market. The departure from the EU of the largest, most liquid and most sophisticated capital markets could also have a disruptive effect. The need to make rapid and substantial progress on a Capital Markets Union under EU law is therefore all the more pressing. The Capital Markets Union remains a crucial component of the current institutional structure of EMU, offering the prospect of a more balanced and diversified financial sector where, alongside the banks, the capital markets can play their full part in financing the economy – especially innovations – and in spreading the risks more effectively. Despite its many adverse effects, Brexit ultimately also offers some great opportunities for the Capital Markets Union. The relocation of European head offices and the business of a range of major financial institutions from the United Kingdom to the continent could generate the volumes needed to develop strong and sophisticated capital markets in the EU. For the Belgian financial market, that means the arrival of a number of major (re)insurers and payment service providers subject to the Bank's direct supervision. In this context, it is also important to map out and, if need be, remove the obstacles that are still holding back the development of a diversified financial sector.

A balanced financial system with sound capital markets is essential for spreading the risks effectively and supporting innovation

36. Full implementation of the Paris Climate Agreement entails substantial additional investment and major technological innovations providing efficient support for the transition to a low-carbon and more sustainable economy. Funding that transition remains a significant challenge for the financial sector. However, this transition also carries financial risks that the supervisory and prudential regulatory authorities need to duly take into account in their policy. The Bank endorses the EC's recent Sustainable Finance initiatives, aimed at developing a transparent market for "green finance" on the basis of harmonised definitions (the taxonomy) of "green" assets and a better flow of information on actual climate risks (disclosure). The prudential treatment of climate-related risks – such as transition risks – is currently being examined. In that regard, it is necessary to recognise that specific prudential treatment – be it in the form of lower prudential requirements for green assets such as the green supporting factor, or a stricter regime for assets that negatively impact the climate, such as the brown penalising factor – must always be based on the real risk profile of the underlying assets.

37. Finally, the financial sector must respect the highest standards and best practices in regard to money-laundering and terrorist financing (AML/CFT). That is actually in the sector's own interests, too. Infringements of the relevant legislation – as observed for a few European banks that have a systemic impact – could have significant prudential implications owing to the possibility of tough sanctions or a loss of confidence in the institution and reputational damage. Since 2016, the Bank has stepped up resources for AML/CFT supervision and devised a new framework for risk-based supervision. Coordination between all the supervisory authorities concerned – both prudential regulators and those

Maintenance of the highest standards must be the guiding principle for the financial sector in the 21st century responsible for AML/CFT supervision – also ought to be strengthened at European level to permit better monitoring of such practices, which frequently operate across borders. In that context, the Bank endorses the EC's recent proposals for a new framework for coordination – featuring a key role for the EBA – between the AML/CFT supervision authorities and the prudential regulators, including the single supervisory mechanism (SSM).

3. Inclusive growth in Belgium: strengthening growth potential while ensuring the sustainability of public finances

Job creation was very strong again in 2018, even though growth was relatively weak

38. In Belgium, too, the economic recovery continued in 2018. The Belgian economy grew by 1.4 %. Although that was 0.3 percentage point below the 2017 figure, the slowdown was less marked than in the euro area, where economic activity had been propelled by the strong export boost in 2017. That export growth was due mainly to capital goods and transport equipment, destined primarily for China and other emerging economies, a combination of goods and markets that affords less support for Belgian exports. Now that the effect of the surge in exports by the euro area has faded away, growth in Belgium is less divergent. However, Belgium has also seen a slowdown in exports of goods and services against the backdrop of weakening world trade. Export growth was down from 5 % in 2017 to 3.5 %.

39. Growth was once again particularly job-intensive. With a rise of 1.2 % – corresponding to 59 000 new jobs – the expansion of employment in 2018 almost equalled that for economic activity. In a favourable business climate, the policies pursued in recent years have been very successful in creating jobs. They aimed to stimulate demand for labour via wage moderation and reductions in employers' contributions, and to support the labour supply by reductions in taxation, the extension of working life and the activation of job-seekers. The experience of recent years shows that expansion of the labour supply may well be accompanied by a fall in unemployment. Over the past four years, the labour force has expanded by around 120 000 units. More than half of that increase is due to a rise in the participation rate, encouraged by government policy. Nonetheless, over the same period, the numbers of unemployed dropped by around 100 000 units, bringing the unemployment rate down to 6 %, the lowest level since the 1970s. In all, no fewer than 220 000 jobs were created in Belgium in the space of four years. And, unlike what has happened in the past, jobs have mainly been created in the business sector rather than in the public sector or in state-aided sectors.

Expansion of the labour supply may well be accompanied by a fall in unemployment

40. However, the full impact of the job creation has yet to be felt, as domestic spending growth has not yet caught up with that in the euro area. In 2018, the growth of private consumption in Belgium was again lower than in the euro area and the three main neighbouring countries. In Belgium, consumption grew by 0.8 %, or about half a percentage point below the figure for the euro area. Such a gap has been apparent for several years now. Initially, the policies concerning wage moderation and the restoration of competitiveness depressed households' disposable income. That factor has now disappeared so that the gap in relation to the euro area has narrowed, though it has yet to be eliminated altogether.

41. Despite the strong job creation, the growth of disposable income and private consumption has remained modest overall during the past two years. For one thing, pay rises excluding wage indexation tended to be small in 2017 and 2018, according to national accounts available to

date. Also, based on the same data, the wage drift worked out smaller than usual, as job creation largely concerned young people and less-skilled workers whose wages are generally lower. That exerts automatic downward pressure on the movement in average wages. Higher oil prices also eroded purchasing power, as there is a time lapse before their impact is reflected in indexation. Finally, it seems that consumption lagged behind the growth of disposable income. The savings ratio has effectively edged upwards in the past two years. These factors may also explain why there has only been a moderate increase in investment in housing construction and renovation.

42. In the future, various factors could bolster purchasing power and domestic expenditure. The drop in oil prices at the end of 2018 and a further cut in taxes on labour incomes in the context of the tax shift are the most salient points here. The nascent dynamism of the labour market could likewise make a contribution. In the case of new recruitment, fixed-term contracts have been more prevalent than in the past. The move to scrap the trial period for a newly concluded employment contract has only fuelled this tendency. Though fixed-term contracts are initially a source of uncertainty, they often seem to form the gateway to a more permanent job. In addition, now that labour market pressures have increased and growth will be based more on productivity gains, pay rises should support disposable income. However, in order to preserve the favourable labour market dynamics, it is important for the pay rises, agreed within the negotiating framework between the social partners, to take sufficient account of the underlying fundamentals. For example, labour market shortages and productivity gains vary between businesses, sectors and sub-regions, and according to the skills in demand. In taking that into account, wage-setting will better reflect where the best job opportunities are and could also contribute to labour mobility. In addition, it is incumbent upon the social partners to consolidate the progress achieved in terms of cost competitiveness, in accordance with the Law on the Promotion of Employment and the Preventive Safeguarding of Competitiveness.

It is important for pay rises to take sufficient account of the underlying fundamentals

43. 2018 was also the year in which the constraints on the Belgian economy became more apparent. Four aspects immediately come to mind: the labour market shortages, weak productivity growth, the inadequacy of the infrastructures and the incomplete fiscal consolidation. Eliminating those constraints is the key to stronger growth, more social cohesion and greater sustainability. It would also respond to some of the challenges thrown up by the ageing population. That will also boost the Belgian economy's ability to adapt, enabling it to take full advantage of the growth opportunities that arise while making it more resilient in the face of potential risks and uncertainties.

Improving the quantity and quality of the labour supply will boost production capacity and enhance social cohesion

44. As a result of the strong job creation in recent years, the proportion of Belgians in the 20-64 age group in work is now 70%. That is 2 percentage points higher than at the start of the economic and financial crisis. Nonetheless, the under-used labour potential is still significant. Mobilisation of that potential could create considerable scope for the economy's production capacity and for per capita incomes. It could also have a positive impact on public finances, by increasing revenue while also reducing recourse to replacement incomes. More specifically, it could offset the downward impact of population ageing on the labour supply. Even though the labour reserve is still substantial, the number of vacancies increased in 2018 and businesses had to curtail production because they did not have enough of the right workers. The list of shortage occupations reveals that it is not only highly-skilled personnel who are scarce, but also

The proportion of Belgians in the 20-64 age group in work has meanwhile risen to 70%. That is 2 percentage points higher than at the start of the crisis many operatives such as cleaners, waiters, technicians or maintenance mechanics. Boosting the labour supply while at the same time matching it more closely to the needs of businesses could therefore have a positive impact on growth straightaway.

45. The unemployment rate is usually mentioned in this connection because it measures the size of the labour reserve already present on the labour market. There are wide variations between the Regions here. In Brussels, the unemployment rate is still over 13 %, and it hovers around 9 % in Wallonia. In Flanders, it is 3 %, so that is the Region where firms are most affected by the tight labour market. In any case, there is a need for greater labour mobility and intensive support and guidance for job-seekers. In addition, within the framework of the social dialogue, wage-setting needs to take sufficient account of the geographical variations on the labour market. Furthermore, the Regions must make maximum use of their extensive socio-economic powers to address the specific challenges confronting them.

There are too few people on the labour market, while the probability of finding a job quickly has seldom been as high

46. Owing to these variations in unemployment rates between the Regions, there are also considerable divergences in the employment rate, which expresses the numbers in work as a percentage of the population of working age. The participation rate, which measures the number of persons on the labour market, is also relatively low in each Region. Even in Flanders, where the rate is highest, it is lower than in the EU and even lower in relation to that in the Nordic countries, which perform well in that respect. There are too few people on the labour market, while the probability of finding a job quickly has seldom been as high. It is therefore necessary to make work sufficiently worthwhile. That was also one of the aims of the tax cuts under the tax shift. Those reductions are proportionately larger where they have the greatest impact, namely in the case of the lowest incomes. By allowing the labour market shortage to play a role in determining employment conditions, the professions facing labour shortages may actually become more attractive. Special attention should also focus on the groups where occupational inactivity is highest. For instance, women are still under-represented on the labour market, although this is less and less the case for younger cohorts. Moreover, the under-utilisation of female potential also takes another form: women generally have fewer opportunities for promotion during their career. That is not only socially unacceptable, it also implies a waste of talent. In the 55-64 age group, the participation rate of both women and men is still low in comparison with rates in other European countries, although it has risen in recent years as a result of the policy on extending working life. A further improvement is in prospect, since the reforms in place take time to exert their full effect. Their impact will be all the greater as the planned reforms are fully implemented, and their success will be scrutinised at every stage of working life. Factors in play here include not only the duties assigned to older workers and their working time regime, but also the fact that remuneration in Belgium is largely determined by seniority without always being matched by a proportional rise in productivity.

There is still a large group of vulnerable young people who struggle to join the labour market

47. Moreover, there is still a large group of vulnerable young people who struggle to join the labour market. They include many low-skilled and young people for whom discrimination based on their origin – or that of their parents – is often an additional handicap. Education and training have a key role to play here. They need to prepare young people properly, develop their talents to the full, and prevent them from dropping out. For some groups, further development in the form of apprenticeships combining work with study may be a solution. Elsewhere in Europe, these systems are successful in easing the transition between school and work. Early initiation into the latest ICT developments or training in solution-seeking processes is crucial, as are language skills – including competence in the other national languages. Scientific and technical courses that offer good job prospects merit special attention.

That is another area where women are still under-represented. Finally, lifelong learning is the key to successfully extending working life and taking maximum advantage of the rapid changes in technologies, working methods and forms of organisation. Getting more people into the labour market and keeping them there will not only boost the economy's production capacity, it is also the best way to achieve greater social inclusion.

Boosting productivity: a question of innovation and resource mobility

48. Another reason why Belgian growth is relatively weak – and could stay that way, according to the estimates of potential growth – is the meagre rise in productivity. Recent years have brought hardly any productivity gains on a macroeconomic scale. That is partly the corollary to the strong job creation, which has a normal, transient downward effect on productivity growth but in principle ensures that future productivity gains will have a greater impact as more workers will share in them. The bigger the gains, and the more widely they are distributed, the greater that effect will be. However, in practice productivity growth is often concentrated on a small number of efficient firms, because they benefit from strong innovative activity in certain sectors, for instance, and world-renowned research centres in Belgian universities. International companies can also take advantage of innovations in other group entities. That is why openness to trade and direct investment is so important.

49. However, the wider distribution of productivity gains throughout the economic fabric is not sufficiently developed in Belgium. One of the reasons is that resources cannot be sufficiently readily transferred from less productive to more productive activities. Both within firms and on the labour market, inflows and outflows are smaller than elsewhere in Europe. Scope for the appropriate transfer of resources will not only boost productivity, it will also ensure that the economy can achieve transitions more readily, that the growth opportunities can be fully exploited and that the economy is better placed to tackle any setbacks. In view of the implications of increasing protectionism or Brexit, the top priority must be to promote openness to trade on the international stage. That said, a small country like Belgium will above all need to ensure that flexibility, adaptability and innovation ultimately make up for the sales which may be lost on markets under threat.

Both within firms and on the labour market, inflows and outflows are smaller than elsewhere in Europe

50. Digitisation provides an excellent opportunity for achieving productivity gains. Existing production processes become more efficient and new products, services and working methods are developed. Making full use of that opportunity does not only imply creative businesses, it also requires an appropriate framework of regulations, particularly for the new production and consumption patterns introduced by e-commerce and the "sharing economy". The concept of competition also needs to be interpreted in the light of these new developments. The objective must be to foster a level playing field. Moreover, competition has only made modest progress on some of the more traditional services markets in Belgium. Yet a lack of competition implies high prices and weak productivity growth. It is also striking to note that e-commerce is still rather under-developed in Belgium. Consequently, a major share of the value added generated by this type of consumption goes abroad and its potential as a distribution channel for exports is not being exploited enough. Digitisation will also make a clear impression on the labour market. Some jobs will disappear completely, while others will be developed because they are able to reinforce the benefits of digitisation. Equipping people with the skills to take part in the far-reaching digital transition is therefore a win-win strategy. It maximises productivity growth while limiting the detrimental effects on the labour market. Investment in training should be a key concern for businesses and workers alike.

Equipping people with the skills to take part in the far-reaching digital transition is a win-win strategy

Improving the infrastructure: reconciling economic and environmental considerations

51. To enhance the Belgian economy's performance, it is also necessary to improve the quality of infrastructure. Here, too, the constraints became more obvious in 2018. The growing traffic congestion and uncertainty over electricity supplies are the prime examples. Traffic jams are a considerable cost factor for firms, reducing their productivity and limiting their operating radius. As the Belgian economic fabric acts as a major link between the large North Sea ports and the European hinterland, it is particularly sensitive to the mobility problem. It is becoming ever more difficult for workers to get to work on time, and commuting eats into their free time. The associated costs could thwart the efforts to expand the labour supply. Traffic jams are also a major source of pollution. The energy supply problems, too, are already having a detrimental impact in the short term. Higher electricity prices drive up inflation, although the effect was small in 2018. Initially, that depresses purchasing power, but later, as the higher prices are reflected in indexation, it becomes a cost-increasing factor for businesses, on top of the higher bills for their own electricity consumption. Apart from the measures taken to avert the risk of an interruption in supplies, it is necessary above all to devise a longer-term strategy. That would make it possible to manage the planned diversification out of nuclear power and ease the transition to a low-carbon and more sustainable economy while containing the costs entailed. Tackling these constraints also makes it more attractive to invest in the Belgian economy, and that in turn augments growth potential in the longer term.

52. There are increasing signs of pressure on the housing market, too. Population growth together with the trend towards smaller family units is driving up demand for housing. Although the supply is not very elastic in the short term, housing construction and renovation of existing homes can help to improve the situation. However, that process is hampered by the intrinsic scarcity of building land. It is therefore no coincidence that the price of building plots has soared in recent decades, and that accounts for much of the rise in house prices. This problem does not only create vulnerabilities within the financial system: the affordability of housing is above all a significant economic and social challenge. Moreover, the way that Belgians live takes up a great deal of available space. That is why there are more and more initiatives aimed at concentrating housing units in the centre of towns and villages. That could reduce the urgency of the mobility issue. That approach would also result in homes consuming less energy and would require fewer network infrastructures. Nonetheless, this process could further exacerbate the shortage of building land unless the number of homes per plot is increased at the same time. Boosting the proportion of rented housing and cutting the transaction costs entailed in house purchases could help to reduce the share of commuter traffic in labour mobility. Space is also scarce: more efficient use of it makes it possible to reconcile economic and environmental considerations.

Space is also scarce: more efficient use of it makes it possible to reconcile economic and environmental considerations

53. In order to improve the overall quality of the infrastructure and make Belgium more attractive to international investors, a National Investment Pact was launched. An initial report was submitted to the various governments in Belgium in September 2018. It lists six priorities where the need is great: the digital transition, cyber security, education, health care, the energy transition and mobility. Not only must the governments provide scope for such investments in their budget; public-private partnerships must also channel Belgium's abundant supply of savings into these forward-looking investment programmes. Making the necessary changes is a lengthy process. The various public authorities in Belgium therefore have a key role to play in coordinating a process which, by establishing appropriate incentives, steers private initiatives and behaviour patterns in the right direction. Those authorities must also keep watch

Belgium's abundant supply of savings must be channelled into forward-looking investment programmes over the social dimension of these transitions. This process encompasses numerous spheres of action and can only succeed if the various competent authorities endeavour to achieve maximum consistency via mutual coordination.

Efficient government and sound public finances

54. The Belgian authorities' budget deficit came to 0.7 % of GDP, slightly less than the 2017 figure. The public debt declined by 1.5 percentage points to 102 % of GDP. Although the deficit has been reduced considerably in recent years and the debt dynamics were reversed several years ago, the consolidation of public finances has not yet been fully achieved. Further progress towards a structurally balanced budget is needed without delay, in accordance with the rules of the Stability and Growth Pact. The Pact also offers some leeway for structural reforms or for supporting public investment, although fairly limited in practice. Progress towards a balanced budget is necessary to continue reducing the public debt, which is still among the highest in the euro area. That will create a buffer and provide new scope in the budget, e.g. to attenuate the impact of future periods of unfavourable economic conditions. Reducing the deficit in a favourable economic climate is more efficient both economically and socially than if it must be done during a recession with severe pressure from the financial markets. The vicious spiral that such procyclical fiscal tightening can trigger was evident during the debt crisis in a number of euro area countries.

55. As regards the course of public finances in 2018, there are three salient points. First, the good budget outcome is due largely to an increase in corporation tax revenues. In the space of just two years, those revenues rose by one percentage point, from 3.4 % of GDP in 2016 to 4.4 % in 2018. This sharp rise is not so much due to an increase in corporate profits or to a higher effective tax rate. The widening of the tax base – notably through a cut in the notional interest tax deduction for risk capital – effectively largely offsets the reduction in the base rate from 33 to 29 % in 2018. These two factors are part of the multiannual reform of corporation tax. The increase appears to be mainly due to the change in the tax payment behaviour. The tendency to settle a larger proportion of the tax bill in the form of advance payments gave a considerable boost to revenues in the past two years, but in the years ahead that could likely imply lower revenues at the time of the final settlement. The structural starting point is therefore less favourable than it appears from the 2018 balance. In addition, there was no further reduction in primary expenditure, which actually rose again from 49.7 % to 50 % of GDP. That is due partly to the surge in local authority investment, typical of a municipal election year. However, the underlying trend is also upwards, partly as a result of ageing-related expenditure. Finally, interest charges declined to 2.3 % of GDP, primarily because of the fall in interest rates. However, future gains will need to come mainly from reductions in the actual debt, via an improvement in the primary balance.

Further progress towards a structurally balanced budget is needed without delay

56. The quest for efficiency is the key guiding principle for the consolidation of public finances, too. First, the government must strive for that efficiency in every aspect of its operations. That applies both to public spending and to the taxes collected. The proper collection of taxes and the battle against tax evasion and social security fraud must remain a focal point of attention. Efficient use of public resources will help to ensure the social safety net needed to accompany the many economic and social transitions. However, efficiency extends beyond the government's own activities. Appropriate economic policies and fiscal incentives encouraging a dynamic economic fabric will help to consolidate public finances. It is therefore desirable, on both the revenue and the expenditure side, to continue seeking adjustments which can support the economy's growth potential, help to achieve the energy transition, and strengthen social cohesion. In a federal

country such as Belgium, that also presupposes that the tailoring of socio-economic policies to the specific needs of the Communities and Regions is accompanied by close coordination and cooperation. That should lead to clear agreements on the allocation of the additional budgetary efforts. It should also avoid imposing an over-burdensome regulatory framework on economic life and encourage policy synergies which will ultimately benefit every Community and Region in the country.

4. Conclusion

57. The Belgian economy withstood the crisis relatively well and has produced a particularly strong performance in recent years in terms of job creation. In that regard, the Belgian economy benefited from the recovery in the euro area and the maintenance of a strong monetary stimulus. In addition, the substantial job creation was reinforced by the federal government's economic policy. That policy aimed to stimulate demand for labour via wage moderation and reductions in employers' contributions, and to support the labour supply via reductions in taxation, the extension of working life and the activation of job-seekers. The result was expansion of the labour supply accompanied by a sharp fall in unemployment. Altogether, no fewer than 220 000 jobs were created in Belgium in the space of four years. At the same time, the public deficit has been cut to 0.7 % of GDP and the public debt has resumed a downward trend, declining to 102 % of GDP in 2018. Nevertheless, there was no further improvement in the structural budget balance in 2018 and it did not meet the target set in the Stability Programme put forward in April. So, there is still a large, sustained effort needed to reach a structural budget surplus.

58. In the meantime, the financial sector has undergone radical restructuring and become more robust, though without any erosion of lending to businesses and households. Nevertheless, vigilance is still required in the face of the new risks which are emerging, such as the increasing private sector debt ratio, the low interest rate environment, developments concerning FinTech, cyber security, and the impact on the financial sector of global warming and the energy transition, or the measures to combat money-laundering.

59. The future progress of the Belgian economy will depend primarily on the international situation. In that regard, the uncertainties and risks increased considerably in 2018, not least as regards the continuing escalation of the trade wars, the vulnerability of the emerging economies – especially China – and the impact of a no-deal Brexit. The Eurosystem's monetary policy which, despite the start of normalisation, is set to remain accommodative for a good while, could perform a moderating role to some degree. However, it cannot eliminate the risks in themselves. Moreover, a small country like Belgium has little control over the challenges arising at global level. Continued development of its own growth potential and adaptability is therefore the key to increased growth, prosperity and social cohesion.

60. The fact that the labour market was already particularly tight in 2018 is a clear indication of the need to expand the labour supply still further. Not only must it be easier for job-seekers to gain access to an appropriate job, the number of people available on the labour market also needs to continue rising. Equipping those people with the required skills is the best way to invest in social inclusion, and that will ensure that the opportunities for innovation, particularly in the sphere of digitisation, can be used to the full. It is not only innovation itself that is important here, but also the appropriate transfer of resources from less productive to more productive activities. Productivity can be further augmented by improving the quality of the infrastructure. Dealing with traffic congestion, securing energy supplies, providing affordable housing and achieving the transition to a low-carbon and more sustainable economy represent major challenges here, and

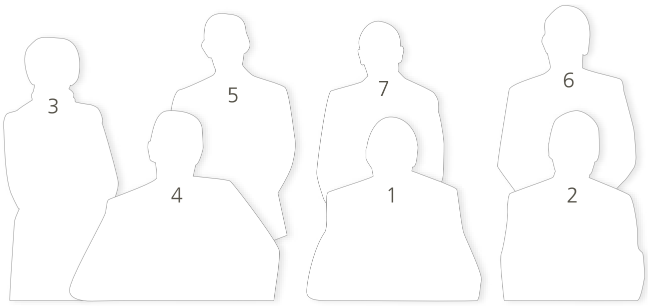
they are also interlinked. In that regard, the government has a role to play not only as an investor in new projects but also and above all as the coordinator of a process which encompasses numerous areas of competence; it must act by providing the appropriate incentives to steer private initiatives and behaviour patterns in the right direction. Finally, the government must make progress towards a structurally balanced budget, which would speed up the reduction in the public debt. By thus creating buffers for the future, the economy will be better able to absorb any shocks and the Belgian social model will be capable of coping with the challenges associated with population ageing.

Pierre Wunsch
Governor

Brussels, 30 January 2019

Board of Directors

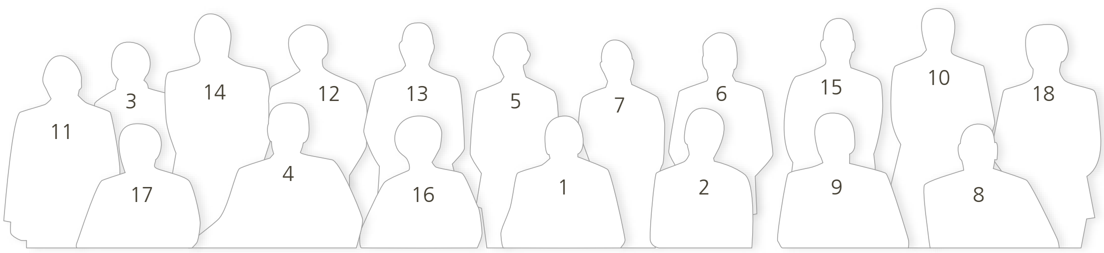
1 **Jan Smets,** GOVERNOR *
2 **Pierre Wunsch,** VICE-GOVERNOR **
3 **Marcia De Wachter,** DIRECTOR ***
4 **Jean Hilgers,** DIRECTOR – TREASURER
5 **Vincent Magnée,** DIRECTOR
6 **Tom Dechaene,** DIRECTOR
7 **Tim Hermans,** DIRECTOR – SECRETARY



* Governor until 1 January 2019. Mr Steven Vanackere was appointed Directeur as of 2 January 2019.
** Governor since 2 January 2019.
*** Marcia De Wachter ended her term as Director on 31 October 2018.

Council of Regency

1 Jan Smets, GOVERNOR *
2 Pierre Wunsch, VICE-GOVERNOR **
3 Marcia De Wachter, DIRECTOR ***
4 Jean Hilgers, DIRECTOR – TREASURER
5 Vincent Magnée, DIRECTOR
6 Tom Dechaene, DIRECTOR
7 Tim Hermans, DIRECTOR – SECRETARY
8 Marc Leemans, REGENT
9 Pieter Timmermans, REGENT
10 Pieter Verhelst, REGENT
11 Yves Prete, REGENT
12 Cedric Frère, REGENT
13 Eric Mathay, REGENT
14 Robert Vertenueil, REGENT
15 Danny Van Assche, REGENT
16 Fabienne Bister, REGENT
17 Edwin De Boeck, REGENT
18 Hans D'Hondt, REPRESENTATIVE OF THE MINISTER OF FINANCE



* Governor until 1 January 2019. Mr Steven Vanackere was appointed Directeur as of 2 January 2019.
** Governor since 2 January 2019.
*** Marcia De Wachter ended her term as Director on 31 October 2018.