REPORT 2021

Preamble

NationalBank OF BELGIUM
Eurosystem

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

For the past two years, the COVID-19 pandemic has dictated the pace of Belgian, European and global economic life. This unprecedented situation has turned our lives upside down, blurred our points of reference and changed our attitude towards the future. The analysis of the Belgian economic situation is presented in this specific context, where breaks in the trend make the conventional economic indicators more difficult to read and reduce the relevance of historical benchmarks. The analysis of the past year therefore cannot rely to the same extent as previously on the established empirical regularities or the usual theoretical arguments, and the forecasts are based more on scenarios deemed plausible rather than projections firmly anchored in the continuation of past trends. This exceptional uncertainty calls for caution and restraint regarding the potential implications for economic policy.

In this Report published on behalf of the Council of Regency, the Governor refers to the extremely atypical economic recovery seen in 2021 and the accompanying uncertainties. Chapter 1 gives a brief narrative and offers some key messages. Chapter 2 presents the global dimension of current developments, including the factors determining the spike in inflation and the resulting challenges for monetary and fiscal policy. Most of the world's economies face the same challenges and their governments are confronted by very similar choices. Chapter 3 details developments and issues specific to the Belgian economy, which has staged a particularly strong recovery in view of the various periods of public health restrictions. Belgium's growth revival was not only stronger than expected, but it also surpassed that in neighbouring countries. This chapter also deals with the necessary response to long-term challenges. Finally, chapters 4 and 5 focus on recent developments in the financial sector and in prudential policy.

* Two Regents were not able to endorse paragraphs 42 to 45 of the Report.

1. The Belgian economy in 2021: reinforcing the recovery in a period of great uncertainty

Stronger-than-expected but uneven economic recovery in Belgium

1. Following the unparalleled economic crisis in the spring of 2020, the year 2021 brought an equally unprecedented recovery which was stronger than expected but also uneven. Despite the disruption of social contact and movement imposed by the episodic restrictions, Belgian GDP has displayed a V-shaped pattern since the start of the crisis. By the end of the third quarter, the strong growth of economic activity (6.1 % in volume over the year) had wiped out the contraction suffered a year previously. Nevertheless, it must be said that this overall performance masks wide variations in individual and sectoral situations.

Monetary and fiscal policies provide exceptional support for demand

2. This economic revival naturally reflects the scale of the initial decline, but also the effectiveness of the safety net, namely the crisis management measures and the operation of automatic stabilisers. In regard to health, wide-scale vaccination and the resilience of the health system were decisive for lifting the restrictions on movement and activity in certain sectors. On the macroeconomic front, public finances performed their shock-absorbing role to the full, at the cost of a substantial budget deficit (–6.3 % of GDP). Monetary policy aided the government budget's nimble response by ensuring historically favourable financing conditions. Though exceptional, the large-scale, simultaneous deployment of fiscal and monetary instruments was in proportion to the challenge posed by the closure of entire swathes of the economy. It can now be concluded that the effective protection of household incomes, labour relations, as well as wide support for businesses, have laid the foundations for the recovery of both production and employment. That said, the overall success should not detract from the wide variations in individual situations. The V-shaped recovery masked the widening inequalities caused by the pandemic which the support measures were unable to mitigate, while at the same time insufficiently targeted emergency measures generated some windfall effects.

Supply constraints and price rises soon emerged

3. The recovery in 2021 also featured the rapid emergence of supply constraints, which fuelled a strong surge in inflation (averaging 3.2 % over the year in Belgium), and the concomitant challenge for monetary policy. This can be ascribed to multiple factors, including the dramatic increase in energy prices, the rising cost of certain essential inputs (such as semiconductors) and the substantial rise in transport costs. While the collapse in 2020 primarily reflected sudden constraints on demand and the corresponding risk of a downward price spiral, the current recovery soon highlighted supply constraints which were synonymous with surprisingly strong and persistent price rises.

Inflationary pressures should gradually fade away

4. The current inflationary pressures should gradually ebb away in the coming months, although there is still considerable uncertainty about that, as some of the factors driving up prices actually reflect a need for global value chain adjustments via investment which will take time to materialise. The risk of production costs fuelling inflation also requires extreme vigilance, especially in view of the dynamic labour market and, in Belgium, automatic wage indexation and the rapid reppearance of labour shortages. Central banks need to balance the risk of spiralling prices against the danger of premature monetary tightening which could strangle the recovery.

5. In the euro area, the September 2021 reform of the monetary policy framework gives the Eurosystem the flexibility it needs to navigate in these uncertain waters. It will have to be both patient and vigilant in the face of an inflationary episode featuring uncertain dynamics while standing ready to change course if there are definite signs of significant deviation from the new symmetrical target of 2 % inflation in the medium term. The expectation that inflation will normalise in the medium term in the region of its target should make it possible to proceed with a gradual tightening while maintaining an accommodative monetary policy without side effects, particularly for financial stability. That is the essence of the December decision by the ECB Governing Council. To sum up, the watchwords for the coming months will be patience, agility and close attention to the relevant indicators.

The ECB will be patient but vigilant and ready to respond to shocks and the risk of inflationary drift

6. The strong recovery, proliferating supply constraints and rising prices imply that the massive support for domestic spending will soon come to an end, in Belgium and everywhere else. A gradual, smooth exit from the crisis policies is vital for the timely regeneration of the leeway essential for attenuating future shocks. However, the continuing public health uncertainties make it difficult to decide the right pace of normalisation. On the one hand, we must not impede the recovery, but on the other hand, it is important to limit the risk of an erratic response by the financial markets to the fragility of public finances or the speed of monetary tightening.

Massive support for demand is no longer justified

7. Switching from macroeconomic stabilisation via demand to the mitigation of supply constraints is no easy transition: designing and implementing structural reforms to address the major changes taking place (in terms of demographics, technology and climate) and to stimulate potential growth affects everyone but in different, and sometimes opposing, ways. More investment needs to go into the green transition, to facilitate the reallocation of resources to sectors with strong growth potential, encourage innovation and the adoption of new technologies and, finally, galvanise the labour market by reducing skill shortages while boosting the labour market participation rate. Public expenditure also needs to focus more on investment in order to rectify the continuing infrastructure deficiencies, particularly in regard to transport, energy security, education, health care and digital technology. Assisting this difficult shift in economic policies is the aim of the recovery plans supported by the European Union's new financial instruments. For Belgium, that support is nevertheless modest given the challenges inherent in implementing long-delayed structural reforms and the need to guarantee the viability of the public debt in all the country's entities.

Exit from the crisis policies marks the return of tough choices while the risks remain significant

8. One last salient point about the recent experience in comparison with other acute crises was the Belgian financial sector's remarkable resilience which enabled it to play a leading role in absorbing the shocks and resolving the crisis. Following the 2008 global financial crisis, the regulatory framework was radically reformed and strengthened to remedy the evident shortcomings and enhance the future resilience of financial institutions. In one sense, the pandemic represented the first – albeit partial – test of that reformed framework. For the first time, the Bank made use of the macroprudential countercyclical capital buffer in the banking sector, built up in a period of favourable economic conditions and released in the event of a crisis. That buffer has yet to be reactivated. However, the high asset prices on the financial markets and the booming Belgian housing market point to a strong upward trend in the financial cycle. The Bank will continue to look closely at the need and the conditions for possibly activating this buffer in 2022. The macroprudential measures for the housing market

should also be maintained in order to safeguard the stability of the Belgian financial sector. Substantial capital buffers and sound bank balance sheets create scope for countercyclical adjustments to the macroprudential tools without any significant impact on lending conditions and hence on the financing of the recovery.

9. The current uncertainties presage considerable risks for the short- and medium-term outlook. While the baseline scenario remains favourable, the sharp slowdown in the final quarter of 2021 and the exponential spread of the new Omicron variant illustrate the threats to growth. Control over the dynamics of the epidemic with vaccines and treatments is still far from perfect and hard to foresee. The monetary policy choices could also be more difficult than expected if it takes a while for supply constraints to clear and for energy and commodity prices to return to normal. The same applies to the cumulative delays in resolving long-standing structural problems, including the sustainability of public finances.

2. Belgium keeping pace with the global recovery with a spike in inflation

A strong but patchy expansion of activity

10. Following an unprecedented contraction of almost 3 % in 2020, global economic activity recorded almost 6 % growth in 2021. International trade flows naturally reflected this trend, increasing in volume by 9.3 %, whereas they had shrunk by more than 8 % in the previous year. The rapid, widespread rollout of effective vaccines in the United States, Europe and China not only made it possible to lift the most severe health restrictions but also made it easier for the economies to withstand new waves of infection. Thanks to the unprecedented support of macroeconomic policies, the level of activity at the end of 2021 thus exceeded the pre-crisis level in most regions of the world including many euro area countries, of which Belgium was one. China stood out with growth of 8.1 %, even without a recession in 2020 (+2.3 %). Elsewhere, some emerging and developing economies did better than others, partly on account of the uneven availability and distribution of vaccines, and partly because of the relative importance of sectors highly vulnerable to health restrictions, such as tourism.

A V-shaped recovery at global level …

11. A specific feature of the 2021 recovery was the speed with which the dramatic slump in demand in the spring of 2020 gave way to supply constraints. In many countries, highly accommodative monetary and fiscal policies meant that consumer purchasing power stood up well overall. Thus, once the main health restrictions were lifted, demand was able to respond immediately. In contrast, it inevitably took longer to get production up and running again, especially where the underlying value chains were complex, globalised and designed to operate "just in time". That is why the constraints on international trade were extremely damaging and revealed the fragility of globally fragmented production processes. In particular, the closure of certain ports vital to maritime traffic combined with other logistical disruptions was enough to throttle many value chains upstream. Shortages of essential inputs (such as semi-conductors) or means of transport (containers, road haulage) impeded the recovery of industrial production in many countries, including Belgium.

… where demand is bouncing back faster than supply

12. The past year has therefore illustrated the degree to which the global dimension of the health shock determined both its direct economic impact and the uncertainty surrounding the medium-term outlook. The successive waves of COVID-19 infections and the emergence of new variants over the past year have shown that the pandemic's economic consequences could spread as rapidly as the virus itself, by disrupting global value chains and transport networks. The risk of perpetuation of the pandemic via new variants potentially resistant to available vaccines and treatments will continue to threaten the global economic recovery so long as high-infection areas persist. Good international coordination (from the sharing of medical data to the wider distribution of vaccines and treatments) remains important to contain this risk.

International coordination remains important to contain the economic and health risks

13. At the very end of the year, the extremely rapid spread of the new Omicron variant put a damper on the global economic prospects which had hitherto been encouraging, despite the marked slowdown in the final quarter. Where vaccination rates were already high, the new health measures were initially less restrictive than a year previously, suggesting that this wave of infections would only interrupt the recovery temporarily. Although the speedy delivery of booster doses offers extra reassurance in that regard, Omicron's infectiousness put a strain on even the most efficient health systems. Many governments had to restrict contact again by closing down certain sectors and maximising recourse to working from home. This situation also tested some countries' zero-COVID policy. While that approach may have offered epidemiological advantages within borders, it impedes the global recovery by perpetuating logistical bottlenecks (blocking of transport infrastructures) and disrupting value chains (closure of production units in lockdown areas). In the short term, the Omicron variant is bound to heighten the economic cost of the pandemic.

14. The vigorous, synchronised revival of global economic activity together with geopolitical factors triggered soaring energy and commodity prices in the second half of the year. Two main factors explain this development. First, widely fluctuating prices typify markets where supply is rigid in the short term, as reopening or closing a mining site is not just a matter of turning a tap or machinery on or off. Next, in the case of energy – and more especially gas – geopolitical uncertainties have been added to an intense debate over the increasing role of this energy source in electricity generation in Europe, just at a time when several countries are turning away from nuclear power or coal. That debate is influencing the expectations of market operators, which may have affected price movements.

The return of inflation

15. While the collapse of demand at the beginning of 2020 rapidly led to a drop in certain prices, the recovery has had the opposite effect, prompting a surge in inflation at global level. That is what happens when supply and demand are temporarily out of sync. On the one hand, prices are adjusted, contributing to inflationary or deflationary pressure depending on the direction of the demand shock. On the other hand, shortages or excess stocks become apparent. This inflation upsurge was surprisingly strong and persistent, reflecting the soaring cost of commodities (especially energy) and the impact of bottlenecks on input prices throughout the value chains.

Inflation is back on the rise …

16. Central banks worldwide are finding it difficult to foresee how long this inflation surge will last. Some are already brandishing the spectre of "stagflation", that persistent combination of high unemployment and inflation which followed the 1979 oil shock and the dramatic tightening of American monetary policy. A repetition of that scenario is highly improbable as economic agents remain confident that, in the medium term, inflation rates will normalise around their official targets (2 % per annum for the euro area). That confidence is based on the firm belief that central banks are supposed to pursue their objectives unhindered. In 1979, that credibility was in jeopardy, since the monetary authorities were viewed as dependent on considerations unconnected with their main mandate.

… but stagflation is not looming

17. Broadly speaking, the expert debate on inflation comes down to two different positions. Some experts believe that the inflationary surge could persist if monetary policy fails to respond fast enough. In their view, the demand pressures are such that many firms are no longer afraid to up their prices, in contrast to their previous approach of maintaining their competitiveness, market shares and profit margins by keeping costs down. In addition, fiscal policies reflecting the desire of many governments to step up investment in infrastructure will continue to fuel demand. These synchronised budgetary pressures could exacerbate the existing strain on some supply chains and be reflected in prices. Finally, a global context of tight labour markets is conducive to wage rises, increasing the likelihood of further price hikes. Others take the view that the current inflationary pressures are fundamentally temporary, because mismatches between supply and demand never last. In particular, the surge in energy and commodity prices will dissipate once supplies on those markets pick up as expected. And the logistical bottlenecks which have driven transport costs sky high are also unlikely to persist. For those who take this view, if the accommodative monetary policies are ended too soon, that would crush a recovery which is still vulnerable to the epidemiological risk.

Opposing views of global inflation: temporary or persistent

18. Such contrasting analyses reflect a reality which is hard to read and a highly uncertain outlook. On the one hand, even if the bottlenecks and other logistical disruptions were to cause a permanent rise in the *level of* some prices, the effect on inflation (which measures *the growth rate* of average prices) would still be transitory. The same logic applies to commodity prices, even if they were to stabilise at a higher level than before the crisis. On the other hand, some inflationary pressures could prove more persistent. First, permanent changes in the structure of expenditure could prolong the constraints on supplies of intermediate inputs or commodities. Be it a question of new private consumption behaviour, accelerated digitalisation or a global increase in green investments, some supply constraints will only be resolved by substantial adjustments to value chains, and that takes time. Second, the pandemic has shown up the fragility of globalised production methods. More fundamental changes designed to enhance their resilience (such as shortening of value chains by the relocation of production) therefore cannot be ruled out, especially if the pandemic persists. That said, any such relocation need not damage production efficiency if accompanied by increased automation. Third, the ongoing reallocations on the labour market are sometimes still difficult to interpret. In any case, the global context is more favourable to wage increases than before the pandemic, and the risk of spiralling cost inflation cannot be ignored.

A pivotal moment for macroeconomic policies

19. While inflation is expected to fall this year, the reforms of the monetary policy framework adopted in the United States and in the euro area in 2021 have given central banks greater flexibility to deal with this specific, highly uncertain environment. More than ever before, monetary policy cannot be reduced to an automatic link between an inflation forecast and what is considered to be the optimum monetary policy stance. The exercise being conducted by credible central banks worldwide concerns risk management. Patience in the face of inflationary blips remains essential so long as a premature tightening of financial conditions would be at the cost of a stalled economic recovery. However, the credibility of patient central banks requires them to signal their willingness to act if inflation expectations clearly deviate from their official target. Striking the right balance between patience and swift response involves continuous, rigorous and transparent analysis of all the relevant data.

Expected to decline this year, inflation will remain subject to close vigilance on the part of central banks

20. This three-pronged approach involving patience, swift response and analysis explains the decisions taken in December 2021 by the Federal Reserve and the European Central Bank (ECB), for instance. In varying degrees, reflecting different economic situations and outlooks, the world's two leading monetary authorities signalled their willingness to make monetary policy less accommodative. By cutting back their asset purchases on the secondary markets, the monetary authorities are reducing their influence on longer-term interest rates, including the level of risk premiums. Elsewhere in the world, a number of central banks (in Latin America, Canada, the United Kingdom, Russia, the Czech Republic and Poland) have also initiated a cycle of monetary tightening. Unless the health risks return in force, those decisions mark the end of an exceptional period of support for demand.

A global change of course is under way

21. The quantitative tightening (tapering) is notably speedier in the United States than in the euro area. Moreover, the American (overnight) policy interest rates are expected to go up several times during 2022. This more vigorous response by the Federal Reserve is due partly to signs of acute stress on the labour market (notably in the form of escalating vacancy rates and unemployment heading towards an all-time low of 3.5 %) and a fiscal policy which is potentially highly expansionary in view of the Biden Administration's plans. These factors are reflected in the American inflation forecasts, which exceed the 2 % target until 2024. Faced with a more fragmented and generally less tight labour market, with budget deficits more under control in some Member States, the ECB predicts that inflation will converge on a level just under 2 % (but within the margin of error) in 2023 and 2024. In principle, it can therefore be more patient than its American counterpart and maintain an accommodative monetary stance for longer.

The Federal Reserve is taking faster and more vigorous action

22. Leaving aside the debate on inflation, more neutral macroeconomic policies are necessary to restore room for manoeuvre in order to cope with future crises. The legacy of massive fiscal support for the economy takes the form of historically high public debt ratios (averaging over 120 % of GDP in the world's advanced countries), constricting future room for manoeuvre. In the central scenario of robust economic growth in 2022, and without prejudice to any targeted crisis measures remaining essential, the window of opportunity for initiating fiscal consolidation is now open. First, an early start offers considerable freedom to choose the rate at which structural deficits are eliminated. The scenario of austerity dictated by the pressure of risk premiums is unlikely so

Normalisation of macroeconomic policies is necessary to restore room for manoeuvre

long as monetary policy remains highly accommodative. But it is much less improbable if monetary policy is obliged to change course. Second, the persistence of real interest rates well below the growth rate makes it possible to stagger the consolidation measures while maximising the reduction in the debt ratio. These conditions favour the chances of success, and hence the credibility, of the debt reduction strategy. Third, the phasing out of fiscal support for demand facilitates a gradual normalisation of monetary policy. At the same time, the credibility of moderate but sustained fiscal efforts reduces the risk of accidents on the sovereign bond markets and, in the euro area, the associated risk of fragmented financing conditions in the Monetary Union. Fiscal consolidation will entail a gradual shift in the financing of priority expenditure away from borrowings (or EU transfers) in favour of resources freed up by the rescheduling of less urgent programmes and reforms designed to contain the structural pressures on certain current expenditure, notably that related to population ageing.

23. The legacy of monetary support for the economy is seen in excessive debt levels for many economic agents and substantial increases in the prices of certain assets, headed by residential property. Low interest rates not only boost the borrowing capacity of households and firms, but they also encourage agents with surplus funds to acquire riskier assets in the hope of positive returns. Thus, in less than two years of crisis, residential property has recorded significant price increases in Belgium (almost 15 % since the end of 2019), but also in Canada (over 20 %), the United States (20 %), the Netherlands (20 %) and even in Germany (15 %), though such a rise is uncommon there. This property price boom is another highly unusual development in the light of other recessions over the past 30 years. As explained in chapter 4 of this Report, the deployment of prudential measures can help to counteract these side effects of monetary policy. However, these measures are not neutral in terms of distribution, and there are limits to their effectiveness.

Macroeconomic stabilisation via demand gives way to the alleviation of supply constraints and support for medium-term transitions

24. The end of the exceptional macroeconomic stabilisation efforts also marks the shift away from a strategy based on stimulating expenditure to an approach aimed at easing supply constraints. At the same time, support is needed for unavoidable demographic, technological and climate transitions. In the United States, following an initial package of emergency measures adopted in March 2021 and totalling $ 1 900 billion, the recovery has taken the form of a $ 1 200 billion public expenditure plan (over ten years, half of it for new initiatives). This plan gives priority to infrastructure for transport, water and electricity supplies and broadband internet. In Europe, under the Recovery and Resilience Facility, governments have devised medium-term plans (2021-2026) geared to investment and structural reforms, aimed at financing the digital and green transitions. This temporary Community instrument financed by European Union debt offers Member States more than € 720 billion, including just under € 340 billion in the form of grants. Although these grants will not be added to the national public debt, they nevertheless constitute a financial obligation on European taxpayers.

The policy mix in the euro area: the start of normalisation and new institutional frameworks

Coordination of monetary and fiscal policies …

25. In the euro area, the combined support for demand offered by national fiscal policies and monetary policy remained at its maximum in 2021. Mass purchases of government securities by the ECB under the pandemic emergency purchase programme (PEPP) ensured ease of financing for public deficits, which still stand at around 6 % of GDP on average in the euro area. Rising inflation during the year even

further reduced the real cost of debt. National governments were thus able to maintain an extensive (albeit more targeted) arsenal of economic support measures to accompany the successive waves of tightening and easing of the public health measures. In that respect, the monetary and fiscal measures complemented each other harmoniously.

26. Some observers saw this harmony as a sign that the central bank was subject to public deficit financing requirements. This "fiscal dominance" argument nevertheless presupposes a fundamental redefinition of a central bank's missions. In reality, monetary policy continued to perform its usual role of steering demand in order to stabilise the economy and prices. Under the particular conditions created by the pandemic, public budgets proved to be the most effective way of safeguarding the economic fabric during its enforced shutdown before proceeding to support the recovery despite persistent uncertainties. The PEPP and, at budgetary level, activation of the general escape clause concerning the European budgetary limits for the 2020-2022 period enabled this vital complementarity between monetary and fiscal policies. The Eurosystem's response was therefore proportionate to the scale of the challenge and in line with the institutional framework defined by the Treaties.

… with due regard for their respective mandates

27. Signs of a gradual normalisation of the policy mix with effect from this year emerged in the second half of 2021. On the monetary front, the conclusion of the strategic review of the ECB's monetary policy framework in June 2021 resulted mainly in a symmetrical interpretation of the 2 % inflation target, explicit recognition of the role of financial stability in price stability, and greater importance attached to the assessment of the proportionality of decisions and their potential side effects. The December 2021 decision forms part of this new strategy. The ECB announced the termination of public debt purchases under the PEPP (at the end of March 2022) and a slower pace of net asset purchases (APP) during 2022. The ECB also decided to terminate, at the end of June 2022, the exceptionally favourable conditions of access for commercial banks to the longer-term refinancing programme (TLTRO III). At the same time, the ECB reaffirmed its preference for a very gradual normalisation of monetary policy, maintained its forward guidance on the key interest rates set in June 2021 (no increase until the inflation projections are deemed compatible with the target of 2 % in the medium term) and affirmed its vigilance concerning the risk of fragmentation of the transmission of monetary policy. To that end, it will watch over the stability of the sovereign debt markets and commercial banks' access to liquidity. This very cautious exit from the crisis policies minimises the risk of a hasty tightening which could strangle growth. However, it is vital not to ignore the opposite risk of unjustified maintenance of extremely accommodative financial conditions despite the ECB's inflation forecasts already very close to the target. Disregarding that risk could fuel concerns over the possibility of a disruptive reversal of monetary policy once inflation regains or even exceeds its target level.

Normalisation of the policy mix and reforms of the institutional framework

28. On the budgetary front, the European Commission proposed deactivating the general escape clause under the Stability and Growth Pact by 2023. National budgets would then once again be subject to the pact's quantitative limits on deficits (3 % of GDP) and public debt (60 % of GDP). The pact's preventive guidelines, namely a sufficiently rapid reduction in the debt, control over the growth of expenditure (unless covered by new revenues) and an adequate reduction in structural deficits), would also offer specific indications of the way to go. However, the stability and growth pact had already demonstrated its limits before the crisis, and radical reform of the European Union's fiscal governance was envisaged. Having been interrupted by the health crisis, this review of the fiscal rules was restarted in the autumn. The European Commission launched a broad public consultation on the improvements to be made to these rules in order to simplify them and reinforce their implementation.

The path of medium-term macroeconomic policies remains uncertain

29. In the absence of a runaway wage-price spiral, attention focuses on two prospective scenarios. In the first, inflation converges sustainably on the 2 % target and monetary policy can be gradually normalised, as envisaged in December. The gradual approach and predictability suit the financial operators, limiting the risk of undesirable side effects on asset prices. In the second scenario, the economy reverts to the pre-crisis situation, namely sluggish growth and inflation obstinately below the official target. In that case, difficult choices might need to be made in the next 18 months. If inflation is too low, it will be necessary to pursue an extremely accommodative monetary policy with no real prospect of normalisation, even though that policy has not succeeded in getting inflation on target despite the sharp rise in 2021-2022. Conversely, financial stability could become so fragile as to endanger the proportionality of monetary policy, because the repercussions of that policy on the balance sheets of individuals and firms, or even the State, would persist (excess debt) while potentially soaring asset prices could imply the risk of sudden reversal (bursting of a potential financial bubble).

Two prospective scenarios for monetary policy

30. As regards public finances, the future path of the budget deficit and the national debt remains unclear despite the expected application of EU rules from 2023 onwards. The consequences of this lack of clarity are minimal so long as monetary policy can pursue its very gradual tightening of financial conditions. Otherwise, there is a possibility of greater risk premium differentiation according to the state of public finances. There would be certain advantages in a return to fiscal strategies based on clear rules geared to the medium term. In other words, while the complementarity of fiscal and monetary policies operated to the full during the crisis, it also applies in the policy mix normalisation phase. Ensuring the clarity of the medium-term fiscal paths would significantly reduce the risk of deviation from the stated course of monetary policy.

Lack of clarity about fiscal consolidation strategies

3. Close-up of the Belgian economy: a strong but uneven recovery in the face of persistent uncertainty and difficult transitions

Profile of an unprecedented but fragile recovery

31. The pandemic has continued to set the pace of the Belgian economy. Although the cyclical indicators were unusually volatile, real GDP achieved a historic rebound of 6.1 % during 2021, surpassing that recorded in neighbouring countries. This V-shaped recovery was in striking contrast to the slow revival which followed the 2008-2009 financial crisis. This performance bears witness to the economy's growing resilience in the face of successive waves of coronavirus infections and the consequent public health restrictions. While many sectors were able to adapt to the health protocols, enabling them to continue operating, the restrictions themselves also became less stringent thanks to the speedy development of effective vaccines and treatments for the virus. After a hesitant start, the Belgian vaccination campaign resulted in very high levels of vaccination, particularly in the population categories most vulnerable to serious forms of the disease. That success made it possible to switch from strict constraints on movement (lockdown of the population, sectoral closures) to social distancing and targeted access rules (hospitality, performances, events, schools, etc.) via rules on numbers, the Covid pass (Covid Safe Ticket), the promotion of remote working and rules on the ventilation of enclosed spaces.

A V-shaped recovery in an economy more resilient to the onslaught of the virus …

32. However, the epidemiological risk has certainly not gone away. A marked slowdown in activity was confirmed in the final quarter of 2021, which brought a new wave of infections and strain on hospitals plus the predictable increase in health restrictions. Belgium likewise suffered the exponential spread of the new Omicron variant, despite the population's wide access to the booster vaccination. These recurrent unpleasant surprises could affect confidence in the existence of a permanent medical solution to the pandemic and in the economy's ability to making a lasting recovery from the consequences of the health restrictions. Any loss of confidence would then cast doubt on the outlook for the growth of private consumption and investment, the two main drivers of the recovery. In the face of these risks, key measures for protecting incomes and preserving employment relationships, such as furlough for employees and the bridging allowance for self-employed workers, were extended until the end of March 2022. Although their use declined steeply during the year, it began to edge upwards in November as the system remains attractive for firms forced to lock down or experiencing supply problems and wishing to retain their skilled labour force.

… but still vulnerable to unpleasant surprises …

33. Like the initial health shock, the benefits of the recovery have varied from one branch of activity to another. The V-shape described above is in fact more like a K, symbolising divergences between sectors within the economy. Compared to services, industry in general enjoyed a strong revival as soon as the economy and international trade were opened up. That said, there are wide variations between the industrial sectors themselves. While pharmaceutical and construction companies logically benefited from very strong demand, firms in metallurgy suffered from the disruption of supply chains and staff shortages. The services sector, being more sensitive to the successive public health measures, generally recorded more modest growth over the year, though there was an uptick in the second half of the year. Certain sub-sectors also suffered much more than others as their business activities were subject to tougher restrictions.

… with wide variations between sectors

34. Employment (+1.8 %) and unemployment (down by almost 30 000 units) reflect the robustness of production. In parallel with the mass recall of furloughed workers and the increase in hours worked, 88 000 additional jobs were created in 2021. Overall, the crisis had no significant effect on the rate of labour market participation (just under 70 %). Similarly, the shortages that existed before the crisis soon reappeared. As in the case of production, substantial differences became apparent between sectors, with losses confirmed in hospitality and other branches vulnerable to the health measures. This sectoral heterogeneity shows that the crisis heightened income inequality and widened geographical disparities. While many workers survived the economic upheavals unscathed, others such as young people, casual student workers and the low-skilled, who are often in a more precarious financial position and are over-represented in the hard-hit sectors, were more exposed to the hazards of the economic situation. Thus, the numbers claiming the subsistence allowance increased considerably in 2020 (+8 % over one year in December). Nonetheless, the numbers began falling slowly at the beginning of 2021 to reach a slightly worse situation at the end of the year than before the crisis. The decline was more marked in Flanders than in Wallonia, whereas in Brussels, which has a higher concentration of vulnerable sectors, the figures merely stabilised at a high level. These divergences are connected with the stronger labour market recovery in Flanders than in the other two Regions of the country.

The employment market proved to be very strong overall

35. The disparate effects of the crisis on the labour market also took the form of significant differences between men and women. Being over-represented in service activities, women were relatively more affected by the health crisis, and in very contrasting ways. Women employed in the health sector and in essential services came under stress while those in hospitality or contact professions were forced to stop work. In addition, the persistent imbalance in the sharing of household duties put particular pressure on women who were able to or had to continue working from home. This may explain why corona parental leave was used mainly by women, affecting their income and in some cases their career prospects. In 2021, the upturn in employment benefited both women and men. However, a higher proportion of these new female workers seem to have been previously inactive rather than unemployed. If that is the case, the rise in the female participation rate is a positive development.

As elsewhere, vigorous demand rapidly encountered supply constraints

A recovery driven by domestic demand …

36. Unusually, domestic demand was the factor driving the recovery. Private consumption (the main component of domestic expenditure) thus regained 6.4 % in volume, indicating normalisation of the household savings ratio while the growth of purchasing power was temporarily eroded by resurgent inflation in the second half of the year. Apart from a specific effect in the pharmaceuticals sector, the remarkable vigour of business investment was a sign of greater digitalisation efforts. Rising sales and expanding gross margins were thus welcome support for this momentum. The highly accommodative fiscal policy which continued in 2021 also enabled public investment and consumption to make a significant contribution to growth. Foreign trade had only a meagre positive impact following the simultaneous jump in imports and exports, the latter being inflated by pharmaceuticals products, including vaccines.

… and soon curbed by supply constraints

37. According to a recent survey by the Bank, Belgian firms suffered seriously from supply constraints, once again with fairly significant sectoral and regional disparities. These constraints are defined as difficulties concerning supplies and recruitment, or substantial increases in input prices. They are due partly to a contagion effect via global value chains, and partly to shortages of skills and available applicants specific to the Belgian labour market. The hardest-hit branches of activity include agriculture, transport and logistics, industry and the hospitality sector. In this last case, as in the travel agency sector, we can see the effect of reallocations away from the branches most affected by the closures in favour of jobs viewed as more secure. In view of the dynamism of the labour market, it is no surprise that labour availability problems occurred primarily in the Flemish Region.

However, there are no tangible signs of permanent damage to Belgium's production potential

38. In the light of these supply-side developments, it is legitimate to ask whether the crisis will leave deep scars on the Belgian economic fabric. Should we fear a permanent decline in the economy's potential production level (or its growth rate)? At a time when the pandemic is still regularly producing unwelcome surprises, it is too soon to give a definite answer. While it already seems certain that some branches of activity will suffer irreparable losses, preliminary indications point towards fairly limited permanent damage overall. In addition, the escalating investment in digitalisation should actually foster productivity growth. Moreover, the current labour market shortages (which do not necessarily affect highly-skilled jobs) are creating a real opportunity to step up the reforms intended to boost the participation rate via

a balanced array of incentives, support and training. Nonetheless, the medium-term outlook for supply conditions is particularly unclear, notably in regard to global value chains which have proved extremely fragile. However, it is still too soon to assess the probability of production relocations aimed at promoting the resilience of value chains rather than their efficiency.

39. At a more microeconomic level, the expected tsunami of bankruptcies has not materialised. On the contrary, the monthly average of less than 600 bankruptcies since March 2020 is well below the figure of more than 800 recorded over the 2010-2019 decade. Apart from effects related to the periods of moratorium, the government support measures seem to have been generally successful in safeguarding the financial situation of firms. Their cash flow benefited from temporary unemployment (transferring payment of the wage bill to Social Security), the tax measures and various regional flat-rate payments. Nor does the crisis appear to have had any significant impact on corporate profitability or solvency, although these indicators are less relevant than in normal times, not least given the impact of all the government interventions on company accounts. Finally, government support for the strengthening of the capital base (for instance, via public investment companies and tax incentives) was a useful addition to the arsenal of measures promoting firms' financial viability. Here, too, the aggregate indicators conceal widely disparate sectoral and individual situations, making it inappropriate to draw definite conclusions. In particular, the scale of the government support could imply the risk of artificially prolonging the activities of non-viable businesses (zombies). However, there have been no signs as yet of any large-scale zombification, which may be due to the relatively targeted nature of the measures taken. Business start-ups have remained at a high level and many entrepreneurs have recapitalised their company and revitalised their business model, while the process of reallocating resources from less efficient producers to other more productive firms does not appear to have stalled during the crisis.

Sharp rise in inflation

40. Belgium has not escaped the global inflation surge. In January 2022, the inflation rate reached 8.5 % compared with January 2021, a record high since the harmonised index of consumer prices was launched for the euro area in 1997. The average rate for 2021 came to 3.2 %, or 0.4 percentage point higher than in the three main neighbouring countries. The influence of "base effects" whereby abnormally low inflation at one point automatically gives way to higher inflation twelve months later is not the sole reason. The main culprit is energy inflation, which reached an historical peak of 22.4 % on average over the year, or twice the average for the three main neighbouring countries. That contrast is due to the specifics of energy pricing in Belgium. These essentially concern the low weight of excise duty on heating oil (which soared in price by an average of 36.4 % over the year), reinforcing the link between the ultimate price and the cost of the commodity, and the variable price contracts for gas (39.6 %) and electricity (16.2 %) which are applied more widely than in the other countries. The health index, the benchmark for wage indexation and all allowances and social benefits, therefore also recorded a very strong rise.

Inflation has been propelled by rocketing energy prices …

41. Apart from energy and other products with notoriously volatile prices (food, alcohol and tobacco), core inflation also exhibited a marked rise during the year. That should be seen as the effect on demand of the reopening of the economy combined with the effect on supply of the value chain bottlenecks. The steep rise in production costs therefore began to filter through to prices of consumer goods (particularly domestic electrical appliances, furniture and furnishings, and second-hand vehicles). To give an idea of the scale here, production and

… and by the rise in the costs of production, transport and imported inputs

import prices in manufacturing industry jumped by 25 % at the end of the year, an increase unheard of since the 1980s. On the basis of a survey by the Bank at the end of November, firms state that they expect to have to continue raising their prices over the next six months. This suggests that inflation could be around for a bit longer, bringing with it a higher risk of a price-wage spiral. Conversely, the individual VAT cuts applied to some sectors have not affected prices and are therefore fully reflected – as intended – in gross margins.

Wage setting and competitiveness

Wage indexation protects purchasing power against inflation …

42. In this specific context, automatic indexation of wages and social benefits as applied in Belgium protects households against the erosion of purchasing power caused by inflation. The health index which forms the basis includes essential domestic energy (gas, electricity and heating oil). Nonetheless, that protection is subject to a slight time lag, depending on technical factors which may vary from one sector to another. In the public sector, the threshold index system involves the threshold being exceeded on two successive occasions at intervals of two months (in December 2021 and February 2022), the actual indexation being applied one month after each overrun in the case of social benefits and two months after it for wages. In the private sector, the indexation mechanism varies from one joint committee to another; it may either refer to a threshold index or take the form of annual or periodic index-linking. For low-income households, this protection is only partial, given that energy expenses take up a relatively larger share of their family budget. According to available estimates, one in every five households is now thought to be living in energy poverty. Apart from indexation, there is a whole array of more specific measures (which are, incidentally, accepted by the European Commission) to reduce energy bills. The Belgian government has therefore taken a number of decisions on the coverage of the social tariff, VAT rates and ad-hoc transfers to cushion the shock for household budgets.

… but temporarily affects the economy's competitiveness

43. Since automatic wage indexation is unusual elsewhere in Europe and the rest of the world, it inevitably affects the Belgian economy's cost competitiveness in the short term. There is therefore a need to strike a balance between the purchasing power protection offered by indexation and its potentially detrimental impact on the economy's competitiveness. That is why wage setting in Belgium is governed by the Law on the Promotion of Employment and the Safeguarding of Competitiveness. This Law is built on the concept of a wage cost gap in relation to the three main neighbouring countries. It gives the social partners a clear and binding framework setting out a maximum wage margin available within which wage-bargaining negotiations must be conducted to preserve the economy's competitiveness.

44. This combination of automatic index-linking and safeguard legislation, specific to Belgium, involves different considerations. The first concerns the business cycle. As empirical analysis suggests that lasting real wage cuts are fairly uncommon in Europe, it will be necessary to see how quickly wages also rise in neighbouring countries to offset the loss of purchasing power. If that *de facto* indexation does take place quite promptly and if energy prices return to normal as expected, there should be no major, lasting deviation in the wage gap. But the uncertainty surrounding this remains high and the Belgian economy's competitive position could deteriorate more sharply than expected. The second consideration concerns the inevitable tension between the macroeconomic steering of wages and microeconomic efficiency which requires flexibility between branches, or even between firms. Taking account of automatic index-linking, which protects real wages from falling, relative changes can only take place via higher wage costs within labour market segments where labour is in short

supply or in branches (firms) achieving significant productivity gains. In that case, the effective reallocation of labour entails a bigger average increase which may soon be constrained by the margin for wage increases, currently set at 0.4 %. That tension between the macro- and microeconomic dimensions of the Law is inherent in the current system. In actual fact, given the sharp rise in inflation, it will be the macroeconomic dimension of the economy's competitiveness that has to be given particular attention in the coming months.

45. In the short term, it should be noted that the usual labour cost statistics, and hence the interpretation of the wage cost gap concept at the heart of the safeguard law, are harder to read. While gross hourly pay was up by 4.8 % in 2020, it was practically unchanged during the year under review (+0.1 %). At first sight, these movements are counter-intuitive, but they are due largely to technical effects concerning the nature of the temporary lay-off system in Belgium, with claimants under this system being excluded from the wage bill. Since these claimants are often in the lower-income groups, the application of temporary lay-offs leads to an increase in the labour cost indicators, while the opposite occurs when the same individuals are reinstated in their jobs. The crisis also accelerated the planned pay rise in the health care sector and triggered the payment of various bonuses.

Lasting impact on public finances : towards gradual consolidation to restore room for manoeuvre and ensure debt viability

46. As stated above, the time has come for gradual normalisation of the exceptionally accommodative fiscal policy stance. Owing to their very nature, the emergency measures are set to disappear or become increasingly targeted while fiscal revenues keep pace with the recovery. The correction of the deficits is therefore largely automatic. Thus, the net funding gap declined from 9.1 % of GDP in 2020 to 6.3 % in 2021. Although there are no specific commitments for the medium term, current forecasts predict stabilisation at around 4 % of GDP, which is above the limits set by the European framework and higher than the figure required to set the government debt ratio firmly on a downward path, especially if the recovery continues as expected. Since the crisis, the regional and Community governments have for the first time made a substantial contribution (around 2 percentage points of GDP in 2020 and in 2021) to the State's financial imbalance and the increase in the national debt. More than ever before, fiscal consolidation will require good coordination of the efforts between the various entities.

The public deficits are still high and their automatic normalisation will not be enough to ensure the viability of public finances

47. Reactivation of the European fiscal framework will provide useful benchmarks for the Belgian government. Despite reforms which have been announced but remain very vague, it seems that the budget deficit limit of 3 % of GDP will again take effect in 2023. To be credible, any fiscal plan will have to strike a balance between the necessary gradual approach to improving budget balances and the sufficiently rapid restoration of room for manoeuvre by cutting the debt ratio. The focus of fiscal policies also needs to switch to medium-term challenges by better prioritisation of expenditure. Before the crisis, Belgium's public finances were fragile owing to an excessive public debt and poorly controlled budget deficits reflecting the pressure of current expenditure. It is true that borrowing conditions have remained highly favourable, enabling the State to raise funds cheaply. But the first signs of financial conditions returning to normal at the end of the year indicate that we can no longer expect any significant fall in the annual debt burden. The earliest possible commitment to medium-term objectives anchored in definite measures would avert a rise in risk premiums and restore the room for manoeuvre essential for coping with the next crisis.

Gradual consolidation is required

48. The sustainability of regional and Community public finances must also come under closer surveillance, particularly in view of their dominant role in the protection of citizens and the economy against exogenous shocks (pandemics, natural disasters) and in the public investment policy. Even without the cost of the summer floods in 2021, the viability of Wallonia's regional debt was pinpointed in an independent report published in September. According to that report, in a favourable financial environment, a sustained effort could alter the debt path without necessarily jeopardising the federated entities' essential contribution to the execution of the recovery plan supported by the European Union and modernisation of the infrastructures (transport, education, health care). Although this EU support is modest for Belgium (just over 1 % of GDP over five years), the amount passed on to the Regions is significant in view of the importance in the recovery plans of investment projects relating to the green transition and digitalisation.

We must take care to ensure the viability of the federated entities' finances

Ensuring that the recovery leads to a resilient, sustainable economy

49. When a crisis comes to an end, that invariably fosters the hope that the impetus generated by the recovery can set the economy on the road to more favourable growth, i.e. growth that is more inclusive and more environmentally sustainable. To achieve that, it is necessary to make maximum use of the economy's structural strengths and tackle its weaknesses by means of ambitious reforms. Belgium's strengths include its capacity for innovation, its strong position in global value chains and its high productivity. Its main weaknesses include productivity growth, inadequate labour market participation, low labour mobility, relatively substantial greenhouse gas emissions and shortcomings in its infrastructure. None of that is new and, in the past, the Bank has made specific recommendations about the nature and direction of the necessary reforms. The current recovery and its litany of supply constraints represent an environment conducive to the speedier manifestation of the benefits expected from these reforms, as buoyant demand helps to mitigate the undesirable redistribution effects caused by certain structural measures.

Building a resilient, sustainable economy requires ambitious reforms

50. A key objective of the structural reforms is to improve market efficiency. Contrary to some received ideas, that is not synonymous with a general *laissez-faire* approach. On the contrary, it is necessary to fine-tune government intervention in proportion to the nature and extent of each market's imperfections. In most cases, that intervention involves a combination of fiscal measures, regulations and efficient infrastructure. In Belgium, three priorities for reform are worth highlighting: relaxation of certain regulations favouring businesses already established on a market over and above new competitors, resolution of the tensions on the labour market, and a fiscal policy which better reflects the priorities of the green transition and infrastructure modernisation. The first priority aims to avoid zombification of the production base by revitalising business demographics, the key objectives being more innovation and stronger productivity growth. The second aims to reduce the labour shortages on certain market segments (lack of applicants for vacancies), to bring the supply of certain skills more into line with demand, and to boost the participation rate. Better use could be made of the many instruments available, including the provision of training geared to shortage occupations, active assistance for job-seekers, notably in the case of workers on long-term leave, an adequate financial gain in the event of transition from inactivity or unemployment into work, and finally, the provision of lifelong education and training. The measures designed to encourage people into work will be all the more effective if the quality of the jobs available or

created is guaranteed and specific arrangements, such as part-time working, can cater for the constraints affecting certain categories of inactive persons. Obviously, some of these measures will take time to produce their full effect and are not neutral in terms of distribution. However, they are relevant instruments for achieving the official target of an 80 % employment rate.

51. The third priority, the green transition, has a global dimension which, as well as substantial public and private investment, also requires reforms capable of achieving a permanent change in consumption behaviour and production choices. Thus, under the Green Deal, the European Union has set ambitious targets for reducing greenhouse gas emissions, increasing the share of renewable energy in consumption, and improving energy efficiency: all these targets are to be achieved by 2030. Here, too, public intervention is based on a combination of regulation, taxation, subsidies and investment. The effectiveness of these various instruments in terms of reducing carbon dioxide emissions at the lowest possible cost involves their influence on the implicit price of carbon. In Belgium, that price is still relatively low, delaying the decisions needed to make progress in the energy transition, and ultimately increasing the cost of the transition. In principle, a specific tax on carbon would be the best way of encouraging the transition, but political constraints and distributional considerations favour a balanced package of less direct measures. While some instruments, such as the European Union's emissions trading system, are not within the remit of the Belgian authorities, others are directly under their control and merit particular attention. Apart from legislation, this concerns fiscal policy instruments (taxes, subsidies and green investment).

Encouraging the green transition entails raising the carbon price …

52. While the greening of the State budget aims to increase the implicit price of carbon, the measures to be taken must be predictable and must fit into a transparent framework. More predictable energy costs will make it easier for the economic agents to plan the investments needed to switch to the use of clean or transitional forms of energy. Conversely, sporadic policy decisions would be liable to encourage price volatility and hamper the planning and implementation of these investments. Excessive price volatility would also undermine political support for the energy transition. In that regard, it cannot be emphasised enough that the sharp price rises observed recently in no way fit the desirable profile of a gradual, predictable rise in fossil fuel prices and the levels expected at the end of the transition bear no comparison with the current peaks.

… in a transparent framework permitting a gradual, predictable rise in fossil fuel prices

53. The question of a greener fiscal policy is not confined to knowing how much carbon will cost at the end of the transition but also entails deciding who will pay. As we know, a consumption tax is often regressive because it affects people on low incomes who spend most of that income on consumption and cannot afford the expenditure necessary for switching to lower-carbon consumption baskets. Any successful greening of the State budget will have to take account of these considerations in order to determine a range of taxes, subsidies, compensatory transfers and green investment compatible with a transition which is ecologically effective, economically efficient and socially fair. That will require the most detailed possible impact assessments.

But the greening of fiscal policy must take account of redistribution effects

4. A resilient financial sector accelerates the economic recovery

54. In a crisis, policy-makers and economic agents must be able to count on a resilient financial sector which helps them to absorb the shocks and lay the foundations for the subsequent recovery. The Bank fosters that resilience by preserving financial stability so that, even in times of crisis, the financial sector can perform its essential functions.

55. During the past two years the Belgian banking and insurance sector has had to contend with the consequences of a public health crisis and extreme flooding. Many customers of banks and insurance institutions took a major financial hit simultaneously, owing to either a sharp fall in their income (due to the pandemic) or serious damage (caused by natural disasters). However, given their sound financial position, financial institutions were able to absorb these shocks and contribute to the design and implementation of support measures for the businesses and households concerned. In the future, too, the financial sector must once again form an integral part of the solution, together with the authorities, in these moments of crisis.

56. The financial institutions' supervisory and regulatory authorities play a key role in that respect. In fact, they have to ensure that financial institutions correctly assess, measure and control the risks that they face so that the vulnerabilities and losses in the event of a severe shock remain manageable. Moreover, the minimum requirements must guarantee that, in a crisis, financial institutions hold sufficient capital reserves both to cover their own losses and to enable them to continue performing their key functions for the other economic sectors. That is why, following the global financial crisis in 2008, the regulatory framework was radically revised and strengthened to remedy the shortcomings identified and to enhance the resilience of financial institutions in the future. In some ways, the pandemic has been the first – albeit partial – test for the financial sector of that reformed framework which, in particular, ensured that the Belgian banking sector's capital buffers were considerably larger at the start of the pandemic than at the outbreak of the global financial crisis: in fact, in March 2020, the ratio between the capital and the balance sheet total (6.5 %) was more than double the August 2007 figure (3.2 %).

The capital buffers ensure the resilience of the financial sector in the event of a crisis

57. At the beginning of the coronavirus crisis, a number of measures were taken to enable the financial sector to assist in managing the crisis. For instance, the micro- and macroprudential authorities promptly relaxed some of the capital and liquidity requirements. They thus enabled the banks to use the capital buffers previously created to cover the losses and continue to finance lending or other forms of support for severely affected customers. Working with the government, the financial sector devised arrangements permitting both the postponement of loan repayments and insurance premiums, and the grant of bank loans and commercial credit insurance backed by the State. Without these general support measures, there was the threat of a wave of payment defaults and disruption in lending to hard-hit households and businesses. The ensuing credit constraints would in turn have damaged the economic recovery.

The economic recovery has reduced the short-term risks for financial stability

58. The economy's strong and swift recovery and the currently very low default rates on loans to Belgian households and firms bear witness to the effectiveness of these exceptional temporary measures. However, it must be borne in mind that the repayment capability of the hardest-hit households and firms is still largely underpinned by the various income support measures adopted by the federal government or the Regions. That said, the combination of all these

initiatives has helped to avoid a spate of defaults and, to a great extent, safeguarded the economic fabric. The short-term risk for the financial system's stability emanating from a sharp rise in non-performing loans has therefore clearly been reduced. The lower than originally expected scale of these loan losses is the main reason why, during the first nine months of 2021, the net profit of the banking sector was maintained at a level well above the figure for the corresponding period in 2020 (€ 5.3 and € 2.7 billion respectively). Nevertheless, the banking sector's business model and medium-term profitability remain key points for the Bank's attention. The challenges stem from the protracted period of very low and even negative interest rates, the rapid and extensive digitalisation of financial services, and the need for further improvements in cost efficiency. That is particularly true for medium-sized and small banks whose business model is geared to retail banking. Compared to large universal banks, they often apply a less diversified revenue model, centred on activities which are most sensitive to the impact of the low interest rate environment. In addition, they benefit less from economies of scale which, for example, would enable them to spread the cost of their necessary IT investment in digitalisation over a broader asset base.

Some of the support measures ended without any cliff effect

59. The economic recovery has made it possible to phase out some of the support measures – which had initially been extended and, if necessary adjusted – without triggering any significant cliff effect in the form of an increase in defaults. The recommendation calling on financial institutions to limit the payment of dividends and other benefits was therefore not extended beyond its expiry date of 30 September 2021, in accordance with the decisions of the ECB and the European Systemic Risk Board (ESRB).

60. The general scheme for postponing payment, set up for existing business and household loans, expired at the end of June 2021. This support measure had peaked at 6 % of outstanding mortgage loans and 13 % of business loans in September 2020. After that, its use declined steadily, falling to a very low volume by the time the scheme ended. Most households and firms resumed their normal schedule of loan repayments. In addition, Belgian banks offered solutions for firms and households which still needed to defer payments or reschedule their debt. Thus, the percentage of restructured business loans increased from around 1 % before the pandemic to 4 % in 2021. Adopting permanent solutions for viable businesses with excess debts, namely debt restructuring or partial cancellation, reduces the number of businesses going bankrupt or defaulting. Ultimately, these bankruptcies and defaults would damage the financial sector itself and weaken the economic recovery. However, the supervisory authorities must continue to make sure that the banks assess non-performing loans properly and make adequate provision for them so as to speed up their resolution. Previous financial crises have demonstrated the importance of recognising losses immediately and swiftly eliminating them from the system in order to shorten the crisis and support the economic recovery.

Banks must continue to assess non-performing loans properly and make adequate provision for them

61. After the first scheme expired at the end of 2020, the second scheme for new State-backed business loans was also terminated at the end of 2021. Use of this second federal government guarantee scheme was optional and reserved for loans to SMEs with terms of one to five years. At the end of 2020, the outstanding amount of State-backed bank loans under the two schemes peaked at around € 2 billion. In December 2021, that figure had dropped below € 750 million. Use of these two schemes was rather limited overall, notably because demand for new investment loans remained low during this period and the banks were willing to continue lending to businesses during the pandemic without this support measure.

62. During 2021, lending to Belgian non-financial corporations caught up to some extent following a period of weak growth in the second half of 2020 and the first half of 2021. At the end of November, the annual growth of lending to non-financial corporations stood at 3.1 %. However, that growth was still well below its pre-crisis level, when it had reached 5 % or more.

Mortgage loans and house prices grew at a steady pace

63. Conversely, driven by mortgage loans, household borrowing was again highly dynamic with annual growth in excess of 5 % in the second half of 2021. This was accompanied by a significant acceleration in house price growth, which reached almost 10 % in the third quarter. Housing became more expensive despite further expansion of the stock of real estate, which reached its highest level in at least thirty years in terms of the ratio of houses to households in Belgium. In recent times, the boom in housing prices and mortgage loans was therefore fuelled mainly by demand factors. However, this surge in prices is not attributable solely to the steady increase in the average size or energy efficiency of the houses sold, the trend in household disposable income, mortgage interest rates and demographics, or changes to property taxes. If these rising prices were to prove unsustainable in a changed economic context, a sharp fall in house prices could pose a threat to financial stability, especially since the debt ratio of Belgian households continues to climb rapidly owing to the strong growth of lending. It currently stands at 63 % of GDP, which is well above the level prevailing ten years ago (55 %) and exceeds – albeit to a lesser degree – the corresponding average in the euro area countries (61 %).

Demand factors fuelled the rapid growth of house prices and mortgage loans

The macroprudential measures for the housing market remain relevant

64. Meanwhile, mortgage lending has made the Belgian banking sector and some insurance institutions very exposed to the housing market. However, that risk is mitigated by two macroprudential measures adopted by the Bank, measures which have dual aims : to prevent the continuing accumulation of risks in the financial sector and to ensure that banks operating with an internal risk model hold sufficient capital to absorb losses and shocks in an orderly way.

65. At the beginning of 2020, to avert a continuing increase in risks, the Bank issued prudential expectations for Belgian mortgage loans, applicable to all types of lenders. Consequently, in 2020 and in the first half of 2021, high ratio loans were far less common than in previous years. As the recommendations for loans to first-time buyers were the least strict, the proportion of young borrowers remained unchanged at around 35 % of new loans. The reduction in loan-to-value ratios protects new borrowers against excess debt and ensures that the risks on financial institutions' loan portfolios do not increase any further.

Young people's share of new mortgage loans is unchanged at 35 %

66. However, in recent new business, the borrowing criteria have not improved to such an extent, that adjustment of the second macroprudential measure is justified. That measure involves an additional capital buffer to cover systemic risks in the portfolios of banks using an internal risk model to calculate the minimum capital requirements. That calculation generally results in very low risk weightings, as Belgium has never experienced a property crisis. It therefore underestimates the potential losses in the event of a severe market shock. The buffer was introduced in 2013 and extended by one year in 2021. Any adjustments required in the light

of recent improvements in loan criteria will not be considered until after the next extension. But in the event of a property market crisis, that buffer can be released immediately to enable the banks to use the capital to cover losses. The capital thus freed up will also need to be used to finance solutions for customers encountering repayment difficulties, while taking account of the risks, so that any potential crisis is not exacerbated by a spate of payment defaults, evictions and forced sales of housing.

Activation of the countercyclical capital buffer could prove necessary in the near future

67. Use of the countercyclical capital buffer – built up during a period of favourable economic conditions for release in a crisis – was applied by the Bank for the first time at the start of the pandemic. At that time, the 0.5 % countercyclical capital buffer had been released in the sum of around € 1 billion. That buffer has not yet been reactivated. However, the high asset prices on the financial markets and the strong momentum on the Belgian housing market indicate a sharp upturn in the financial cycle. The Bank will continue to keep a close eye on the need to activate this buffer and the arrangements for doing so during 2022.

68. Macroprudential measures are in fact the first line of defence for cushioning any repercussions on financial stability of a highly expansionary monetary and fiscal policy. Their activation extends the necessary scope for pursuing these expansionary policies. However, it should be noted that macroprudential policy cannot contain all the risks. Moreover, capital buffers, such as the countercyclical buffer, are not in themselves able to restrain the financial cycle. They merely oblige the banks to build up a reserve to cover any losses in the event of a crisis.

Macroprudential policy is the first line of defence for cushioning the impact on financial stability of a highly expansionary monetary and fiscal policy

The Bank calls for transposition in accordance with Basel III for European banks

69. Since regulatory authorities need to learn useful lessons from times of crisis, the 2008 global financial crisis led to radical redesign of the regulation and supervision of the financial system. The Basel Committee on Banking Supervision completed its reforms of banking legislation at the end of 2017 with the publication of measures limiting and – via the output floor – supplementing the use of internal models for the determination of the risk-weighted assets (i.e. the denominator of the risk-weighted capital ratio). This last requirement specifies that the total risk-weighted assets as calculated by internal models must not be less than 72.5 % of the same total risk-weighted assets as calculated by the standard, more conservative model. The Bank regrets that, in its proposal at the end of October 2021, the European Commission does not transpose these Basel III rules fully into European legislation. The transitional period for adoption of the output floor is longer and the transitional measures go much farther than the Basel Committee's provisions. Moreover, the proposal maintains the existing exemptions from the Basel rules in force in European legislation, which reduce the requirements for European banks. In addition, it is proposed that the output floor should only be imposed at consolidated level for international banking groups, whereas the banking rules have hitherto always applied to their various local subsidiaries as well.

70. Together with more than 25 other central banks and European supervisory authorities, the Bank – which is in favour of full and timely implementation of the Basel III standards – addressed a letter to that effect to the European Commissioner for Financial Services. In the long term, it is in the interests of the economy that banks should be adequately capitalised, since they are a major – and probably the most important – factor for the resilience of the financial system. Furthermore, the proposal for applying the output floor only at consolidated level creates a regrettable precedent for Member States such as Belgium, which host banks from other European Member States, since the Banking Union has not yet been completed. Financial stability can only be ensured if the subsidiaries of foreign banking groups which play a prominent role in the domestic banking sector also hold sufficient capital to absorb any substantial, unexpected shocks.

Local subsidiaries of foreign banking groups must hold sufficient capital to ensure the financial stability of the domestic banking sector

The regulatory framework for non-bank financial intermediation needs to be strengthened

71. While Belgian investment funds stood up well to the COVID-19 shock, the Bank also gives high priority to strengthening the regulatory framework governing non-bank financial intermediation. The coronavirus crisis and the ensuing dash for cash in March 2020 showed that vulnerabilities persist in certain sub-segments of the money market, the bond market and the real estate funds market. In addition, as emerged in the light of the Greensill and Archegos cases in the first quarter of 2021, developments in the non-bank financial sector can have a great impact on the banking sector. We need to draw the right lessons from these experiences and strengthen the regulatory framework where necessary. The Bank fully supports the ongoing work on this subject at international and European level. The supervisory and regulatory authorities must likewise continue to keep a close watch on the risks concerning the interlinks between banks and non-banks. They must also examine the possible need to supplement the existing regulations, notably in regard to systemic exposures, e.g. to central counterparties for derivatives.

Digitalisation and climate change are the top priorities

72. While digitalisation of the financial world offers opportunities for financial institutions, it also implies various risks. In September 2021 the European Commission therefore proposed a strategy for promoting this digital innovation and creating a single digital market for financial services. However, the set of measures proposed for digital finance also aims at better control over the risks associated with digital innovation. It includes proposals concerning the markets in crypto-assets (MiCA), digital operational resilience (DORA) and distributed ledger technology (DLT). The proposals also aim to remedy a gap in the existing European legislation in order to prevent the current legal framework from impeding the use of new digital financial instruments while ensuring that these new technologies and products conform to the regulations and the management of corporate operational risks in the European Union. The aim of these initiatives is to encourage innovation and new financial technologies while ensuring adequate protection for consumers and investors. It is in fact increasingly crucial to guarantee cyber security and the continuity of the underlying IT systems in order to ensure the availability and operation of essential financial services providers. We must continue to make sure that the financial players' administrative bodies have the necessary expertise and information to monitor these risks properly and to take the necessary steps to control them. The emergence of cryptocurrencies and crypto assets

The emergence of crypto-currencies and crypto-assets requires the creation of a sound framework so as to maintain control over the risks for financial stability

requires the creation of a sound framework to maintain control over the risks to financial stability. Finally, all financial institutions must adapt their business model in line with the changing preferences of financial services customers, without however forgetting access to banking services for customers less familiar with the use of digital tools. The supply of financial services tends to favour digital channels and is able to exploit the latest technological innovations. In that regard, financial institutions increasingly need to compete with non-bank service providers as well. On this subject, the Bank's FinTech survey shows that, while most Belgian banks have actually established a strategic vision for FinTech and digitalisation, there are significant divergences between institutions in terms of digital performance and the development of innovative or digital applications. There is a risk that the business model of some banks may come under pressure, and not only because of competition from new players such as the BigTechs. It is also possible that the banks which are farthest advanced in terms of digitalisation and the integration of FinTech solutions might set the bar higher for all players in the sector by responding better and/or more efficiently to customers' needs.

73. In publishing its report on the digital euro at the end of 2020, the ECB initiated an in-depth review of the need for its own digital currency and the arrangements for issuing it. If a digital euro were to be issued, it would aim to support the digitalisation of the European economy and ensure sovereignty over foreign digital currencies or private means of payment. Since the use of cash is tending to decline, at least in some Member States, this project could offer citizens an alternative for securing their access to central bank currency. However, there is no question of discouraging or phasing out the use of cash, nor of competing with the private sector. On the other hand, the aim is to improve cooperation between banks, payment entities and other financial institutions. The Bank is cooperating with the other euro area central banks on this project in the High-Level Task Force, which is examining the main aspects of the design and characteristics of the digital euro.

74. Climate change and the transition to a more sustainable, low-carbon economy may also have a significant effect on the economy and on the financial system's stability. The prudential authorities are examining how to incorporate climate risks in the prudential legislation, while the supervisory authorities are ensuring that financial institutions analyse, monitor and manage these risks. The Network for Greening the Financial System (NGFS) remains a major source of inspiration for the regulatory and supervisory authorities. This is a global partnership of central banks and supervisory authorities aiming to exchange knowledge and experience in regard to climate and environmental risks and sustainable finance. The Bank plays an active part in this European and international work on climate risks in order to devise a risk-based approach to regulation and supervision. For the banking sector, for example, the Basel Committee on Banking Supervision examines how these risks could be incorporated in the assessment of company-specific risks (second pillar) and in the minimum capital requirements (first pillar) of the Basel framework. However, these capital requirements must continue to be risk-based. There can therefore be no question of relaxing the capital requirements unless it can be shown that the exposures concerned are less risky; it is also necessary to impose more stringent capital requirements in the case of exposures highly sensitive to climate risks. In the meantime, progress has been achieved in the definition of the rules for measuring (taxonomy) and reporting climate risk-sensitive exposures, and work has continued on the introduction of climate risk reporting in order to ensure that financial institutions worldwide take account of these risks in the same way. The creation of the International Sustainability Standards Board by the IFRS Foundation should permit internationally comparable and consistent reporting of these risks. Pending the availability of more data and adjustments to the prudential regulations, the Bank recommends that Belgian financial institutions identify these climate risks and control them as best as they can. To that

The Bank is actively involved in devising a risk-based approach to climate risks in regulation and supervision

end, the Bank published a Circular at the end of 2020 setting out its expectations concerning the collection – and incorporation in risk management – of data on the energy efficiency of real estate exposures. Those data must also be notified to the Bank in the case of new mortgage loans. The climate-related stress test to be carried out by the SSM in 2022 is an interesting exercise which will, in particular, reveal how much progress Belgian banks have made in the analysis of their climate risks.

A new European authority to strengthen the fight against money-laundering and terrorist financing

75. In July, the European Commission presented an ambitious set of legislative proposals for strengthening the EU rules aimed at combating money-laundering and terrorist financing. This legislative package also contains a proposal for the creation of a new EU authority for combating money-laundering. It forms part of the Commission's commitment to protect EU citizens and the EU financial system against money-laundering and terrorist financing. Its aim is to improve the detection of suspicious transactions and activities and to remove any loopholes that criminals exploit in order to launder the proceeds from illegal activities or to finance terrorist activities via the financial system. The measures considerably strengthen the existing EU framework by taking account of the emergence of new challenges relating to technological innovation. Those challenges include virtual currencies, the increased integration of financial flows in the Single Market, and the international character of terrorist organisations. The Bank supports these proposals as they will permit the creation of a much more harmonised framework, making it easier for operators subject to the rules on money-laundering and terrorist financing to abide by those rules, particularly if they engage in cross-border activities.

76. During the course of the period under review, the question of "de-risking" has become increasingly problematic. De-risking is a complex phenomenon that mainly consists of financial institutions inadequately applying anti-money-laundering legislation and ceasing to supply financial services to entire sectors or entire categories of clients. This obviously has major social and economic consequences. Following an Opinion on this published by the European Banking Authority (EBA) at the beginning of 2022, the Bank set out its expectations for the sector through a Circular. For the Bank, this is also a key element of its supervisory actions over the coming period. The Bank realises that a balanced approach is necessary, one that can meet commitments in terms of the fight against money-laundering, while ensuring certain specific social responsibilities. The Bank hopes that the policy framework provided for this will contribute.

Major changes in the legal framework governing resolution of (potentially) defaulting institutions

Transposition of the BRRD2 Directive into Belgian law is one of the key resolution developments

77. The Bank also exercises a mandate as the national resolution authority, within the Banking Union, alongside the SRB and other national resolution authorities of the participating Member States. Major changes were made to the legal framework governing resolution by the BRRD2 Directive, transposed into Belgian law in 2021. For example, the BRRD2 Directive introduces the concepts of a "resolution entity" and a "resolution group". From now on, group resolution plans must identify, within a banking group, the entities to which the resolution authority intends to apply the resolution instruments in the event of failure, and the ones which will continue to operate without going into resolution. That distinction permits differentation between Single Point of Entry (SPE) resolution strategies in which only the parent

company goes into resolution, and Multiple Point of Entry (MPE) resolution strategies. In the latter case, the resolution instruments are applied to both the parent company and some of its subsidiaries, leading to dismantling of the group. In addition, the regulatory framework relating to the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) was radically revised and the rules on the subordination of the MREL instruments were tightened up. However, other adjustments are desirable for further strengthening of the second pillar of the Banking Union. In particular, they aim to extend the public interest test, permitting use of the resolution instruments for a wider range of banks, or harmonisation of deposit rankings in order to prevent a resolution from including deposits in a bail-in. Similarly, the treatment of banking groups in resolution – and particularly the single point of entry model – needs to be strengthened because at present this model only establishes a presumption which does not guarantee group solidarity in the event of resolution. This also implies the question of burden-sharing, in the event of a crisis, between the home state and the host state, which requires an answer commensurate with the challenges.

Pierre Wunsch
Governor

Brussels, 2 February 2022

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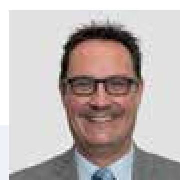
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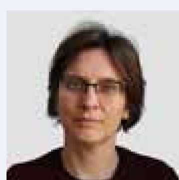
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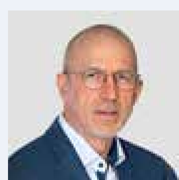
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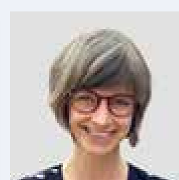
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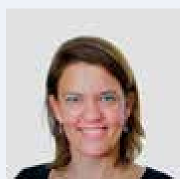
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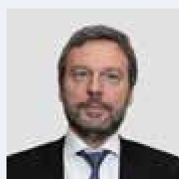
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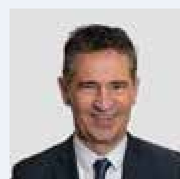
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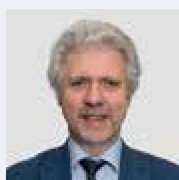
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