REPORT 2022

Preamble

NationalBank OF BELGIUM

Eurosystem

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

In 2022, extremely high inflation caused widespread pain. The strong recovery in the wake of the coronavirus pandemic was followed by a new period of economic turbulence, which propelled inflation beyond expectations and ensured that it remained at an elevated level. Russia's invasion of Ukraine not only caused unspeakable human suffering but also exacerbated pre-existing tensions in the energy markets, mainly through the imposition of mutual economic sanctions, both formal and informal, by Western countries and Russia. In particular, a substantial increase in the price of natural gas, and consequently of electricity, was the main driver of the rapid rise in inflation in Europe. The wave of inflation gradually broadened as more and more producers began to pass through, at least in part, their higher costs to sales prices.

Inflation is eroding purchasing power, while government budgets and corporate earnings are being dragged down by the costs of the energy shock. Governments have gradually introduced more measures to support purchasing power and curb inflation through price ceilings. For their part, companies face not only escalating energy costs but also, and unavoidably, increasing wage demands in response to the decline in purchasing power. In Belgium, the process of wage adjustment is automatic as salaries are almost fully indexed to price increases, albeit not at the same pace in all sectors.

Rapidly rising inflation has forced many central banks to tighten monetary policy. This global shift has not been synchronised, however. It is indeed a difficult exercise, which requires that local specificities be taken into account and future economic developments correctly assessed. Furthermore, rate hikes cause volatility on financial markets and can hamper economic growth; in this connection, it is important to avoid a hard landing. In addition, the dampening effects of adjusted monetary policy on inflation are only felt with some delay. The abatement of inflation towards the end of the year in the euro area was due solely to a decline in energy inflation ; core inflation continued to climb.

This introduction to the NBB's annual report, drawn up on behalf of the Council of Regency, sets out the main economic developments over the past year, with a particular focus on the euro area and Belgium. It also examines the policy challenges facing Belgium. Some of these relate to a lack of economic agility in the face of major economic shocks, as was the case last year. Others concern longer-term adjustments needed to preserve and improve growth potential. This summary is followed by a more detailed analysis in the various chapters of the report.

* Two Regents have not endorsed paragraphs 39, 42, 50, 51 and 57 of the Report.

1. Major economies experienced a sharp slowdown in growth and often skyrocketing inflation

1. **The past year was marked mainly by extremely high inflation in much of the global economy.** Although price increases were not caused by the same factors across the board, the main Western advanced economies were ultimately affected by particularly rapid monetary depreciation.

2. **The surge in inflation was due to a combination of factors.** Certain price pressures were to be expected in the recovery from the deep crisis caused by the pandemic and the global health measures but, in most cases, inflation reached levels not seen in recent decades. While the wave of inflation was global in scope, local factors also played a role. For example, the large-scale fiscal stimulus in the US came up against an already tight labour market and other supply constraints. The energy price shock and new supply chain disruptions, both of which were, at the very least, fanned by Russia's invasion of Ukraine, increased production costs for companies, especially in Europe. While the pandemic gradually subsided in the West, China's zero-Covid policy continued to disrupt certain supplies due to regular closures of industrial centres.

3. **Over the course of the year, soaring inflation caused, through various channels, a sharp decline in global economic growth.** This slump was temporarily offset by the strong post-pandemic recovery, which continued well into 2022, especially in the services sectors. This "re-opening momentum" helped many countries record high year-on-year real growth rates in 2022. Gradually, however, unusually high inflation pushed activity off course in many advanced economies. On the one hand, high inflation and the resulting uncertainty weighed heavily on demand, especially at the level of household consumption and private investment. On the other hand, soaring costs caused the profitability of some energy-intensive companies to fall below a critical threshold. As a result, production had at times to be cut back or temporarily halted.

4. **Growth differentials in 2022 across countries and regions were determined by both exposure to various common shocks and highly specific factors.** These factors included, for example, the precise timing of the lifting of health-related measures, dependence on specific supply chains, raw materials or foodstuffs, and differences in fiscal policies.

5. **Of the world's most advanced economies, the US and the UK reported relatively low annual growth in 2022.** The US does not depend on gas imports and was therefore less affected by the energy price shock. Yet US economic activity declined slightly in the first half of the year. Domestic demand remained robust, but this led in part to the depletion of stocks and an increase in imports. In addition, health-related measures were lifted earlier, which is likely to have lessened the contribution of the services sector to the post-pandemic recovery in 2022. In the UK, the economy contracted in the second half of the year. The negative impact of the energy price shock was compounded by a sharp rise in market rates. The latter factor came into play when confidence in the sustainability of public finances was severely undermined in September by the announcement of budgetary plans that would have caused public debt to balloon. These plans were quickly revised and were followed by a change in government.

6. **Turning to emerging markets, the most notable developments were a sharp slowdown in growth in China and the contraction of the Russian economy.** The significant weakening in China was largely caused by draconian public health measures, which weighed on production in the major industrial centres and undermined confidence, thereby dampening consumption and investment. In addition, the property crisis in China expanded, thereby worsening liquidity problems affecting major real estate developers. This caused a sharp decline in the private construction sector, which was only partially offset by increased public investment.

The Russian economy was affected by economic and financial sanctions and the withdrawal of many Western companies following Russia's invasion of Ukraine. However, the negative impact on growth was ultimately mitigated by a diversion of trade flows to or through countries that had not imposed sanctions and by a series of other – often informal – adjustment mechanisms. In addition, the initial financial turbulence was short-lived due to strong intervention by the Russian central bank, while high export prices for fossil fuels continued to shore up the Russian economy and the public budget. Overall, the Russian economy appears to have been less affected, at this stage, than some initial forecasts predicted.

7. **Current analyses suggest that the global slowdown will remain limited in both duration and magnitude, due in part to the resilience of labour markets.** Confidence indicators fell sharply over the past year, often to levels that seem consistent with a severe economic crisis. Households in particular, but also businesses in some countries or sectors, are very concerned about the economic situation. For the time being, however, the global slowdown in advanced economies has not turned into a deep recession. In some countries, there are even signs that a turning point has been reached and that the business cycle is improving. Meanwhile, labour markets continue to perform well. While employment growth could lose momentum, the existing tightness in the labour market should limit layoffs. As a result, the cost crisis does not currently appear to be leading to a substantial increase in the number of unemployed. This reduces considerably the likelihood of a significant drop in household consumption and a deeper crisis. It is worth noting here that current economic projections are subject to a high degree of uncertainty.

8. **Central banks in advanced economies were faced with the delicate task of vigorously reining in inflation without stifling demand.** The search for a soft landing has been complicated by the usual lags in the effects of monetary policy and highly volatile inflation projections, as well as by the fact that the current wave of inflation has been driven to a large extent by supply factors.

9. **Adjustment of the global monetary stance caused some turmoil in financial markets, but the impact on the real economy remained limited.** For example, the US dollar surged over the past year and depreciated somewhat only in the last quarter. This was due to rising demand and higher prices for US gas and to the fact that the Federal Reserve significantly tightened its monetary policy earlier than other central banks. Heightened risk aversion and the associated flight to safe haven investments also played a role. In addition, yields on fixed-income securities rose, triggering portfolio shifts. Equity markets plunged, while the rise in risk-free interest rates was passed through fairly quickly to business and household loans. The sharp rise in mortgage rates is a risk factor for the housing market and is already causing residential real estate prices to fall in some markets. Rising interest rates and portfolio shifts, as well as a number of scandals, have also caused the highly speculative crypto-currency markets to implode. Overall, however, financial market volatility appears to have had only a limited impact on economic growth so far.

2. In the euro area, inflation reached record highs and a gradual normalisation of monetary policy began

10. **In the euro area, inflation averaged 8.4 % for 2022, well above the ECB's target.** Over the course of the year, inflation rose almost continuously, reaching 10.6 % on an annual basis in October, by far the highest level ever recorded. It should be noted, however, that there have been vast differences in inflation between countries, particularly due to the measures taken by governments in response to the sharp rise in energy prices. Indeed, in some cases, these measures

exerted downward pressure on prices. Only in the last two months of the year did inflation ease somewhat in the euro area, mainly due to lower prices on the international gas markets.

11. **The wave of inflation, certainly in Europe, can be traced back to the unprecedented surge in gas prices.** This surge was largely attributable to geopolitical factors. Rising tensions at the Ukrainian border earlier in the year ultimately culminated in the Russian invasion in February 2022. Economic sanctions by and against Western countries, coupled with supply uncertainty, propelled gas prices upwards. By the end of the summer, they had reached unprecedented highs. In the background, the scheduled phase-out of nuclear capacity in some countries also plays a role. During a transition to a net-zero economy, this is associated with increased demand for natural gas pending investment in renewables.

12. **Rising energy prices alone accounted for almost 45 % of total inflation in the euro area: even without any other price increases, inflation would still have averaged 3.8 % in 2022.** The European pricing mechanism, based on the marginal costs of the most expensive energy source, has led to a sharp rise in electricity prices as well. Of course, the rise in energy prices also had indirect spin-off effects. Indeed, the increase in energy bills was passed through, in varying degrees, to the prices of other goods and services. The prices of certain goods were also pushed up by higher prices for raw materials, intermediate products and transport. Food prices also rose steadily over the past year, partially due to energy-intensive production as well as more specific problems, such as tight conditions for fertiliser supply owing to the war in Ukraine.

13. **Finally, inflation spread to a very broad range of goods and services.** Unlike headline inflation, core inflation continued to rise until the beginning of 2023, to an annual rate of over 5 %, despite the recent moderation, or even decline, in energy prices and other input costs. In addition, underlying price pressures are persisting for longer due to lags in the pass-through of cost increases.

14. **Although the root causes of the current wave of inflation are mainly outside the euro area, a few factors within the euro area contributed to the rapid spread of price increases.** Strong policy support, both fiscal and monetary, ensured that the draconian health measures did not lead to a complete economic collapse in 2020 and that the economic fabric did not suffer severe, persistent damage. That being said, the sustained economic recovery meant that the measures introduced to support demand, which were only gradually withdrawn, encouraged to some extent more substantial price increases. This was especially the case when supply chain disruptions slowed the flow of goods. Under these circumstances, the recovery of demand led to price hikes more quickly.

15. **Still highly accommodative monetary policy also contributed to fostering an environment conducive to inflation in the post-pandemic recovery period.** Before and during the pandemic, inflation in the euro area remained well below the target rate, and monetary policy focused on combating deflationary risks. To this end, the ECB kept the deposit facility rate in negative territory for quite some time. In addition, a wide range of other instruments, such as targeted longer-term refinancing operations and various debt purchase programmes, were used to bolster lending and demand. The aim was also to prevent the entrenchment of weak price increases in inflation expectations. During the pandemic, these instruments were expanded further.

16. **The ECB's response to growing inflation in the euro area was initially slow.** One of the reasons for this was that the inflation resulted from a supply shock, which both pushes up prices and weighs on real growth. In this case, the central bank must clearly assess the extent to which demand needs to be moderated in order to curb inflation. Moreover, the duration of

the shock and the ensuing wave of inflation were difficult to estimate in advance ; the market expectations on which energy price estimates were based turned out to be overly optimistic. This was also due to new external shocks, such as, of course, Russia's invasion of Ukraine and the subsequent economic sanctions, which pushed energy prices even higher. Estimating the duration of a shock is essential, however, as monetary policy focuses on the medium term and thus does not necessarily need to react strongly to a temporary surge in inflation. This is especially true when the economy is not showing signs of overheating. In this sense, the situation in the euro area was different from that in the United States, where, as noted above, it was clear that inflation was being driven more by conventional demand factors. As a result, the Federal Reserve vigorously started to tighten monetary policy earlier.

17. **The rapid and persistent rise in inflation in the euro area forced the ECB to catch up and radically modify its monetary policy over the past year.** This was done in accordance with a precise timetable and in line with a predetermined strategy. First, the ECB's asset purchase programmes were discontinued. However, maturing debt securities were still reinvested. Second, policy rates were gradually raised by 250 basis points starting in July 2022, bringing the deposit rate to 2 % by year's end.

18. **The tightening of monetary policy led to an increase in market rates at the long end of the yield curve as well.** This in turn increased financial market volatility over the course of the year, including in the currency markets. The US dollar appreciated strongly against the euro due to differences in the pace of monetary tightening. In addition, in order to avoid excessive fragmentation in the transmission of monetary policy within the euro area, a new accompanying instrument was created in July 2022, the so-called transmission protection instrument (TPI). Based on the TPI, the ECB can purchase the sovereign bonds of euro area countries facing large interest rate fluctuations which are not justified by fundamental economic factors. At this stage, it has not been necessary to use the instrument. However, its mere existence gives the ECB more leeway to counter speculative interest rate fluctuations that could undermine the consistency of monetary policy. Overall, the fragmentation of financing conditions has been limited so far : the transmission of monetary policy has not been hampered by an unjustifiably wide divergence in spreads on government securities.

19. **In any case, making monetary policy less accommodative in the euro area is a delicate exercise in a slowing economy.** There was a feeling, particularly against the backdrop of a sharp deterioration in confidence indicators, that the economy was on the verge of a deep crisis. The challenge was therefore to curb galloping inflation in a context where the economy was already seen as very fragile. This type of situation requires a proper assessment of the economic costs of stubbornly high inflation and the downward pressure exerted by monetary tightening on demand.

20. **As for other monetary authorities, this exercise is complicated by the fact that the impact of these policies is not immediately apparent.** Monthly inflation rates are strongly influenced by developments in the energy markets. Conversely, monetary policy is mainly aimed at preventing the entrenchment of a high inflation rate in the longer term. Various indicators pointed to a clear rise in inflation expectations over the year, certainly for the short term. This suggested that monetary adjustment was necessary to prevent inflation from remaining above the target rate for too long.

21. **The persistence of inflation also depends on how it affects wages.** Real wages in the euro area have fallen sharply. If inflation expectations are rising, there is a greater likelihood that wages will also rise more strongly to counteract an excessive loss of purchasing power. The pace at which this occurs will depend on the frequency of wage negotiations. This could

trigger a longer-lasting wage-price spiral, with wage increases in turn impacting sales prices. In such a context, it is crucial that inflation expectations remain well anchored at a level close to the ECB's target rate

22. **An additional challenge for monetary policy is its interaction with fiscal policy.** In most euro area countries, a wide range of support measures have been introduced to preserve household purchasing power. While these measures have undoubtedly been successful in shoring up low-income household consumption, they have often been applied too broadly. Aside from possible short-term negative effects on prices, broad demand support exacerbates the currently prevailing stubbornly high inflation, meaning monetary policy needs to be adjusted even more forcefully. This threatens the overall consistency of the policy stance, which was a factor that contributed to the success of the measures put in place during the pandemic. In addition, extensive support measures weigh on the budget and may hinder the desired further reduction in the consumption of fossil fuels, insofar as they cause the prices for these fuels to drop.

23. **Moreover, monetary tightening is not over.** Given the current level of inflation, real interest rates clearly remain in negative territory. In December, the ECB Governing Council expressly stated that it would be necessary to continue to raise interest rates significantly in order to ensure a return to the medium-term inflation target of 2 %. This will be done in accordance with a step-by-step approach, based on incoming data. In addition, the ECB's balance sheet is no longer expanding strongly but has not yet started to shrink rapidly, with purchased debt securities still being fully reinvested upon maturity. However, monetary normalisation also means that, in the future, there will be a predictable and gradual balance sheet reduction. In this respect, the balance sheet will be reduced from March 2023 onwards by no longer reinvesting maturing debt securities in full. Through the end of the second quarter, the ECB's balance sheet should already shrink by, on average, €15 billion per month.

24. **Ultimately, the euro area economy proved quite resilient, not least thanks to strong labour market performance.** In the first half of the year, growth rates were even well above potential, due in part to temporary factors. For example, growth was bolstered by strong post-pandemic reopening effects, which boosted household consumption. Despite soaring costs, industrial activity also held up well at first. Indeed, the unclogging of supply chains, which had been temporarily disrupted as a result of Russia's invasion of Ukraine, allowed existing order backlogs to be rapidly cleared. Starting in the summer, however, the European economy began to slow markedly as the effects of these temporary factors faded and high inflation continued to erode purchasing power. Ultimately, the cost crisis is not expected to result in a deep recession, only a limited cyclical slowdown and gradual recovery in the course of 2023. The robustness of labour markets also helps to explain the resilience of European economies. Many countries are experiencing labour shortages, as evidenced by an unprecedented number of vacancies. Given the present difficulties in finding staff, companies are refraining from laying off workers for the time being. Indeed, if the economic downturn is considered temporary, workers are more likely to be retained than if it is seen as permanent. This will limit the duration and depth of the recession and contribute to recovery.

3. The cost crisis has also affected the Belgian economy but not led to a recession

25. **As was the case in other euro area countries, the Belgian economy lost momentum over the course of the year but, at this stage, has not entered a recession.** As in other countries, the gradual lifting of restrictive public health measures led to a very strong

recovery. These reopening effects continued well into 2022; the strong rebound of market services, which had been those most directly affected by the restrictions, was the main driver of growth throughout the year. The manufacturing industry started the year off well, thanks to an improvement in supply chain bottlenecks in the autumn of 2021. However, this upturn was interrupted by Russia's invasion of Ukraine and the resulting economic and financial sanctions. In addition, the rising cost of energy and other inputs increasingly eroded the profitability of many companies. This led a series of companies in some energy-intensive sectors to cut back on or even temporarily halt production in the second half of the year. As a result, industrial activity contracted from the summer onwards, although a sharp fall in gas prices from the record levels reached in late August brought some relief. Nonetheless, the price of gas remains significantly higher than before the pandemic.

26. **As the impact of reopening effects on the services sector tapered off and growth returned to more normal levels, the Belgian economy slowed sharply in the second half of the year.** Here, too, however, the slowdown was clearly not proportionate to the alarming signs of certain indicators, such as consumer confidence. The latter, as in the rest of Europe, fell back in September to levels comparable to those seen at the start of the pandemic, although there was clearly a recovery towards the end of the year. In the end, the economy again grew slightly in the fourth quarter of the year. For 2022 as a whole, growth even exceeded 3%, although this was also due to the level effect of the strong recovery in 2021. Given the improvement in business cycle indicators at year's end, the slowdown should be short-lived, giving way to a gradual recovery as from the beginning of 2023. The risks surrounding these projections remain high, however, and include fluctuations in international gas prices and, more generally, developments in energy supply and competitiveness.

27. **Despite concerns about household purchasing power, initial statistics indicate that household consumption continued to grow strongly in 2022.** This is noteworthy, as household purchasing power is currently estimated to have fallen slightly, despite automatic indexation mechanisms and a wide range of – mostly temporary – government measures to support it. Indeed, indexation mechanisms only respond to inflation with a lag, meaning real incomes fell in 2022. A portion of the compensation for price increases will thus only follow in 2023. This implies that the shock to purchasing power is considered temporary, which has certainly also had the effect of shoring up consumption. Households have effectively dipped into their savings and, as expected, the saving rate fell to around its pre-pandemic level, but not lower. In other words, the saving rate merely normalised, and savings built up in 2020 during the pandemic were not actually used to give an additional boost to consumption.

28. **The decline in confidence, however, was clearly reflected in the sharp slowdown in private investment.** Many businesses postponed or scaled back investments due to an uncertain outlook and sharp rise in costs. While annual growth in residential investment remained positive, it began to contract sharply in the spring, as did business investment. This was undoubtedly due to continuing uncertainty, in particular geopolitical, but rising interest rates also weighed on property investment. On the one hand, mortgages are becoming more expensive; on the other hand, supply has been stimulated recently by portfolio transfers, as the search for yield has brought more investors into the property market. Since the relatively significant rise in long-term market rates, however, this may be less the case. A significant increase in the prices of building materials, clearly in excess of headline inflation, has also had a negative influence on housing investment.

29. **Once again, the labour market was very resilient and helped to shore up purchasing power.** Despite the cost crisis, employment grew at a record level of about 100,000 new jobs, spread across almost all industries and statuses. Only in financial services was there a

systematic decline in employment, due in part to digitalisation and a reduction in the number of bank branches. Nonetheless, growth in the number of self-employed slowed somewhat, although it remains clearly positive. Job creation tended to focus on highly skilled workers. The labour market participation of the low- and medium-skilled increased less than that of the highly skilled, and the unemployment rate for these two groups remains higher than at the end of 2019. Young workers have also not benefited sufficiently from the recovery: their employment rate is still slightly lower than prior to the pandemic, while that of older groups has improved, although it remains relatively weak. Strong net job creation can also be attributed to the absence, so far, of a large wave of bankruptcies. The unemployment rate fell sharply over the course of the year, although this trend petered out in the last few months. The flip side of strong employment growth is unprecedented tightness in the labour market: an inability to find workers, let alone the right profiles, is inhibiting output growth in many companies and industries.

30. **Inflation turned out to be much more stubborn than initially thought, mainly due to a further surge in gas prices.** Earlier inflation forecasts were based on overly optimistic estimates of future gas prices. Indeed, gas prices, taking into account their link with electricity prices, amongst other factors, have a large and difficult-to-predict direct impact on headline inflation. Finally, inflation continued to rise until October; it was not until November that the fall in gas prices on the international markets, which had started at the end of the summer, led to a sharp drop in energy inflation, including in Belgium. This decline proved sufficiently substantial to dampen headline inflation, but underlying pressures on prices continued to build. Core inflation, according to the measure commonly used in Europe (the HCIP), exceeded 5 % at the end of 2022 and had in any case not yet clearly dropped by the beginning of 2023. According to the national price index, however, core inflation was even higher (7.3 % in December 2022), mainly due to a different definition that includes processed foods.

31. **Driven by soaring gas prices, inflation reached its highest level since the 1970s in 2022, according to the national consumer price index.** According to the HICP, inflation averaged 10.3 % last year. As in previous periods of rapidly rising prices, the surge in inflation was driven by an energy shock, namely an unprecedented rise in gas prices. Energy inflation was in fact higher in Belgium than the average for its three largest neighbours combined. This was due to both methodological factors, specifically the inflation measurement in Germany, and various government measures. In Belgium, these initiatives, including a reduction in VAT on electricity and gas, a basic energy package and various subsidies, effectively helped curb inflation. However, in other countries, such as France, the dampening effect was even more pronounced as a result of the direct capping of gas and electricity prices (with the difference compared to the market price covered by the government budget).

32. **Although inflation was triggered by an external energy shock, it spread to a growing number of goods and services throughout the year.** For example, food prices in Belgium, as elsewhere, rose at an increasing pace. Reaching 4 % in 2022, core inflation, which measures the average change in the prices of non-energy goods and services, exceeded its long-term average of around 1.5 %. This was related to so-called second-round effects, whereby sellers raise their prices in response to price increases for energy and other inputs. In this context, inflation for non-import-intensive goods also increases, due for example to the partial pass-through of higher wage bills, as a result of indexation, to sales prices.

33. **However, measured inflation may overestimate the average real increase in the cost of living.** For example, to determine energy prices in Belgium, inflation measures take into account only new contracts for gas and electricity. While this method is fully in line with existing Eurostat guidelines, it is not applied in the same way in all countries and means that an

acceleration in international prices leads relatively quickly to higher measured energy inflation. However, households that still have a fixed-rate energy contract or those whose variable rate has not yet been adjusted will not feel the price increase immediately. The actual purchasing power of households may therefore be somewhat underestimated by standard indicators (which adjust nominal incomes for measured inflation). Last year, this phenomenon led to a discussion in the Netherlands, amongst other countries, on the appropriateness of this measure of inflation. The potential bias is obviously greater when inflation is mainly driven by increases in gas and electricity prices, as was the case in 2022. In Belgium, there is an additional aspect: the indexation of wages and other forms of income is based on the health index, which takes into account increases in the official measures of gas and electricity prices. If the latter overstate the rise in the cost of living, the indexation mechanisms raise wages and other forms of income disproportionately. The possible underestimation of purchasing power could partially explain the resilience of household consumption.

34. **The external shock that hit the Belgian economy is clear from the sharp deterioration in the current account balance.** For 2022, a current account deficit of more than 4 % of GDP is expected. This is, of course, mainly attributable to the sharp increase in the energy import bill, despite weaker energy consumption, but additional factors, such as higher prices for other raw materials and inputs and the depreciation of the euro, also played a role. The increase in the price of energy imports alone implies an impoverishment of around 3 % of GDP. Such a large current account deficit represents a significant loss of income vis-à-vis the rest of the world. As a result of the deterioration in the cost competitiveness of Belgian companies, described below, the current account is likely to remain under pressure in the coming years. This means that, given the large government budget deficit, investments will increasingly have to be covered by foreign savings. In the long run, this could increase the vulnerability of the economy.

35. **As with the health crisis, the impact of the cost crisis is heterogeneous: for companies, the decisive factors are mainly gas dependency, labour intensity and market power.** The impact of the gas shock has clearly been felt above all in sectors that are heavily dependent on this fuel source for production and have difficulty finding alternatives in the short term. These are mainly specific segments of the manufacturing industry as well as retail trade. Furthermore, indexation significantly increases the cost of labour, which disproportionately affects companies and industries that are relatively labour intensive. Finally, not all companies have the same capacity to pass through a sharp rise in costs to sales prices. Large companies and industrial firms traditionally have more market power in this respect and are therefore better able to protect their profit margins by passing on a greater share of cost increases to their customers. On the other hand, the profit margins of smaller companies and the self-employed will be harder hit.

36. **For households, the heterogeneous impact of the cost of living crisis is due to specific circumstances and consumption patterns, but the broad middle class generally seems to be more affected.** Income indexation is based on the consumption basket of an average household. In this context, the share of gas and electricity expenditure in the household budget plays an important role. This share tends to be higher for lower-income households and lower for higher-income households. As all incomes are adjusted on the basis of the average weights in the health index, some lower-income households will, in principle, be undercompensated for an increase in the price of these energy sources, while higher-income households will be overcompensated. In addition, government measures to protect purchasing power also play a role. Some measures mainly benefit lower (or the lowest) incomes. This is clearly the case, for example, with the social tariff, a favourable tariff for gas and electricity, the scope of which has been extended but which is still reserved for lower-income groups. As the social tariff is

incorporated into the health index, any extension of the scheme reduces the level of indexation across the board and thus the purchasing power of households that are ineligible for this preferential tariff. It is therefore important that all secondary effects of the measures introduced to shore up purchasing power be properly identified. Overall, it turns out that it is mainly households with the lowest incomes and those with the highest incomes, due to the social tariff and wage indexation, respectively, that have been best protected from the price shock and even, on average, somewhat overcompensated. For the broader middle-income group, on the other hand, purchasing power has fallen slightly. It should be noted, however, that these analyses are based on average values: thus, relatively vulnerable households may still be hard hit, for example if they do not apply in time for the measures to protect purchasing power.

37. **In the residential real estate market, nominal price growth has slowed, but not stopped, and strong price growth since 2020, combined with a sharp increase in mortgage rates, has made it more difficult to buy a home.** The repayment burden for an average new mortgage loan has risen sharply over a short period of time, returning to the peak level reached before the 2008 global financial crisis. In addition, the average down payment required for a home purchase has risen sharply in a short space of time, even taking into account the high level of inflation which is also pushing up incomes. This can be a growing obstacle to home ownership, especially for younger households with lower incomes or that receive less financial assistance from parents or grandparents. Moreover, it should be noted that these findings apply to the average house purchase. The repayment burden is much higher in some of the country's more expensive areas notably Brussels and Flemish "core cities" (*kernsteden*). This means that home ownership in these areas has become very difficult for low-income households with limited financial means. More generally, since 2000, the rate of home ownership has decreased for low-income groups (while this is not the case for the population as a whole), although there has been some stabilisation recently.

38. **The flip side to higher financial barriers for potential homeowners is the gain for existing homeowners with a mortgage.** Most mortgages are fixed rate, meaning the interest rate on the mortgage loan does not rise along with income indexation and therefore the interest burden becomes less onerous over time.

4. The cost crisis has brought to the fore structural vulnerabilities in the Belgian economic fabric

39. **Wage formation is highly regulated in Belgium: automatic indexation and regulated wage bargaining balance each other out under normal circumstances.** On the one hand, the various automatic income indexation mechanisms aim to prevent a loss of purchasing power due to inflation and thus to bolster household consumption in the short term. For companies, however, wages are a cost that they can scarcely control and whose development is moreover independent of the performance of the company or its line of business. Generalised automatic indexation used to be common in a number of countries but has been abolished almost everywhere over the years, except in Belgium and a handful of other countries. That being said, certain countries still maintain indexation rules for specific sectors or for the minimum wage. On the other hand, wage formation in Belgium is governed by legislation on the promotion of employment and the preventive safeguarding of competitiveness. This legislation, structured around the concept of wage cost differentials with the country's three main neighbours, aims to prevent Belgian wage costs from rising faster than those of its main trading partners, which would worsen the cost competitiveness of Belgian businesses. The law provides a clear and binding framework with a maximum wage margin within which the social partners can negotiate growth in collectively agreed wages.

40. **This combination of automatic indexation and competitiveness legislation is unique in the world and creates a certain degree of macro- and microeconomic rigidity.** At the macroeconomic level, price increases in Belgium automatically – and therefore more quickly than in other countries – lead to higher wage bills for companies. As collectively agreed wages cannot, in principle, be lowered, cost competitiveness can only be safeguarded if nominal wages in other countries at least keep pace with inflation and if the inflation differentials between countries are limited. In the event of a strong inflationary surge, such as that caused by the terms of trade shock in the past year, there is at least a temporary loss of cost competitiveness, even without wage increases other than through indexation. This loss can only be offset if wage growth in other countries recovers afterwards. However, such an outcome is highly uncertain, and the loss of cost competitiveness may become ingrained if, in other countries, the terms of trade shock is partially absorbed by a fall in real wages. At the microeconomic level, this regulatory framework makes it more difficult to align wage growth to productivity. Indeed, it limits the potential wage gap between best and worst performers, at both industry and firm level. This prevents or delays necessary transitions and, a fortiori in a very tight labour market, reduces the overall productivity of the economy. Concretely, it becomes more difficult for companies to retain and attract staff by offering better wage conditions. At the same time, struggling companies cannot reduce real wages to help absorb a negative shock.

41. **The extent to which automatic indexation protects purchasing power is not, as mentioned above, the same for all households.** Indeed, there are different indexation systems for wages (but generally not for the income of the self-employed) and replacement income. Indexation always takes place with a certain delay, but for employees the frequency depends on the joint committee to which their employer is affiliated. Moreover, the interaction between automatic indexation and measures to preserve purchasing power often leads to redistribution effects between households. Regardless of the impact of specific consumption patterns and the precise origin of a price shock, income class plays a role. In the current cost of living crisis, the broad middle class is least protected against a loss of purchasing power. Moreover, when the health index was introduced, some goods were removed from the basket used for indexation, which resulted in a certain asymmetry. This means, for example, that an oil price shock is absorbed by households to a greater extent than a gas price shock, insofar as motor fuels (excluding LPG) are not included in the health index.

42. **At present, the cost competitiveness of Belgian companies is deteriorating sharply and policies need to be attentive to the risk of dislocation in the long term.** Due to automatic indexation, businesses and the self-employed are initially bearing the brunt of the rise in energy prices affecting the entire economy. The sharp rise in the cost of energy and other inputs is putting pressure on the profitability of companies, which are also facing rising wage bills. In other countries, household purchasing power is protected to a greater extent through specific budgetary measures that are not directly borne by companies, with taxpayers ultimately footing the bill. In the short term, the costs of Belgian companies are therefore rising much faster than those of their foreign counterparts. The most recent calculations by the Central Economic Council (CCE/CRB) date back to September, but there can be no doubt that the wage differential with Belgium's three main neighbours will widen considerably in 2022-2023. According to the available statistics, corporate profit margins were very high at the beginning of 2022. Companies therefore have some buffers available to absorb cost increases, just as they did in the past, albeit in an environment in which costs and inflation were rising at a much slower pace. It should be noted, however, that the macroeconomic figures represent averages and that there is considerable heterogeneity: for some industries or companies, the ability to use their profit margins to partially absorb the current shock is much more limited. Recent analyses show that the average firm's profit margin effectively fell in 2022.

43. **It is not certain that the loss of cost competitiveness will be made up in the coming years.** According to current projections, any catch-up will only be partial. Moreover, the loss of competitiveness could be greater if inflation falls more slowly than currently expected. This could be the case, for example, if energy prices exceed current market expectations or in the event of more rapid cost pass-through to sales prices on average.

44. **In this sense, there is, at least at the macroeconomic level, a trade-off between protecting the profitability of companies in the short term and safeguarding cost competitiveness in the medium term.** The greater the extent to which companies are able to pass through higher costs to sales prices, the less affected their profit margins will be. Inflation will then remain higher for longer, increasing the risk of a prolonged wage-price spiral. This will push up labour costs above the current outlook, thereby undermining cost competitiveness and increasing the need for urgent policy interventions.

45. **Cost competitiveness depends not only on the cost of labour but also, of course, on the cost of a reliable energy supply.** Differences in other types of costs, aside from labour, can also influence cost competitiveness. The price and guaranteed availability of energy are extremely important, certainly for energy-intensive industrial companies. In this respect, despite falling recently, natural gas is still several times more expensive in Europe than in other markets. This is a major competitive disadvantage for European companies and could make the European market less attractive for large investments by multinational groups. Indeed, some large industrial groups have already announced that, in future, they intend to expand mainly outside Europe. As regards the EU Member States as well, it is advisable to coordinate measures to support businesses, such as energy subsidies, insofar as possible, in order to avoid creating an uneven playing field for companies based in different countries.

46. **Persistent disruption to the competitiveness or financial health of businesses could threaten longer-term prosperity.** Healthy and resilient businesses are crucial to the economic fabric. Indeed, companies will only hire and invest if their demand and profit outlooks are favourable. This requires that they remain competitive compared to their foreign counterparts. Proper monitoring of competitiveness is therefore, especially in the present circumstances, essential. More generally, the Belgian economy must continue to provide a fertile ground for business and investment.

47. **The state of public finances in Belgium is worrisome and unsustainable growth in spending needs to be urgently addressed.** The general government budget deficit in Belgium has continued to decline but, at almost 4 % of GDP, remains high. This improvement is not the result of fiscal consolidation but rather a direct consequence of the strong economic recovery in the wake of the pandemic (which continued to boost the annual growth rate in 2022) and a net reduction in the one-off support measures that temporarily widened the deficit. The additional spending associated with the pandemic is gradually being phased out as the health crisis becomes a distant memory, but these cuts have been partially offset by a series of new deficit-widening measures. In addition to spending on refugees from Ukraine, the measures in question are mainly intended to support purchasing power, such as the VAT reduction on electricity and natural gas, the lowering of excise duties on petrol and diesel, and extension of the social tariff to a wider target group. All in all, though, the adverse impact of temporary measures on the deficit has decreased compared to last year. In addition, high inflation has had a temporarily positive effect on government revenue. Indeed, as a result of indexation, more households fall into the upper-income tax brackets. However, this favourable impact on public finances is short-lived since these brackets are in turn adjusted a year later to account for higher prices.

48. **The governmental measures have, together with indexation, supported purchasing power relatively well but in general have been insufficiently targeted and have not always had the desired effect.** Support measures should in principle target those groups most in need. The social tariff for gas and electricity is an example of a measure specifically designed to target the lowest income groups. Conversely, other measures, such as the VAT reduction (and various rebates) on household electricity and natural gas consumption are not targeted at all. Under the so‑called "basic energy package", the financial support received is subject to income tax, meaning a portion is recouped from higher‑income households. The untargeted nature of energy support measures obviously increases the fiscal burden. Moreover, a significant proportion of these measures fail to achieve their stated objective and do not actually help to bolster household consumption. For example, recent research suggests that financially secure households, i.e. those with high income and substantial savings, simply save most of the energy aid they receive, perhaps in part as a precautionary measure to counter future energy bill increases. On the other hand, it has been shown that the social tariff is relatively effective in bolstering the consumption of financially insecure households. Finally, discounts on gas and electricity bills obviously do not encourage more frugal consumption of fossil fuels. In this respect, the fall in consumption in 2022 showed that the price signals worked.

49. **All analyses and estimates, including those by the Bank, clearly indicate an underlying weakness in Belgium's fiscal situation.** The budget deficit is projected to remain high over the next few years at around 5 % of GDP, while the already very high public debt will continue to grow. Belgian public finances are clearly amongst the worst in the euro area on both counts.

50. **This underlying weakness is not due solely to previous or current crises, such as the pandemic or the cost crisis, but rather to unsustainable growth in current spending in the medium term.** From the turn of the century until the outbreak of the pandemic, current spending (excluding interest expenses) rose from less than 40 % to almost 47 % of GDP. Since then, it has risen further, to almost 49 % of GDP in 2022. In the coming years, governments are expected to allocate more than half of GDP on an annual basis to primary current expenditure alone. This growth will mainly be due to a sharp rise in expenditure on social services and benefits, as well as an increase in subsidies to businesses (including those in the non‑profit sector) and in the wage bill and pensions of civil servants. At the same time, the tax burden in Belgium remains amongst the highest in the world's advanced economies, which pushes up labour costs significantly. For example, the gap between the total cost of labour for employers and net wages in Belgium is amongst the highest of all OECD countries. Specific budgetary efforts will therefore mainly have to target a firm adjustment of public spending growth.

51. **Population ageing will exert even more pressure on public finances in the years and decades to come.** While this problem affects all advanced countries, it should be noted that the pension bill in Belgium is increasing more than in most other EU countries and, above all, in other Member States with higher public debt. It is noteworthy that this is not due to purely demographic factors, such as changes to the population pyramid, but rather to slower adaptation of the pension system to these demographic developments. Indeed, in other countries, the cost of population ageing is already much more contained by policy measures, such as a higher effective retirement age or adjustments to the technical parameters of pension systems (replacement rates, equivalent periods, exceptions that lower the effective retirement age, etc.).

52. **Ensuring the sustainability of public finances is the responsibility of all levels of government.** This means that the efforts needed to guarantee sustainability must be allocated effectively to different levels of government. Various allocation formulas can be used for this purpose. In any case, the federal government and the social security administration should not

be solely responsible for consolidation efforts; regional governments must contribute, too. Indeed, the Walloon and Brussels-Capital Regions and the French Community, like the federal government and the social security administration, are on unsustainable budgetary trajectories. Expressed as a percentage of revenue, the debt ratio is projected to continue to rise over the next decade. This is less the case for the Flemish Community, although it, too, will have to make efforts to ensure the sustainability of its budget in the coming years.

53. **The European fiscal framework is currently still suspended, for the third year running, pending comprehensive reform.** In this respect, the European Commission has issued some proposals to make the regulatory framework simpler and more workable. It is still too early to tell whether these proposals will be able to achieve this goal and whether they will be accepted. The sustainability of public finances is an important focal point of the package. The European Commission plans to at least impose stricter rules on countries that present high sustainability risks. However, reconciling public debt reduction with flexible fiscal policy remains a major challenge. In addition, the idea is to give a greater role to independent national fiscal councils, in particular in the preparation and monitoring of national plans defining the medium-term direction of fiscal, investment and reform policies. The focus on the medium term and enhanced national "ownership" of the European fiscal framework are in principle positive developments. However, they need to be accompanied by clear rules on which national fiscal councils can base their policy assessments. The greater emphasis on the medium term in the current proposals should not divert attention from the need for enforceable annual standards. Moreover, the enforceability of fiscal standards is particularly difficult in countries without a clear hierarchy between levels of government.

5. The longer-term challenges associated with sustainable wealth creation are becoming increasingly pressing

54. **Aside from management of the current crisis, policy efforts should continue to focus on more resilient structural growth that ensures sustainable wealth creation.** Belgium has a number of significant advantages in this regard, such as a high innovation capacity, solid integration into global value chains and a high level of productivity. However, it is important to maintain these assets. For example, total factor productivity growth has been steadily declining. Although this is a trend affecting all advanced economies, the decline is more pronounced in Belgium than in other EU countries. This measure of macroeconomic productivity reflects the efficiency with which means of production are converted into economic wealth. Belgium's edge in this area is therefore becoming smaller. In addition, the country is performing relatively poorly when it comes to the utilisation of means of production. Both capital stock and the employment rate are lower than in neighbouring countries and certainly in the best performing EU Member States. Moreover, the Belgian economy is relatively energy intensive, meaning it takes more energy than elsewhere to produce the same value. In this respect, it is still heavily dependent on fossil fuels, which are to a large extent imported. As the previous year has shown, this increases the economy's vulnerability to external shocks. In order for the Belgian economy to be better able to create sustainable wealth, policy interventions that address these factors through various channels are needed. This will entail implementing a wide range of structural reforms, to which the Bank has regularly drawn attention in the past. Three specific aspects are discussed in more detail below: the employment rate, productivity and adjustment of the energy infrastructure.

55. **The first objective remains to continue to raise the employment rate.** The latter rebounded following the pandemic, thanks to dynamic job creation, but it remains too low compared to other countries. In this respect, the target of raising the employment rate to 80 %

by 2030 has been included in the federal coalition agreement. However, further ambitious reforms are needed to achieve this goal: based on current figures, around 530,000 people still need to find paid work in order to achieve 80 % employment, which is more than the number of full-time unemployed. Hence, these figures indicate that it is necessary to focus not only on reducing unemployment but also on increasing labour market participation. To do so, it is especially important to address excessively high inactivity rates. The specific groups for which there is high potential in this respect are well known: the employment rate remains relatively low in the Walloon and Brussels-Capital Regions, due to higher unemployment or lower labour market participation on average, as well as for the low-skilled, older workers and citizens of non-EU countries.

56. **Increasing women's participation in the labour market is also a lever and a concrete action included in the European Pillar of Social Rights Action Plan.** The lower employment rate for women is mainly due to the fact that they still bear a disproportionate share of domestic duties. This is also reflected in the greater gap with men's labour market participation in couples with children compared to those without. Facilitating the labour market participation of both parents, especially that of single parents, requires specific responses, such as ensuring the widespread availability of reliable, flexible and inexpensive childcare, shared parental leave, flexible working time arrangements and home-based work options.

57. **Broad reforms are needed to make employment more attractive.** Several factors can complicate the transition from unemployment or inactivity to employment. These range from working conditions to the match between required and available skills and even the availability of public transport options before and after working hours. However, in any case, an important factor when it comes to unemployment or inactivity traps is that the financial difference between a job and benefits is too slim, especially for the lowest-paid workers. In Belgium, the level of social benefits as a percentage of wages is higher than in most other OECD countries, and this remains true in the long term. On top of this, benefits recipients are often entitled to other advantages such as social tariffs, which are sometimes lost when taking up a job, while people in employment have to bear additional costs, such as transport and childcare. Since 2012, measures have been taken to make unemployment benefits more degressive over time, but their effective impact has been limited. Far-reaching labour market reforms are best undertaken when the labour market is tight, i.e. when, as at present, there are sufficient jobs available.

58. **Boosting productivity requires sufficient labour mobility and a quality labour supply as well as innovation and investment.** High labour availability is only one factor needed for sustainable growth. Productivity is at least as important. To this end, the allocation of labour and other factors of production should fully support growth in the most productive sectors. Labour mobility is relatively limited in Belgium and, as mentioned above, rigid wage formation can complicate transitions between sectors. Moreover, the protections introduced during the recent crises have also helped non-viable firms, thus delaying necessary transitions. Furthermore, the quality of the labour supply is also an important factor. In any case, training should be provided for occupations in short supply, including in the fields of healthcare and teaching. In this respect, the number of STEM (sciences, technology, engineering and mathematics) graduates is still largely insufficient to meet employer demand. In this respect, Belgium is not at the top of the international rankings, even though research suggests that there is a positive correlation between a company's productivity and the number of STEM profiles in its workforce. More generally, while the quality of education in Belgium remains good according to the OECD PISA indicators, there are significant differences between regions, and the downward trend in the quality of education is cause for concern. Young people's skills in reading, mathematics and science are deteriorating, both in absolute terms and compared to other countries, which could affect future productivity. Technological progress is also key to maintaining productivity growth.

Belgium performs well in terms of innovation, but the diffusion of new technologies could be better, including in the area of exports. Likewise, infrastructure, which contributes to economic productivity, is less well rated in Belgium in a number of areas than in other countries.

59. **Finally, sustainable wealth creation must go hand in hand with continued efforts towards carbon neutrality.** Although emissions as a percentage of production have fallen on a trend basis, the process is too slow, and emissions remain too high given the objective of achieving a net-zero economy by 2050. In this area, Belgium has opted for increasing the electrification of energy consumption, for example for transport and heating. This means that electricity production will need to be increased considerably in order to keep pace with strongly growing consumption. In addition, the energy infrastructure will have to be adapted accordingly, which will require major investment in the grid. It is also important in this respect to ensure that the administrative burden does not cause excessive delays to much-needed projects.

60. **Public authorities have an important role to play in accelerating the energy transition and have a range of policy instruments at their disposal but must proceed with caution.** The current energy crisis illustrates that price incentives can influence consumption choices: gas consumption has fallen sharply under the influence of high prices. A priori, an instrument allowing a correct carbon price to be determined would be the best tool to encourage consumption change. However, political constraints and redistribution considerations require a balanced package of measures, including taxes and subsidies, as well as regulations and green investment. It is also important that government guidance be progressive: it is only possible to move away from fossil fuels if sufficient alternatives have been developed. The competitive position of companies should also be taken into account: compensatory mechanisms should be provided if companies in other parts of the world can produce at lower cost due to a more favourable implicit carbon price. In addition, as climate-related measures tend to have redistributive effects between households, accompanying measures will be needed to offset undesired redistribution.

6. Financial markets and the financial sector have had to adapt to the new macrofinancial situation

61. **A long period of very generous financing conditions and high asset prices came to an end in 2022.** High inflation and its corollary, an unexpectedly sharp rise in risk-free interest rates, weighed on the valuation of equity and bond markets and led to large losses for investors. The advantage of a diversified portfolio, comprised of both equity and debt securities, made little difference. Therefore, in many cases, the total capital losses in the investment portfolios of institutional and retail investors were probably higher than following previous stock market corrections.

62. **Nevertheless, price corrections in the traditional financial markets generally proceeded in an orderly fashion.** The high level of uncertainty with which market participants were confronted pushed up risk premiums and depressed liquidity in some sub-segments of the capital markets. However, in general, the financial markets were spared widespread turbulence such as that seen in March 2020 at the start of the pandemic.

63. **In the UK, the central bank had to intervene to stabilise the gilt market.** This market found itself in trouble due to adverse interaction between leveraged investments of UK pension funds and a sharp rise in UK government bond (gilt) yields, initially triggered by the announcement of an unexpectedly expansionary fiscal policy. Although the problems were

more or less confined to the UK market, this episode is yet another illustration of the risks that can arise in the non-bank financial sector when entities use leverage to increase returns or fail to maintain sufficient reserves to cope with liquidity shocks. For example, when the pandemic began in March 2020, many investors shifted to liquid assets. This forced open-ended investment funds to dump assets on the financial markets in order to pay back investors. These events prompted central banks to intervene so as to stabilise the markets. A year later, the collapse of the financial services company Greensill and the family office Archegos showed that banks can sustain significant losses when they are exposed to poorly regulated entities with a high risk profile. The challenge now is to translate into the international regulatory and supervisory framework the recommended reforms, established by the Financial Stability Board (FSB), to the global non-bank financial sector.

64. **In Belgium, non-bank financial intermediation was comparatively resilient in 2022, following the good financial performance posted in March 2020.** This resilience to market shocks reflects generally prudent risk management. The latest report prepared by the Bank in cooperation with the FSMA found that the market for asset management and non-bank financial intermediation in Belgium can be considered fundamentally sound. Based on the definition used by the FSB, the total financial assets of this sector – concentrated mainly in Belgian non-equity investment funds – amounted to €161 billion in mid-2022. The conclusions of the analysis on the interdependence of various Belgian sectors (households, companies, banks, non-banks, public authorities) with the global non-bank financial sector were also rather reassuring. However, vigilance is still called for, given the rapid developments in and vulnerabilities of the global non-bank financial sector.

65. **The crypto-assets markets, which are not subject to financial regulation, were thrown into turmoil in 2022.** Alongside a substantial loss in the value of crypto-assets, the sector witnessed a number of high-profile failures, such as the collapse of the third largest stablecoin (TerraUSD) and the bankruptcy of a leading trading platform (FTX and its affiliates). In this context, strong similarities with past financial bubbles demonstrate that the valuation of these assets is based on highly speculative practices. As in the past, widespread turbulence also revealed fraud and inadequate due diligence, made possible in particular by shortcomings in the management and governance of the firms active on these markets. However, due to limited connections between regulated financial institutions and the crypto-assets markets, the tumult affecting the latter had little impact on the former.

66. **The environment in which Belgian banks and insurance companies operate changed dramatically in 2022 due to the geopolitical situation, a sharp rise in energy prices, high inflation, rising interest rates and less favourable growth prospects.** This new macrofinancial context presents both opportunities and challenges.

67. **In practice, Belgian financial institutions first had to meticulously apply the financial sanctions adopted by the EU and the rest of the world in response to Russia's invasion of Ukraine.** Monitoring compliance with these sanctions is the responsibility of the Belgian Treasury, while overseeing the prudent management of these "compliance risks" by financial institutions is the responsibility of the supervisory authority. In the wake of these events, the Bank therefore deemed it appropriate to remind supervised institutions of the applicable guidelines and good practices in this area.

68. **Other direct effects of the Russian invasion of Ukraine were quite limited due to low exposures to counterparties in the region of the hostilities and minor exposure to energy and commodity derivatives.** Non-financial corporations use the market for energy and commodity derivatives to, amongst other things, hedge against fluctuations in the prices of

important inputs over a certain period of time. The counterparty is usually a financial institution, and corporations are required to pay an initial margin when entering into the contract to cover the credit risk. Changes in the market value of the derivative between conclusion and maturity of the contract are covered by another guarantee, the so-called variation margin. In the European financial sector, this market is mainly concentrated in the hands of a few (non-Belgian) investment banks and central clearing counterparties (CCPs). The sharp rise in energy prices meant that some non-financial corporations had difficulty meeting additional margin calls as they could no longer raise the funds needed to serve as collateral for the contracts. Some countries, but not Belgium, were obliged to introduce a system of state guarantees to meet liquidity needs under these derivative contracts and thus mitigate the risks to the financial sector.

69. **However, the Belgian financial sector has had to adapt to a changed macrofinancial environment, which could affect the credit quality of its corporate and household exposures.** Some of the changes observed in the financial sector can be considered positive overall. This is particularly true for the rise in interest rates, which has put an end to a long period of very low (or even negative) interest rates. Indeed, the profitability and viability of important components of the business model of Belgian banks and life insurers – such as the conversion of deposits into loans (financial intermediation) and the provision of life insurance with a guaranteed minimum return – were severely affected by the very low or even negative yields on risk-free investments. To make up for the downward pressure on interest margins, banks were incentivised to increase lending volumes (especially in the mortgage market). For life insurers, this search for yield mainly took the form of a rebalancing of investment portfolios, so as to shift away from government bonds. They thus invested to a greater extent in riskier and less liquid assets, such as corporate bonds, mortgages and commercial real estate or related financial assets. It is hoped that the normalisation of the interest rate environment will dampen the search for yield in the financial sector, which will also benefit long-term financial stability.

70. **Most assets acquired by banks and insurers during the period of low interest rates are still on their balance sheets.** These assets could become a source of losses now that the interest rate environment is normalising. Indeed, soaring energy prices and inflation, worsening growth prospects and tighter financial conditions are weakening the borrowing capacity of vulnerable households and businesses and lowering their credit ratings. These factors could lead to a cooling of the housing market. The new macrofinancial climate and the normalisation of the interest rate environment therefore also present risks for the financial sector. These risks could lead to higher than expected losses, for example in the event of a severe economic downturn, and rising unemployment. Credit losses resulting from repayment difficulties on the part of borrowers could be amplified by possible downward corrections in the commercial or residential property market.

71. **In a period of rising interest rates, banks need to manage their interest rate and liquidity risk carefully.** A rising interest rate environment leads to higher financing costs for credit institutions. For debt issues and deposits by banks and institutional investors, these costs are closely tied to fluctuations in market conditions. The interest rates on these sources of financing were therefore negative when interest rates were low. However, a non-negligible source of bank financing is household and corporate sight and savings deposits. A substantial percentage of sight deposits traditionally do not generate interest, while interest on savings accounts generally follows market conditions with a certain delay and only in part. Moreover, regulated savings accounts must comply with certain statutory provisions in order for the first tranche of interest payments to be tax exempt. Thus, during the negative interest rate period, a statutory effective lower limit of 0.01 %, for the base rate, and 0.10 %, for the loyalty bonus, applied. Now that market interest rates are higher, banks have room to increase the remuneration on these deposits. In this respect, however, they need to take into account the development of

their interest income, part of which is generated by assets for which the long-term interest rate was set in a low interest rate environment, e.g. mortgages. In order to safeguard the stability of deposits as a source of financing for the Belgian banking sector, the deposit interest rate should, however, remain more or less in line with changing market conditions. Otherwise, banks run the risk of seeing a portion of this stable source of financing and, ultimately, for loans to Belgian households and businesses, channeled to other investment vehicles.

72. **For life insurers, rising financing costs are of less concern, as their liabilities are generally based on long-term contracts, with an average duration that is generally higher than on the assets side.** A rise in interest rates therefore has a positive effect on the interest rate risk position and solvency of insurers. However, it can also lead to additional liquidity requirements. Insurers use interest rate derivatives to hedge the duration gap (the difference in average duration between assets and liabilities), and these positions may generate additional liquidity needs in the context of the collateralisation of these derivatives. On the other hand, when interest rates rise, there is an increased risk of policyholders deciding to surrender their life insurance contracts prematurely. In this case, the insurer must be able to liquidate the underlying investments in order to reimburse the policyholder. However, given the generally long term and tax treatment of most contracts falling under the second and third pension pillars, this risk seems relatively manageable.

73. **Over the past three years, clients of the Belgian banking and insurance sector have had to deal with the consequences of a public health crisis, exceptional flooding, a war and historically high energy prices.** However, financial institutions absorbed these shocks well and were able to support affected businesses and households by means of appropriate measures. As seen during the pandemic, a resilient financial sector can help to cushion shocks and lay the groundwork for subsequent recovery. The Bank promotes such resilience by working to maintain financial stability so that, even in times of crisis, the financial sector can continue to perform its essential functions.

74. **The Belgian financial sector maintained a strong financial position in 2022 and is well equipped to support the real economy.** With a tier 1 capital ratio of 17.1 % and a solvency ratio of 227 %, respectively, the banking and insurance sectors more than meet the applicable minimum capital requirements. This enables them to cope with any possible unexpected losses without jeopardising their main function in the Belgian economy or financial stability.

75. **To preserve this robust financial position, a sound regulatory framework is necessary.** Such a regulatory framework ensures that capital buffers remain commensurate with potential losses in times of crisis. The regulatory framework must therefore also be adapted to changes in the financial sector, such as digitalisation, or in the nature of the financial risks to which financial institutions are exposed, such as climate-related risks.

76. **For the banking sector, the Bank, like the ECB and the European Banking Authority, thus continues to advocate for compliant and timely implementation of the Basel III standards.** The banking provisions proposed by the European Commission derogate significantly from these international standards and would make the rules applicable to European banks less stringent.

77. **One of the areas in which the Bank has increased its focus in recent years is the prevention of money laundering and terrorist financing.** Compliance with these provisions requires significant efforts by the sector to manage compliance risk and the associated reputational risk. In this context, the phenomenon of de-risking has received much attention. This is the practice whereby financial institutions exclude customers or entire sectors

from banking services, without conducting an individual risk assessment, on the ground that they belong to a particular sector or carry out a particular type of business. Following European recommendations, the Bank issued not only a circular setting out its expectations in this area but also a comprehensive action plan, providing for inspection of a range of institutions. The overriding requirement in this respect is that higher risks of money laundering in certain sectors should be accompanied by enhanced due diligence, without this leading a priori to the exclusion of a range of customers and sectors from essential banking services.

78. **With regard to the insurance sector, work continued over the past year on the revision of the Solvency II Directive and, at national level, the development of a clear statutory framework on the cost allocation of claims related to future natural disasters is of paramount importance.** The floods in July 2021 caused significant damage. Although not all losses were insured, a significant proportion was compensated by the insurance sector, mainly under fire insurance policies. In order to safeguard the insurability of natural disasters, in the past specific mechanisms have been developed in the framework of a public-private partnership, such as capping the insurance limit per insurer and per natural disaster, combined with a contribution by the regional disaster funds when this limit is exceeded. However, after the floods in July 2021, the statutory insurance limit was doubled by mutual consent of the regions and the insurance sector. This meant that insurance and reinsurance companies bore a greater share of the claims burden. Nonetheless, more than a year after the floods, a stable legal framework, unambiguously determining how the costs of future natural disasters should be allocated, is still lacking. This situation and the resulting legal uncertainty are already having a significant impact on Belgian insurers, in particular due to uncertainty as to the possibility and level of reinsurance and the costs associated with reinsuring disaster risk. On the regulatory side, this uncertainty could lead to a thorough review of the models used to determine the capital requirements for insurance companies, which in turn could adversely affect their solvency. These difficulties and uncertainties also threaten to increase policyholder premiums in the long run. In order to provide greater certainty for all parties involved, the competent federal and regional authorities should work towards establishing a clear statutory framework as soon as possible. This framework should clarify the allocation of costs of future natural disasters in Belgium, the financing of regional disaster funds, the treatment of insured and uninsured claims, and its own robustness to climate change. As all regions are likely to be affected by natural disasters in the future and most Belgian fire insurers are active throughout the country, a consistent approach between regions is desirable.

79. **In the banking sector, the conditions seemed to be met at the beginning of 2022 to reactivate the macroprudential countercyclical capital buffer.** This is a temporary buffer built up, further to a decision by the Bank, in the expansion phase of the credit cycle to ensure that when the cycle enters a downturn, banks are able to absorb credit losses, support lending and finance solutions for customers at a high risk of default. The buffer was first activated in the summer of 2019, in response to dynamic lending to households and businesses. In keeping with its intended purpose, the buffer was put to use immediately in March 2020, at the start of the pandemic, to help banks absorb unexpected losses and finance measures to support the economy. The recovery of the economy and renewed dynamic growth in loans to households and businesses in early 2022 suggested that reactivation of the buffer could be appropriate. However, given the high level of uncertainty created by Russia's invasion of Ukraine, high inflation and soaring interest rates, the Bank decided to take a cautious approach and to continue to assess the need for reactivation of the countercyclical capital buffer.

80. **In September 2022, the Bank decided that reactivation of the countercyclical capital buffer was no longer justified, given the deterioration in the growth outlook and the indications of a turning point in the financial and credit cycles.** Therefore, in order

to avoid a pro-cyclical macro-prudential policy and to ensure that Belgian banks had full flexibility to use their ample available capital reserves to support the real economy, the buffer was maintained at 0 %. Instead, the Bank asked banks to use the capital thus freed up to help Belgian households and non-financial corporations meet, if necessary, the challenges posed by historically high energy prices and difficult macroeconomic conditions. Indeed, in addition to ensuring an adequate flow of credit to the real economy, the focus should be on proactively offering moratoria and other debt rescheduling options to borrowers. In October, Belgian banks started offering such repayment assistance to their customers, following their unilateral commitment in September to offer moratoria to eligible mortgage holders and individual solutions to other households and non-financial corporations facing financial difficulties in these challenging times. The Bank expects Belgian banks to continue to proactively assist borrowers in 2023.

81. **Given the difficult macrofinancial conditions and the vulnerabilities that accrued during the long period of low interest rates, banks also need to ensure that they set aside sufficient provisions to absorb any larger credit losses.** While the asset quality indicators, which are mainly backward-looking, do not (yet) indicate an increase in loan repayment problems, banks should nonetheless prospectively base their credit risk provisions on sufficiently conservative assessments of difficult economic scenarios and use their current strong solvency position to proactively increase these provisions if necessary. It is not wise to extrapolate from the absence of payment defaults during the pandemic – mainly due to monetary, fiscal and, partially, prudential support measures – in order to draw conclusions about the current situation. The capital reserves still available as a result of the decision not to reactivate the countercyclical capital buffer leave sufficient room for additional provisions and should be used for this purpose. In this context, the Bank also recommends that financial institutions remain cautious in their decisions regarding dividends and other types of profit distributions.

82. **As it cannot be ruled out that vulnerabilities in the housing market could lead to higher than expected losses, the Bank has kept in place macroprudential measures for mortgages.** The macroprudential capital buffer for mortgages, for which minimum capital requirements are calculated using internal models, has taken the form of a 9 % sectoral systemic risk buffer since May 2022. This corresponds to €2 billion in capital in the banking sector which can be used in the event of a crisis to absorb losses and finance solutions for borrowers facing repayment problems. This buffer can prevent a sharp increase in evictions and foreclosures should a housing crisis arise. Although macroprudential expectations for mortgage lending have led to a sharp decline in origination of the riskiest mortgage loans, reduction of the capital buffer would appear premature at this time given the prospect of a possible cooling of the housing market. These prudential expectations continued to pay off in 2022, without reducing access to the mortgage market for young people.

83. **The digitalisation of the financial world offers opportunities for financial institutions but also presents risks.** Digitalisation is playing an ever-growing role in the work of the Bank and other authorities responsible for the regulation and supervision of financial institutions. Technological innovation is increasingly influencing the business models of financial institutions and creating opportunities for new market players, such as fintech companies. However, these new trends can also generate or exacerbate risks. For example, as digitalisation increases interconnectivity, it is more and more crucial to ensure the (cyber)security and continuity of underlying systems and infrastructure. The Bank is working on a solution to mitigate these risks through targeted national initiatives and participation in European and international projects. For example, in 2022, the Bank conducted a stress test to assess the sensitivity of Belgian insurance companies to cyber risks affecting insurance contracts.

84. **In addition, the Eurosystem's work to prepare for the possible introduction of a digital euro continued.** At the end of 2020, the ECB launched an in-depth 24-month inquiry into the feasibility of developing its own digital currency and the arrangements necessary for its introduction. Over the past year, further progress was made on this important project. Choices were made regarding the design and introduction of the digital currency, while working on the development of a prototype. An analysis was also carried out of the tools that could be used to avoid excessive circulation of digital currency and the adverse effects this could have on the stability of the financial system. The Bank is cooperating with the other central banks of the euro area on this project through the High-Level Task Force, which is discussing the main characteristics and design aspects of the digital euro.

85. **Climate change and the transition to a more sustainable, low-carbon economy could have a significant impact on the economy and the stability of the financial system.** Prudential authorities are therefore in the process of considering how to include climate-related risks in prudential regulation, while supervisors are tasked with verifying that financial institutions properly analyse, monitor and manage these risks.

86. **In this regard, one of the main risks to the Belgian financial sector identified by the Bank is the transition risk associated with energy-inefficient buildings.** This risk could have adverse consequences for both the value of mortgage collateral and borrowers' repayment capacity. The Bank therefore issued a circular at the end of 2020 outlining its expectations regarding the collection by lenders of information on the energy efficiency of buildings and the integration of this information into the management of real estate exposures. Although it is far from perfect, the energy performance certificate (EPC) still constitutes the main source of information on energy efficiency. For new mortgages, lenders are required to report this information to the Bank. They are getting better at gathering this information for new mortgages but are having more difficulty doing so for existing ones. For this reason, the Bank has been actively supporting the banking sector's efforts to obtain access to regional EPC databases for several years. In the meantime, financial institutions are required to continue to request an EPC from their customers, provided one is available.

87. **At both the European and international levels, the Bank actively participates in various initiatives by the competent authorities to integrate climate and environmental risks into financial sector regulation.** This work focuses in particular on reporting requirements (Pillar 3), company-specific risk assessments (Pillar 2) and minimum capital requirements (Pillar 1). With regard to Pillar 3, the new European Corporate Sustainability Reporting Directive (CSRD) was adopted in 2022 and will enter into force as from 2024, ensuring that both banks and large companies report on sustainability-related issues in line with European standards. With regard to the assessment of company-specific risks (Pillar 2), the Basel Committee has approved a set of principles for the banking sector on the effective management and monitoring of climate-related risks. For the European insurance sector, EIOPA has issued guidance. Finally, with regard to minimum capital requirements (Pillar 1), the Basel Committee issued clarifications at the end of 2022 on how banks should deal with climate-related risks under the current requirements.

88. **Climate-related risks are also increasingly pervasive in the supervision of financial institutions.** For example, in 2022, the Single Supervisory Mechanism (SSM) conducted a comprehensive thematic review of the extent to which significant institutions (SIs) meet the expectations set out in the ECB's "Guide on climate-related and environmental risks", following a 2021 self-assessment. In addition, the SSM carried out a climate risk stress test for the first time this past year, the results of which were published in July. Finally, in late December 2022, the SSM published good practices for climate risk stress testing to ensure that banks improve

their practices in this regard. Belgian banks performed this exercise relatively well compared to others but still have a long way to go to fully meet expectations.

89. **The key role played by fossil fuel supply in the current geopolitical situation presents both opportunities and challenges when it comes to addressing climate-related risks.** On the one hand, high energy prices can contribute to a sustainable reduction in the demand for fossil fuels. On the other hand, the energy crisis is a reminder of the major challenges posed by the energy transition, especially when geopolitical factors are taken into account. Recent experience has brought to the fore the risks associated with a strategy in which a reduction in the supply of fossil fuels is too rapid and ambitious compared to the decline in demand. This type of situation leads to significant price increases and, in times of crisis, measures that are incompatible with the long-term objective, such as renewed reliance on coal as an energy source. In this context, increased transparency on climate-related exposures and better management of the related risks appear to be important factors in facilitating the resolution of these challenges. With that in mind, the approach to climate-related risks in the financial sector should remain risk-based and form part of a more comprehensive policy that pursues a reduction in fossil fuel dependency in the long term while ensuring that these efforts are reconcilable, insofar as possible, in the short term with security of supply in light of the geopolitical situation.

Pierre Wunsch
Governor

Brussels, 8 February 2023

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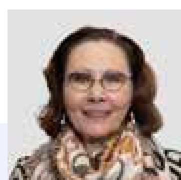
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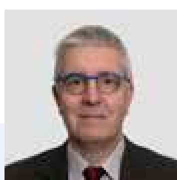
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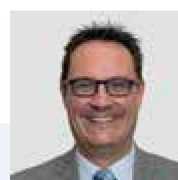
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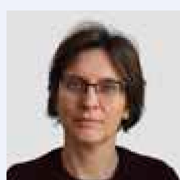
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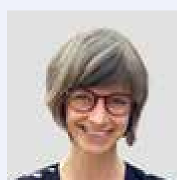
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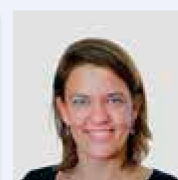
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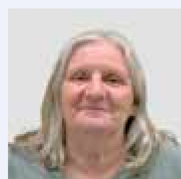
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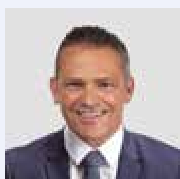
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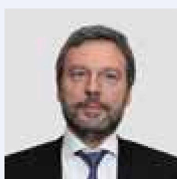
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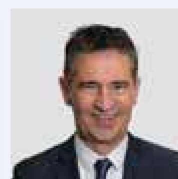
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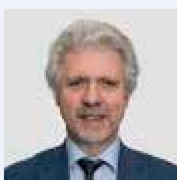
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