EUROPEAN CENTRAL BANK

ANNUAL REPORT 2004

EUROPEAN CENTRAL BANK

ANNUAL REPORT 2004

In 2005 all ECB publications will feature a motif taken from the €50 banknote.

Address
Kaiserstrasse 29
60311 Frankfurt am Main, Germany

Postal address
Postfach 16 03 19
60066 Frankfurt am Main, Germany

Telephone
+49 69 1344 0

Website
http://www.ecb.int

Fax
+49 69 1344 6000

Telex
411 144 ecb d

Photographs:
Claudio Hils
Martin Joppen
Stefan Laub
Constantin Meyer
Marcus Thelen
European Parliament

The cut-off date for the data included in this report was 25 February 2005.

ISSN 1561-4573 (print)
ISSN 1725-2865 (online)

CONTENTS

LIST OF BOXES

LIST OF TABLES

LIST OF CHARTS

ABBREVIATIONS

COUNTRIES

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
GR	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom
JP	Japan
US	United States

OTHERS

BIS	Bank for International Settlements
BPM5	IMF Balance of Payments Manual (5th edition)
c.i.f.	cost, insurance and freight at the importer's border
CPI	Consumer Price Index
ECB	European Central Bank
ECU	European Currency Unit
EEA	European Economic Area
EER	effective exchange rate
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
EUR	euro
f.o.b.	free on board at the exporter's border
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMF	International Monetary Fund
MFIs	monetary financial institutions
NCBs	national central banks
PPI	Producer Price Index
ULCM	Unit Labour Costs in Manufacturing

In accordance with Community practice, the EU Member States and the accession countries are listed in this report using the alphabetical order of the country names in the national languages.

Since 1998 the ECB has organised a series of exhibitions entitled “Contemporary art from the Member States of the European Union”. Each exhibition aims to give ECB staff and visitors an insight into the art of a particular EU country. Contemporary art has been chosen since it reflects the period in which Monetary Union has become reality.

Some of the artworks are purchased for the ECB’s art collection, which is to be expanded. The eight pages which separate the chapters of this Annual Report show a selection of works from this collection.

FOREWORD

When looking back at the events of last year, the enlargement of the EU which took place on 1 May 2004 stands out as a major historical achievement. We had prepared for this enlargement well in advance in our areas of competence, in particular by involving our fellow governors of the central banks of the ten new Member States as early as possible, as observers in the General Council meetings; the success of this enlargement also resulted from the intense preparatory work carried out by the ECB and its staff. In addition, we opened up the committees of the European System of Central Banks (ESCB) to experts from those central banks, who also participated as observers. The thorough and friendly nature of this preparation permitted the smooth entry of these countries and central banks into the EU and the ESCB. The first General Council meeting held after enlargement was a moving occasion for all of us, while the first teleconference of the General Council also marked a significant milestone: we were able to assure ourselves of the perfect functioning of our new, secure communication network and to demonstrate our capacity to engage in effective discussion through teleconferencing right across Europe.

The ten new Member States have joined the EU without an "opt-out" clause. They have thus made a commitment to ultimately join the euro area. We are all in agreement that, in full conformity with the Treaty requirements, the best possible preparation for adopting the euro, namely a high level of sustainable convergence in accordance with the Maastricht criteria, is of the essence.

During 2004 three more currencies, those of Estonia, Lithuania and Slovenia, entered the exchange rate mechanism II (ERM II), which was previously composed of its anchor, the euro, and the Danish krone. The three new entrants are committed to participating in ERM II in such a way as to ensure both the smooth functioning of the system and the best possible contribution to the achievement of sustainable convergence.

***

The members of the EU are on their way to ratifying the newly signed Treaty establishing a Constitution for Europe. The Constitution is a powerful illustration of the will of Europe to proceed with the historical deepening of the Union alongside its enlargement. The Eurosystem, which has as its primary objective the responsibility to deliver price stability, is fully conscious of its role, confirmed by the Constitution, in the deepening of the EU. The Constitution also confirms all the essential elements of the policy framework for EMU, under both the monetary pillar and the economic and fiscal pillar. The ECB looks forward to the ratification of the Constitution.

***

2004 was a year of moderate growth in the euro area, with real GDP growth for the year as a whole standing at 1.8% compared with 0.5% in 2003. The growth profile of the year was marked by a relatively dynamic first half followed by slow growth in the third and fourth quarters. Overall, the diagnosis of a gradual recovery taking place in the context of a number of domestic and international uncertainties has been confirmed.

The Governing Council of the ECB maintained the main refinancing rate at the exceptionally low level of 2% throughout 2004. It pursued a monetary policy which aimed to preserve price stability in a complex international environment marked, in particular, by commodity and oil price increases, episodes of volatility in the exchange markets, the persistence of significant global imbalances and the significant contribution to global growth arising from the very rapid development of a number of emerging economies. Throughout the year one of the Governing Council's main messages was of vigilance in respect of the inflationary risks associated with the possible "second-round effects" of wage and price increases following the headline inflation humps which resulted, in particular, from the commodity and oil price shocks. Not least because economic agents and social partners have understood our message clearly, second-round effects remain subdued.

During the first half of 2004 we observed some upward tendency in the medium and long-term estimates of inflation expectations extracted from various surveys and from indexed bonds. This adverse trend stopped around the middle of 2004 and started to reverse during the second half of the year. The Governing Council's firm expression of its vigilance during this period certainly contributed to preserving the overall anchoring of inflation expectations at a level in line with our definition of price stability: below 2% and close to 2%.

This anchoring of medium and long-term inflation expectations in the euro area, which reflects the credibility of the Governing Council of the ECB, is essential. It is this credibility which allows the ECB to deliver price stability, in line with the mandate assigned to it by the Treaty, even when circumstances are difficult, by providing economic agents with a clear reference in the price and wage-setting process. It also allows the euro area to benefit from a financial environment that is favourable to growth and job creation, through historically low medium and long-term market interest rates, which incorporate inflation expectations in line with our definition of price stability.

***

A good monetary policy is a necessary condition for sustainable growth and job creation. However, it is not sufficient on its own. It must be accompanied by a sound fiscal policy and an appropriate set of structural reforms.

This is why the Eurosystem has always argued so firmly in favour of the correct implementation of the Stability and Growth Pact, and has consistently emphasised the need to fully preserve the integrity of the corrective arm of the Pact, in particular the nominal anchor of 3% of GDP as the limit for fiscal deficits, as well as of the excessive deficit procedure itself.

It is also the reason why the Eurosystem has called so strongly for the euro area to embark resolutely on implementing structural reforms in labour markets, in education and training, in research and development, in goods and services markets as well as in the management of social security spending. These reforms are of the utmost importance in order to raise the growth potential of the European economy, to foster job creation and to reduce unemployment significantly. Throughout 2004 the ECB supported the initiatives of the European Commission and the EU Council aimed at reviving and speeding up the implementation of the structural reforms embodied by the Lisbon agenda. We also welcomed the proposals included in the report by the high-level group chaired by Wim Kok, published at the end of 2004, to focus the Lisbon agenda on a limited number of priority areas that support higher growth and employment.

***

Turning to the organisation and functioning of the ECB, 2004 was a challenging year for the institution. The ECB made a net loss of €1,636 million, compared with a net loss of €477 million in 2003. This net loss was again due to the development of exchange rates which affected the value, in euro terms, of the ECB's holdings denominated in foreign currency. Our accounting principles are based on maximum prudence. For this reason, these unrealised exchange rate losses are treated as realised and taken to the profit and loss account at the year-end: in 2004 the appreciation of the euro resulted in net exchange rate revaluation losses of almost €2.1 billion. By contrast, unrealised gains from exchange rate and market price revaluations are not recognised as profit, but transferred directly to revaluation accounts.

The ECB's regular income is derived primarily from investment earnings on its holdings of foreign reserve assets and its paid-up capital of €4.1 billion and from interest income on its 8% share of the euro banknotes in circulation. Interest income in 2004 was again low, due in particular to the exceptionally low level of interest rates, the main refinancing rate having been maintained at 2% throughout 2004. The ECB earned total net interest income of €690 million, compared with €715 million in 2003. The ECB's administrative expenses on salaries and related costs, rental of premises, and goods and services amounted to €340 million. At the end of 2004 the ECB employed 1,314 members of staff, compared with 1,217 one year earlier.

Last year saw the completion of the ECB in Motion project, which aimed to improve the effectiveness and efficiency of the ECB, to enhance the management of human resources and to reinforce central banking values among all staff. Most of the measures contained in the programme and approved by the Executive Board have already been completed and a few are still being implemented. ECB in Motion has been a remarkable programme which has helped to improve our working culture and to consolidate team spirit within the Bank. The Executive Board is fully committed to the implementation of the programme and to the preservation of the spirit of ECB in Motion.

2004 was marked by two other important developments. First, the adoption of the ECB core values: competence, effectiveness and efficiency, integrity, team spirit, transparency and accountability, and working for Europe. The second major development was the decision to embark on a zero-based budgeting exercise. From its creation on 1 June 1998, the ECB has grown quickly in order to successfully meet the historical challenges it was faced with; having proved its effectiveness, the ECB felt that it was time to thoroughly review the efficiency of its functioning. The Executive Board thus launched in 2004 a zero-based budgeting exercise aimed at examining all the tasks of the institution and the related allocation of staff. The project is in progress and will be completed by mid-2005.

***

The Executive Board, the Governing Council and the General Council of the ECB are inspired by an exceptional team spirit. In the euro area, the ECB and the 12 national central banks make up a single team, the Eurosystem. 2004 saw the creation of the "Eurosystem Mission Statement" (included in Box 15 of this Annual Report), a single statement for 13 institutions and their staff throughout the euro area. This statement offers a striking illustration of our collective will to reinforce further our Eurosystem team in the service of Europe and of its single currency. The ECB is proud to be at the forefront of this unique team.

Frankfurt am Main, March 2005

Jean-Claude Trichet

Artist
Stephan Jung
Title
P.WP1, 2002
Material
Oil on canvas
Format
230 × 265 cm

CHAPTER I

ECONOMIC DEVELOPMENTS AND MONETARY POLICY

1 MONETARY POLICY DECISIONS

The recovery in economic activity in the euro area, which started in the second half of 2003, continued in 2004. The euro area economy strengthened in the first half of the year, benefiting from strong global economic growth. In the second half of 2004 economic activity in the euro area weakened somewhat, partly on account of rising oil prices. Overall, real GDP grew – on a working day-adjusted basis – by 1.8% in 2004, up from 0.5% in 2003 and 0.9% in 2002.

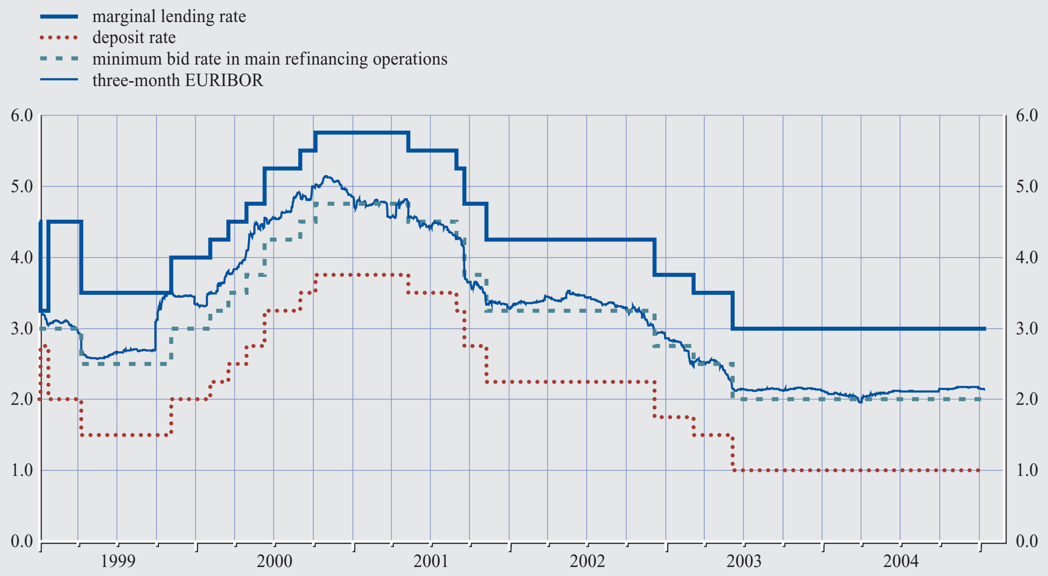
Against this background of gradual economic recovery, underlying domestic inflationary pressures remained contained, benefiting significantly from subdued increases in labour compensation. The slight appreciation of the euro in nominal effective terms also contributed to somewhat lower inflationary pressures. Headline inflation rates in 2004 were, however, significantly affected by increases in administered prices and indirect taxes, and, particularly in the second half of the year, by rises in oil prices. Overall, therefore, annual HICP inflation in 2004 was 2.1% – unchanged from the previous year.

In this environment of subdued domestic price pressure and a positive outlook for price stability over the medium term, the Governing Council of the ECB kept the key ECB interest rates unchanged throughout 2004, at historically low levels. The minimum bid rate on the ECB's main refinancing operations was kept at 2%, while the rates on the deposit facility and the marginal lending facility were maintained at 1% and 3% respectively (see Chart 1).

Looking at monetary policy decisions in more detail, data in the first months of 2004 confirmed a continuation of the gradual economic recovery that had started in the second half of 2003. On the external side, export growth was buoyant, aided by the strong dynamics of the world economy. In addition, the very favourable financing conditions within the euro area and the improved outlook for corporate earnings, reflecting balance

Chart 1 ECB interest rates and money market rates

(percentages per annum; daily data)



Source: ECB.
Note: The rate for main refinancing operations is the rate applicable to fixed rate tenders for operations settled before 28 June 2000. Thereafter, the rate reflects the minimum bid rate applicable to variable rate tenders.

sheet adjustments, provided a positive picture for investment. With regard to private consumption, a gradual recovery was expected on the basis of an anticipated increase in real disposable income and a gradual improvement in labour market conditions. Regarding prices, HICP inflation declined to below 2% in early 2004, largely owing to easing inflationary pressures resulting from the appreciation of the euro in the last few months of 2003 and from the base effects stemming from the strong increases in energy prices in early 2003.

Annual M3 growth in the first quarter of 2004 continued the downward trend that began in the summer of 2003. This mainly reflected the unwinding of earlier portfolio movements, as investors gradually shifted the structure of their portfolios towards longer-term and riskier financial assets outside M3, following a period of exceptional preference for liquidity associated with the heightened economic and financial uncertainty observed between 2001 and mid-2003. Notwithstanding the normalisation observed in M3 growth, significantly more liquidity remained in the euro area than was needed to finance non-inflationary economic growth. While this implied that upside risks to price stability had to be carefully monitored, on balance, the Governing Council assessed the outlook for price stability as being favourable in the first quarter of 2004.

Economic developments in the second quarter of 2004 suggested two possible opposing scenarios. On the one hand, the data available pointed to continued robust growth in the global economy and a very favourable picture for euro area exports. On the other hand, oil prices started to increase markedly after March 2004, gradually posing stronger downside risks to the ongoing recovery. Overall, as the second quarter proceeded, the former scenario prevailed and economic indicators increasingly confirmed that the recovery was gaining momentum. Indeed, by the end of the second quarter, data releases indicated that the economic recovery seen in the euro area in the first half of 2004 had been more pronounced than previously expected, thus nurturing optimism about the outlook for economic growth. Real GDP grew, on average, by 0.6% quarter on quarter in the first half of the year, the highest rate recorded in the euro area since the first half of 2000. The momentum of the recovery mainly reflected stronger exports and, following a long period of stagnation, an initial strengthening of private consumption. Against this background, the June 2004 Eurosystem staff projections saw euro area real GDP growth increasing to between 1.4% and 2.0% on average in 2004 and rising to between 1.7% and 2.7% in 2005. Forecasts by international and private organisations were also in line with expectations of a strengthening economic upswing in the second half of 2004.

The surge in oil prices exerted considerable short-term upward pressures on consumer prices and had a sizeable effect on inflation. Annual HICP inflation rates rose again in the second quarter of 2004, partly as a result of rises in administered prices and indirect taxes. However, when assessing price trends over the medium term, the Governing Council took the view that inflationary pressures were likely to remain contained, particularly given the subdued labour market conditions and the expectation that wage increases would remain moderate in the context of only gradually improving labour markets and the gradual pace of the economic recovery. These views were in line with the June 2004 Eurosystem staff projections, which put average annual HICP inflation at between 1.9% and 2.3% in 2004 and between 1.1% and 2.3% in 2005, and consistent with forecasts by international and private organisations. However, some upside risks to these projections, stemming from oil price developments, uncertainty surrounding changes in indirect taxes and administered prices, and potential second-round effects via wage and price-setting behaviour, were identified. In addition, medium to longer-term inflation expectations in financial markets increased somewhat in this period.

The annual growth rate of M3 broadly continued its downward trend in the second quarter of 2004, reflecting a further normalisation of the portfolio behaviour of holders of money. Nonetheless, this normalisation process proceeded rather slowly and M3 growth remained relatively high, due also to the stimulative effect of low interest rates on demand for liquid assets. The Governing Council therefore remained concerned about the persistently high excess liquidity in the euro area, which, in an economic upswing, could lead to inflationary pressures over the medium term.

While the main scenario of an ongoing recovery did not fundamentally change over the second half of 2004, it became increasingly apparent that the recovery in euro area activity would proceed at a somewhat more moderate pace than anticipated. This development stemmed mainly from a temporary deceleration in world economic growth, a further substantial increase in oil prices in the third quarter and a marked appreciation of the euro in the fourth quarter. Indeed, in the course of the second half of the year, data confirmed that the impact of higher oil prices had continued to unfold, dampening the growth in demand both inside and outside the euro area. Real GDP growth in the euro area was only 0.2% quarter on quarter in the third and fourth quarters of 2004. The Eurosystem staff projections published in December 2004 pointed to real GDP growth of between 1.4% and 2.4% in 2005 and between 1.7% and 2.7% in 2006. In addition, the Governing Council stressed that there were downside risks to these projections, linked to potential unfavourable developments in the oil market.

With respect to price developments, over the second half of 2004 annual HICP inflation rates continued to hover somewhat above 2%, mainly as a result of rising oil prices. However, there were no indications of stronger domestic inflationary pressures building up. Wage increases had remained subdued since the last quarter of 2003, a trend that was expected to continue in the context of ongoing moderate growth and continued labour market weakness.

Against this background, the Eurosystem staff projections published in December 2004 put the annual HICP increase at between 1.5% and 2.5% in 2005 and between 1.0% and 2.2% in 2006. However, the balance of risks to these projections remained tilted to the upside. Risks related mainly to developments in oil prices, uncertainty about further increases in indirect taxes and administered prices, and potential second-round effects in wage and price-setting behaviour.

Such risks were also increasingly signalled by the ECB's monetary analysis. In the second half of 2004 the upward impact on M3 growth – particularly its more liquid components – from continued low interest rates came to predominate over the gradual downward impact stemming from the normalisation of portfolio behaviour. Low interest rates also further fuelled private sector demand for credit. In particular, demand for loans for house purchase increased from already robust levels, contributing to the strong house price dynamics in several euro area countries. In this context, the Governing Council noted that persistently high excess liquidity and strong credit growth were regarded not only as upside risks to price stability but also as a possible source of unsustainable asset price increases, particularly in property markets. In early 2005 this picture did not fundamentally change. The strong monetary growth seen since mid-2004 continued and significantly more liquidity remained in the euro area than was needed to finance non-inflationary growth.

Overall, in the second half of 2004 and early 2005, the Governing Council expressed increasing concern about adverse short-term inflation developments. At the same time, it noted that there were no indications that domestic inflationary pressures were building up. Against this background, the key ECB interest rates were kept unchanged throughout this period. However, the Governing Council stressed that a number of upside risks to price stability over the medium term required continued vigilance.

2 MONETARY, FINANCIAL AND ECONOMIC DEVELOPMENTS

2.1 THE GLOBAL MACROECONOMIC ENVIRONMENT

WORLD ECONOMY REGISTERED STRONGEST GROWTH IN OVER TWO DECADES

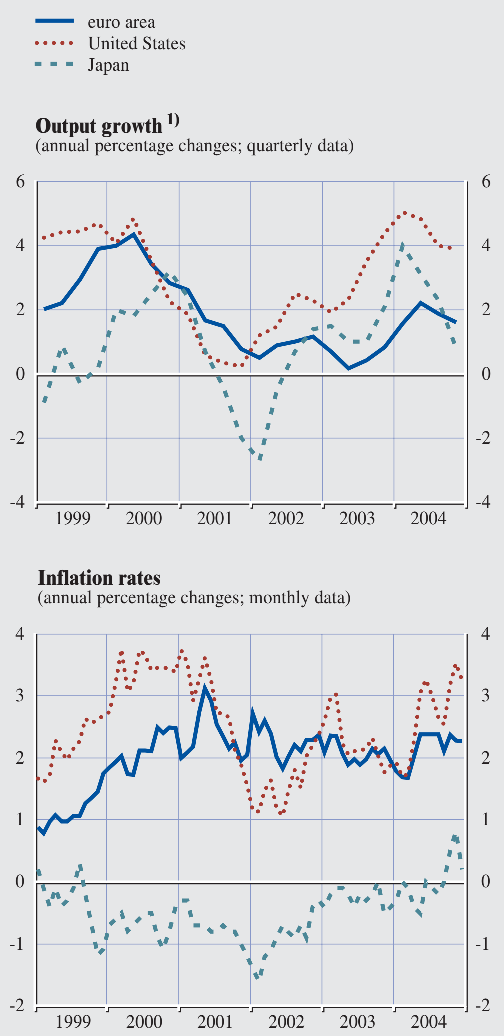
In 2004 the global economy expanded at its fastest rate since 1976, with growth being relatively broad-based across the various regions (see Chart 2). Growth in the Asian region was particularly robust, with the Chinese economy showing signs of overheating. Strong global economic growth was supported by favourable financing conditions and stimulative macroeconomic policies in many countries. It was accompanied by a robust expansion of world trade, which, in 2004, reached its highest level since 2000.

The expansion of the global economy was especially strong in the early months of the year, decelerating thereafter in most countries. This slowdown partly reflected a normalisation of the strong dynamics observed in the preceding quarters, and the beginning of a gradual withdrawal of policy stimuli. The significant increase in oil prices, which reached a peak in October 2004, exerted an additional dampening influence. The rise in oil prices contributed to a moderate increase in inflation rates in many countries, largely as a result of developments in energy-related price components. Underlying inflation trends remained relatively stable, however, suggesting that second-round effects were fairly well-contained (see Chart 2).

Continued robust growth in the United States (compared with some of its trading partners) contributed to a further widening of the US current account deficit. This, together with the uncertainties surrounding the country's fiscal policy outlook, rekindled market concerns about the sustainability of global imbalances. Partly reflecting these concerns, the US dollar experienced a relatively broad-based depreciation in the last months of the year.

In the United States, economic growth continued at a generally brisk pace in 2004, with real GDP increasing by 4.4% for the year as a whole (according to preliminary estimates). This expansion also broadened further to encompass the long-awaited improvement in the labour market. Growth in real GDP was supported by continued strength in household consumption and business investment (particularly on equipment and software), while net trade made a negative contribution to growth.

Chart 2 Main developments in major industrialised economies



Sources: National data, BIS, Eurostat and ECB calculations.
1) Eurostat data are used for the euro area; for the United States and Japan national data are used. For all countries, GDP figures have been seasonally adjusted.

Private consumption growth remained solid for most of the year, reflecting the continued effects of accommodative macroeconomic policies, a strong rise in residential house prices and a significant improvement in payroll employment. Although employment growth picked up after several years of weakness, upward pressures on wages remained generally contained owing mostly to remaining slack in the labour market. Subdued growth in labour costs, combined with high oil prices, contributed to restraining underlying growth in real disposable income in the second half of 2004. In the absence of a one-off boost to income coming from an extraordinary large dividend payment in December, this would have pushed down the personal saving rate still further. At the same time, household debt rose to a historically high level as a proportion of disposable income in 2004.

Business investment grew vigorously in 2004, led by increased investment in equipment and software, in an environment of favourable financing conditions, temporary fiscal incentives and low levels of inventories accompanied by strong demand. Although higher oil prices contributed to an increase in the cost of raw materials, corporate profitability remained strong. Partly reflecting the improvement in the labour market, productivity growth declined during 2004, although it still remained relatively strong for the year as a whole.

The external balance of the United States continued to deteriorate in 2004, with the US trade and current account deficit rising to historically high levels as a proportion of GDP. In real terms, growth in imports continued to outpace that of exports despite the cumulative depreciation of the US dollar since early 2002, as strong domestic demand in the United States significantly outpaced that of major trading partners. The related domestic saving/investment imbalance reflected continued public sector dissaving and a historically low personal saving rate.

Consumer price inflation rebounded in 2004, largely in response to higher energy prices, with annual CPI growth standing at 3.3% at the end of the year. Inflation excluding food and energy also reversed its downward trend of the last few years, rising to 2.2%. Upward price pressures, however, remained relatively moderate owing to a gradual absorption of labour market slack, continued strong productivity growth and only a limited pass-through of the depreciation of the US dollar into consumer prices. Accordingly, survey-based and market measures of longer-term inflation expectations remained contained, despite a moderate rise in the latter.

Following a period of historically low interest rates, the Federal Open Market Committee (FOMC) of the Federal Reserve System increased the federal funds rate target by 125 basis points in 2004. This increase was carried out in five successive 25 basis point steps beginning in June 2004, which brought the target for the federal funds rate to 2.25% by the end of the year (in early February 2005 it reached 2.5%). While the FOMC noted that policy accommodation could be removed at a pace that was likely to be measured, it underlined that it would respond to changes in economic prospects as and when needed in order to fulfil its obligation to maintain price stability. With respect to fiscal policy, the federal government budget deficit worsened to 3.6% of GDP in the fiscal year 2004, despite the pick-up in economic activity.

In Japan, the economic recovery lost momentum in the course of 2004. Following a strong expansion in the first quarter of the year, economic activity significantly decelerated throughout the rest of 2004. This deceleration in economic activity particularly reflected lower public spending and weakening private domestic demand, as well as a moderation in the dynamics of exports. Nevertheless, as a result of base effects and the strong first quarter, in 2004 annual real GDP growth rose to its highest rate since 1996 (2.6%). Some gradual improvements were observed in labour market conditions. Meanwhile, the restructuring of corporate balance sheets, together with cost-cutting efforts, contributed to a strong rebound in corporate profit growth, while the banking sector reduced the level of outstanding non-performing loans.

Concerns about deflation eased somewhat during the year, but did not fully dissipate. Corporate goods prices increased, mainly reflecting increases in raw material prices, while final goods prices continued to decline moderately. The annual rate of change in consumer prices for the year as a whole stood at 0%, compared with -0.3% in 2003. In October signs of abating deflationary pressures led some Bank of Japan Policy Board members to predict a slight increase in the CPI excluding fresh food in the fiscal year 2005. However, deflationary pressures re-emerged towards the end of 2004 as a result of the decline in prices of liberalised utility services. The Bank of Japan raised the target range for the outstanding balance on current accounts held with it to JPY 30-35 trillion in January 2004. The monetary policy stance remained unchanged during the remainder of the year.

Sustaining strong momentum from the previous year, the non-Japan Asian economies registered another very robust year of growth in 2004, benefiting particularly from strong external demand, reviving domestic demand and China's investment boom. Regional integration in Asia strengthened, as indicated by the rapid growth in intra-regional trade and investment flows. Nevertheless, the growth momentum eased towards the end of 2004 amid moderating external demand and high oil prices. At the country level, the Chinese economy continued to grow strongly, with some signs of overheating in the first half of the year. Policy measures slowed investment momentum in the second half of the year, but did not dampen overall economic activity. In the year as a whole, Chinese GDP grew by 9.5%.

In Latin America, the economic situation showed a considerable improvement, supported by both export activity and domestic demand. Growth in Brazil and Mexico gained momentum over the course of the year, mainly sustained by robust exports and the strengthening of investment activity. In Argentina, the recovery of economic activity remained strong, although it moderated somewhat in the course of the year.

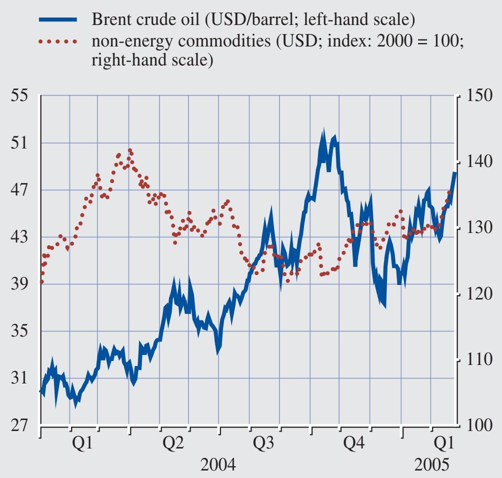
COMMODITY PRICES ROSE STRONGLY IN 2004

Oil prices increased throughout most of the year amid considerable volatility. The price of Brent crude oil reached a peak of USD 51 at the end of October, compared with USD 30 at the beginning of the year (see Chart 3). For the whole of 2004, the average price of Brent crude oil was USD 38, 33% above the average of 2003. If measured in terms of euro, the price of Brent crude oil increased by 20% over the same period. The main factors behind the surge in oil prices in 2004 were the strength of global demand for oil, security concerns about oil supplies and a supply and demand mismatch for different qualities of oil.

Demand for oil soared, particularly in Asia and North America, and continued to exceed expectations throughout 2004 in a context of robust global economic growth. According to the International Energy Agency, the global demand for oil increased by 3.4% in 2004, its highest rate of growth in almost three decades.

Turning to supply conditions, in early 2004 market participants expected – in response to statements by the Organisation of Petroleum Exporting Countries (OPEC) – that cuts in OPEC production were imminent, even though they did not subsequently materialise. Instead, both OPEC and non-OPEC producers increased crude oil production significantly in 2004. As the global supply of oil increased, spare production and refining capacity shrank considerably, leaving only a very limited margin for unexpected oil supply disruptions. As a result, oil prices in 2004 became very sensitive to unanticipated changes in the supply/demand balance, to market perceptions

Chart 3 Main developments in commodity markets



Sources: Bloomberg and HWWA.

about the security of crude oil supplies and to concerns over the adequacy of oil inventories. In addition, rapidly rising demand for final oil products and growing supplies of crude oil led to a quality mismatch, resulting in record high premiums for high-quality crudes such as Brent.

The prices of non-energy commodities, which had been buoyant since the second half of 2003, peaked in the first half of 2004 (see Chart 3) owing to the strong global economic recovery. Overall non-energy commodity prices eased somewhat in the second half of 2004, as the prices of both food and agricultural raw materials fell from the peaks reached earlier in the year. The prices of metals, however, continued to rise. In US dollar terms, overall non-energy commodity prices were, on average, 22% higher in 2004 than a year earlier.

2.2 MONETARY AND FINANCIAL DEVELOPMENTS

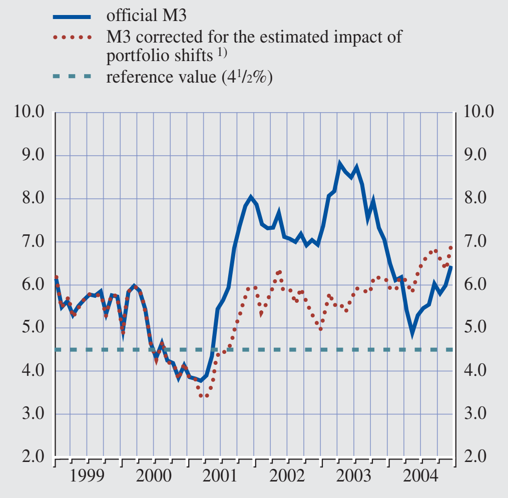
M3 GROWTH INFLUENCED BY TWO OPPOSING FORCES

Against the background of the monetary policy stance and capital market developments, monetary dynamics in 2004 were influenced by two opposing forces: on the one hand, the low level of interest rates and, on the other hand, the normalisation of portfolio allocation behaviour of euro area residents following their strong preference for liquidity between 2001 and mid-2003. In the first half of 2004 the moderating impact on M3 growth of the normalisation of portfolio allocation behaviour dominated and the annual growth rate of M3 continued the slowdown that had started in the summer of 2003, declining to 5.3% in June 2004. The annual growth rate of M3 strengthened again in the second half of 2004, standing at 6.4% at the end of the year, as the stimulative impact of the low level of interest rates and the resulting low opportunity costs of holding money came to the fore, reinforced by a renewed decline in long-term interest rates. At the same time, monetary dynamics in 2004 also reflected the fact that output growth was stronger than in the previous year.

The normalisation of portfolio allocation behaviour seen in 2004 proceeded only slowly. Although the exceptional economic and financial market uncertainty of previous years diminished, the risk aversion of, inter alia, euro area households appeared to remain pronounced after a prolonged period of capital losses in stock markets between 2000 and mid-2003. This may explain the liquidity preference among investors, which was greater than would be considered normal for this stage of the economic cycle. Moreover, the stimulative impact of the low level of interest rates on money holdings may be particularly strong when interest rates are very low. This could be due to the existence of transaction costs that are associated with shifts out of liquid assets and would further lower the opportunity costs of holding such assets.

Chart 4 M3 and M3 corrected for the estimated impact of portfolio shifts

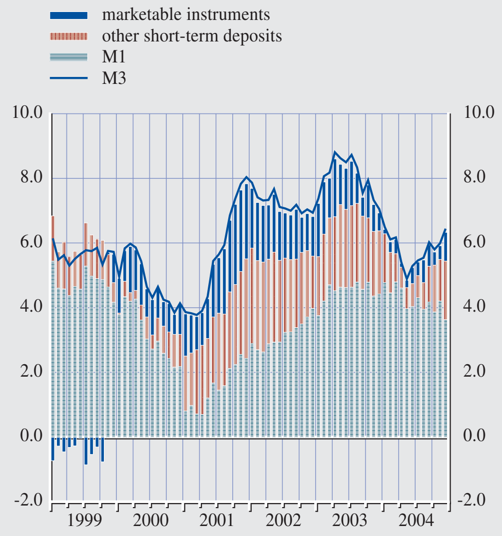
(annual percentage changes; adjusted for seasonal and calendar effects)



Source: ECB.
1) Estimates of the magnitude of portfolio shifts into M3 are constructed using the approach discussed in Section 4 of the article entitled "Monetary analysis in real time" in the October 2004 issue of the ECB's Monthly Bulletin.

Chart 5 Contributions to annual M3 growth

(in percentage points; M3 growth in percentages; adjusted for seasonal and calendar effects)



Source: ECB.

The increasing dominance of the low level of interest rates in driving M3 dynamics can be illustrated with the help of a measure of M3 which is corrected for the estimated impact of portfolio shifts into M3[1] during the period of exceptional financial market uncertainty between 2001 and mid-2003. By construction, this measure is also unaffected by the subsequent normalisation of portfolio allocation behaviour and should thus provide clearer indications of the effect of interest rates than the official M3 series. It should be stressed that the estimate of M3 corrected for the impact of portfolio shifts is surrounded by a considerable degree of uncertainty and should therefore be interpreted with caution. Over the last three quarters of 2004 the official M3 growth rate was below the annual growth rate of the corrected M3 series, suggesting that the normalisation of portfolio allocation behaviour had a moderating impact. However, the fact that both the growth rate of the official M3 series and that of the corrected M3 series strengthened in the second half of 2004 may indicate that the stimulative impact associated with the low level of interest rates, rather than the normalisation of portfolio allocation behaviour, was the main driving force behind M3 dynamics (see Chart 4).

As had been the case in 2003, the main contribution to annual M3 growth in 2004 came from the most liquid components, i.e. those contained in the narrow monetary aggregate M1 (see Chart 5). That contribution was a result of substantial increases in the holdings of both currency in circulation and overnight deposits. The growth of currency in circulation reflected the continued strong demand for euro banknotes both inside and outside the euro area (see also Section 3 of Chapter 2 on banknotes and coins).

1 For further details, see Section 4 of the article entitled "Monetary analysis in real time" in the October 2004 issue of the ECB's Monthly Bulletin.

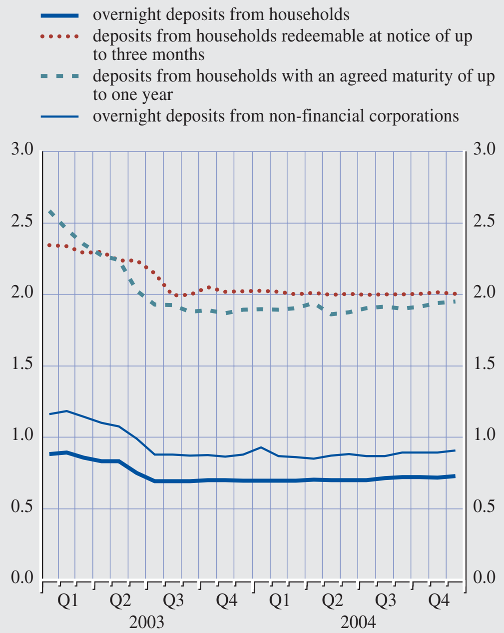
The growth rate of overnight deposits remained rather high in 2004, supported by the very low opportunity costs of holding these deposits. The average interest rates on overnight deposits of households and non-financial corporations remained broadly unchanged compared with end-2003, at levels of 0.73% and 0.90% respectively at the end of 2004 (see Chart 6). This mirrored developments in money market rates in 2004.

The contribution to annual M3 growth of short-term deposits other than overnight deposits was around 1.1 percentage points in 2004, considerably lower than in 2003. This lower contribution mainly reflected developments in short-term time deposits (i.e. deposits with an agreed maturity of up to and including two years), the annual growth rate of which was negative, while short-term savings deposits (i.e. deposits redeemable at notice of up to and including three months) grew strongly. The different developments in these two sub-components may reflect the fact that the typical remuneration advantage of time deposits up to one year over savings deposits did not exist in 2004 (see Chart 6). In such a situation, short-term savings deposits are relatively attractive, as they possess a higher degree of liquidity.

Finally, the contribution of marketable instruments to the annual growth rate of M3 diminished to 0.4 percentage point in 2004, from 1.2 percentage points in the previous year. This reflected in particular a strong decline in the annual growth rate of money market fund shares/units. These assets are often held by households and firms as a safe savings vehicle in times of economic and financial uncertainty, and the fact that their growth slowed reflects the normalisation of the portfolio allocation behaviour of euro area residents in 2004 (see also Box 1 entitled "Trends in the financial investment of the euro area non-financial sector in 2004").

Chart 6 Short-term MFI interest rates on deposits

(percentages per annum; rates on new business; weight-adjusted [1])



Source: ECB.
1) For the period from December 2003 onwards, the weight-adjusted MFI interest rates are calculated using country weights constructed from a 12-month moving average of new business volumes. For the preceding period, from January to November 2003, the weight-adjusted MFI interest rates are calculated using country weights constructed from the average of new business volumes in 2003. For further information, see the box entitled "Analysing MFI interest rates at the euro area level" in the August 2004 issue of the ECB's Monthly Bulletin.

Box 1

TRENDS IN THE FINANCIAL INVESTMENT OF THE EURO AREA NON-FINANCIAL SECTOR IN 2004

The annual growth rate of the financial investment of the non-financial sector in the first three quarters of 2004 was broadly unchanged compared with the average rate of growth in 2003 (see table). This stability masked somewhat heterogeneous developments in the various categories of financial investment. While there was a pick-up between 2003 and 2004 in the rate of growth of investment in long-term debt securities and quoted shares, the growth rate of investment in money market fund shares/units declined significantly. Moreover, while investment in equity and equity-linked funds grew at a faster rate in 2004 than in previous years, purchases of bonds and bond-linked funds slowed somewhat. Overall, these developments provide further confirmation of a gradual normalisation of the portfolio allocation behaviour of euro area residents as agents' propensity to invest in riskier and longer-term assets recovered.

Households continued to invest a large percentage of their financial savings in insurance reserves, albeit at a slightly slower pace than in 2003. The high degree of interest in these products has been sustained over several years. It probably reflects precautionary savings for retirement in an ageing society and possibly also agents' concerns regarding public pension schemes.

Financial investment of the euro area non-financial sector

	Outstanding amount as a percentage of financial assets 1)	Annual growth rates								
		1999	2000	2001	2002	2003	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Financial investment	**100**	**5.6**	**6.5**	**4.6**	**3.8**	**4.4**	**4.3**	**4.6**	**4.5**	**.**
Currency and deposits	37.8	3.0	3.3	4.6	4.9	5.5	5.3	5.3	5.6	.
Securities other than shares	12.2	8.0	9.0	8.1	0.7	-2.4	-0.6	3.7	3.2	.
of which: short-term	1.2	2.8	29.8	4.9	-13.8	-16.1	-4.7	15.4	11.9	.
of which: long-term	11.0	4.4	6.4	8.6	2.7	-0.7	-0.2	2.6	2.4	.
Mutual fund shares	11.9	2.3	6.3	6.0	4.6	6.9	4.6	2.3	1.3	.
of which: mutual fund shares, excluding money market fund shares	9.2	4.7	7.1	4.1	3.4	6.5	5.2	2.4	1.6	.
of which: money market fund shares	2.6	13.1	0.1	21.4	12.0	8.5	2.8	1.7	0.5	.
Quoted shares	13.0	14.4	8.5	-0.9	-0.1	1.1	1.3	3.3	2.6	.
Insurance technical reserves	25.2	2.7	8.5	7.2	6.2	6.6	6.3	5.9	5.8	.
M3 2)		5.6	4.1	8.0	7.0	7.1	6.2	5.3	6.0	6.4
Annual gains and losses on the holdings of securities by the non-financial sector (as a percentage of GDP)		10.7	-2.4	-9.1	-14.1	4.1	7.9	3.8	3.6	.

Source: ECB.
Notes: See also Section 3.1 in the "Euro area statistics" section of the ECB's Monthly Bulletin. Annual data as at the end of the period.
1) As at the end of the third quarter of 2004. Figures may not add up due to rounding.
2) As at the end of the period. The monetary aggregate M3 includes monetary instruments held by euro area non-MFIs (i.e. the non-financial sector and non-monetary financial institutions) with euro area MFIs and central government.

MORE BROADLY BASED GROWTH OF MFI CREDIT TO THE PRIVATE SECTOR

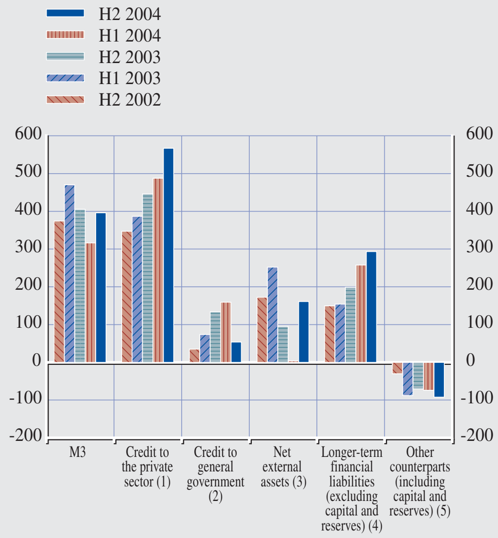
Developments in the counterparts of M3 confirmed the influence of the two opposing forces on monetary dynamics mentioned previously. On the one hand, stronger growth in MFI longer-term financial liabilities and, in the first half of the year, lower increases in net external assets reflected the unwinding of past portfolio shifts into M3. On the other hand, stronger growth in MFI loans to the private sector reflected the prevailing low level of interest rates.

In the first half of 2004 capital outflows from the euro area remained robust, whereas weaker capital inflows led to a decline in the annual flow of the net external assets of the euro area MFI sector (see Chart 7). Such capital outflows were the result of euro area residents purchasing assets from non-euro area residents – one aspect of the normalisation of portfolio allocation behaviour by euro area residents. To the extent that such transactions are settled through the euro area MFI sector, the net external assets of the MFI sector and the deposits of euro area residents decrease. The first half of 2004 also saw a sustained expansion in MFI longer-term financial liabilities (excluding capital and reserves), which was consistent with the ongoing normalisation of portfolio allocation behaviour, as funds were shifted from liquid monetary assets into longer maturity instruments. These developments in net external assets and longer-term financial liabilities were essentially a continuation of trends observed in the second half of 2003. However, already in the first half of 2004 the dampening effect of these factors on M3 growth was partly offset by the robust growth in MFI credit to euro area residents in an environment characterised by low levels of interest rates and improved economic conditions.

In the second half of 2004 the continued strengthening of growth in MFI credit to the private sector made that counterpart the dominant factor driving M3 dynamics. Moreover, the dynamism of MFI loans to the private sector became more broadly based across the main non-financial sectors. Upward pressure on M3 dynamics was also associated with the reversal of the previous downward trend in the annual flow of net external assets, a reversal which resulted from capital inflows caused by a renewed interest in euro area equity and bonds on the part of non-euro area residents as well as expectations of a further appreciation of the euro exchange rate. The average contribution of net external assets to annual M3 growth increased from 1.1 percentage points in the second quarter of 2004 to 2.2 percentage points in the fourth quarter. At the same time, the growth in MFI longer-term financial liabilities (excluding capital and reserves) strengthened further, pointing to an ongoing normalisation of portfolio allocation behaviour by euro area residents in favour of non-monetary assets.

Chart 7 Movements in M3 and its counterparts

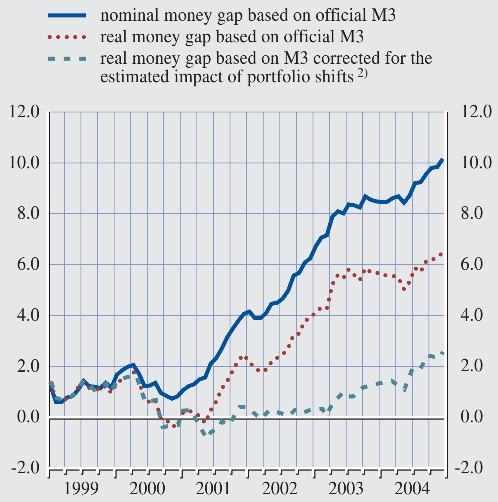
(annual flows; end of period; EUR billions; adjusted for seasonal and calendar effects)



Source: ECB.
M3 = 1 + 2 + 3 - 4 + 5

Chart 8 Estimates of the money gap[1]

(as a percentage of the relevant measure of the stock of M3; adjusted for seasonal and calendar effects; December 1998 = 0)



Source: ECB.
1) The nominal money gap is defined as the difference between the actual level of M3 and the level of M3 that would have resulted from constant M3 growth at its reference value of 4½% taking December 1998 as the base period. The real money gap is defined as the difference between the actual level of M3 deflated by the HICP and the deflated level of M3 that would have resulted from constant nominal M3 growth at its reference value of 4½% and HICP inflation in line with the ECB's definition of price stability, taking December 1998 as the base period.
2) Estimates of the magnitude of portfolio shifts into M3 are constructed using the approach discussed in Section 4 of the article entitled "Monetary analysis in real time" in the October 2004 issue of the ECB's Monthly Bulletin.

LIQUIDITY REMAINED AMPLE

The strength of M3 dynamics over the course of 2004 implied a further increase in available measures of excess liquidity, which denotes the liquidity available in the euro area that exceeds the amount needed to finance non-inflationary growth (see Chart 8). The first of these measures is the nominal money gap, which is defined as the difference between the actual level of M3 and the level of M3 that would have resulted from constant M3 growth at its reference value of 4½% taking December 1998 as the base period; the second is the real money gap, which corrects the nominal money gap for the excess liquidity that has been absorbed by past price developments (i.e. the cumulated deviation of inflation rates from the ECB's definition of price stability); and the third is an alternative measure of the real money gap which is constructed using an estimate of M3 corrected for portfolio shifts.

When assessing these measures of excess liquidity, it should be recognised that the choice of December 1998 as the base period is arbitrary. The levels of the measures must therefore be interpreted with caution. Moreover, as noted previously, the estimate of M3 corrected for portfolio shifts is surrounded by a considerable degree of uncertainty.[2] Bearing these caveats in mind, all estimates of the money gap rose further in the second half of 2004, having shown signs of levelling off in the first half of the year. The large difference between the real money gap measure based on the official M3 series and that based on M3 corrected for the estimated impact of portfolio shifts indicates that much of the stock of excess liquidity reflected previous portfolio shifts into M3. However, Chart 8 also shows that the corrected measure has risen significantly since mid-2003, indicating that excess liquidity in the euro area has increasingly ceased to be a reflection only of portfolio shifts.

These levels of excess liquidity signal risks to medium-term price stability. If a significant part of this excess liquidity were to be transformed into transaction balances, particularly at a time when confidence and economic activity strengthened, this could contribute to the emergence of inflationary pressures (see Box 2 entitled "What could happen with the excess liquidity in the euro area?"). In addition, ample liquidity and strong credit growth could become a source of strong asset price increases, particularly in housing markets.

2 For further details, see Section 4 of the article entitled "Monetary analysis in real time" in the October 2004 issue of the ECB's Monthly Bulletin.

Box 2

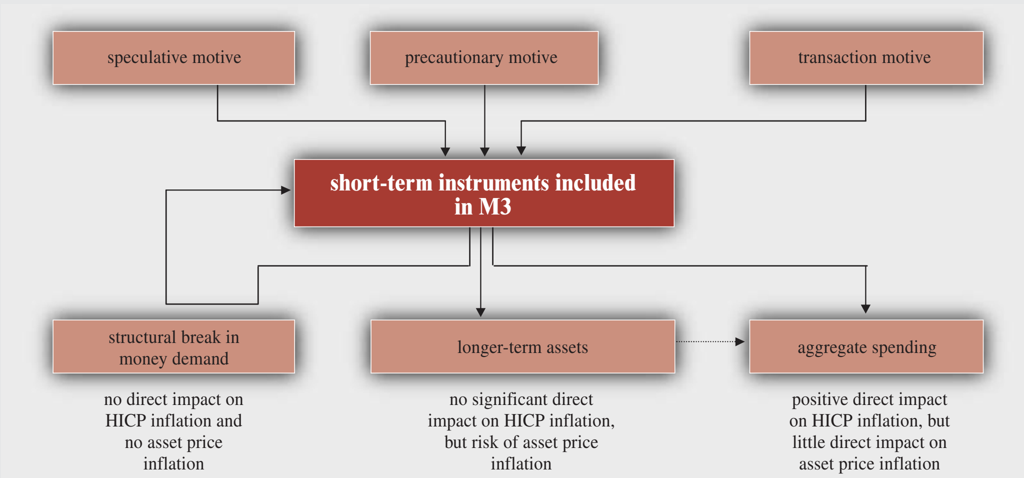
WHAT COULD HAPPEN WITH THE EXCESS LIQUIDITY IN THE EURO AREA?

The strong growth in M3 since mid-2001 has led to a sustained increase in measures of excess liquidity in the euro area, which have reached historical highs. This implies that there was substantially more liquidity in the euro area in 2004 than needed to finance non-inflationary economic growth. However, the levels of these measures should be interpreted with caution.

When assessing what could happen with the excess liquidity, the factors responsible for its build-up should be borne in mind. Two broad factors can be identified. First, the protracted period of economic, financial and geopolitical uncertainty between mid-2001 and mid-2003 led to a significantly increased preference during this period for safe and liquid instruments included in M3. Second, the low level of interest rates across the maturity spectrum and the associated low opportunity costs of holding liquid assets have added to the demand for money, particularly over the most recent period. On the basis of these factors, the strong demand for short-term instruments included in M3 may reflect a mixture of mainly speculative and precautionary, rather than transaction, motives. Each of these motives may, in turn, imply different ways in which excess liquidity can be used in the future and, accordingly, different degrees of risk to price stability (see the chart).

One possibility for the use of excess liquidity is for economic agents to invest their liquid holdings in longer-term assets, in equity or debt securities, or in real estate, either directly or indirectly via investment funds. In order to achieve an aggregate reduction of excess liquidity, it is necessary for either the resident MFI sector or agents outside the euro area to act as counterparties in these transactions. This use of excess liquidity would have no direct impact on HICP inflation, but the readjustment of portfolios may, under certain circumstances, have an impact on asset prices which, in turn, could have indirect effects on inflation at a later point in time via wealth effects.

Schematic presentation of how excess liquidity may be used



A second possibility is that the excess liquidity will at some point translate into transaction balances. This is most likely to be the case at a time when economic confidence is strengthening. To the extent that these balances are used to increase the demand for domestic goods and services, this could progressively reabsorb the current margins of idle capacity. Should strong consumption growth continue for a sufficiently long time, a tightening of production capacities could eventually cause risks to price stability.

Finally, it cannot be entirely ruled out that the current situation of excess liquidity to some extent reflects a permanent change in the money demand behaviour of economic agents, i.e. a structurally higher liquidity preference and, hence, an increase in the desired level of money holdings. Such a permanent change could, for example, be due to structurally higher risk aversion on the part of households as regards financial investments following the significant losses they incurred on the stock markets between 2000 and 2003. To the extent that such a factor plays a role, excess liquidity in the euro area would be lower than indicated by the current measures and would not have an inflationary impact.

In reality, the situation is probably a combination of these three possibilities. At the current juncture, it is difficult to determine whether or not there has been a permanent rise in liquidity preferences over recent years. At the same time, a continued strong preference for real estate purchases could be associated with strong rises in real estate prices. Furthermore, there is some evidence that economic agents have readjusted their portfolio behaviour by investing more in longer-term financial assets. Looking ahead, it cannot be ruled out that some of the excess liquidity will be used for higher nominal transactions, particularly at a time of stronger economic confidence, and then be associated with higher inflation.

Overall, therefore, even if some of the excess liquidity reflects a higher liquidity preference on the part of households and companies in the euro area, the high levels reached in 2004 remain a concern for the ECB and call for vigilance. In order to capture the relative empirical importance of the possible scenarios for the use of excess liquidity and, thereby, the risks to medium-term price stability, the ECB will continue to monitor closely developments on all fronts, in particular: a) evidence of portfolio reversals and the risk of emerging asset price bubbles, b) evidence of stronger than usual consumption and c) evidence of any structural change in money demand.

MONEY MARKET RATES REMAINED BROADLY STABLE

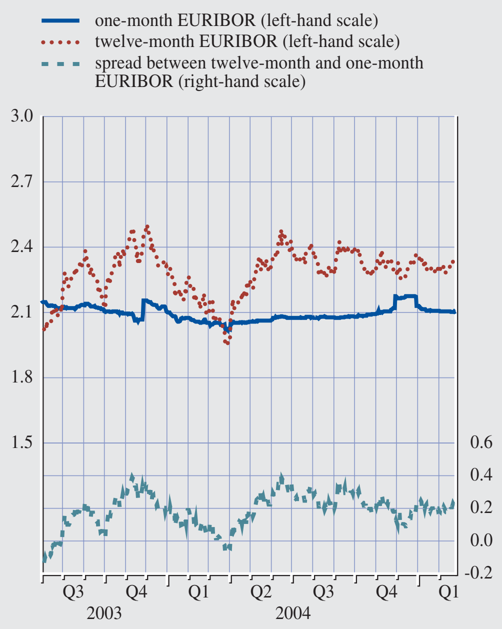
In 2004 the Governing Council of the ECB decided to keep its key interest rates unchanged. As a consequence, money market rates at the very short end of the yield curve remained broadly stable throughout the year.

Money market interest rates at longer maturities declined significantly in the first quarter of 2004, continuing the downward trend observed from mid-December 2003 (see Chart 9). Towards the end of March 2004, in a context where key ECB interest rates were expected to decline further, the money market yield curve became negatively sloped. In fact, the slope of this curve, as measured by the difference between the twelve-month and the one-month EURIBOR, reached its lowest point on 26 March 2004, at -7 basis points.

However, between April and June 2004 a normalisation of the slope of the yield curve was observed, with significant increases in interest rates at longer maturities, while interest rates remained broadly stable at the very short end of the curve. Thereafter, longer-term money market interest rates remained

Chart 9 Short-term interest rates and the slope of the money market yield curve

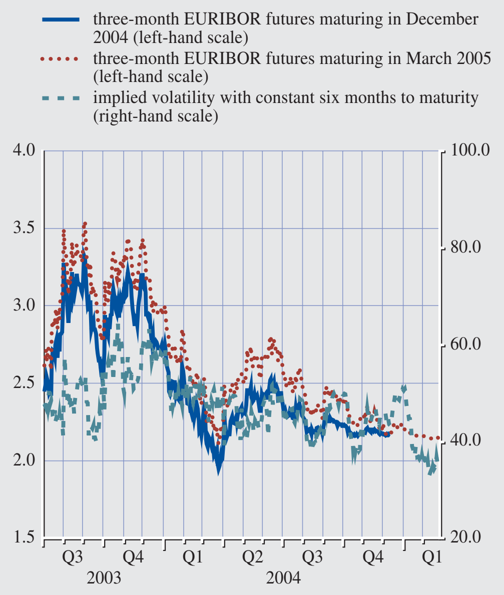
(percentages per annum; percentage points; daily data)



Source: Reuters.

Chart 10 Three-month EURIBOR futures rates and implied volatility derived from options on three-month EURIBOR futures

(percentages per annum; basis points; daily data)



Sources: Bloomberg, Reuters and ECB calculations.

broadly stable, fluctuating in a very narrow range of around 10 basis points. At the end of the year the one-month and twelve-month EURIBOR stood at 2.12% and 2.35% respectively, close to the levels reached at the end of 2003.

In the first two months of 2005 EURIBOR interest rates at longer maturities remained broadly stable, as market participants expected short-term interest rates to remain stable over most of 2005, and term premia remained subdued. On 24 February 2005 the one-month and the twelve-month EURIBOR stood at 2.10% and 2.34% respectively.

The changes in short-term money market interest rates in the course of 2004 were generally mirrored in the evolution of the implied three-month EURIBOR futures rate. The implied volatility derived from options on three-month EURIBOR futures contracts declined substantially throughout the year, indicating that market participants saw very little uncertainty in the expected future path of short-term interest rates (see Chart 10).

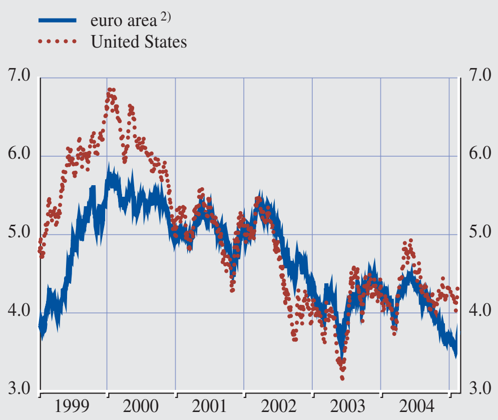
LONG-TERM GOVERNMENT BOND YIELDS DECLINED SIGNIFICANTLY IN 2004

Long-term government bond yields in the euro area ended 2004 at very low levels by historical standards. While in the first half of the year euro area ten-year government bond yields fluctuated somewhat but did not change much overall, in the second half of 2004 they exhibited a protracted downward trend and, by year-end, had reached 3.7%, significantly below the levels prevailing at the end of 2003 (see Chart 11).

Overall, these movements in euro area long-term bond yields mainly reflected the changing perceptions of market participants with regard to inflationary pressures and the outlook for the euro area economy, perceptions which were in turn closely related to changes in global

Chart 11 Long-term government bond yields[1)]

(percentages per annum; daily data)



Sources: Reuters, Bloomberg and Thomson Financial Datastream.
1) Ten-year bonds or the closest available bond maturity.
2) From 1 January 2001, data include Greece.

macroeconomic prospects throughout the year. Market participants' expectations regarding the impact of the upsurge in oil prices over the year strongly influenced perceptions regarding both inflationary pressures and economic activity. These expectations, however, seemed to vary over time in line with the flow of macroeconomic data releases. Indeed, although in the spring market participants appeared to be mainly concerned about the inflationary effects of the sharp rise in oil prices, later in the year concerns appeared to shift towards the impact of the high level of oil prices on economic activity.

In the first quarter of the year long-term bond yields in the euro area declined, mirroring movements in the US market, amid growing concerns about the strength of the economic recovery in the United States. Despite the gradual strengthening in euro area economic activity, long-term index-linked bond yields in the euro area also declined in the first quarter of the year in line with comparable US yields, reflecting the fact that market participants' expectations regarding future global economic activity appeared to be influenced largely by concerns about the sustainability of the economic recovery in the United States.

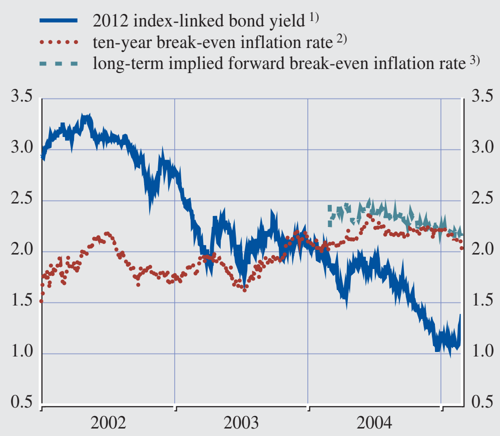
The decline in euro area long-term bond yields in the first three months of the year was quickly reversed from early April onwards. The subsequent rise in long-term bond yields appeared to be influenced by two main factors. First, there was increasing confidence among market participants regarding the ongoing recovery in the euro area, by then also supported by better prospects for the world economy. Second, market participants became increasingly concerned about the potential inflationary impact of the surge in oil prices against the background of the ongoing global economic recovery. Indeed, in the spring long-term bond yields and break-even inflation rates edged up amid renewed inflationary concerns on the part of investors (see Chart 12). However, such concerns were much less pronounced in the euro area than in the United States, where bond yields and break-even inflation rates rose more sharply.

Between April and June 2004 market participants' inflation expectations in the euro area appeared to increase most over shorter horizons, while longer-term inflation expectations, as measured by implied forward break-even inflation rates, appeared to be somewhat more stable, although these remained at relatively high levels.[3] It is likely that the increase in euro area break-even inflation rates reflected to some extent a higher inflation risk premium required by investors in the light of the uncertainty surrounding the impact of the oil price developments. Additional information from survey measures of euro area inflation expectations, which did not show an increase in the point estimates for long-term inflation expectations, was consistent with this interpretation.

3 Chart 12 shows that, in spring 2004, the rise in the 2012 spot break-even inflation rate, which reflects, among other things, average inflation expectations between 2004 and 2012, was stronger than that in the long-term implied forward break-even inflation rate, which reflects average inflation expectations between 2008 and 2014. This suggests a stronger increase in inflation expectations at shorter horizons.

Chart 12 Long-term real bond yields and break-even inflation rates in the euro area

(percentages per annum; daily data)



Sources: Reuters, French Treasury and ECB calculations.
1) Derived from French Treasury bonds indexed to the euro area HICP excluding tobacco which mature in 2012.
2) For details of calculation, see Box 2 in the February 2002 issue of the ECB's Monthly Bulletin.
3) Calculated from index-linked bonds in the euro area, maturing in 2008 and 2014, since the issuance of the latter.

Developments in oil prices continued to exert a substantial influence on bond yields over the second half of the year. However, markets also appeared in this period to be increasingly concerned about the impact of oil prices on economic activity in the euro area and the global economy. This was reflected in the gradual decline, observed from mid-June onwards, in long-term nominal and index-linked bond yields, suggesting that the markets expected the pace of economic growth in the euro area to decline somewhat. A further depreciation of the US dollar vis-à-vis the euro, in particular over the last quarter of 2004, also seemed to contribute to the moderation in market participants' perceptions of the near-term growth prospects of the euro area. The decline in long-term nominal and index-linked bond yields in the euro area also mirrored downward revisions to market expectations regarding the pace of monetary policy tightening over the near to medium term.

As a result of these developments, nominal long-term bond yields in the euro area fell significantly over 2004, declining by around 60 basis points to end the year at 3.7%, close to their historical lows. The interest rate differential vis-à-vis the United States remained broadly stable for most of the year, reflecting more or less synchronous changes in the macroeconomic prospects in the two economies. However, some decoupling of long-term bond yield movements occurred towards the end of 2004, when the interest rate differential between US and euro area ten-year government bond yields widened somewhat, reaching a level of almost 60 basis points.

Break-even inflation rates also moderated slightly in the second half of 2004. Nevertheless, long-term break-even inflation rates in the euro area remained at the end of the year above their average values since late 2001, when inflation-linked bonds indexed to the euro area HICP excluding tobacco were first issued. The ten-year break-even inflation rate ended the year at around 2.2%, an increase of more than 10 basis points compared with December 2003.

A further decline in implied volatility in the bond market – a measure which provides evidence of market views about the ranges within which bond yields are expected to move in the near term – was also a noticeable feature of 2004. Indeed, subsequent movements in realised volatility confirmed those market expectations of lower bond market volatility (see Box 3 entitled "Common trends in implied financial market volatility").

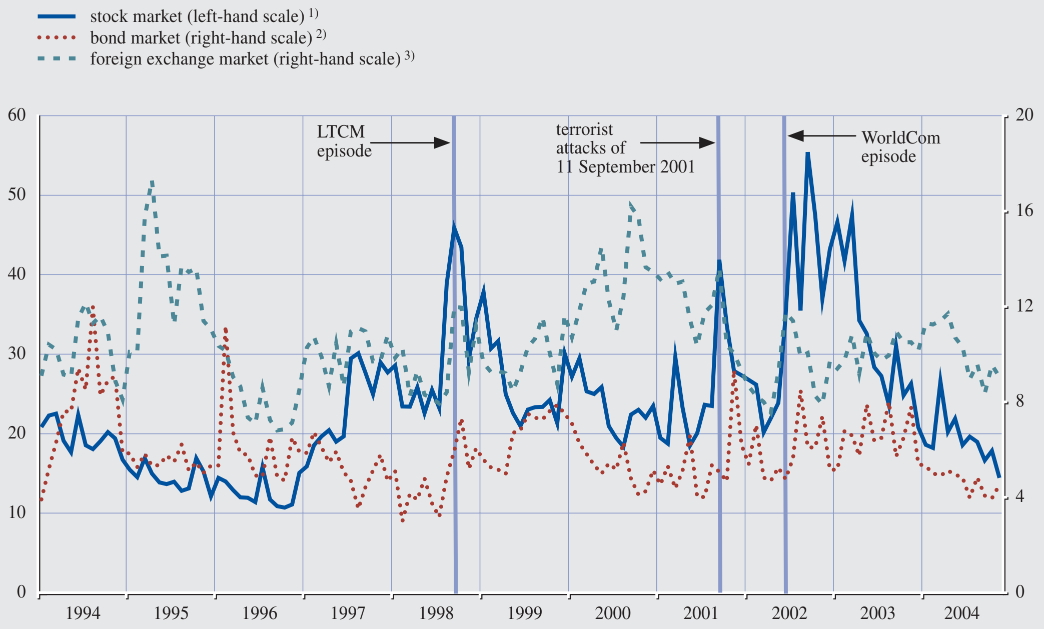
Box 3

COMMON TRENDS IN IMPLIED FINANCIAL MARKET VOLATILITY

The year 2004 brought a marked overall decline in implied volatility across several financial market segments in the euro area and in other advanced economies. Implied volatility – which is derived from option prices – is usually interpreted as a measure of market participants' uncertainty regarding near-term developments in different financial markets. In 2004 there was some concern that the relatively low levels of implied volatility might not be fully justified insofar as they may have been driven down by factors other than market participants' expectations of future realised volatility. Such a potential "mis-pricing" of volatility could constitute, among other things, a risk to financial stability. If financial institutions, for example, respond to lower volatility by increasing their risk exposure accordingly, they might incur heavy losses if an upward correction of volatility were to take place. According to empirical evidence, no such mis-pricing was detected and the decline in implied volatility in various financial markets was correctly followed by lower realised volatility.[1] Lower realised volatility, in turn, can be explained, for instance, by an ongoing process of normalisation, especially in the global stock markets, after several years of exceptionally turbulent developments.

Chart A Implied financial market volatility in the euro area

(percentages per annum; monthly data)



Sources: Bloomberg and ECB calculations.
1) Volatility index for the German DAX index, measuring implied volatility for the next 45 calendar days.
2) Implied volatility for options on Bund futures contracts with 22 trading days to maturity.
3) Implied volatility for option contracts on the USD/EUR exchange rate with around one month to maturity.

1 See the boxes entitled "Recent trends in implied stock market volatility" and "Recent trends in implied bond market volatility" in the November and December 2004 issues of the ECB's Monthly Bulletin respectively.

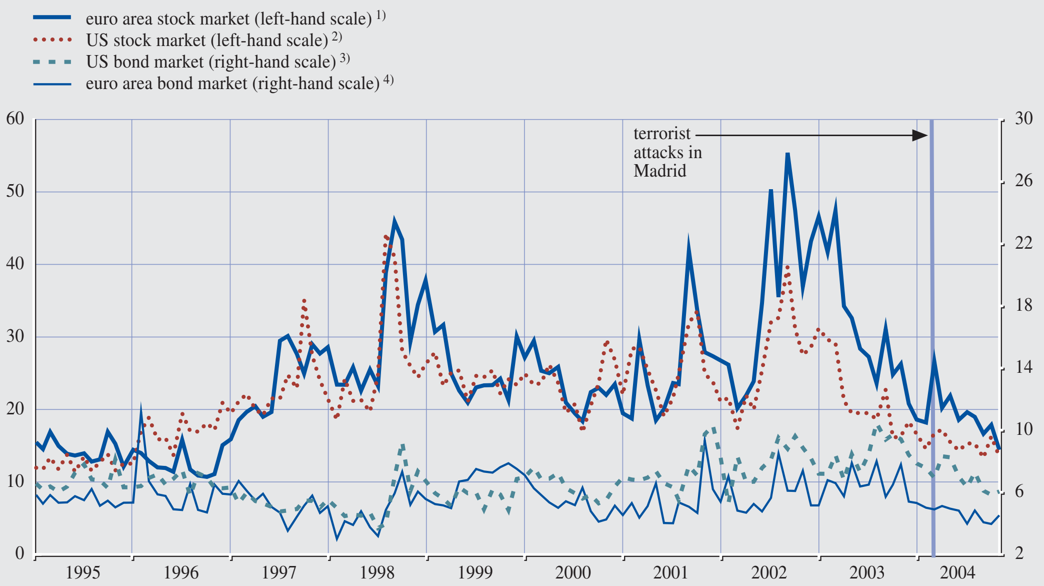
Chart A shows the implied volatility of (i) the German DAX index, as measured by the VDAX volatility index, (ii) long-term government bonds, as extracted from options on Bund futures with 22 trading days to maturity, and (iii) the euro exchange rate vis-à-vis the US dollar, as derived from currency options with around one month to maturity. Since all the options concerned are from the same day and have roughly the same remaining time to maturity, the implied volatility series shown in the chart measure market participants' uncertainty in all three market segments over a similar short-term horizon.

In the past, there seemed to be a rather low degree of co-movement in near-term expected volatility in the different market segments, except in occasional periods of cross-market turmoil that were probably triggered by common rather than market-specific shocks. More recently, the decline in volatility over the first three quarters of 2004 was quite similar across markets. In the absence of evidence of mis-priced volatility, this would suggest widespread and gradually increasing confidence among financial market participants regarding more tranquil market conditions in the near term. Over the last few months of 2004, however, the strong decline in implied volatility in the USD/EUR exchange rate came to a halt amid a renewed acceleration of US dollar weakness.

Today's capital markets are highly integrated and one may suspect that the international volatility linkages within each market segment are significant. Chart B below shows the implied volatility in stock markets in both the United States and the euro area, as measured by the VIX and the VDAX indices respectively, as well as implied volatility in the corresponding

Chart B Implied bond and stock market volatility in the euro area and the United States

(percentages per annum; monthly data)



Sources: Bloomberg and ECB calculations.
1) Volatility index for the German DAX index, measuring implied volatility for the next 45 calendar days.
2) Volatility index for the S&P 500 index, measuring implied volatility for the next 30 calendar days.
3) Implied volatility for options on US Treasury futures contracts with 22 trading days to maturity.
4) Implied volatility for options on Bund futures contracts with 22 trading days to maturity.

long-term bond markets, as derived from options on US Treasury and Bund futures respectively.

It is clear from the chart that there is a high degree of co-movement in implied volatility within both asset classes in the United States and in the euro area. Moreover, the international linkages seem to be somewhat stronger for the equity markets than for the long-term government bond markets. Still, country and market-specific factors can play a dominant role. The terrorist attacks of 11 March 2004 in Madrid, for instance, had a larger, albeit temporary, impact on expected stock market volatility in the euro area than in the United States. The chart also provides further evidence that the overall decline in implied volatility over the past few years has not been restricted to the euro area.

All in all, the linkages within certain financial asset classes across geographic areas are quite strong, particularly for the equity markets. While there is no general tendency for implied volatility to move in parallel across market segments in normal circumstances, there seems to be a stronger connection in times of turbulence. The recent alignment of implied volatility across the three asset classes is noteworthy since it is not related to any financial turmoil and, therefore, lends support to the widespread anticipation among market participants of calmer financial market conditions in the near future than was the case at the beginning of 2004.

In early 2005, long-term bond yields in global markets at first continued to decline before they sharply rebounded around mid-February 2005. As a result, on 24 February ten-year government bond yields, both in the euro area and the United States, stood at levels close to those prevailing at the end of 2004.

EURO AREA STOCK MARKETS CONTINUED TO SHOW STRONG GAINS IN 2004

In 2004 euro area stock prices continued the upward trend observed from early 2003 (see Chart 13). The Dow Jones EURO STOXX index ended the year with a gain of around 10% compared with the end of the previous year, a slightly higher increase than the Standard & Poor's 500 and the Nikkei 225.

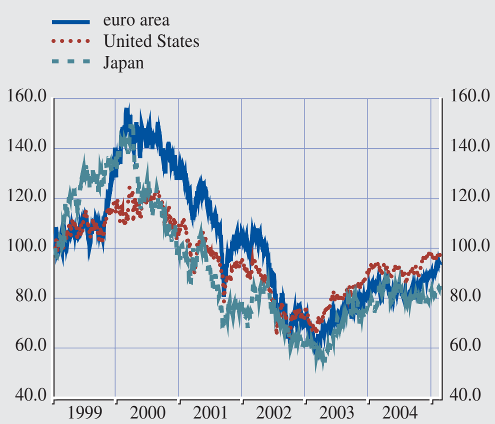
These overall stock price increases in the euro area appeared to reflect several factors, in particular declines in long-term interest rates and strong growth in actual earnings and dividend payouts (see Chart 14).

A substantial decline in stock market volatility, which suggested reduced uncertainty among market participants regarding the stock market outlook, also seemed to contribute positively to the stock price gains over the year (see also Box 3). Potentially negative factors, such as the somewhat less optimistic outlook for global growth as a result of oil price rises and – particularly towards the end of 2004 – exchange rate developments, seemed to have only an attenuating effect on stock prices.

As regards the sectoral breakdown, the increase in euro area stock prices in 2004 was broadly based, with only one sector (technology) out of the ten economic sectors of the Dow Jones EURO STOXX index recording lower stock prices at end-2004 than a year earlier. The strongest gains were recorded in the healthcare and utility sectors, while the telecommunication sector recovered in 2004 as well. The energy sector also outperformed the overall index, supported by the fact that its revenues are positively linked to oil price developments. This factor also contributed to the performance of the utility sector, as demand shifts towards alternative energy sources such as natural gas are common in periods of high oil

Chart 13 Major stock market indices [1]

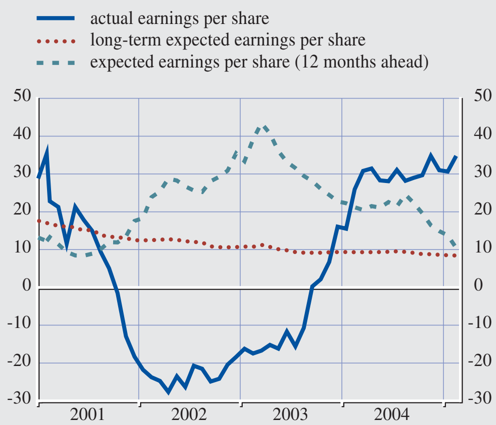
(index: 1 January 1999 = 100; daily data)



Sources: Reuters, Thomson Financial Datastream and ECB calculations.
1) The Dow Jones EURO STOXX broad index for the euro area, the Standard & Poor's 500 for the United States and the Nikkei 225 for Japan. From January 2001 onwards, euro area data also include Greece.

Chart 14 Growth in actual and expected corporate earnings

(annual percentage changes; monthly data)



Source: Thomson Financial Datastream (analysts' earnings estimates from Institutional Brokers Estimate System, IBES).

prices. By contrast, the consumer sector was weaker than the overall index in 2004, both for cyclical and non-cyclical goods and services. This may reflect investors' concerns about the strength of domestic demand, and private consumption in particular, in the euro area.

The upward trend in global stock price developments continued in the first two months of 2005. The Dow Jones EURO STOXX index gained more than 3% between the end of 2004 and 24 February, while the Standard & Poor's 500 and the Nikkei 225 also rose slightly in the same period. These price increases seemed to be mainly supported by further strong improvements in corporate profitability.

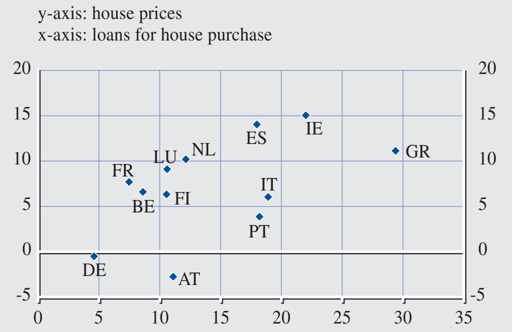
STRONG DEMAND FOR HOUSEHOLD FINANCE

Demand for financing on the part of the household sector was strong in 2004, as reflected by the fact that the annual average rate of growth of MFI loans to households rose to 7.8%. Household loan dynamics in 2004 continued the upward trend observed from the first quarter of 2002 and were primarily related to robust growth in long-term loans. Over the first three quarters of 2004 the annual growth rate of total loans to households was higher than that of loans by MFIs, pointing to a continued high rate of growth of loans by other financial institutions (OFIs) in the context of the securitisation of residential mortgages in a number of countries.

Long-term MFI loans to households were mostly composed of loans for house purchase. The strong dynamics of this component were supported by buoyant house price developments in several euro area countries and continued growth in house prices at an annual rate of more than 7% for the euro area as a whole in the first half of 2004. Available data suggest that growth in household borrowing for house purchase remained sluggish in most countries with subdued house price developments, while it was strong in countries where house prices were rising rapidly (see Chart 15). In a number of euro area countries, developments in house prices and house financing may also have contributed to supporting consumption. The increase in house prices created greater financing requirements

Chart 15 Housing market dynamics and loans in euro area countries

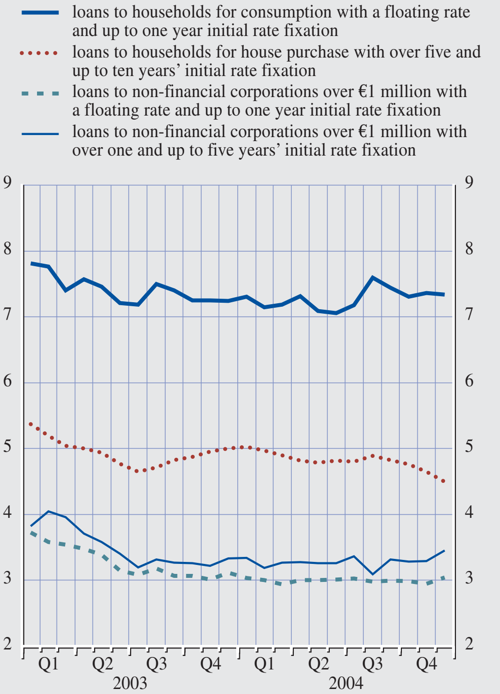
(average annual growth between 1998 and 2003; percentages)



Source: ECB calculations based on MFI data for loans and latest available national data on house prices.

Chart 16 MFI interest rates for lending to households and non-financial corporations

(percentages per annum; rates on new business; excluding bank overdrafts; weight-adjusted [1])



Source: ECB.
1) For the period from December 2003 onwards, the weight-adjusted MFI interest rates are calculated using country weights constructed from a 12-month moving average of new business volumes. For the preceding period, from January to November 2003, the weight-adjusted MFI interest rates are calculated using country weights constructed from the average of new business volumes in 2003. For further information, see the box entitled "Analysing MFI interest rates at the euro area level" in the August 2004 issue of the ECB's Monthly Bulletin.

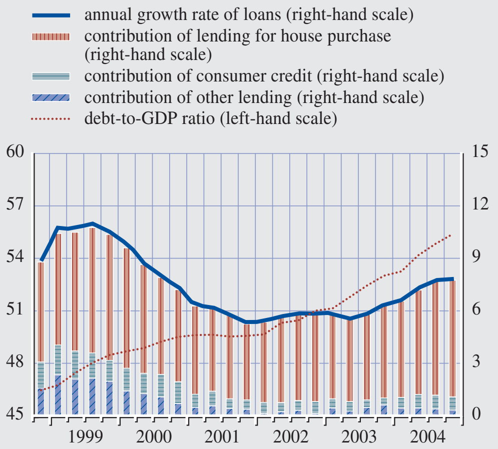
but may also have enhanced the access of households to credit by increasing the amount of collateral available to them. At the same time, the strong growth in loans for house purchase may itself have become a source of increases in house prices.

A factor underpinning the strong growth in loans for house purchase was the low cost of financing for housing loans, which declined further in 2004 from the already low level prevailing in previous years. This increased the affordability of house purchases. MFI interest rates on new loans for house purchase with over five and under ten years' initial rate fixation declined by 52 basis points over the course of the year and stood at 4.49% in December 2004 (see Chart 16), mirroring developments in comparable market interest rates for medium-term government bonds. It also appears that the overall availability of financing for households improved in 2004. Indeed, the results of the Eurosystem's bank lending survey suggest that there was some easing of credit standards applied by banks to the approval of loans for house purchase in the last three quarters of 2004.

The annual growth rate of consumer credit also strengthened in 2004, although from a more subdued level and with a lag compared with the developments in lending for house purchase. This strengthening might reflect the gradual improvement in the European Commission's indicator of consumer confidence in an environment of relatively low interest rates on loans to households for consumption. The results of the Eurosystem's bank lending survey also indicate that the availability of both credit for consumption and other lending improved as lending conditions eased over the course of 2004.

Chart 17 Debt-to-GDP ratio and growth in loans of households

(debt-to-GDP ratio and annual growth in percentages; contribution to annual growth rate in percentage points)



Source: ECB.
Note: The ratio of debt to GDP is somewhat lower on the basis of the quarterly financial accounts than on the basis of the annual financial accounts mainly because loans by non-financial sectors and banks outside the euro area are not included.

RISING HOUSEHOLD DEBT

The increased borrowing of households resulted in a further edging-up of the ratio of household debt to GDP (see Chart 17). The rise in the debt-to-GDP ratio is partly a reflection of the move towards an environment of price stability and lower interest rates in several euro area countries after the adoption of the euro. Indeed, the debt service burden (i.e. the ratio of interest payments and principal repayments to disposable income) remained fairly low as a result of the low level of interest rates. The debt-to-GDP ratio of euro area households also remained low for example relative to the United Kingdom and the United States. Nonetheless, this rise in debt is not without risk, as it increased households' exposure to changes in interest rates, income and asset prices. The risk of higher sensitivity applies, for instance, to households that, under the historically low interest rate conditions, financed mortgages at variable rates with low initial interest payments. Estimates of this sensitivity are surrounded by considerable uncertainty because, for instance, the share of existing mortgage debt exposed to changes in prevailing interest rate conditions depends on the features of the underlying mortgage contracts. These features are linked to the national mortgage market structure, cultural habits and historical factors, as well as regulatory and fiscal issues, all of which vary substantially across the euro area.[4]

LOW COST OF EXTERNAL FINANCING FOR NON-FINANCIAL CORPORATIONS

Debt financing conditions for non-financial corporations in the euro area remained very favourable throughout 2004, as was reflected in corporate bond market rates and bank interest rates. Firms enjoyed low debt financing costs and generally unconstrained access to sources of finance.

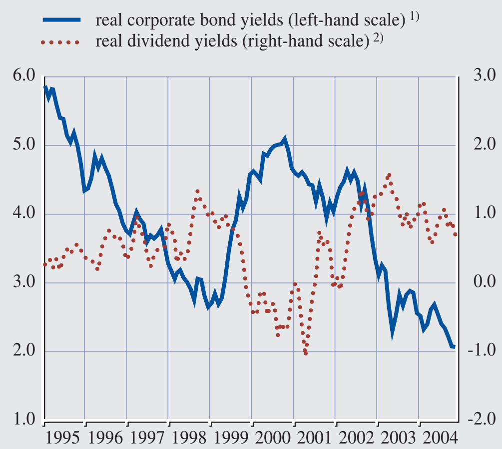
As regards financing in the form of securities, the yields on bonds issued by non-financial corporations stood at historically low levels both in nominal and in real terms (see Chart 18). At the same time, real dividend yields (which can be seen as an indicator for the real cost of equity financing), while remaining at a somewhat higher level than their average since the mid-1990s, declined from the peak observed in 2003.

The low cost of bond financing is to a large extent a consequence of the historically low levels of interest rates across the maturity spectrum, as well as a reflection of investors' perceptions of a positive outlook for corporate credit risk in the euro area. Spreads between corporate bonds and government bonds, particularly for AA and BBB-rated bonds, declined further in 2004 from already low levels. The decline in spreads may be explained by fundamental factors such as the pronounced decline in volatility in financial markets (see Box 3 entitled "Common trends in implied financial market volatility") and improvements in corporate profitability. At the same time, in

4 For further details, see the box entitled "Features of mortgage contracts in the euro area" in the November 2004 issue of the ECB's Monthly Bulletin.

Chart 18 Indicators of market-based financing costs of non-financial corporations

(percentages per annum)



Sources: ECB, Thomson Financial Datastream, Merrill Lynch and Consensus Economics Forecasts.

1) Bond yields of non-financial corporations are based on an index compiled by Merrill Lynch referring to investment-grade non-financial corporations as well as on a high-yield index. Prior to April 1998, only national data are available (Belgium, France, Germany, Italy, the Netherlands and Spain). Yields are aggregated using GDP weights corresponding to the purchasing power parity in 2001. Nominal yields are deflated by average inflation expectations (published by Consensus Economics Forecasts) over a period equal to the average duration of the corporate bonds.

2) Dividend yields are defined as the annual dividends anticipated by market participants, expressed as a percentage of the share price. Nominal yields are deflated by the HICP.

the context of low interest rates, the possibility cannot be ruled out that an extensive search for yield by investors continued to play a role in the fall in corporate yields.

Turning to the financing costs associated with MFI loans, which are the main form of debt financing for non-financial corporations, MFI interest rates remained broadly stable in 2004 (see Chart 16), after the declines which occurred in 2002 and 2003, and were very low overall.

Firms may have also had easier access to bank credit in 2004. The results of the bank lending survey conducted by the Eurosystem indicate a gradual decrease in the net tightening of credit standards applied to loans to enterprises during the first half of 2004, which became a net easing in the second half of the year. At the same time, there were some differences between large enterprises and small and medium-sized enterprises in terms of financing costs (see Box 4 entitled "Were small and medium-sized enterprises subject to less favourable financing conditions than large enterprises in the euro area in 2004?").

Box 4

WERE SMALL AND MEDIUM-SIZED ENTERPRISES SUBJECT TO LESS FAVOURABLE FINANCING CONDITIONS THAN LARGE ENTERPRISES IN THE EURO AREA IN 2004?

Small and medium-sized enterprises (SMEs) may, in general, be subject to greater constraints than large companies in terms of costs of financing and access to external finance. In contrast to larger firms, SMEs are typically not able to raise financing in the capital markets and, therefore, have to rely predominantly on bank credit or more expensive types of external finance (e.g. trade credit, leasing and factoring, etc.). In addition, smaller firms would be expected, on average, to suffer more from problems relating to potential creditors' lack of information when trying to obtain funding as they are often younger and face less rigorous reporting requirements (i.e. they provide less detailed accounting statements, etc.). Moreover, SMEs tend to have less collateral (e.g. fixed assets) to offer, which could mitigate the problems of inadequate information, than more established larger firms. As a consequence, banks may often apply tighter credit standards to loans to smaller and younger firms as they tend to have less information about these firms.

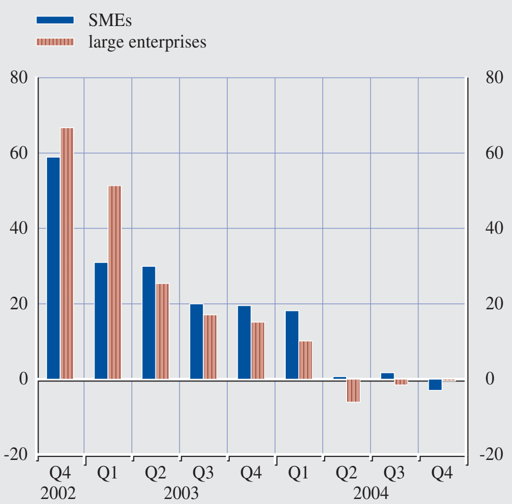
Furthermore, SMEs often face higher financing costs (e.g. in terms of bank interest rates) than larger enterprises. The relatively higher interest rates on small-sized loans may be explained by a number of factors. For example, there may be fixed costs of lending that are not proportional to the size of the loan. Small corporations may also be riskier than larger and more established ones (although the diversification effects for banks may even be greater with respect to loans to SMEs). In addition, there may be a lack of competition among lenders to SMEs, which may thus be better able to "lock in" their small-sized borrowers, thereby increasing these borrowers' bank switching costs. Moreover, owing to their relatively constrained access to, and higher costs of, external financing, SMEs traditionally rely more on internal financing by holding, on average, more liquid assets in their balance sheets. Since holding liquid assets is costly, this may represent an additional burden for small enterprises.[1]

Against this background, increasing attention has recently been paid to SMEs' financing conditions in the euro area. The bank lending survey (BLS), which is conducted by the Eurosystem four times a year, provides qualitative information on the financing conditions of SMEs and large enterprises. In particular, the BLS reports the changes in credit standards for loans granted to large enterprises and SMEs (see Chart A). Since the fourth quarter of 2002, banks' credit standards for loans to SMEs and large companies have followed a broadly similar pattern of a gradual decrease in the net tightening of credit standards. The credit standards applied to loans to large enterprises have tended, on average, to be marginally less tight, and were even eased (in net terms) from the second quarter of 2004 onwards. In the fourth quarter of 2004 the net tightening of credit standards on loans to SMEs declined relatively more and eased for the first time since the start of the BLS.

The introduction of the new MFI interest rate statistics (from January 2003 onwards) allows rates on loans of different sizes (below and above €1 million) to be compared.[2] Assuming that loans of more than €1 million are granted more often to large enterprises, a comparison of interest rates charged on loans of different sizes may provide some information on SMEs' costs of financing compared with those of large enterprises. Naturally, this can only be a rough distinction. Throughout the period from January 2003 to December 2004, the level of interest rates on small-sized MFI loans (as measured by MFI interest rates on

Chart A Changes in the credit standards applied to the approval of loans or credit lines to non-financial corporations

(net percentages)



Source: ECB.
Note: The net percentages refer to the difference between the sum of the percentages for "tightened considerably" and "tightened somewhat" and the sum of the percentages for "eased somewhat" and "eased considerably".

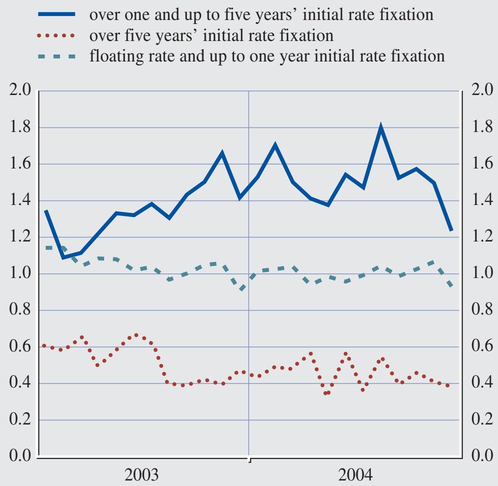
1 For a more detailed discussion of the financing of SMEs in Europe, see "Europe's changing financial landscape: The financing of small and medium-sized enterprises", EIB Papers, vol. 8, No 2, 2003, and the European Commission's "SMEs and access to finance", Observatory of European SMEs, 2003, No 2.
2 See also Box 13 entitled "Financial integration in the euro area credit market" later in this report.

loans of up to €1 million to non-financial corporations) was between 0.4 and 1.8 percentage points higher than the level of interest rates on larger MFI loans (as measured by MFI interest rates on loans of more than €1 million to non-financial corporations) (see Chart B). Overall in the period since January 2003, the spreads between small-sized loans and large-sized loans changed only slightly. Looking at recent developments in more detail, in 2004, the spread of interest rates on small-sized loans over both those on large-sized loans with over one year's and up to five years' initial rate fixation and those on such loans with over five years' initial rate fixation decreased slightly (by 10 and 15 basis points respectively), while it remained broadly unchanged over the interest rates on loans with floating rates and up to one year's initial rate fixation.

It is difficult to draw firm conclusions on the basis of the evidence available. While the cost of financing of SMEs remained relatively high compared with large companies, the developments in 2004 were broadly similar for small and large companies. At the same time, some evidence suggests that SMEs' access to finance improved significantly in the same period.

Chart B MFI interest rate spreads between small-sized loans and large-sized loans to non-financial corporations [1), 2)]

(percentage points; new business loans)



Source: ECB.
1) For the period from December 2003 onwards, the weight-adjusted MFI interest rates are calculated using country weights constructed from a 12-month moving average of new business volumes. For the preceding period, from January to November 2003, the weight-adjusted MFI interest rates are calculated using country weights constructed from the average of new business volumes in 2003. For further information, see the box entitled "Analysing MFI interest rates at the euro area level" in the August 2004 issue of the ECB's Monthly Bulletin.
2) Small-sized loans are loans up to €1 million and large-sized loans are loans over €1 million.

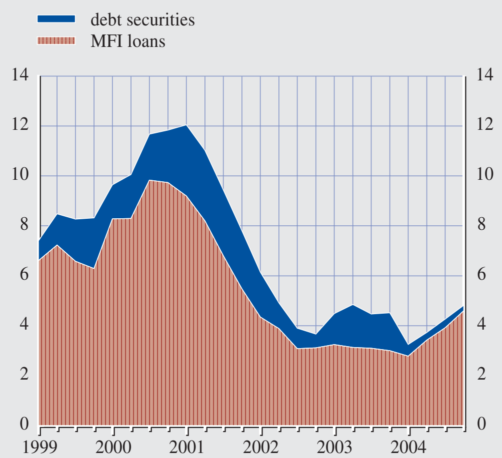
LIMITED RECOURSE TO EXTERNAL FINANCING DURING 2004

Despite financing conditions remaining favourable, non-financial corporations had only limited recourse to external financing in 2004. The annual rate of growth of debt financing stood at 4.8% at the end of 2004, slightly higher than the 4.5% at the end of 2003. In the second half of 2004, it picked up somewhat mainly as a result of an increase in loan financing (see Chart 19). Indeed, the annual growth rate of MFI loans to non-financial corporations rose to 5.4% at the end of 2004, from 3.5% at the end of 2003. At the same time, the growth rate of the net debt securities issuance activity of non-financial corporations was considerably lower in 2004 than in the previous year, declining from 10.5% at the end of 2003 to 2.4% at the end of 2004.

The fact that, overall, debt financing flows remained relatively subdued may be related to several factors. First, improvements in corporate profitability, at least for major companies in the Dow Jones EURO STOXX index (see Chart 14), by boosting internal savings, may have increased the incentive of firms to reduce their total debt. Second, the relatively slow growth of debt financing might also reflect the gradual nature of the current

Chart 19 Contribution to the annual rate of growth of debt of non-financial corporations

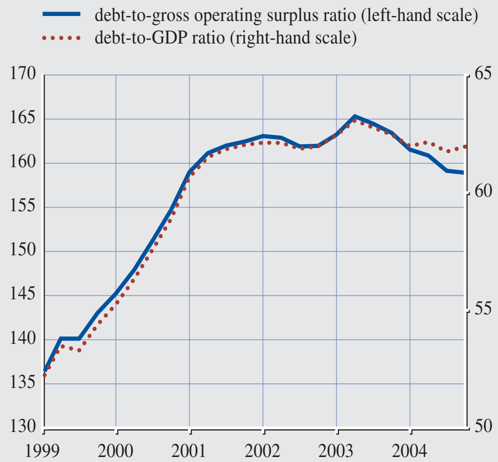
(percentage points)



Source: ECB.

Chart 20 Balance sheet indicators for non-financial corporations

(percentages)



Sources: ECB and Eurostat.
Note: The figures for the fourth quarter of 2004 have been estimated on the basis of transactions reported in the money and banking statistics and in securities issues statistics. The debt ratios are somewhat lower on the basis of the quarterly financial accounts than on the basis of the annual financial accounts mainly because loans by non-financial sectors and banks outside the euro area are not included.

economic recovery. In this respect, companies appeared to adopt a cautious wait-and-see approach with regard to the financing of additional large capital investments.

In 2004 there was also a slowdown in indirect financing of non-financial corporations through companies in the non-monetary financial corporations sector. This sector includes financial subsidiaries of non-financial corporations, special-purpose vehicles and other corporations which raise funds on behalf of banks.

The annual growth rate of net issuance of debt securities by non-monetary financial corporations declined from 22.3% at the end of 2003 to 13.2% at the end of 2004. Nevertheless, it remained strong compared with the issuance activity of the other sectors.

The annual growth rate of quoted share issuance by non-financial corporations in the euro area was 0.9% at the end of 2004, broadly unchanged from the very low level observed over the previous two years. The low recourse to equity financing is a consequence both of relatively low demand for external financing and of the very low cost of other sources of finance. The low net issuance of quoted shares is also, to some extent, a reflection of a number of more structural developments, such as the delisting of stocks and buyback operations, which are principally carried out by companies that have generated enough cash to both reinvest in their businesses and buy back their stocks.

The favourable financing conditions led to some improvement in the balance sheet positions of firms in 2004 (see Chart 20). From a historical perspective, corporate debt ratios remained at a rather high level. However, as a result of the general decline in MFI interest rates, these have not resulted in markedly higher debt servicing costs for non-financial corporations over recent years.

2.3 PRICE DEVELOPMENTS

Overall HICP inflation in the euro area stood at an average of 2.1% in 2004, unchanged from the previous year (see Table 1). Higher oil prices and further increases in indirect taxes and administered prices were the main factors exerting upward pressure on prices. These were offset by a further strengthening of the euro, subdued demand conditions and the substantial decline in the annual growth rate of unprocessed food prices. Yet, despite the sizeable upward impact of oil price developments on euro area consumer prices, there was little evidence of stronger underlying inflationary pressures building up in the euro area economy. Producer prices grew at an average annual rate of 2.3% in 2004, compared with 1.4% in 2003, largely on account of increases in energy and intermediate goods prices. However, there were only limited signs of significant pass-through to prices at a later stage of the production chain. Similarly, wage increases remained contained in 2004, in the context of ongoing moderate growth and labour market developments.

In January 2005 overall HICP inflation fell to 1.9%, a decline of 0.5 percentage point compared with December 2004. This decline was broadly based across components of HICP inflation and partly driven by base effects. It also reflected additional favourable influences from the decline in the annual growth rate of energy prices, the fall in unprocessed food prices and deeper seasonal sales discounts in some euro area countries.

HEADLINE INFLATION AFFECTED BY VOLATILE COMPONENTS

The volatile components of the HICP, in particular energy and to a lesser extent unprocessed food prices, largely explain the pattern of headline inflation in 2004 (see Chart 21).

Oil prices were higher than expected in 2004. In December, the average euro price of a barrel of Brent crude oil stood 25% above its average in December 2003 (see Box 5 for more details on the impact of oil prices on the euro area economy). This put significant direct upward pressure on consumer energy prices in the euro area, which rose by an average of 4.5% in 2004

Table 1 Price developments

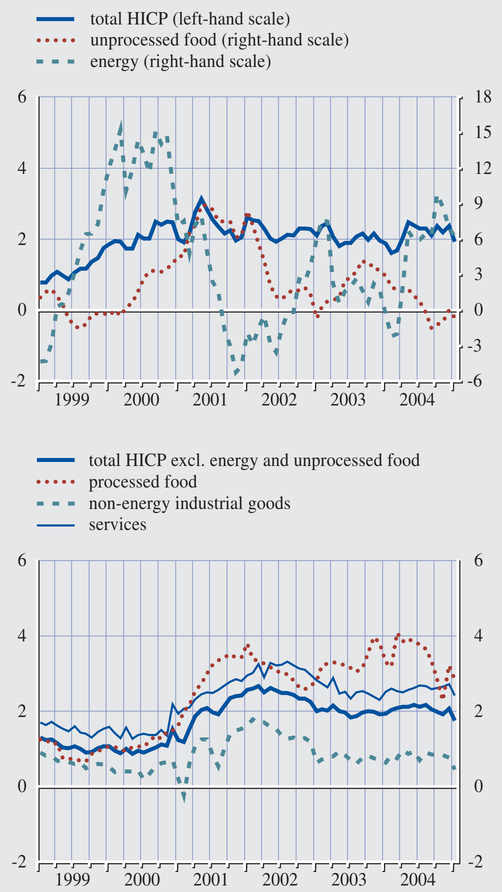
(annual percentage changes, unless otherwise indicated)

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2004 Dec.	2005 Jan.
HICP and its components										
Overall index	2.3	2.1	2.1	2.0	1.7	2.3	2.2	2.3	2.4	1.9
Energy	-0.6	3.0	4.5	1.6	-1.5	4.8	6.3	8.5	6.9	6.2
Processed food	3.1	3.3	3.4	3.8	3.5	3.9	3.6	2.8	3.2	2.8
Unprocessed food	3.1	2.1	0.6	3.6	2.2	1.5	-0.3	-0.7	0.0	-0.6
Non-energy industrial goods	1.5	0.8	0.8	0.8	0.7	0.9	0.8	0.8	0.8	0.5
Services	3.1	2.5	2.6	2.4	2.6	2.6	2.6	2.7	2.7	2.4
Other price and cost indicators										
Industrial producer prices [1]	-0.1	1.4	2.3	1.0	0.2	2.0	3.1	3.8	3.5	.
Oil prices (EUR per barrel) [2]	26.5	25.1	30.5	24.5	25.0	29.3	33.3	34.5	30.0	33.6
Commodity prices [3]	-0.9	-4.5	10.8	-1.2	9.8	20.9	11.9	1.3	-0.2	-1.9

Sources: Eurostat, Thomson Financial Datastream and Hamburg Institute of International Economics.
1) Excluding construction.
2) Brent Blend (for one-month forward delivery).
3) Excluding energy; in EUR.

Chart 21 Breakdown of HICP inflation: main sub-components

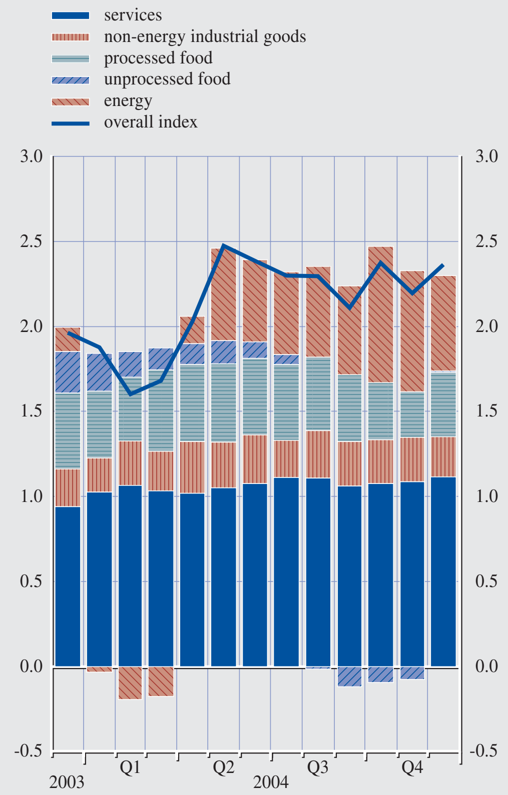
(annual percentage changes; monthly data)



Source: Eurostat.

Chart 22 Contributions to HICP inflation from sub-components

(annual percentage point contributions; monthly data)



Source: Eurostat.
Note: Due to rounding, the contributions do not add up exactly to the overall index.

after 3.0% in 2003. Their contribution of 0.4 percentage point to the average annual inflation rate in 2004 was the highest in four years (see Chart 22).

Driven by strong base effects in the energy component of the HICP, headline inflation declined to around 1.7% year on year in the first quarter of 2004. It then started to rise in line with unexpected energy price increases and peaked at 2.5% in May. This upward pressure largely offset the moderating impact of unprocessed food prices, for which the annual growth rate declined from 2.1% on average in 2003 to 0.6% in 2004. Over the summer and autumn, unprocessed food prices, dampened by favourable weather conditions, had a moderating influence on overall HICP developments. However, HICP inflation remained slightly above 2% until the end of the year.

Other sources of external inflationary pressures were also at work in 2004. In particular, non-oil commodity prices increased strongly in the first half of the year, before moderating. However, the significant appreciation of the euro partly offset the inflationary impact of both oil and non-oil commodity prices.

The remaining, less volatile components of the HICP contributed to some persistence in headline inflation in 2004, notably due to developments in indirect taxes and administered prices. As in 2003, further increases in tobacco taxes were introduced in several euro area countries, contributing to significant upward pressure on processed food prices. Consequently, processed food prices grew at an average of 3.4% in 2004, compared with 3.3% in 2003. The annual rate of change of non-energy industrial goods prices stood at 0.8% in 2004, unchanged from 2003. A decline in this component was prevented by increases in administered prices, in particular for healthcare goods and pharmaceutical products. Similarly, government measures targeting administered prices for health care triggered substantial increases in medical, dental and hospital services prices. These explained the increase in overall services price growth, from 2.5% in 2003 to 2.6% in 2004. The upward impact of energy prices on transport costs also contributed, albeit to a lesser extent, to the increase in services prices as a whole. Box 5 details the impact of oil price developments on the euro area economy.

Box 5

OIL PRICES AND THE EURO AREA ECONOMY

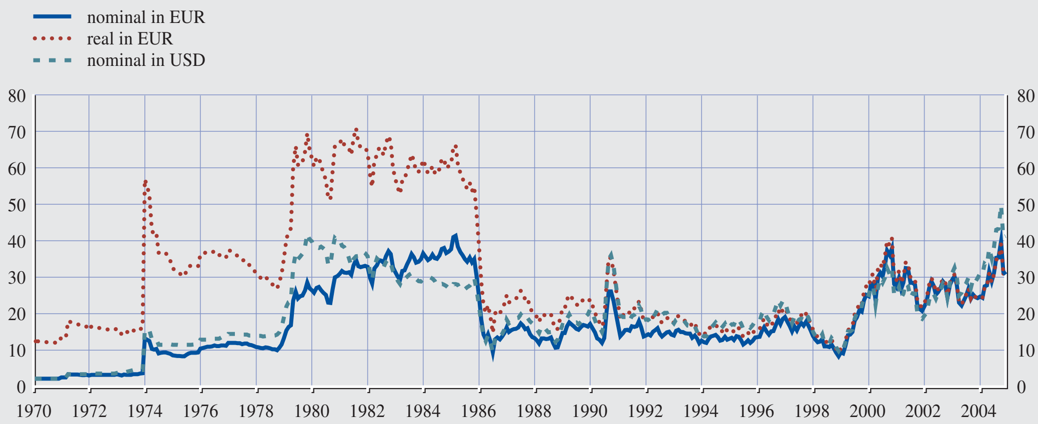
This box describes oil price developments in 2004 and their effect on the euro area economy. First of all, it puts the oil price increase of 2004 into a historical perspective. It then goes on to describe the channels through which oil prices affect euro area inflation and output growth. Finally, it gives a tentative quantification of the impact of the oil price increase, but stresses that some effects cannot be captured by models.

Developments in oil prices from a longer-term perspective

Oil prices in US dollars rose to record levels in nominal terms during 2004. There are, however, key differences between this increase and previous oil price shocks. First, the increase in 2004

Chart A Brent crude oil prices

(per barrel)



Sources: IMF and ECB calculations.
Note: Real oil prices allow a comparison of the impact of oil price developments on purchasing power over time. They are computed by deflating nominal oil prices with the euro area HICP with December 2004 as a base. Price data before 1990 refer to national CPI data.

was considerably smaller than those observed during other major oil price shocks (see table). On average, the price of Brent crude oil in 2004 was 33% higher than in 2003. Nonetheless, as a result of the overall appreciation of the euro against the US dollar, oil prices in euro terms went up by 20% in 2004. Second, after taking account of inflation, i.e. in real terms, oil prices were significantly lower in 2004 than they were during earlier periods of high prices (see Chart A). Third, the factors driving the price increase in 2004 also differed from earlier oil price shocks. In contrast to the oil price increases of 1973, 1979, 1990 and 1999, which were mainly caused by sizeable disruptions to the supply of oil, a variety of factors had an impact on oil prices in 2004. These factors include buoyant demand for oil that surpassed expectations, the dwindling global spare capacity and concerns over the security of supplies from several oil-producing countries.

Increases in Brent crude oil prices over specific periods

(percentage change of the annual average)

	1973-1974	1978-1979	1999-2000	2003-2004
in USD	204	125	60	33
in EUR	210	110	84	20

Sources: IMF and ECB calculations.

Transmission of oil price changes to euro area inflation

Turning to the impact of the oil price increase on euro area prices, it is helpful to distinguish between direct, indirect and second-round effects.[1] First, direct effects refer to the impact of an oil price change on the overall HICP through its immediate effect on consumer prices of energy. The energy component constitutes 8% of the overall HICP and is strongly correlated with oil prices in euro terms. Chart B shows the contribution of the most important oil-related items of the energy component to the annual overall HICP inflation rate along with oil price developments. This chart shows that the direct effect materialises within a year of the oil price increase.

1 See also the article entitled “Oil prices and the euro area economy” in the November 2004 issue of the ECB’s Monthly Bulletin and the box entitled “Recent oil price developments and their impact on euro area prices” in the July 2004 issue of the same publication.

Chart B Oil prices and the contribution of energy components to HICP inflation

(percentage point contribution, unless otherwise indicated)

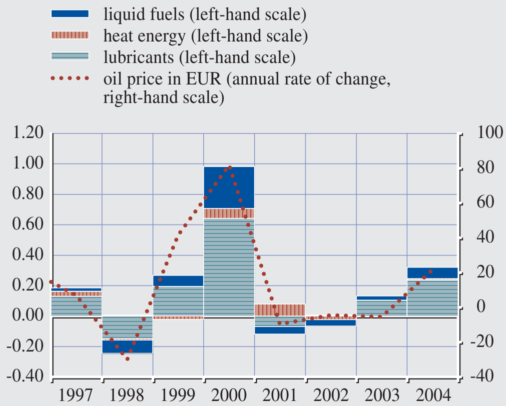
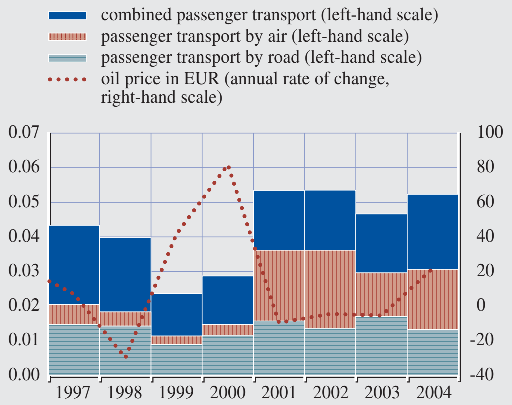


Chart C Oil prices and the contribution of transport components to HICP inflation

(percentage point contribution, unless otherwise indicated)



Sources: Eurostat, Thomson Financial Datastream and ECB calculations.

Second, indirect effects refer to the possibility that, in addition to direct effects, an oil price shock, by increasing energy input costs, may have an impact on the prices of other goods and services. This may result in a more general rise in prices, although it also depends on the extent to which profit margins can absorb rising costs. As an example, Chart C illustrates the indirect effect through transport-related service components of the HICP. The contribution of these components to overall HICP inflation tends to increase with some lag after oil price increases. It should, however, be noted that other factors also have an impact on these components, while other components of the HICP are also indirectly affected by oil price changes.

Finally, second-round effects refer to the possibility that, in addition to the direct and indirect effects mentioned above, an oil price shock may have a further impact on inflation because it might result in higher wage claims to compensate for the decline in real income. Such second-round effects tend to occur with a lag. Typically, besides the expectations concerning the persistence of the shock, the occurrence of second-round effects depends on whether the economic context, in particular the labour market situation, encourages higher wage claims. In 2004, second-round effects related to the oil price shock remained contained owing to the cyclical position of the euro area economy and labour market conditions. Less wage indexation than in the 1970s and 1980s may have also contributed to reducing the role played by inflation in the wage formation process.

Transmission of oil price changes to euro area output growth

There are primarily two channels through which oil price shocks affect the real economy. First, there is the supply-side channel, because oil is an important input factor in the production process. A rise in the price of oil entails, particularly in the short term, an increase in production costs, as the options for substituting other energy sources for oil are limited. The level of output may fall as a result of the oil price increase, which may also imply lower demand for other production factors such as labour. Second, on the demand side, an increase in oil prices entails a deterioration in the terms of trade of net oil-importing economies like the euro area. The resulting decline in real income translates into lower domestic demand insofar as it is not compensated for by reduced saving or increased borrowing. A number of other channels, which are more difficult to measure, transmit the effects of an oil price shock via confidence or stock markets for example.

Model-based quantification of the impact of the oil price increase

The impact of the oil price increase observed over the last year on euro area inflation and real GDP growth can be approximated using different models. Such estimations generally suggest that a 20% increase in oil prices raises euro area inflation by about 0.2 percentage point in the first year, with a further impact of around 0.1 percentage point expected for the following two years. As regards real GDP growth, the estimated impact would amount to around -0.1 to -0.3 percentage point in the first year, with only a minor effect in the second and third years.[2]

2 For further information, see also the article referred to in footnote 1.

The simulation results should, however, not be taken at face value. On the one hand, several caveats should be clearly borne in mind, such as the possible existence of non-linearities and asymmetries, and the fact that models do not include all possible transmission channels. On the other hand, it should also be noted that, from a structural perspective, several factors suggest that the euro area economy has become more resilient to oil price shocks in recent years, with the result that model simulations could overestimate the impact. First of all, compared with the 1970s, the oil intensity of production and the share of oil consumption in total energy consumption have fallen significantly in the euro area. Moreover, labour and product markets appear to have become somewhat more flexible, allowing for a smoother and faster reallocation of resources, which should reduce the impact of an oil price shock on the economy. Furthermore, the credibility and the reaction of monetary policy play an important role in determining the impact of oil price increases on the euro area economy, rendering quantification of the effect uncertain.

However, further structural reforms are clearly needed to increase the ability of the euro area economy to adjust more smoothly and quickly to future shocks. In particular, increasing the degree of effective competition in the euro area energy sector would be highly beneficial as it would allow higher oil prices to be absorbed without significant distortions. To this end, compensating for oil price increases with fiscal measures, such as tax cuts, is not advisable because this would increase existing distortions in the allocation of resources and thus prevent economic agents from adjusting to such an external shock.

DYNAMIC RESIDENTIAL PROPERTY PRICES

Euro area residential property prices, which are not included in the measurement of the HICP, continued to rise strongly in 2004, increasing by 6.9% in the first half of 2004 compared with the first half of 2003. This figure conceals contrasting developments across euro area countries, with double-digit increases in Spain, Ireland, France and Italy, and a small decline in Germany. Available data for the second half of 2004 suggest that strong price increases continued, which would make 2004 the fourth consecutive year in which residential property prices increased by around 6-7% (see Chart 23). However, this period of sustained and robust increases followed a period of relatively modest increases (of less than 3%) during the mid-1990s.

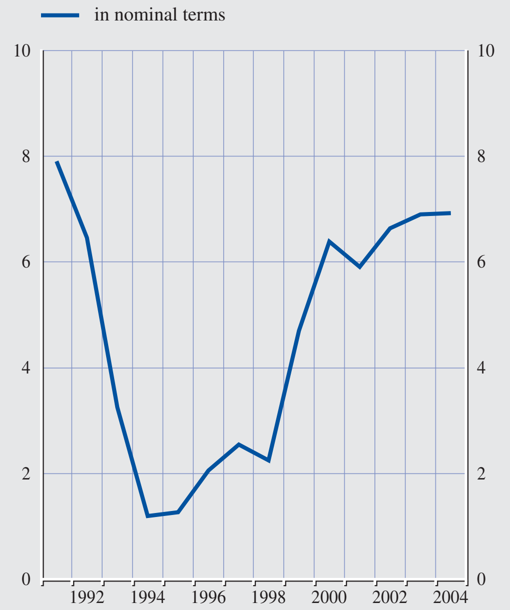
INCREASING PRODUCER PRICES AT EARLY STAGES OF THE PRODUCTION CHAIN

The overall annual rate of growth of industrial producer prices in the euro area (excluding construction) rose steadily in the course of 2004 (see Chart 24). The increase gathered momentum in the second quarter and was primarily driven by energy and intermediate goods prices. This is in line with rising oil and non-oil commodity prices, which put pressure on input prices at early stages of the production chain. On average, intermediate goods prices rose by 3.5% in 2004, compared with 0.8% in 2003.

There was, however, little sign of significant price pressures building up at later stages of the production chain. On average, consumer goods producer prices grew by 1.3%, still below their historical average but above the average increase of 1.1% in 2003. A significant part of the increase in consumer goods producer prices between 2003 and 2004 resulted from tobacco tax increases. More generally, as it takes time for upward pressure from input prices to feed through the production chain, the lagged effect of commodity price increases, already observed at earlier stages of production, on consumer goods producer prices may have only started to gather momentum in early 2005. However, subdued demand conditions may

Chart 23 Residential property price developments in the euro area

(annual percentage changes; annual data)



Source: ECB calculations, based on non-harmonised national data.
Note: Data for 2004 refer to the first half of the year.

Chart 24 Breakdown of industrial producer prices

(annual percentage changes; monthly data)

Source: Eurostat.

prevent firms from passing on increases in energy and intermediate goods prices.

MODERATE DEVELOPMENTS IN LABOUR COSTS IN 2004

Labour cost indicators in the euro area continued to ease in 2004 compared with recent years (see Table 2). Growth in compensation per employee showed a decline in the first half of 2004, with an average annual growth rate of 2.2% compared with 2.4% in 2003. This decline was broadly based across the main sectors of the economy (see Chart 25), although it was somewhat stronger in market-related services. Available data on compensation per employee in the second half of 2004 point to a further moderation of wage growth. This is also suggested by other labour cost indicators. The annual growth rate of negotiated wages stood at 2.2% in 2004, compared with 2.4% in 2003. Anecdotal evidence from wage bargaining agreements signed in the period up to late 2004

Table 2 Labour cost indicators

(annual percentage changes, unless otherwise indicated)

	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Negotiated wages	2.7	2.4	2.2	2.2	2.3	2.3	2.0	2.2
Total hourly labour costs	3.7	2.8	.	2.3	2.8	2.2	1.9	.
Gross monthly earnings	3.0	2.6	.	2.5	2.6	2.5	2.3	.
Compensation per employee	2.5	2.3	.	2.2	2.2	2.1	1.4	.
Labour productivity	0.3	0.3	.	0.6	1.2	1.7	1.3	.
Unit labour costs	2.2	2.0	.	1.5	1.0	0.4	0.1	.

Sources: Eurostat, national data and ECB calculations.

Chart 25 Sectoral compensation per employee

(annual percentage changes; quarterly data)

Sources: Eurostat and ECB calculations.

in several euro area countries did not suggest the emergence of second-round effects of higher oil prices. The annual growth rate of hourly labour costs also declined gradually throughout 2004, to reach an average significantly lower than in 2003. With ongoing moderate real GDP growth and limited pressure in euro area labour markets, wage developments remained subdued in 2004.

The moderate growth in wages combined with a rebound in productivity growth rates to an average of 1.4% in the first three quarters of 2004 resulted in a significant decline in unit labour cost growth. Unit labour costs grew by an average of 0.5% in the first three quarters of 2004, compared with 2.0% in 2003.

2.4 OUTPUT, DEMAND AND LABOUR MARKET DEVELOPMENTS

ECONOMIC RECOVERY CONTINUED IN 2004

The recovery of economic activity in the euro area, which started in the second half of 2003, continued in 2004. At 1.8%, the highest rate recorded since 2000, overall GDP growth in

Table 3 Composition of real GDP growth

(percentage changes, unless otherwise indicated; seasonally adjusted)

	Annual rates [1]								Quarterly rates [2]				
	2002	2003	2004	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Real gross domestic product	0.9	0.5	1.8	0.8	1.6	2.2	1.9	1.6	0.4	0.7	0.5	0.2	0.2
of which:													
Domestic demand	0.4	1.2	1.9	1.5	1.2	1.7	2.6	1.9	1.0	0.3	0.3	0.9	0.3
Private consumption	0.7	1.0	1.1	0.6	1.2	1.2	0.9	1.3	0.0	0.8	0.0	0.1	0.5
Government consumption	3.1	1.6	1.6	1.4	1.9	1.8	1.5	1.2	0.5	0.2	0.4	0.4	0.2
Gross fixed capital formation	-2.5	-0.6	1.7	0.2	1.2	1.9	2.1	1.6	1.1	-0.1	0.5	0.6	0.6
Changes in inventories [3), 4)]	-0.1	0.4	0.5	0.8	-0.1	0.2	1.3	0.5	0.7	-0.1	0.1	0.7	-0.1
Net exports [3)]	0.5	-0.6	0.0	-0.6	0.4	0.6	-0.6	-0.3	-0.6	0.4	0.2	-0.7	-0.2
Exports [5)]	1.9	0.2	5.6	0.2	3.6	7.2	5.6	6.0	0.1	1.4	2.7	1.3	0.5
Imports [5)]	0.5	2.0	5.9	2.0	2.8	6.0	7.8	7.1	1.7	0.4	2.4	3.1	1.0
Real gross value added													
of which:													
Industry excl. construction	0.4	0.2	2.2	0.9	1.3	3.6	2.6	1.2	0.8	0.8	1.1	-0.1	-0.6
Construction	-0.2	-1.5	0.8	-1.0	0.8	1.1	0.6	0.8	0.1	0.6	0.5	-0.7	0.3
Purely market-related services [6)]	1.0	0.9	1.9	0.9	1.5	2.4	1.8	2.0	0.1	0.8	0.8	0.2	0.3

Sources: Eurostat and ECB calculations.
1) Percentage change compared with the same period a year earlier.
2) Percentage change compared with the previous quarter.
3) As a contribution to real GDP growth; in percentage points.
4) Including acquisitions less disposals of valuables.
5) Exports and imports cover goods and services and include internal cross-border trade in the euro area. Since intra-euro area trade is not cancelled out in import and export figures used in national accounts, these data are not fully comparable with balance of payments data.
6) Includes trade, transport, repairs, hotels and restaurants, communication, finance, business services, real estate and renting services.

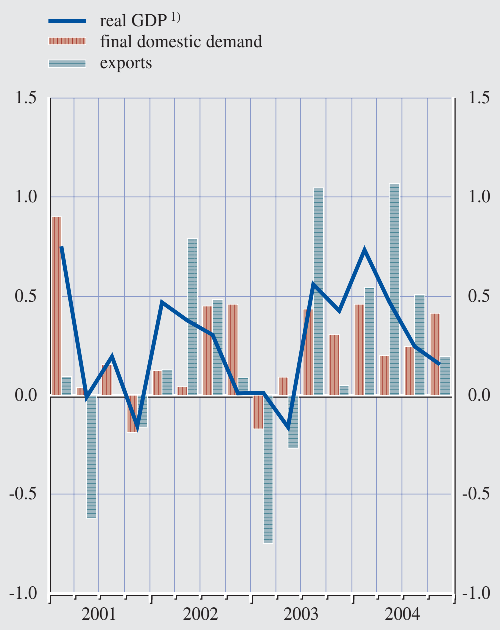
2004 was broadly in line with expectations towards the end of 2003. The recovery was led by the strength of exports, which were 5.6% higher in 2004 than in 2003. Domestic demand, especially investment, was also higher. However, various developments which had not been fully anticipated prevented the recovery from strengthening over the course of 2004. In particular, growth on a quarter-on-quarter basis was higher in the first half of the year than in the second. Oil price and exchange rate developments weighed on growth, and only gradually improving labour market conditions and low consumer confidence contributed to the weakness in private consumption.

From mid-2003 to mid-2004 the recovery was largely driven by export growth, while the contribution of final domestic demand (i.e. excluding changes in inventories) was relatively modest (see Chart 26). The moderation of quarter-on-quarter growth in the second half of 2004 largely resulted from a marked decline in the contribution from the external sector, which was only partially compensated for by gradually increasing final domestic demand growth. The contribution from inventories was relatively significant in some quarters during the recovery but was also volatile. With the exception of changes in inventories, these developments are broadly consistent with the characteristics of recoveries observed in the past few decades in the euro area.

As regards the domestic side, quarter-on-quarter growth in private consumption was on average relatively weak during 2004, reflecting not only subdued labour market developments but also continuing uncertainty regarding the implementation of necessary structural reforms (see Box 6 for more details on the progress with structural reforms). This is likely to have weighed on consumer confidence. Gross fixed capital formation rose significantly during 2004, despite the negative impact of significant declines in German construction investment growth in the first half of the year and of falls in general government investment in the second half.

Chart 26 Contributions to quarterly real GDP growth

(quarterly percentage point contributions; seasonally adjusted)



Sources: Eurostat and ECB calculations.
1) Percentage change compared with the previous quarter.

The pattern of economic growth in 2004 was also influenced by specific external factors, including oil price and exchange rate developments. Euro area growth was affected not only by the direct impact of oil price increases, in the form of increased production costs and reduced purchasing power of consumers' income, but also indirectly via the impact on the international environment. The strong expansion of global economic activity observed at the beginning of 2004 was dampened in the second half of the year. It was affected by, among other factors, oil price increases recorded from mid-2004 onwards, which thus contributed to reducing the growth of foreign demand for euro area exports during the second half of the year. Similarly, the significant appreciation of the euro exchange rate observed during most of 2003, despite having reduced the cost of oil for euro area importers, also had a lagged negative effect on the competitiveness of the euro area as a whole.

Box 6

PROGRESS WITH STRUCTURAL REFORMS IN EU LABOUR AND PRODUCT MARKETS

Structural reforms in product and labour markets are essential to enhance Europe's economic growth potential, facilitate adjustment and increase resilience to shocks. Measures to raise the potential rate of economic growth are all the more important in view of the downward impact that population ageing is likely to have on future labour supply. In March 2000 the Lisbon European Council introduced an ambitious reform agenda aimed at making the EU the most competitive and dynamic knowledge-based economy in the world by 2010. The November 2004 report by the high-level group chaired by Wim Kok[1] formed the starting point for the mid-term review of this strategy. In February 2005 the European Commission's Spring Report to the European Council called for increased national ownership of the Lisbon strategy, its simplification and streamlining and an increased focus on growth and employment. The mid-term review of the strategy was concluded by the European Council in March 2005. This box briefly reviews the progress made in implementing the EU's reform agenda over recent years and particularly in 2004.

The EU defines overarching priorities for various fields of economic policy in the Broad Economic Policy Guidelines (BEPGs). These priorities then form the basis of policy recommendations which are made for each EU Member State. In the field of *labour markets*, the BEPGs for the period 2003-05, together with the update of the BEPGs carried out in 2004 to incorporate the new Member States, stress the need to: (i) improve the combined incentive effects of taxes and benefits in order to make work pay, (ii) ensure efficient, active labour market policies targeted towards the most disadvantaged groups, (iii) promote a more flexible organisation of work and review employment contract regulations, (iv) facilitate geographical and occupational mobility, and (v) ensure that wage bargaining systems allow wages to reflect productivity.

Over recent years a number of countries have implemented reforms in their tax and benefit systems in order to reduce non-wage labour costs and encourage labour supply. Income tax rates have decreased in the bottom and middle income brackets and employees' and employers' social security contributions have been reduced, particularly for the low-paid. Moreover, progress has been made in increasing the employment rate among people on the margins of the labour market. Some Member States have strengthened the role of temporary work agencies and relaxed employment protection legislation on temporary contracts. There have also been changes to working time regulations to allow for a more flexible calculation of maximum allowable working hours across the EU, and the right to work part-time has been extended in some countries. There is some evidence that firms have acquired greater flexibility in their use of labour resources as a result of reforms implemented in the past. For example, recent evidence suggests that the adjustment of working hours played a more important role in the euro area in the 2001-03 slowdown than in earlier cycles.[2]

1 For more details, see Section 1.1 of Chapter 4.

2 For more details, see the box entitled "Developments in total hours worked in the euro area" in the October 2004 issue of the ECB's Monthly Bulletin.

Most EU Member States introduced further labour market reforms in 2004, including the continued reform of income tax systems, the restructuring of social security and benefit systems, and policies to increase the average retirement age. However, reforms seem to lag behind what is implied in government announcements. Limited progress has been made in attracting more people into the labour market, investing in human capital accumulation and increasing the adaptability of both workers and enterprises to changing macroeconomic conditions. Measures that aim to reduce long-term unemployment through retraining and seek to increase labour productivity through vocational and professional development and lifelong learning continue to be priority areas for reform. Moreover, further reforms are needed to encourage labour mobility by improving the transferability of pensions and healthcare rights and by allowing wage differentiation according to local, regional and sectoral differences in productivity.

The structural reform agenda for *product markets* covers a wide range of areas. Among other things, the BEPGs urge Member States to foster competition in goods and services markets by: (i) transposing internal market directives more quickly into national legislation, (ii) further opening up public procurement, (iii) giving adequate powers and resources to competition and regulatory authorities and ensuring their independence, (iv) reducing state aid and (v) encouraging market entry and effective competition in network industries.

The percentage of EU internal market legislation which Member States had not yet transposed into national law (known as the "transposition deficit") increased further. The European Commission has taken several steps to improve the functioning of the internal market, in particular in the service sector, where some significant barriers to its functioning remain. Many of these barriers appear to be due to national regulations, for example administrative burdens and procedures for setting up subsidiaries in other EU countries. At the beginning of 2004 the Irish, Dutch, Luxembourg and British presidencies agreed upon a joint initiative to prioritise regulatory reforms over the course of 2004 and 2005 and step up efforts to reduce the administrative burden. Many countries have taken steps to improve the efficiency and transparency of public procurement procedures. In addition, some countries have increased the powers and independence of their competition and regulatory authorities. Moreover, the trend towards reducing and redirecting state aid towards horizontal objectives seems to have continued over recent years, although state aid still plays an important role in some sectors, such as transport. Member States have continued to implement regulatory reforms in network industries, although the regulatory reform agenda in this area has not yet been completed. De facto competition in previously sheltered sectors, such as electricity and gas, should be increased further.

To sum up, further progress with structural reform was made in 2004, especially in labour markets, but overall the pace of reform remained disappointing. As a result, the EU will most likely not be able to achieve the Lisbon targets unless Member States vigorously step up their efforts to implement reform. Renewed momentum in the process of structural reform will not only increase overall economic efficiency and enhance longer-term growth prospects, but will also strengthen the basis for a sustained economic upswing.

From a sectoral perspective, value added growth tended to track overall real output developments over the cycle. In particular, value added growth in both manufacturing and purely market-related services was sustained during the first half of 2004 but moderated in the second half. The cyclical movement of the economy in the past year seems therefore to have been driven mainly by aggregate, rather than sector-specific, disturbances.

Various dispersion measures indicate that the divergence of real GDP growth rates among euro area countries declined in 2004. Reflecting in part the global economic upswing, average annual real GDP growth increased in all euro area countries in 2004 compared with the year before, except in Greece, where it nonetheless remained relatively strong.

IMPROVEMENT IN LABOUR MARKET AND PRODUCTIVITY GROWTH IN 2004

Labour market conditions did not change significantly in the euro area in 2004, although signs of a gradual improvement can be detected. After remaining broadly unchanged in 2003, employment rose throughout 2004 (see Table 4). The overall increase was moderate, however. This was partly in line with the lagged response of employment to economic activity but also reflected the unusual resilience of employment (measured in terms of persons employed) during the economic slowdown in 2001-03, which lessened the need to hire labour at this stage of the upturn. While developments in the number of persons employed were relatively stable during the recent cyclical phases, available evidence indicates that employment in terms of hours worked was more responsive to the business cycle. This suggests that during the recent slowdown and subsequent recovery employers may have decided to adjust employment more in terms of hours than in terms of persons employed.

Employment continued to decline in industry (excluding construction) in the course of 2004, although to a decreasing extent over successive quarters, while it rose continuously in the services sector. Labour productivity continued to recover significantly during 2004 (especially in the industrial sector) (see Chart 27). Labour productivity growth had been increasing since mid-2003, reflecting usual cyclical developments in activity and employment.

Table 4 Labour market developments

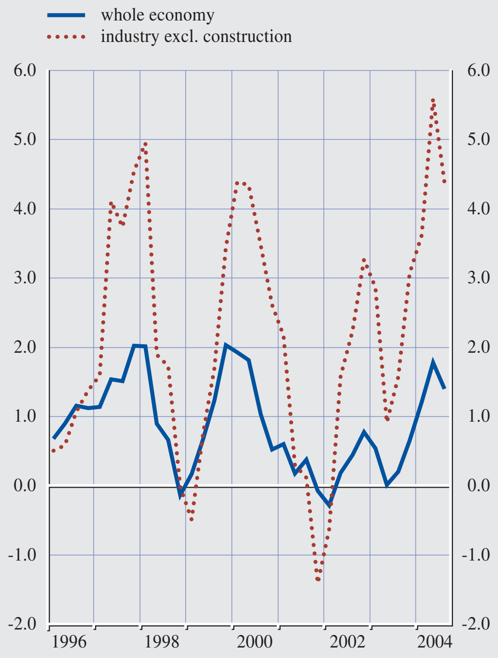
(percentage changes compared with the previous period; percentages)

	2002	2003	2004	2002 Q3	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Labour force	1.0	0.7	.	0.1	0.1	0.2	0.2	0.1	0.1	0.2	0.1	0.2	.
Employment	0.6	0.2	.	-0.0	0.0	0.0	0.1	0.0	-0.0	0.1	0.2	0.2	.
Agriculture [1]	-2.1	-2.5	.	-0.8	-0.7	-0.9	-0.6	-0.1	-0.1	-0.4	0.1	-0.1	.
Industry [2]	-1.2	-1.5	.	-0.4	-0.5	-0.3	-0.3	-0.5	-0.5	-0.5	0.3	-0.2	.
– excl. construction	-1.3	-2.0	.	-0.4	-0.6	-0.5	-0.5	-0.5	-0.7	-0.6	-0.0	-0.2	.
– construction	-0.7	-0.2	.	-0.3	-0.1	0.1	0.4	-0.4	-0.0	-0.2	1.2	-0.1	.
Services [3]	1.4	1.0	.	0.2	0.3	0.2	0.3	0.2	0.1	0.4	0.2	0.3	.
Rates of unemployment [4]													
Total	8.2	8.7	8.8	8.3	8.4	8.6	8.7	8.7	8.8	8.9	8.8	8.8	8.8
Under 25 years	16.8	17.6	17.8	16.9	16.8	17.2	17.5	17.6	18.0	18.0	18.0	17.8	17.6
25 years and over	7.0	7.4	7.6	7.1	7.2	7.4	7.4	7.5	7.5	7.6	7.6	7.6	7.6

Sources: Eurostat and ECB calculations.
1) Includes fishing, hunting and forestry.
2) Includes manufacturing, construction, mining and quarrying, electricity, gas and water supply.
3) Excludes extra-territorial bodies and organisations.
4) Percentage of the labour force according to ILO recommendations.

Chart 27 Labour productivity

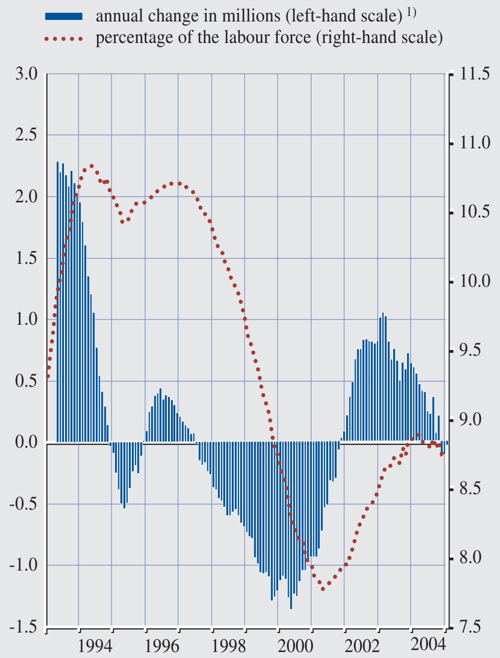
(annual percentage changes)



Source: Eurostat.

Chart 28 Unemployment

(monthly data; seasonally adjusted)



Source: Eurostat.
Note: Data refer to the Euro 12 (including periods prior to 2001).
1) Annual changes are not seasonally adjusted.

The unemployment rate in the euro area remained broadly stable at 8.8% in 2004 (see Chart 28). There was also no significant change recorded in the unemployment rates by age group and by gender. However, the number of unemployed decreased by about 50,000 persons overall in 2004, after having increased markedly in 2003. These signs of improvement, albeit modest, were in line with other indications of a turning-point in the labour market. These include developments in the number of vacancies, which increased in the second half of 2004 after having fallen continuously since 2001.

The unemployment rate in most euro area countries was broadly unchanged on average between 2003 and 2004, although the unemployment figures recorded in some countries were affected to some extent by statistical changes. All in all, the degree of dispersion of unemployment rates among euro area countries declined slightly in 2004.

Box 7

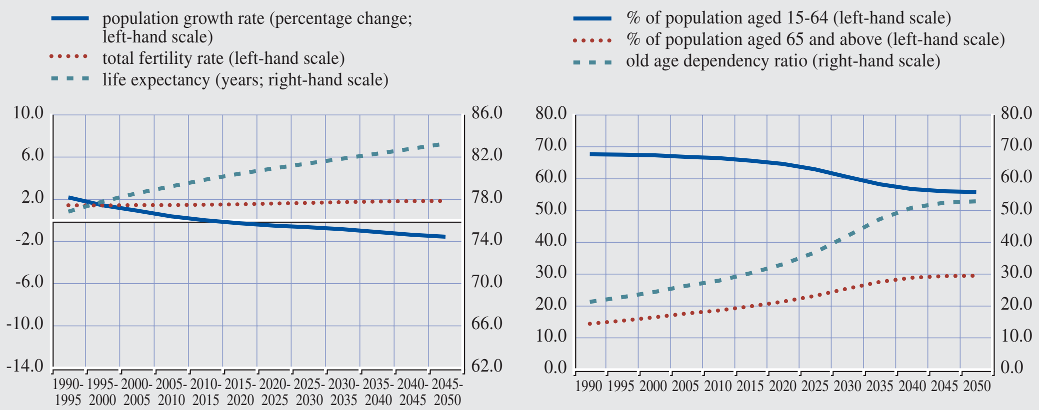
POTENTIAL EFFECTS OF DEMOGRAPHIC CHANGE IN THE EURO AREA

Recent and projected demographic dynamics in the euro area, as in many other industrialised countries, are characterised by decreasing population growth and a gradual ageing of the population. These developments are the result of low fertility rates in most euro area countries and increasing life expectancy. Although considerable uncertainty surrounds all demographic projections, these patterns seem to be common to most, including those by Eurostat and the United Nations. This box discusses some of the main implications.

Demographic changes

According to the most recent projections available for euro area countries (the United Nations 2002 World Population Prospects[1]), total fertility rates in the euro area are expected to remain below the population replacement level of about two children per woman in the period to 2050. At the same time, average life expectancy is expected to increase by five years between 2005 and 2050 (see left-hand panel of the chart below). The combination of these two effects implies a slowdown in the euro area's population growth rate and, from around 2015, a decline in its total population. Furthermore, the proportion of older people (aged 65 and over) in the population is projected to increase and the proportion of people of working age (aged 15 to 64) to decrease (see right-hand panel of the chart below), gradually at first and then at a faster rate from around 2015. This would imply an increase in the euro area's old age dependency ratio (i.e. the ratio of the population aged 65 and above to the population aged 15 to 64) from about 26% in 2005 to about 30% in 2015 and to more than 52% in 2050, a total increase of about 26 percentage points over the period 2005 to 2050.

Main demographic developments in the euro area



Sources: United Nations 2002 World Population Prospects (medium fertility variant) and ECB calculations.

1 The figures in this paragraph and the charts refer to the "medium variant" assumptions regarding fertility, which can be seen as the most likely. For more information, see "World Population Prospects: The 2002 Revision", United Nations.

Economic implications

Such a demographic shift will have a profound effect on euro area economies. For example, the composition of the labour supply will change as the proportion of older workers increases, and the labour supply may even fall if workers continue to retire early and too few new workers enter the labour market to replace those leaving it. The projected decrease in the working age population will exert downward pressure on the growth rate of potential output of the euro area, unless it can be compensated for by increased contributions from other growth factors, such as increases in labour market participation, labour productivity and/or the productive use of other resources such as capital. There has been some discussion of the extent to which immigration may help to increase labour supply. Most studies suggest that the role of migration in addressing Europe's demographic challenge is likely to be small and temporary, being limited by the number of potential migrants relative to the size of the problem and by practical and political constraints.

The financing of social security systems, and in particular public pension systems based on the pay-as-you-go principle, will also come under pressure as the ratio of the number of pensioners to the number of contributors to pension and health systems rises. Public expenditure on health and long-term care is expected to increase as progress in medical technologies continues to be made and the demand for these services grows with the number of elderly people. The size of these potential effects could be substantial. Estimates by the European Commission's Economic Policy Committee's Working Group on Ageing Population suggest additional pension expenditure of between 3% and 6% of GDP by 2050 in most euro area countries. A further increase in expenditure of 2% to 4% of GDP could result from rising health and long-term care costs.

Population ageing is also likely to induce changes in the structure of financial markets and the pricing of financial assets. Households of different generations typically hold different amounts of financial assets and choose assets with different risk profiles for their investment portfolios. Given that long-run demand for housing depends, inter alia, on the number of households in an economy, demographic changes may also affect real estate prices. Furthermore, pension reforms, in particular a move towards more private funding, are likely to have a significant effect on financial markets as the role of institutional investors, such as pension funds and insurance corporations, increases. The limited availability of long time series of financial prices, measurement problems and the fact that typically only a small fraction of the population hold equities limit the extent to which possible effects of demographic change on financial markets can be quantified. However, simulations carried out using models based on the "life-cycle" theory generally find that an ageing population implies a decrease in financial asset prices (both equities and bonds) and an increase in the required equity premium when the currently active population retires.

The need for comprehensive reforms

To cope with such effects of demographic change, governments need to undertake comprehensive reforms. Such reforms should aim to address specific problems in pension and healthcare systems, reduce overall public debt and strengthen the forces driving economic growth. Within the EU, governments have agreed on a three-pronged strategy. This strategy was first set out in the 2001 BEPGs and comprises three broad objectives: to raise employment rates, reduce government debt and reform pension systems, including moves towards greater reliance on funding.

In euro area countries there is an urgent need to increase labour market participation and employment for all groups within the working age population and particularly some, such as over 55-year-olds, among whom the participation rate is especially low. A first important step is to further reduce the disincentives to work currently persisting within a number of euro area labour markets due to the interplay of taxes and benefits and the provision of early retirement schemes. Such systems create disincentives particularly for second earners, low-paid workers, the youngest and oldest workers, and women. Policies to increase female labour market participation must make it easier for women to combine family and work by increasing the flexibility of working hours and improving services for childcare and care of the elderly. Furthermore, in some cases it might be useful to improve incentives to continue working later in life, for example through gradual exit-from-work policies and increased provision of part-time or temporary positions for older workers. However, there must also be sufficient incentives for employers to hire and/or retain older workers. Moreover, many countries will need to embark on a sustained process of investment in human capital and research and development in order to offset the possible effects of population ageing on labour and total factor productivity.

Reducing public debt would contribute to improving fiscal sustainability and thus make public finances less vulnerable to the impact of demographic changes. In particular, lower debt levels would provide governments with additional leeway in times of increased ageing-related fiscal burdens. Likewise, lower interest payments on public debt would free up fiscal resources and give governments more flexibility to cope with any unforeseen developments. In this regard, the provisions of the Stability and Growth Pact, in particular the requirement that public finances remain close to balance or in surplus, establish incentives in the right direction for governments to prepare for ageing-related fiscal burdens.

The scale of the projected pressure on pension systems suggests that two sets of strategies need to be pursued in the area of pension reform. First, further adjustments to the structure of benefits and contributions within existing pay-as-you-go arrangements are needed (parametric reforms). These include revisions of benefit formulas and adjustments to the indexation of pension benefits. As a complement, it will be necessary for most countries to move towards greater funding of benefits and the diversification of financing arrangements (systemic reforms). Instead of through current transfers from labour income, pensions would be financed from previously accumulated capital via pension funds. Thus, policies should be put in place to facilitate the development of an infrastructure that would enable these funds to efficiently allocate retirement savings and manage the related risks, and to safeguard the non-speculative character of retirement savings.

In conclusion, population projections suggest that demographic change in the euro area will be most apparent from around 2015, although developments in individual countries are proceeding at different rates and in a number of euro area countries the total population has already begun to decline. Although many countries are starting to improve the incentive compatibility of their tax and benefit systems and the sustainability of public finances, further wide-ranging reforms are necessary in the near future. The timely implementation of comprehensive and incentive-compatible reforms is needed in order to prepare for demographic change.

2.5 FISCAL DEVELOPMENTS

BUDGET BALANCE BROADLY STABLE IN 2004

Fiscal developments in the euro area were unsatisfactory in 2004. According to the latest data available from Eurostat, the euro area deficit remained broadly stable at 2.7% of GDP (see Table 5). The budgetary outcome in 2004 reflected a slight fiscal loosening, while the impact of the economic cycle was minor. Most euro area countries failed to meet the targets set out in the updated stability programmes of end-2003 and early 2004. Targets were missed on average by 0.3 percentage point of GDP, mainly because of a failure to meet ambitious structural consolidation plans on the part of countries with substantial imbalances.

A number of countries recorded deficit ratios at or above the 3% of GDP reference value and four countries (Germany, Greece, France and the Netherlands) were in an excessive deficit situation. For the third year in a row, deficits exceeded 3% of GDP by a significant margin in Germany and France. Following significant statistical revisions, it became clear that according to the ESA 95 methodology Greece had recorded deficits above the reference value since 1997; its deficit for 2004 was 6.1% of GDP. Italy posted a deficit of 3.0% of GDP and Portugal recorded a deficit of just below 3% of GDP, despite the continued (though declining) implementation of sizeable temporary policy measures.

Table 5 Fiscal positions in the euro area

(as a percentage of GDP)

General government surplus (+) / deficit (-)

	2001	2002	2003	2004
Euro area	**-1.8**	**-2.5**	**-2.8**	**-2.7**
Belgium	0.4	0.1	0.4	0.1
Germany	-2.8	-3.7	-3.8	-3.7
Greece	-4.1	-4.1	-5.2	-6.1
Spain	-0.5	-0.3	0.3	-0.3
France	-1.6	-3.2	-4.2	-3.7
Ireland	0.9	-0.5	0.2	1.3
Italy	-3.0	-2.6	-2.9	-3.0
Luxembourg	6.2	2.3	0.5	-1.1
Netherlands	-0.1	-1.9	-3.2	-2.5
Austria	0.3	-0.2	-1.1	-1.3
Portugal	-4.4	-2.7	-2.9	-2.9
Finland	5.2	4.3	2.5	2.1

General government gross debt

	2001	2002	2003	2004
Euro area	**69.6**	**69.5**	**70.8**	**71.3**
Belgium	108.0	105.4	100.0	95.6
Germany	59.4	60.9	64.2	66.0
Greece	114.8	112.2	109.3	110.5
Spain	57.8	55.0	51.4	48.9
France	57.0	59.0	63.9	65.6
Ireland	35.8	32.6	32.0	29.9
Italy	110.7	108.0	106.3	105.8
Luxembourg	7.2	7.5	7.1	7.5
Netherlands	52.9	52.6	54.3	55.7
Austria	67.1	66.7	65.4	65.2
Portugal	55.9	58.5	60.1	61.9
Finland	43.8	42.5	45.3	45.1

Sources: Eurostat and ECB calculations.
Note: Data are based on the excessive deficit procedure definitions. Budget balances exclude proceeds from the sale of UMTS licences.

When measured by the change in the cyclically adjusted primary balance according to European Commission estimates, the budgetary outcome for the euro area as a whole reflected a slightly expansionary fiscal stance. With interest expenditure virtually unchanged, the deterioration of the primary balance was the main factor behind this outcome. GDP growth is estimated to have increased broadly in line with potential growth, and the economic environment is therefore estimated to have had very little effect on the change in the cyclical component of the budget on average. Structural consolidation was implemented in only a few cases. All three very highly indebted countries (Belgium, Greece and Italy) continued to benefit from interest expenditure savings, with a favourable effect on overall budgetary positions. This partly compensated for the worsening of the primary balances in these countries.

Fiscal developments reflect the fact that, on average in the euro area, tax cuts and the gradual phasing-out of temporary adjustment measures were insufficiently financed by savings in primary expenditure. Revenue-reducing factors included cuts in direct taxes and social security contributions as well as a fall in capital revenue due to the gradual disappearance of temporary measures. These were partly compensated for by increases in indirect taxes. On the expenditure side, there is evidence of some restraint (mainly via public consumption and social benefits) despite the partial disappearance of temporary measures. While this reflects a reversal of more lax expenditure policies in recent years, it was not sufficient to fully offset the revenue decline.

The euro area debt-to-GDP ratio increased, for the second year in a row, to 71.3% in 2004. This worsening mainly reflects the low (and falling) primary surplus ratio, the fact that economic growth was lower than the implicit average interest rate on public debt, and in some cases sizeable discrepancies between deficit and debt developments – known as deficit-debt adjustments. Among the seven countries posting debt ratios higher than 60% of GDP, only Belgium recorded a significant decline in its debt ratio, to below 100% of GDP, reflecting budget outcomes that remained close to balance. Greece and Italy continued to exhibit debt ratios above 100% of GDP, with little change since 2001. Germany, France, Austria and Portugal posted debt ratios moderately above the reference value of 60% of GDP, and in all of these countries except Austria the ratio increased by comparison with 2003. The continued deterioration of budget balances and the rising debt-to-GDP ratio is also reflected in the amount of outstanding government debt securities (see Box 8).

Box 8

DEVELOPMENTS IN GENERAL GOVERNMENT DEBT SECURITIES IN THE EURO AREA

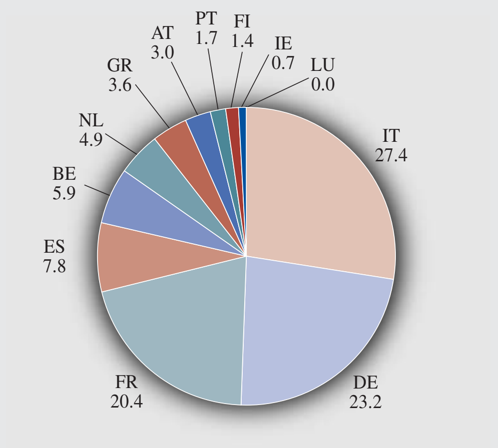
Against a background of rising general government deficits in the euro area, the level of outstanding general government debt securities has increased in recent years. This development is reflected both in the increase in the debt-to-GDP ratios and in the higher annual growth rates of debt securities issued by general government in the euro area – 5.0%, 5.5% and 5.4% at the end of 2002, 2003 and 2004 respectively (against 3.3% at the end of 2001).[1]

1 Growth rates are based on financial transactions and are corrected for reclassifications, revaluations, exchange rate variations and other changes that do not arise from transactions. For details, see the Technical note for Sections 4.3 and 4.4 of the “Euro area statistics” section in the ECB’s Monthly Bulletin.

Looking at the total amount of general government debt securities outstanding at the end of 2004, the main players in this segment of the euro area capital markets are Italy, Germany and France, with shares ranging between approximately 20% and 30% of the total market (see Chart A).

Chart A Euro area outstanding government debt securities by issuing country in 2004

(percentages; end of period)



Source: ECB.

The evolution of the structure of outstanding general government debt securities in the euro area has three key features. First, government debt is issued predominantly by central government, which accounted for 94.3% of outstanding debt securities in 2004, with other general government responsible for the remaining 5.7% (see the table below). Nevertheless, the other general government sector has become more active. The share of debt securities issued by central government has been steadily declining since 1998, while the share of debt securities issued by other general government almost doubled between 1998 and 2004.

Second, regarding the breakdown of government debt securities by maturity, long-term debt accounted for around 91.6% of outstanding debt securities at the end of 2004. The table below shows that the share of short-term debt declined between 1998 and 2000 but subsequently rose again.

Third, the table also indicates that the vast majority of long-term general government debt securities are issued at a fixed rate. Over time, the relative importance of floating-rate issues has decreased substantially, from 12.3% of the total in 1998 to 7.6% in 2004. Underlying this development is the gradual decline towards the end of the 1990s in the term premium paid by some governments on fixed-rate long-term securities in an environment of price stability. Italy,

Structure of amounts outstanding of debt securities issued by euro area governments

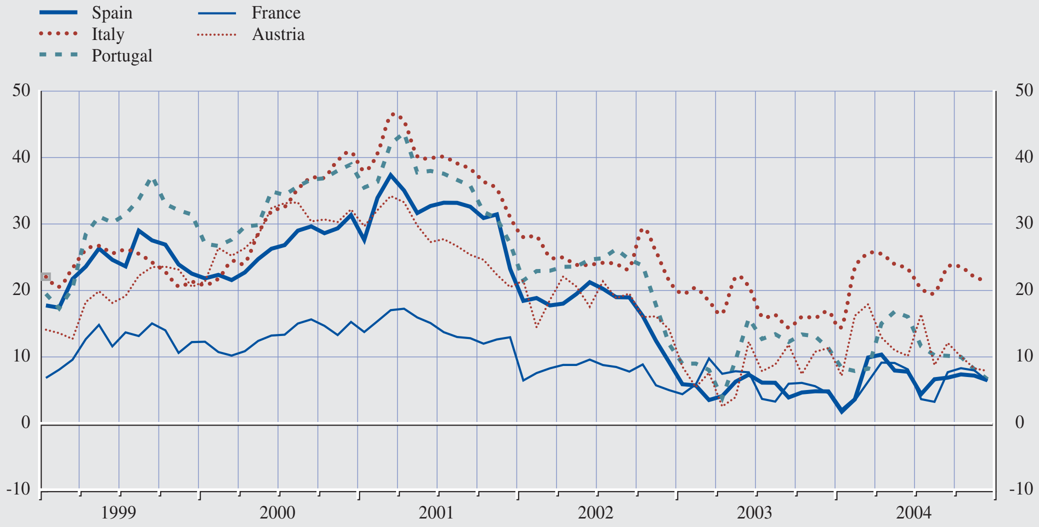
(as a percentage of total debt securities issued by general government; end of period)

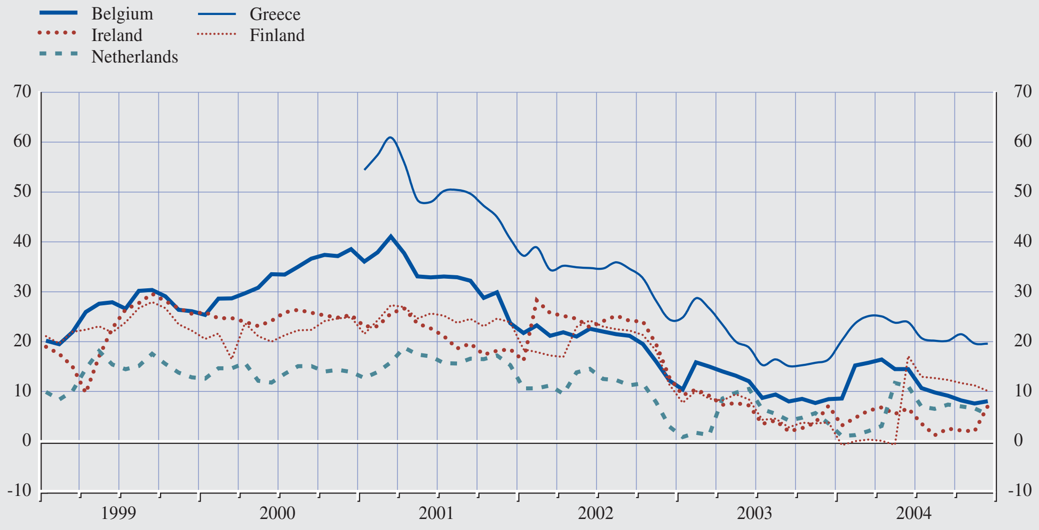
	1998	1999	2000	2001	2002	2003	2004
Central government	96.9	96.9	96.7	96.3	95.4	94.7	94.3
Long-term securities	*87.5*	*89.3*	*89.9*	*89.0*	*87.2*	*85.8*	*36.0*
Short-term securities	*9.4*	*7.6*	*6.9*	*7.2*	*8.2*	*8.9*	*8.3*
Other general government	3.1	3.1	3.3	3.7	4.6	5.3	5.7
Long-term securities	*3.0*	*3.0*	*3.2*	*3.6*	*4.5*	*5.2*	*5.6*
Short-term securities	*0.1*	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Total general government							
Long-term securities	*90.5*	*92.3*	*93.0*	*92.6*	*91.7*	*91.1*	*91.6*
fixed-rate	75.4	79.3	81.2	82.5	82.1	82.2	82.9
floating-rate	12.3	10.5	10.0	8.7	8.0	7.5	7.6
Short-term securities	*9.5*	*7.7*	*7.0*	*7.4*	*8.3*	*8.9*	*8.4*
Total general government in EUR billions	3,304.9	3,450.5	3,546.4	3,764.6	3,939.3	4,141.2	4,362.5

Source: ECB.

Chart B Long-term government bond yield spreads against Germany [1]

(basis points; monthly data)





Sources: BIS and ECB calculations.
1) Long-term government bond yields refer to ten-year bonds or to the closest available bond maturity.

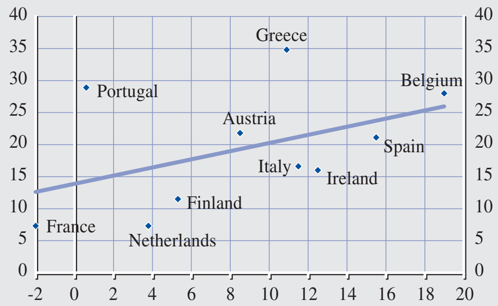
where the share of floating-rate debt securities is 20.7%, is the only country significantly above the euro area average.

The decline in risk premia has been reflected in more favourable costs of debt financing in recent years. For example, the euro area average ten-year government bond yield declined from an average of 7% in the period 1994-98 to an average of 4.7% in the period 1999-2004. As shown in Chart B, however, there are differences between government bond yields across euro area countries, which could reflect differences in liquidity and credit risk.

German long-term bond yields have been the lowest in the euro area primarily because German government bonds are relatively liquid. The financing advantage of the German government over all other euro area governments in terms of basis points was in the double-digit range until early 2001. From that time the spreads between ten-year government bond yields of other euro area countries and comparable German bond yields declined constantly, reaching a low at the end of 2003. The most significant decreases in yield spreads have been experienced in Belgium, Greece, Italy, Portugal and Spain. One of the factors underlying this convergence may have been the fiscal developments in Germany, where, between 2001 and 2004, the debt-to-GDP ratio worsened relative to that of all other euro area countries except France.

Chart C Changes in relative debt-to-GDP ratios against Germany[1] and changes in yield spreads[2] between 2001 and 2004

(x-axis: in percentage points; y-axis: in basis points)



Sources: Eurostat and ECB.
1) X-axis: decrease in the relative debt-to GDP ratio against Germany, i.e. in the difference between the debt-to-GDP ratio of Germany and that of other euro area countries, between 2001 and 2004.
2) Y-axis: decrease in yield spreads against German ten-year government bonds between January 2001 and December 2004.
Note: The chart should be read as follows, using Belgium as an example. The debt-to-GDP ratio in Belgium was 108.0% in 2001 and 95.6% in 2004, while in Germany it was 59.4% in 2001 and 66.0% in 2004. Thus, the difference between the debt-to-GDP ratio of Germany and that of Belgium – a relative debt-to-GDP ratio of Belgium against Germany – was 48.6% in 2001 and 29.6% in 2004. This difference decreased between 2001 and 2004 by 19.0 percentage points – an improvement in the relative debt-to-GDP ratio against Germany – as shown on the x-axis. Over the same period, the spread between Belgian and German government bond yields decreased by 28 basis points, as shown on the y-axis. The straight solid line represents the fitted regression line.

Available data suggests that those countries that experienced an improvement in their debt-to-GDP ratio relative to Germany between 2001 and 2004 also experienced a decrease in long-term yield spreads vis-à-vis German government bonds, as depicted by the positive relationship in Chart C. Although other factors, mainly related to the liquidity of the bonds, may also be of importance, this may be regarded as a first indication that investors to some extent take into account the fiscal positions of euro area governments when pricing bonds.

Overall, recent trends in the structure of government financing reflect the significant macroeconomic advantage which has arisen in conjunction with the move to more stability-oriented policies over the last decade. The most visible benefit for the public is the significantly lower proportion of government budgets spent on interest payments.

FISCAL PLANS FOR 2005

The latest update of the stability programmes suggests that, despite some progress, too little is planned to address the problem of budget deficits and that comprehensive structural reform agendas are still lacking. For 2005 the average deficit for the euro area as a whole is expected to decline by about half a percentage point of GDP. Both a marginal decline in interest expenditure and a moderate improvement of the primary balance should contribute to this development. Economic growth is expected to stay near potential. However, about half the euro area countries, i.e. Germany, Greece, France, Italy, the Netherlands and Portugal, are projected to continue to report deficits close to or at 3% of GDP. Only a few are projected to be in a close-to-balance or in-surplus position. The debt-to-GDP ratio is expected to decline by about half a percentage point of GDP.

CONSOLIDATION IN LINE WITH PRIOR COMMITMENTS NEEDED

Public finances face three major challenges in the euro area. First, there is a need for substantial fiscal consolidation: macroeconomic stability hinges significantly on the sustainability of public finances, which is the ability of a government to meet its outstanding obligations (see Box 9). Compliance with the EU fiscal framework and the strict application of the rules are critical because this contributes to the sustainability of public finances in EMU. In particular, the deficit limit of 3% of GDP – if credibly implemented – provides an anchor for expectations of fiscal discipline and future debt developments. It is therefore an important signal of fiscal soundness for financial markets and the public.

The fact that the euro area average deficit is near the 3% reference value and that a number of countries have deficits close to or above this value underlines the urgent need to strengthen the position of public finances. The improved economic environment offers a good opportunity to accelerate the process of fiscal consolidation. Growth dividends in the form of higher than expected tax revenues should be assigned to reducing budget imbalances. Countries with excessive deficits should correct this situation as soon as possible and fulfil their commitments. Moreover, the recurrence of excessive deficits needs to be avoided. It is also desirable that those euro area countries which do not have a budgetary position close to balance or in surplus, but are not in an excessive deficit situation either, progress with budgetary consolidation in line with the Eurogroup agreement of October 2002, according to which underlying deficit ratios should be cut by at least 0.5 percentage point of GDP per year.

Box 9

FISCAL POLICY AND MACROECONOMIC STABILITY

This box discusses the main influences of fiscal policy on macroeconomic stability and price developments, as well as the way in which the EU fiscal framework reflects these influences.

Fiscal policies can have an impact on the short-run macroeconomic environment via discretionary measures and automatic stabilisers. Discretionary measures, i.e. active changes to government revenue or expenditure, can affect economic growth and prices, via their effect on both aggregate demand and aggregate supply. Experience over the last few decades has shown, however, that discretionary fiscal fine-tuning, aimed at stabilising the economy, often proves to be pro-cyclical. Moreover, the asymmetrical use of fine-tuning measures (mainly during downturns and to a much lesser extent during upswings) has led to higher fiscal deficits over time. The free operation of automatic stabilisers, on the other hand, can help to smooth economic fluctuations, via the stabilising impact of taxes and unemployment benefits on the disposable income of households. Their automatic nature makes them timely and more predictable, while their symmetrical operation leaves the government debt level unaffected over a business cycle.

As regards medium-term fiscal effects, the setting of fiscal policies is particularly important for the sustainability of public finances and potential economic growth. Fiscal sustainability can be described as the ability of a government to meet its outstanding obligations. The ratio of government debt to GDP gives an indication of this, although other elements, such as contingent and implicit government liabilities, also need to be taken into consideration. Sustainabilty of public finances has a positive impact on the macroeconomic environment, as consumers and households do not expect major tax increases or difficulties experienced by governments in servicing their obligations. Economic confidence is thus enhanced, long-term decision-making (e.g. for private investment) is facilitated and financial conditions are more favourable. As regards potential economic growth, fiscal measures that improve the "quality" of public finances can have a beneficial effect on the economic growth rate compatible with price stability. For example, government expenditure on physical and human capital may improve the quality of production factors. Furthermore, tax rates have an impact on incentives to work, save, invest and innovate. Higher growth, in turn, supports sustainability, as existing debt is serviced by a larger economic base.

Setting fiscal policy in accordance with rules is generally preferable to an ad hoc approach. Rules can discourage an undue focus on short-term gains and a disregard for longer-term costs. Furthermore, rules can anchor expectations, thereby giving economic agents guidance on future fiscal policy in the event of shocks and thus facilitating longer-term planning in the private sector. Of course, the rules must be observed in order for these benefits to materialise. The advantages of following rules are even greater in a monetary union such as EMU, where distortions in fiscal incentives can be exacerbated. For instance, a larger deficit bias may arise as, with a single currency and more integrated financial markets, the impact of a country's higher debt level on interest rates is smaller than before. Fiscal rules in a monetary union need to be applicable in a straightforward manner, given that they need to apply to all member countries in a uniform way in order to ensure equal treatment. A transparent fiscal framework also raises awareness in the financial markets and the public at large, and can help to enforce compliance with the rules.

The medium-term, rule-based framework adopted in EMU takes into account both short-term stabilisation and long-term sustainability considerations. The reference values for the budget deficit and government debt are ways of promoting responsible fiscal behaviour. A medium-term budgetary position close to balance or in surplus contributes to short-term economic stabilisation via the free operation of automatic stabilisers, while preventing excessive deficits in the future and ensuring improvements in the sustainability of public finances by inducing lower government debt ratios.

From the perspective of a central bank whose primary objective is to maintain price stability, the focus of fiscal policy analysis is on the impact of fiscal policies on inflation and macroeconomic stability because these policies form part of the environment in which monetary policy has to operate. Sound fiscal policies facilitate monetary policy by creating an environment of stable economic conditions, in both the short and long term.

STRUCTURAL REFORMS REMAIN VITAL

A second challenge for public finances in the euro area is to integrate fiscal consolidation plans into a structural reform agenda that favours growth, competitiveness and employment. This would also help to put budgetary developments on a more sustainable footing, particularly against the background of the increasing fiscal burden related to ageing populations. Expenditure reforms are crucial in this regard, although there might also be some room for efficiency gains on the revenue side. Expenditure reforms allow fiscal consolidation, pave the way for further tax cuts and may also render tax/benefit systems more growth-friendly. Within given expenditure budgets, productive investments in infrastructure and human capital should be prioritised.

RELIABLE STATISTICS UNDERPIN THE CREDIBILITY OF THE FISCAL FRAMEWORK

Third, the integrity of government finance statistics is a precondition for the credibility of the EU fiscal framework. Large revisions of past deficit figures – as witnessed, for example, in the case of Greece in 2004 – are clearly damaging to public confidence and the credibility of the entire framework. They undermine the accurate and timely identification of imbalances and adjustment needs, which can cause serious delays in the implementation of policy measures. By adding uncertainty to fiscal monitoring, they reduce the value of multilateral surveillance procedures and, thus, weaken the effectiveness of peer pressure. It is therefore of vital importance that action be taken to ensure the reliable compilation and timely reporting of government finance statistics. All Member States should respect the European accounting rules when reporting expenditure and revenues. As stated by the ECOFIN Council on 2 June 2004, budgetary statistics must not be vulnerable to political and electoral cycles.

2.6 EXCHANGE RATES AND BALANCE OF PAYMENTS DEVELOPMENTS

EURO CONTINUED TO STRENGTHEN AMID BROAD-BASED WEAKENING OF THE US DOLLAR

In the foreign exchange markets, movements in the main bilateral euro exchange rates were relatively moderate in the first nine months of 2004, particularly if compared with the marked appreciation of the euro in the preceding two years. Thereafter, the euro appreciated strongly, particularly against the US dollar. At the end of 2004 the euro stood in effective terms moderately above its level at the beginning of the year, reflecting a significant appreciation against the US dollar, the Asian currencies pegged to the US currency and, to a smaller extent, the Japanese yen. This was partially counterbalanced by the depreciation of the euro against the currencies of some smaller trading partners of the euro area (the Swiss franc, the Norwegian krone and the Korean won) as well as the currencies of several of the new EU Member States.

In more detail, after the appreciation of the euro levelled off in January and February 2004, the euro reversed some of its earlier gains amid an improvement in the global economic outlook and shifting market perceptions about the fundamental forces affecting exchange rates. At that time, there were increasing signs that the recovery was taking hold in the United States and Japan, while the outlook for the euro area continued to be more subdued. This served to switch the market's attention from the large and persistent US current account deficit towards expectations of higher returns in the United States, thereby providing support to the US currency. Between May and mid-October 2004 the euro strengthened slightly, amid a gradually improving outlook for the euro area economy as tentative signs emerged of economic expansion spreading from the export sector to domestic demand. At the same time, market concerns about the outlook for global growth – fuelled mainly by geopolitical uncertainty and soaring oil prices – appeared to be putting some renewed downward pressure

on the US dollar and the Japanese yen. Decisions by the FOMC to raise interest rates had already been priced in by the financial markets and did not affect exchange rate developments. As of mid-October, however, the euro strengthened significantly against the US currency, as well as against several Asian currencies, given their formal or informal peg to the dollar. This occurred in the context of a broad-based weakening of the US currency in the last quarter of 2004. During this quarter the US dollar reached multi-year lows against the euro, the pound sterling and the Japanese yen.

At the end of 2004 the euro stood in nominal effective terms – as measured against the currencies of 23 important trading partners of the euro area – 2.3% above the level observed at the beginning of the year. This overall appreciation in 2004 conceals counterbalancing movements of the euro against a number of partner currencies included in the effective exchange rate index. More specifically, the euro appreciated markedly against the US dollar, as well as against the Chinese renminbi and the Hong Kong dollar, which are both linked to the US currency. On 31 December 2004 the euro stood at USD 1.36, roughly 8.2% stronger than at the beginning of the year. During the same period the euro also strengthened against the Japanese yen (by 3.7%) and was quoted by the end of the year at JPY 139.7, implying an appreciation of the Japanese yen against the US dollar by more than 4%. Against the pound sterling, the euro was at GBP 0.71 at the end of the year, unchanged compared with its level on 2 January 2004.

At the same time, the euro moderately depreciated against the Swiss franc, the Norwegian krone and, to a larger extent, the Korean won (by 6.3%). It also depreciated against the currencies of several of the new EU Member States: the Czech koruna, the Hungarian forint, the Polish zloty and the Slovak koruna (see also Section 3). The Cyprus pound also appreciated slightly, while the Latvian lats, which was partially linked to the US dollar, depreciated vis-à-vis the euro. With effect from 1 January 2005, however, the Latvian lats has been pegged to the euro at LVL 0.702804, and has since traded close to the peg rate. The Maltese lira remained relatively stable against the euro in 2004, reflecting the dominant weight of the euro in the currency basket underlying its peg.

In ERM II the Danish krone traded close to its central parity, while the currencies that entered ERM II on 28 June 2004 (the Estonian kroon, the Lithuanian litas and the Slovenian tolar) either moved in a very narrow range or were unchanged relative to their central parity against the euro.

In the first two months of 2005 the euro retreated against most major currencies, notably against the US dollar. The developments in euro exchange rates over this period were affected by signs of robust economic activity in the United States, while market concerns about the US current account deficit seem to have subsided somewhat. On 24 February 2005 the euro stood in nominal effective terms about 1.4% below its level at the beginning of the year. The depreciation reflected a weakening against the US dollar, the Chinese renminbi and, to a lesser extent, against the pound sterling, which all have a relatively large weight in the trade-weighted euro exchange rate index.

The real effective exchange rate of the euro – based on cost and price indices – also continued to rise in 2004, in line with the increase in the nominal effective exchange rate (see Chart 29). In the fourth quarter of 2004 the real effective exchange rate indices of the euro stood well above their level in the first quarter of 1999, and the measures based on consumer and producer price developments were also fairly close to the peak levels observed over the past ten years.

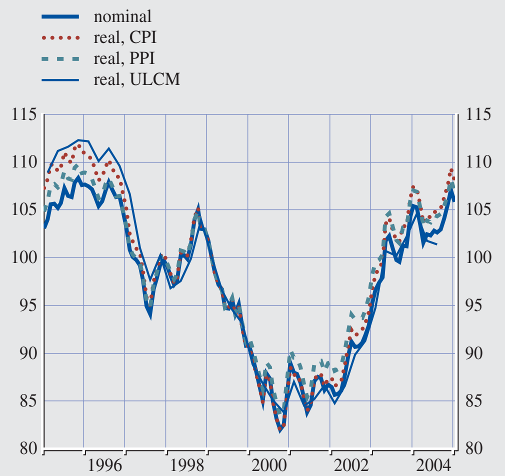
CURRENT ACCOUNT SURPLUS INCREASED SLIGHTLY IN 2004

The euro area current account surplus increased to €40.2 billion in 2004 (i.e. around 0.5% of GDP), from €22.2 billion in 2003 (0.3% of GDP). This increase was largely the result of a decline in the income and current transfers deficits combined with a marginal increase in the services surplus (see Chart 30). The goods surplus remained broadly unchanged, as exports and imports of goods increased in value terms by a similar amount.

In the course of 2004, however, the 12-month cumulated seasonally adjusted goods surplus experienced two significant movements. In the first half of the year it increased (from €106 billion in December 2003 to more than €125 billion in June 2004), owing particularly to strong exports in this period. Subsequently, though, it decreased to a level close to that seen at the end of 2003, as a result of the strong imports registered in the second and third quarters of 2004 and the deceleration of exports that took place in the second half of the year. Turning to the fall in the income deficit, this reflected mostly a significant increase in income receipts, which rose much faster than income payments. The rise in income receipts seems for the most part to have been driven by favourable developments in returns on

Chart 29 Nominal and real effective euro exchange rates [1)]

(monthly/quarterly data; index: 1999 Q1 = 100)

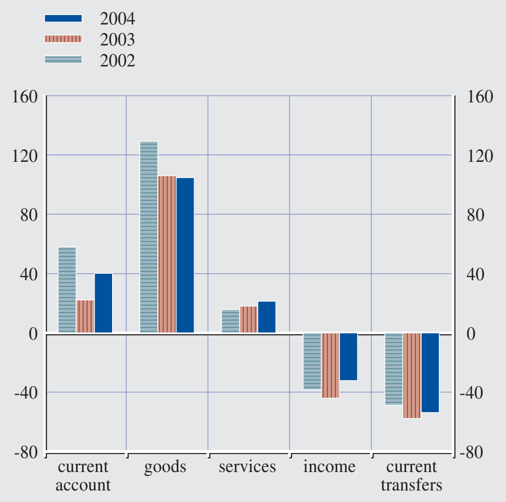


Source: ECB.

1) An upward movement of the EER indices represents an appreciation of the euro. The latest observations for monthly data are for December 2004. In the case of the ULCM-based real EER, the latest observation is for the third quarter of 2004 and is partly based on estimates.

Chart 30 Current account balance and its components

(EUR billions; seasonally-adjusted data)



Source: ECB.

investment reflecting the strong growth of the global economy, which more than offset the negative impact of the higher euro (as an appreciation of the euro reduces the euro value of income credits received in foreign currencies).

Developments in exports and imports of goods can be better understood by breaking down the values into prices and volumes on the basis of Eurostat's external trade statistics (the available statistics cover the period up to October 2004). Such a breakdown shows that the strong rise in export values that took place in the first half of the year was mostly accounted for by robust growth in export volumes, while export prices remained subdued. It seems, therefore, that the negative effect of the appreciation of the euro on euro area export volumes was more than compensated for by the strong growth of foreign demand during the first half of 2004. In terms of geographical destination, the volume of exports to Asia and the new EU Member States grew particularly rapidly over this period. Although export prices experienced some upward pressure from rising costs owing to higher oil prices, this may have been partly counterbalanced by some reductions in profit margins as exporters attempted to partly offset the loss in price competitiveness resulting from the appreciation of the euro. The deceleration of euro area exports in the second half of the year seems to stem mostly from weaker exports to Asia and the new EU Member States, although exports to the United States also slowed substantially. As regards the increase in the value of imports of goods that took place in the second and third quarters of 2004, this reflected rises in both prices and volumes. Most of the rise in import prices was a result of the higher price of oil. Part of the increase in import volumes can be attributed to the recovery in euro area domestic demand, particularly the high import-intensity categories of expenditure.

NET INFLOWS IN COMBINED DIRECT AND PORTFOLIO INVESTMENT IN 2004

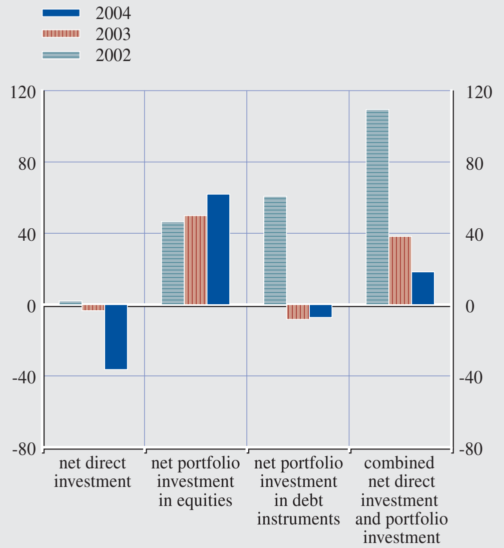
In the financial account, combined direct and portfolio investment experienced net inflows of €18.3 billion in 2004, compared with net inflows of €38.3 billion in 2003. This lower level of net financial flows into the euro area was mainly a result of increased net outflows in direct investment (see Chart 31).

Developments in direct investment can be primarily accounted for by the gradual decline in foreign direct investment inflows into the euro area, basically due to direct investment in euro area equity capital by non-residents being one-third of that recorded a year earlier. This decline was larger than the decline in euro area direct investment abroad in the form of equity capital and may partly reflect a stronger growth outlook for the global economy in 2004 relative to the euro area.

The rise in net inflows in portfolio investment emanated mainly from an increase in net purchases of euro area equity securities by non-residents. Market survey data indicated a

Chart 31 Financial account balance and its components

(EUR billions)



Source: ECB.

renewed interest in euro area equity securities among foreign investors. The fact that euro area equities were seen, in relative terms, as being attractively priced, together with expectations of an appreciation of the euro in the course of 2004, also contributed to this development.

Turning to debt instruments, cross-border flows were of a similar magnitude in 2003 and 2004, amounting to roughly €200 billion on both the asset and the liability sides. On the liability side, the low level of euro area short-term interest rates did not encourage foreign investment in euro area money market instruments, with non-residents investing almost exclusively in euro area bonds and notes in 2004. On the asset side, euro area investors allocated about 75% of their international portfolio of debt instruments to bonds and notes and 25% to money market instruments. Compared with 2003, this allocation amounted to a smaller weight being given by euro area residents to international bonds and notes in 2004. This may have been linked to anticipation of possible capital losses as a result of expected higher long-term interest rates in the United States. Indeed, euro area debt flows to the United States declined from €75 billion in 2003 to €29 billion in the first three quarters of 2004.

Based on cumulated flows over the first three quarters of 2004, the euro area recorded net outflows in foreign direct investment vis-à-vis most of its main partner countries, apart from the United States and Switzerland. The United Kingdom and the United States were both the main recipients of euro area direct investment and the main investors in the euro area.

The geographical breakdown of portfolio investment shows that euro area portfolio investment abroad in the first three quarters of 2004 was directed primarily towards the United Kingdom and the United States, which are traditionally the main recipients of that category of investment. Euro area investors were also large net purchasers of Japanese equity securities. The improvement of the economic outlook in Japan, particularly at the beginning of 2004, appears to have influenced the portfolio investment decisions of euro area investors.

3 ECONOMIC AND MONETARY DEVELOPMENTS IN NON-EURO AREA EU MEMBER STATES

ECONOMIC ACTIVITY

Real GDP growth in the non-euro area EU Member States was relatively strong in 2004 and generally exceeded the euro area average (see Table 6). Output growth was highest in the Baltic States and Poland, the countries with the lowest level of GDP per capita in the EU. At the other end of the scale, it was lowest in Denmark and Malta, although real GDP growth started to recover in these countries from the subdued rates that prevailed in 2003.

Domestic demand was the main contributor to real GDP growth in 2004 in many non-euro area EU Member States. In particular, gross fixed capital formation was the key driver of output growth. Growing industrial confidence, a high degree of capital utilisation and an improved demand outlook contributed to the recovery in investment in many of the new Member States, Denmark and Sweden. In many of the new Member States, particularly in the Baltic States, the robustness of domestic demand also reflected the significant growth in private consumption, which was supported by gains in real disposable income associated with vigorous wage increases and improvements in the labour market. In the United Kingdom, private consumption growth was sustained by the strong performance of the labour market and growth in housing wealth. In a number of non-euro area EU Member States, especially in the Baltic States and Hungary, household spending was also backed by high and, in some cases, increasing credit growth to the private sector. In addition, in most of the new Member States, price rise expectations stemming from changes in taxation and regulated prices related to EU accession stimulated consumption spending in the first half of 2004. Finally, in some countries, the fiscal stance remained relatively loose.

Turning to external demand, the contribution of net exports to real GDP growth varied significantly across the non-euro area EU Member States. While external demand significantly supported output growth in Poland and Sweden, it acted as a drag on growth in most of the new Member States and the United Kingdom. Despite this, it is important to note that export and import growth remained relatively strong in 2004, especially in the new Member States. In particular, goods and services trade volumes were spurred by the removal of barriers to trade on EU accession,

Table 6 Real GDP growth in the non-euro area EU Member States and the euro area

(annual percentage changes)

	2000	2001	2002	2003	2004	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Czech Republic	3.9	2.6	1.5	3.7	4.0	3.8	3.9	4.2	4.2
Denmark	2.8	1.6	1.0	0.4	2.0	1.7	2.5	1.8	2.2
Estonia	7.8	6.4	7.2	5.1	.	6.8	5.9	6.1	.
Cyprus	5.0	4.1	2.1	2.0	3.7	3.7	4.1	4.0	3.1
Latvia	6.9	8.0	6.4	7.5	8.5	8.7	7.7	9.1	8.6
Lithuania	3.9	6.4	6.8	9.7	6.7	7.1	7.3	5.8	6.7
Hungary	5.2	3.8	3.5	3.0	4.0	4.3	4.2	3.7	3.8
Malta	6.4	-1.7	2.2	-1.8	1.5	2.3	-0.5	1.9	2.3
Poland	4.0	1.0	1.4	3.8	5.3	6.9	6.1	4.8	3.9
Slovenia	3.9	2.7	3.3	2.5	4.6	4.1	4.9	5.0	4.3
Slovakia	2.0	3.8	4.6	4.5	5.5	5.4	5.5	5.3	5.8
Sweden	4.3	1.0	2.0	1.5	3.5	3.4	4.0	3.7	2.8
United Kingdom	3.9	2.3	1.8	2.2	3.1	2.8	3.5	3.1	2.9
EU10 [1]	4.2	2.7	2.6	3.9	4.8	5.4	5.1	4.6	4.3
EU13 [2]	3.9	2.2	1.9	2.3	3.3	3.2	3.7	3.3	3.0
Euro area	3.5	1.6	0.9	0.5	2.0	2.0	2.5	1.7	1.8

Source: Eurostat.
Note: Quarterly figures are seasonally adjusted for the Czech Republic and seasonally and working day-adjusted for the United Kingdom.
1) The EU10 aggregate comprises the 10 new EU Member States.
2) The EU13 aggregate comprises the 13 non-euro area EU Member States.

by higher demand in trading partner countries and by further gains in productivity.

As a result of the recovery in economic activity, sizeable foreign direct investment inflows received in the last few years and ongoing structural reform, the labour market situation gradually improved in most non-euro area EU Member States throughout 2004, particularly in the Baltic States. Employment growth, however, tended to be rather subdued in most of the new Member States, due to earlier increases in wage costs in some countries and a structural skill mismatch between labour supply and demand. In several countries, especially Poland and Slovakia, unemployment rates remained very high. In the United Kingdom the labour market was tighter.

PRICE DEVELOPMENTS

Price dynamics in the non-euro area EU Member States were very mixed across countries in 2004. Denmark, Lithuania, Sweden and the United Kingdom recorded the lowest annual HICP inflation rates at around 1%, thus well below the euro area average. In most of the new Member States, inflation was above the euro area average. In Latvia, Hungary and Slovakia, annual HICP inflation rates were almost three times higher than the euro area average.

Most of the new Member States recorded higher HICP inflation rates in 2004 compared with 2003 (see Table 7). The strongest increase in inflation was observed in the Czech Republic, Latvia, Lithuania, Hungary and Poland. In some non-euro area EU Member States, however, average inflation rates declined in 2004. The strongest declines were recorded in Cyprus and Slovenia. Moreover, the inflation pattern during 2004 varied across countries. In a number of countries, inflation picked up considerably in the first half of 2004 before either stabilising at a higher level or gradually declining in the second half of the year. In a few other Member States, however, HICP inflation rates remained broadly stable for the whole year.

Inflation developments in the non-euro area EU Member States were partly driven by some common factors, in particular the strong increase in oil prices in 2004. However, the precise impact of this factor on inflation varied across countries, largely reflecting differences

Table 7 HICP inflation in the non-euro area EU Member States and the euro area

(annual percentage changes)

	2000	2001	2002	2003	2004	2004 Q1	2004 Q2	2004 Q3	2004 Q4
Czech Republic	3.9	4.5	1.4	-0.1	2.6	2.0	2.5	3.0	2.7
Denmark	2.7	2.3	2.4	2.0	0.9	0.7	0.8	1.0	1.2
Estonia	3.9	5.6	3.6	1.4	3.0	0.6	3.2	3.9	4.4
Cyprus	4.9	2.0	2.8	4.0	1.9	1.0	1.2	2.5	2.8
Latvia	2.6	2.5	2.0	2.9	6.2	4.3	5.8	7.4	7.2
Lithuania	0.9	1.3	0.4	-1.1	1.1	-1.1	0.5	2.3	3.0
Hungary	10.0	9.1	5.2	4.7	6.8	6.8	7.4	7.0	5.9
Malta	3.0	2.5	2.6	1.9	2.7	2.5	3.3	3.0	2.2
Poland	10.1	5.3	1.9	0.7	3.6	1.8	3.4	4.7	4.5
Slovenia	8.9	8.6	7.5	5.7	3.6	3.7	3.8	3.6	3.5
Slovakia	12.2	7.2	3.5	8.5	7.4	8.2	8.0	7.2	6.0
Sweden	1.3	2.7	2.0	2.3	1.0	0.6	1.2	1.2	1.1
United Kingdom	0.8	1.2	1.3	1.4	1.3	1.3	1.4	1.2	1.4
EU10 1)	8.4	5.7	2.6	1.9	4.0	2.9	4.0	4.8	4.4
EU13 2)	3.2	2.7	1.8	1.6	2.1	1.7	2.2	2.3	2.3
Euro area	2.1	2.4	2.3	2.1	2.1	1.7	2.3	2.3	2.3

Source: Eurostat.
1) The EU10 aggregate comprises the 10 new EU Member States.
2) The EU13 aggregate comprises the 13 non-euro area EU Member States.

in consumption patterns, market structures and energy intensity of production. Moreover, in some countries the pass-through of higher oil prices into inflation might not have fully materialised yet in 2004. Some inflationary pressures also emerged from strong real GDP growth in most countries. Consequently, wage pressures have also started to rise in a number of countries.

In the new Member States, EU accession also caused some inflationary pressures. Food prices increased in most new Member States in the first half of the year as these countries were integrated into the Common Agricultural Policy and as remaining sectoral trade barriers were removed. Given the relatively large share of food prices in their HICP consumer baskets, this had a noticeable impact on HICP inflation in most of the new Member States. Moreover, indirect taxes and excise duties were increased in a number of the new Member States to bring them more into line with those prevailing in the EU. The prospect of tax-induced price increases following EU accession led to higher demand in early 2004, thereby also causing higher inflation. In the second half of 2004, however, the impact gradually started to reverse in a number of countries. Furthermore, in some new Member States, administered prices have been substantially raised with a view to completing the adjustment of some state-owned enterprises to producing at cost-recovery levels.

Nominal effective exchange rate developments and their lagged pass-through to import prices also influenced inflation developments in 2004. In a number of countries, in particular the Czech Republic, Hungary and Slovakia, effective exchange rate developments had a dampening impact on inflation, while in others, such as Latvia, the impact contributed to inflation pressures. In Poland the lagged impact of exchange rate developments contributed in the first half of 2004 to an increase in HICP inflation, but their impact reversed in the second half of the year.

FISCAL POLICIES

Three non-euro area EU Member States (Estonia, Denmark and Sweden) recorded a fiscal surplus and ten countries recorded fiscal deficits in 2004. As set out in ECOFIN Council decisions on 5 July 2004, six countries (the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) were found to be in an excessive deficit situation. In all cases but Cyprus, the Council decisions allow for the correction of these excessive deficits in a medium-term framework given the existence of special circumstances, because (i) the general government deficit upon EU accession was significantly above the reference value and (ii) for the Czech Republic, Hungary, Poland and Slovakia, the structural shift to a modern service-oriented market economy accompanying the process of real convergence was still ongoing. The United Kingdom, recorded a deficit ratio above the 3% reference value in both 2003 and 2004. The large number of countries still in an excessive deficit situation points to a continued need for a stronger political commitment to carrying out structural reforms and fiscal consolidation.

General government budget balances improved in ten of the 13 non-euro area EU Member States in 2004, while they deteriorated in the remaining three countries (see Table 8). The

Table 8 Fiscal positions in the non-euro area EU Member States and the euro area

(as a percentage of GDP)

	General government surplus (+) / deficit (-)				General government gross debt			
	2001	2002	2003	2004	2001	2002	2003	2004
Czech Republic	-6.2	-6.8	-11.7	-3.0	27.2	30.7	38.3	37.4
Denmark	2.9	1.7	1.2	2.8	47.8	47.2	44.7	42.7
Estonia	0.3	1.4	2.9	1.8	4.4	5.3	5.3	4.9
Cyprus	-2.3	-4.5	-6.3	-4.5	61.9	65.2	69.8	71.9
Latvia	-2.1	-2.9	-1.5	-0.8	14.9	14.1	14.4	14.4
Lithuania	-2.0	-1.5	-1.9	-2.5	22.9	22.4	21.4	19.7
Hungary	-3.7	-8.5	-6.2	-4.7	52.2	55.5	56.9	57.6
Malta	-6.4	-5.9	-10.5	-5.2	62.4	62.7	71.8	75.0
Poland	-3.9	-3.6	-4.5	-4.8	36.7	41.2	45.4	43.6
Slovenia	-3.3	-2.4	-2.0	-1.9	28.1	29.5	29.4	29.4
Slovakia	-6.0	-6.0	-3.7	-3.3	48.7	43.3	42.6	43.6
Sweden	2.5	-0.3	0.2	1.4	54.3	52.4	52.0	51.2
United Kingdom [1]	0.7	-1.7	-3.4	-3.2	38.8	38.3	39.7	41.6
EU10 [2]	-4.2	-4.9	-5.7	-3.9	37.3	40.1	43.5	42.7
EU13 [3]	0.2	-1.9	-3.1	-2.4	40.9	40.9	42.1	42.9
Euro area	-1.8	-2.5	-2.8	-2.7	69.6	69.5	70.8	71.3

Sources: Eurostat and ECB calculations.
Note: Data are based on the excessive deficit procedure definitions. Budget balances exclude proceeds from the sale of UMTS licences.
1) Calendar year estimates.
2) The EU10 aggregate comprises the 10 new EU Member States.
3) The EU13 aggregate comprises the 13 non-euro area EU Member States.

improvement can be explained mainly by temporary factors, as well as by the positive effect of the economic cycle. In the Czech Republic and Malta, the countries recording the largest improvement in their fiscal balance, temporary factors had sizeable deficit-increasing effects in 2003.

In 2004 the debt ratios in most non-euro area EU Member States remained well below the average ratio in the euro area. The ratios declined in six of the 13 non-euro area Member States in line with their improved government budget balances. In the other countries, the increase in the debt ratios reflected mainly the low primary surplus ratios and debt-increasing deficit-debt adjustments, i.e. variations in public debt that cannot be explained by the deficit/surplus. Only Cyprus and Malta continued to record debt ratios above the 60% of GDP reference value.

In most countries, budgetary outcomes in 2004 were either broadly in line with or better than the targets of the convergence programmes submitted in May 2004. In several countries revenue collection was more favourable than anticipated. Expenditure execution was generally close to the pre-set spending paths. Hungary showed signs of significant slippage relative to the May 2004 convergence programme targets. Furthermore, some governments (for example, in Estonia and Lithuania) utilised part of their excess revenues in 2004 to finance additional expenditure rather than improve their budget balances.

BALANCE OF PAYMENTS DEVELOPMENTS

As regards external balances, Sweden and Denmark continued to report sizeable surpluses on current account in 2004, while the United Kingdom and most new Member States recorded current account deficits, which in some countries were large (see Table 9). The only exception was Slovenia, which has a history of broadly balanced current account positions. Particularly large current account deficits – close to or above 10% of GDP – were observed in the Baltic States and Hungary, while Slovakia and Poland showed more moderate current account deficits, which contracted in the past two years compared with the previous two years.

Table 9 Balance of payments of the non-euro area EU Member States and the euro area

(as a percentage of GDP)

	Current account plus capital account balance				Net foreign direct investment flows			
	2001	2002	2003	2004 [1]	2001	2002	2003	2004 [1]
Czech Republic	-5.4	-5.7	-6.2	-6.1	9.0	11.2	2.6	2.4
Denmark	3.1	2.1	3.3	2.8	-1.9	1.0	0.1	-0.6
Estonia	-5.6	-9.9	-12.7	-13.3	5.7	2.2	8.3	4.5
Cyprus	-3.3	-4.5	-3.3	-4.8	7.3	5.7	3.7	4.6
Latvia	-7.2	-6.5	-7.6	-11.0	1.4	2.7	2.4	3.5
Lithuania	-4.7	-4.8	-6.5	-8.7	3.6	5.0	0.8	3.2
Hungary	-5.6	-6.9	-9.0	-8.8	6.9	4.2	0.8	3.3
Malta	-4.2	0.5	-5.6	-6.6	6.2	-10.3	5.7	7.3
Poland	-2.8	-2.6	-2.2	-1.6	3.1	2.0	1.9	1.4
Slovenia	0.2	0.7	-1.0	-0.9	1.1	6.8	-0.5	-0.4
Slovakia	-8.0	-7.6	-0.5	-2.6	7.4	16.5	2.2	3.3
Sweden	4.3	5.3	6.4	7.8	2.5	0.4	-4.7	-1.7
United Kingdom	-2.2	-1.7	-1.6	-2.0	-0.3	-0.5	-2.5	0.4
Euro area	-0.1	1.0	0.5	0.8	-1.7	0.0	0.0	-0.5

Source: ECB.
1) Figures for 2004 are a four-quarter moving average for the period from the fourth quarter of 2003 to the third quarter of 2004, except for Cyprus, for which the average is for the period from the third quarter of 2003 to the second quarter of 2004.

In many of the new Member States the rise in the current account deficit in 2004 was associated with strong import growth owing to robust domestic demand and high oil prices. Other structural and temporary factors have also affected the current account position. On the structural side, current account deficits are a normal characteristic of catching-up economies such as the new Member States. Whereas these deficits could signal problems regarding the sustainability of external positions, the current account deficits in many new Member States were to some extent linked to a rise in the income deficit reflecting earnings related to past foreign direct investment inflows. As a transitory factor, current account balances may have been affected by the EU accession process itself as, for instance, companies increased their stocks in anticipation of higher tariffs.

Looking at the financing side of the balance of payments, net foreign direct investment inflows recovered somewhat in most new EU Member States in 2004, having slowed the year before (see Table 9). Among these countries, only Slovenia recorded moderate outflows in net foreign direct investment in 2004. As to the other non-euro area EU Member States, Denmark and Sweden witnessed net outflows of foreign direct investment in the same period, while in the United Kingdom, net foreign direct investment turned positive after registering modest outflows in previous years. Overall, net foreign direct investment inflows constituted an important source of financing in recent years for a number of the non-euro area Member States, although in most cases these inflows were not sufficient to cover the current account deficit. Net inflows in portfolio investment and in "other investment" provided additional financing. As a result the external indebtedness of some countries also rose.

ERM II AND EXCHANGE RATE-RELATED ISSUES

On 28 June 2004 Estonia, Lithuania and Slovenia joined Denmark as participants in ERM II. They entered the mechanism with a standard fluctuation band of ±15% around their central rates against the euro, while Estonia and Lithuania kept their currency boards as a unilateral commitment. To ensure their smooth participation in ERM II, the countries have firmly committed to taking the necessary measures to preserve macroeconomic and exchange rate stability. Box 10 provides an overview of the characteristics of ERM II.

Participation in ERM II has not been associated with tensions in the foreign exchange markets

Box 10

MAIN ELEMENTS OF THE EXCHANGE RATE MECHANISM II

With the introduction of the euro on 1 January 1999, the exchange rate mechanism II (ERM II) replaced the European Monetary System (and its exchange rate mechanism component) which had been in operation since 1979. ERM II is a multilateral arrangement of fixed but adjustable exchange rates, with bilateral central rates between the euro and participating currencies, and a standard fluctuation band of ±15% around those central rates.

Participation in ERM II for at least two years without severe tensions prior to the examination of economic convergence is a requirement for fulfilling the exchange rate criterion of the Maastricht convergence criteria that must be met in order to adopt the euro. The economic rationale behind this requirement is that it helps Member States outside the euro area to orient their policies towards stability and enhances the prospects of achieving a lasting convergence of economic fundamentals.

This reflects the notion that economic conditions and policies of participating Member States should be consistent with the preservation of the central rates set. The overall goal of this process is to foster macroeconomic stability in the new EU Member States, thereby providing the best possible contribution to sustainable growth and real convergence. Moreover, sound macroeconomic policies and stable exchange rates are supportive of a smooth functioning of the internal market.

According to the Governing Council, the mechanism, as well as the policy orientation required for participation, is designed to help Member States outside the euro area in their efforts to adopt the euro, while dealing with the complex relationship between economic fundamentals and exchange rate stability.[1]

The mechanism foresees a range of policy instruments that may be combined to address market pressures: interest rate measures, flexibility of the exchange rate within the band, interventions, and possible realignments of the central rate.

From an operational perspective, decisions concerning central rates and the standard fluctuation band are taken by mutual agreement of the ministers of the individual euro area countries, the ECB and the ministers and central bank governors of the non-euro area EU Member States participating in the mechanism. The General Council is responsible for monitoring the functioning of ERM II and serves as the forum for monetary and exchange rate cooperation. It closely monitors, on a permanent basis, the sustainability of the bilateral exchange rate between each participating currency and the euro.

1 See also "Policy position of the Governing Council of the European Central Bank on exchange rate issues relating to the acceding countries", 18 December 2003.

Table 10 Developments in ERM II

(in percentage points)

	DKK	EEK	LTL	SIT
Maximum deviation from ERM II central rate [1]				
(ten-day moving average of daily data at business frequency)				
Upward	+0.5	0.0	0.0	0.0
Downward	0.0	0.0	0.0	-0.2
Short-term interest rate differential				
(monthly data, average)				
Fourth quarter of 2004	0.0	0.3	0.5	1.9

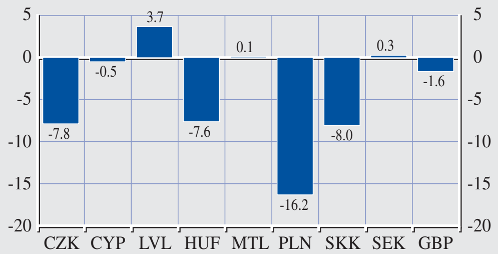
1) For Estonia, Lithuania and Slovenia the reference period is from 28 June 2004 to 24 February 2005. For Denmark the reference period is from 1 November 2002 to 24 February 2005.

of any of the participating countries. The four currencies in ERM II have traded continuously at or close to their central rates, while short-term interest rate differentials vis-à-vis the euro area have been small in most countries (see Table 10). In the context of ERM II entry, Banka Slovenije smoothly discontinued the gradual trend depreciation of the Slovenian tolar against the euro.

Most of the currencies of the non-euro area EU Member States experienced a strengthening against the euro in 2004 and also a marked appreciation on a trade-weighted basis. The weakening of the euro was particularly pronounced against the currencies of several of the larger new EU Member States, amid a relatively favourable growth outlook for these countries (see Chart 32). The Polish zloty experienced the largest appreciation against the euro in 2004, followed by the Czech koruna, the Slovak koruna and the Hungarian forint. By contrast, the Latvian lats, which in 2004 was partially linked through its exchange rate regime to the US dollar, depreciated against the euro. Since the beginning of 2005 Latvia has changed the peg of the lats from the special drawing right (SDR) currency basket to the euro, at LVL 0.702804 per euro. Since the re-pegging, the lats has fluctuated within a narrow band around its peg rate. The Swedish krona, the Maltese lira and the Cyprus pound were relatively stable against the euro. The pound sterling appreciated somewhat against the euro in early 2004 amid a favourable outlook for the UK economy and rising interest rates. In the second half of the year, however, it depreciated vis-à-vis the euro.

Chart 32 Exchange rate changes of the euro against EU currencies outside ERM II

(in percentages)



Source: ECB.
Note: A positive (negative) value represents an appreciation (depreciation) of the euro. Changes refer to the period from 2 January 2004 to 24 February 2005.

MONETARY POLICY

The primary objective for monetary policy in all non-euro area EU Member States is price stability. Monetary policy strategies differ to a great extent from country to country, reflecting the heterogeneity among them in nominal, real and structural terms (see Table 11). During 2004 the monetary policy and exchange rate regimes in the non-euro area EU Member States remained largely unchanged, although some refinements were made to the monetary policy frameworks of several countries with a view to gearing monetary policy more towards future monetary integration. In particular, Estonia, Lithuania and Slovenia joined ERM II on 28 June 2004. Moreover, in Latvia, Latvijas

Banka re-pegged the lats from the SDR to the euro on 1 January 2005.

Regarding monetary policy decisions in 2004 in countries with an exchange rate objective, the Central Bank of Cyprus increased its policy interest rate by 100 basis points to 5.5%, thus sending a signal of support for the Cyprus pound against the background of rumours of devaluation. Moreover, a minimum reserve

Table 11 Official monetary policy strategies of the non-euro area EU Member States

	Monetary policy strategy	Currency	Features
Czech Republic	Inflation target	Czech koruna	Inflation target: 2-4% by end-2005, thereafter 3% ±1 percentage point (p.p). Exchange rate strategy: (managed) float.
Denmark	Exchange rate target	Danish krone	Participates in ERM II with a ±2.25% fluctuation band around central rate of DKK 7.46038 per euro.
Estonia	Exchange rate target	Estonian kroon	Participates in ERM II with a ±15% fluctuation band around central rate of EEK 15.6466 per euro. Estonia continues with its currency board arrangement as a unilateral commitment.
Cyprus	Exchange rate target	Cyprus pound	Peg to the euro at CYP 0.5853 per euro, with ±15% fluctuation bands. The Cyprus pound has de facto fluctuated within a narrow range.
Latvia	Exchange rate target	Latvian lats	From February 1994 peg to the SDR (euro weight 36.4%) with a ±1% fluctuation band. Since 1 January 2005 peg to the euro at LVL 0.702804 per euro with a ±1% fluctuation band.
Lithuania	Exchange rate target	Lithuanian litas	Participates in ERM II with a ±15% fluctuation band around central rate of LTL 3.4528 per euro. Lithuania continues with its currency board arrangement as a unilateral commitment.
Hungary	Inflation target with an exchange rate constraint	Hungarian forint	Exchange rate target: peg to the euro at HUF 282.36 per euro, with ±15% fluctuation band. Inflation target: 3.5% (±1 p.p.) by end-2004, 4% (±1 p.p.) by end-2005 and 3.5% (±1 p.p.) by end-2006.
Malta	Exchange rate target	Maltese lira	Peg to a currency basket comprising the euro (70%), pound sterling (20%) and US dollar (10%). No fluctuation margin but a trading margin of ±0.25% for foreign exchange market operations.
Poland	Inflation target	Polish zloty	Inflation target: 2.5% ±1 p.p. (year-on-year change in CPI) as from 2004. Free floating exchange rate.
Slovenia	Two-pillar strategy monitoring monetary, real, external and financial indicators of macroeconomic conditions	Slovenian tolar	Participates in ERM II with a ±15% fluctuation band around central rate of SIT 239.640 per euro.
Slovakia	Combined inflation targeting and managed float [1]	Slovak koruna	Inflation objective: short-term inflation target set at 3.5% (±0.5 p.p.) at end-2005. The inflation target for the period 2006-2008 is set below 2.5% for end-2006 and below 2% at end-2007 and thereafter. Exchange rate strategy: managed float.
Sweden	Inflation target	Swedish krona	Inflation target: 2% increase in the CPI with a tolerance margin of ±1 p.p. Free floating exchange rate.
United Kingdom	Inflation target	Pound sterling	Inflation target: 2% as measured by the 12-month increase in the CPI [2]. In the event of a deviation of more than 1 p.p., the Governor of the Bank of England is expected to write an open letter to the Chancellor of the Exchequer. Free floating exchange rate.

Source: ESCB.
1) Národná banka Slovenska's official wording is "inflation targeting in the conditions of ERM II".
2) The CPI is identical to the HICP.

requirement of 2% for deposits in foreign currency was introduced. In Latvia the central bank increased its key policy rate by 100 basis points to 4%. To contain risks stemming from high economic growth, strong credit growth and a widening current account deficit, it also decided to increase minimum reserve requirements from 3% to 4% and to expand the base for minimum reserves by including bank liabilities to foreign banks and foreign central banks with an agreed maturity or redeemable at a period of notice of up to two years. In Malta the official interest rate remained unchanged at 3% throughout 2004.

Turning to the non-euro area EU Member States with an inflation targeting framework in place, the Czech Republic and Poland increased interest rates in 2004 with a view to containing inflationary pressures and limiting possible second-round effects of higher inflation rates. In the Czech Republic the key policy rate was increased by 50 basis points to 2.5% – although it was lowered to 2.25% in January 2005 – and in Poland the key rate was raised by 125 basis points to 6.5%. In the United Kingdom, the repo rate was raised by 100 basis points to 4.75%, mainly due to a worsened outlook for CPI inflation. In contrast, Hungary, which follows an inflation target combined with an exchange rate constraint, reduced interest rates by a total of 300 basis points to 9.5% in 2004, and further to 8.25% in February 2005. The gradual interest rate cuts throughout 2004 reversed the one-off 300 basis point increase that had taken place in November 2003 after a sudden deterioration of investor confidence. The reversal was made possible by the easing of short-term risk perceptions, an improvement in the inflation outlook and relatively subdued developments in private sector wage growth. In Slovakia appreciation pressures on the koruna were the main motivation for a reduction in the key interest rate by a total of 200 basis points to 4%. In Sweden limited inflationary pressure supported the reduction of interest rates by 75 basis points to 2%.

FINANCIAL DEVELOPMENTS

In 2004 long-term bond yield developments were mixed in non-euro area EU Member States. Long-term interest rates, as measured by the ten-year benchmark government bond yield, increased in Cyprus, the Czech Republic and Poland, but towards the end of 2004 started to decline again. As a result, bond yield spreads vis-à-vis the euro area increased in these countries. In Hungary long-term bond yields were relatively volatile, with a downward trend in the second half of 2004, while in Latvia, Lithuania, Slovenia and Slovakia, long-term interest rates continued to decline in the course of 2004, narrowing the spread vis-à-vis the euro area, in particular in the countries participating in ERM II. In Malta long-term interest rates were stable, while in Denmark, Sweden and the United Kingdom they moved in parallel with the rates in the euro area as indicated by stable bond yield spreads.[5]

Stock markets in the non-euro area EU Member States continued to perform favourably in 2004, with some of the stock market indices, especially those of most of the new Member States, reaching all-time highs and recording annual increases in a range between 20% and 80%. Stock markets in all the new Member States, with the exception of Cyprus, significantly outperformed euro area stock prices, as measured by the Dow Jones EURO STOXX index. Stock markets in Denmark, Sweden and the United Kingdom continued to follow broadly the development of the Dow Jones EURO STOXX index, with the first two countries slightly outperforming and the last one slightly underperforming the euro area benchmark.

5 Estonia does not have a developed market for long-term bonds denominated in domestic currency. A proxy indicator for long-term interest rates in Estonia, developed jointly by the European Commission, the ECB and Eesti Pank and based on a weighted average of interest rates for new business loans denominated in domestic currency with maturities of over five years, shows a downward trend during 2004.

Artist
Isa Dahl
Title
“eben still”, 2004
Material
Oil on canvas
Format
ø 190 cm

CHAPTER 2

CENTRAL BANK OPERATIONS AND ACTIVITIES

1 MONETARY POLICY OPERATIONS, FOREIGN EXCHANGE OPERATIONS AND INVESTMENT ACTIVITIES

1.1 MONETARY POLICY OPERATIONS

The key operational task of the Eurosystem is the implementation of monetary policy. The operational framework which the Eurosystem has set up for this purpose consists of three categories of instruments: open market operations, standing facilities and the minimum reserve system. All credit operations carried out by the Eurosystem have to be covered by adequate collateral provided by counterparties.[1] The Eurosystem took major steps in 2004 towards the establishment of a single list of collateral.

INITIAL EXPERIENCE WITH THE NEW FRAMEWORK FOR MONETARY POLICY IMPLEMENTATION

The operational framework continued to work well in 2004, delivering stable short-term money market rates and clearly signalling the monetary policy stance. In order to further improve the implementation of monetary policy, two important changes to the framework were introduced on 9 March 2004.

- The timing of the reserve maintenance periods was adjusted so that these periods always start on the settlement day of the main refinancing operation (MRO) following the Governing Council meeting at which the monthly decision on the monetary policy stance is scheduled. Previously, reserve maintenance periods started on the 24th calendar day of one month and ended on the 23rd calendar day of the subsequent month, irrespective of the Governing Council's meeting schedule. As a complement, changes in the standing facility rates are now implemented, as a rule, on the first day of the new maintenance period. Previously, these changes took effect on the day after the Governing Council's meeting.

- The maturity of the MROs was shortened from two weeks to one week. Together with the above-mentioned changes, this means that MROs settled in one reserve maintenance period no longer extend into the subsequent reserve maintenance period.

These changes were designed to align the reserve maintenance period with the cycle for interest rate decision-making, ensuring that, as a rule, changes in key ECB interest rates only take effect at the beginning of the subsequent reserve maintenance period. The ECB thereby aims to eliminate expectations of changes in the key ECB interest rates within a maintenance period and thus stabilise market participants' bidding behaviour in the MRO. Previously, such expectations have occasionally destabilised counterparties' bidding in the MROs. In particular, when there were expectations of imminent interest rate reductions, counterparties bid for less liquidity than the ECB intended to allot. This phenomenon, known as underbidding, reflected counterparties' attempts to fulfil their reserve requirements at the lowest possible cost, i.e. after a potential interest rate reduction.

Moreover, communication to counterparties was enhanced. On MRO announcement days, the ECB continues to publish the forecast of the autonomous liquidity factors which are not under the direct control of the ECB's liquidity management, such as banknotes in circulation, government deposits and net foreign assets. In addition, the ECB has started to publish an updated forecast on the allotment day. The ECB now also communicates the benchmark amount on both the announcement and the allotment day. The benchmark amount is the allotment amount that allows the euro area banking system as a whole to smoothly fulfil its reserve requirements, given the Eurosystem's complete liquidity forecast, i.e. including autonomous factors and excess reserves. This improved communication makes explicitly clear to the market whether the ECB's

1 A detailed description of the operational framework can be found in the ECB publication entitled "The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures", February 2005.

allotment decisions in MROs aim to balance liquidity conditions or not.

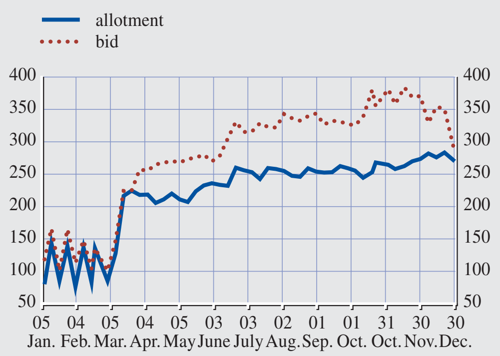
The implementation of the changes to the framework was smooth. The shortening of the MRO maturity from two weeks to one week and the elimination of the overlap between operations led to an immediate doubling in size of each MRO. Counterparties' bidding behaviour adapted quickly to the strong increase in the average allotment amount, although in the third MRO with a maturity of one week, the total amount of bids fell short of the benchmark amount by €5 billion. The total MRO bid amount quickly increased thereafter to levels steadily above the allotment amount, standing in November 2004 at an all-time high of around €384 billion (see Chart 33). Overall, the bid-cover ratio, which is the ratio of submitted bids to satisfied bids, has been sound, ranging almost consistently between 1.20 and 1.50 since March 2004. The smooth adaptation of market participants' bid volumes also indicates that the larger turnover of collateral implied by the shortening of the MRO maturity was managed well by credit institutions.

Since the changes to the framework came into effect, the short-term fluctuations in the allotment amount have decreased. From June 2000 to March 2004 the average weekly change in the allotment amounted to €33 billion, while this figure fell to €7 billion in the period between the implementation of the changes and December 2004. This reduction can be attributed to the fact that the MRO maturity is now always aligned with the time horizon of the liquidity targeted by the ECB in its allotment. As a further consequence, the reduction in the short-term fluctuation of the allotment amount has contributed to a stabilisation of credit institutions' bidding in the MROs.

Approximately 2,100 credit institutions in the euro area are eligible to participate in the MROs. The average number of bidders in MROs increased from 266 in 2003 to 339 in 2004, thus reversing the declining trend observed since 1999. In the period from March to December 2004, i.e. after the changes to the framework were implemented, the average number of bidders reached 351. This increase is probably primarily the consequence of the reduction in the maturity of the MROs from two weeks to one week, which implies that banks now need to submit a bid each week instead of every second week in order to satisfy their liquidity needs. However, it is possible that the increased transparency and simplicity of the new framework have made it easier for counterparties to prepare their bids and have therefore also facilitated increased participation in tenders.

Chart 33 Bid and allotment amounts in weekly MROs in 2004

(EUR billions)



Source: ECB.

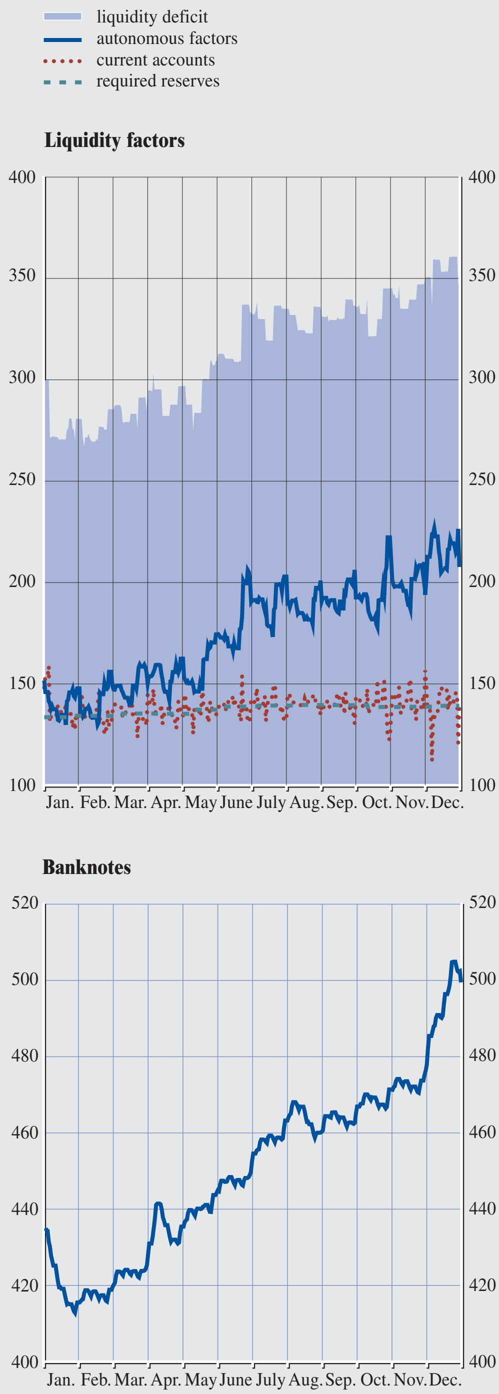
Overall, the volatility of the EONIA declined in 2004. The standard deviation of the spread between the EONIA and the minimum bid rate of the MRO was 9 basis points in 2004, against 16 basis points in 2003 and 13 basis points in 2002. However, significant volatility has been observed in the spread after the settlement of the last MRO of some maintenance periods. This is a result of the fact that the allotment of the last MRO now usually takes place eight days before the end of the reserve maintenance period, while previously the timing of the last allotment varied from month to month between eight and two days before the end of the reserve maintenance period. The closer the underlying forecast is to the end of the reserve maintenance period, the more accurate it is. Therefore, the changes to the framework lead to an increased likelihood of substantial liquidity imbalances accumulating after the allotment of the last MRO of a reserve maintenance period and, thus, of the overnight rate deviating from the minimum bid rate earlier and more substantially than in the past.

The ECB's enhanced communication policy helps to mitigate this risk to some extent as it makes it somewhat easier for market participants to detect a given liquidity imbalance since the last MRO allotment of the maintenance period. However, some evidence emerged in particular during the autumn of 2004 that excessive volatility in the overnight rate at the end of the maintenance period can have a somewhat disruptive effect on the smooth functioning of the money market. As the ECB aims to establish neutral liquidity conditions in the overnight market, it responded to these developments, carrying out fine-tuning operations on the last day of five maintenance periods with a view to offsetting expected undesirable liquidity imbalances which mainly resulted from changes in the Eurosystem's forecast of autonomous factors. Two operations were liquidity-absorbing (11 May and 7 December 2004) and three were liquidity-providing (8 November 2004, 18 January and 7 February 2005). These operations were successful in restoring neutral liquidity conditions at the end of the respective maintenance periods.

The changes to the operational framework also had implications for the conduct of longer-term refinancing operations (LTROs). In order to minimise disruption to the timetable of LTROs, the technical link between the maintenance periods and the allotment days of LTROs has been discontinued. As of 26 February 2004 LTROs are normally allotted on the last Wednesday of the month (instead of the first Wednesday of the maintenance period). In contrast to the MROs, LTROs – which have a monthly frequency and a maturity of normally

Chart 34 Liquidity factors and the development of banknotes in the euro area in 2004

(EUR billions)



Source: ECB.

three months – are not used for signalling the Governing Council's monetary policy stance and are conducted as pure variable rate tenders with a pre-announced allotment volume. On average, LTROs accounted for around 23% of the total net liquidity provided through open market operations in 2004. In view of the higher liquidity needs anticipated for the euro area banking system, the LTRO allotment volume was increased from €20 to €25 billion in January 2004 and from €25 to €30 billion in January 2005.

DEVELOPMENT OF LIQUIDITY NEEDS

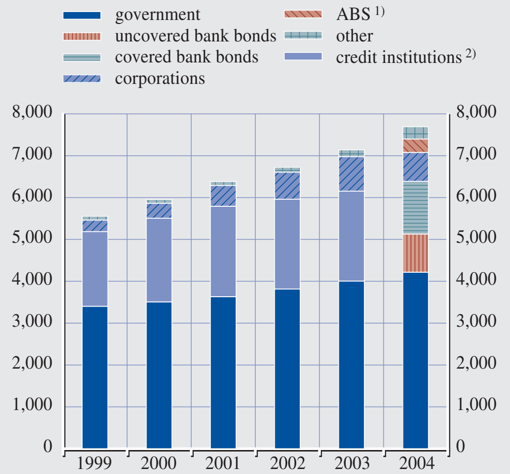
In order to prepare its weekly tenders, the ECB monitors on a daily basis the liquidity needs of the euro area banking system, which are defined as the sum of reserve requirements imposed on banks, excess reserves (funds held by credit institutions in excess of the reserve requirements) and net autonomous factors. The daily average liquidity needs of the euro area banking system amounted to €311.8 billion in 2004, representing a 30% increase by comparison with 2003, when they stood at €241.5 billion (see upper part of Chart 34).

During 2004 net autonomous factors continued to grow strongly, averaging €174.2 billion as compared with €109.3 billion in 2003. This steep rise was almost exclusively due to the continued strong growth in banknotes, which increased at an annual rate of almost 15% in 2004, reaching an all-time high of €505 billion on 24 December 2004 (see lower part of Chart 34).

The minimum reserves that euro area credit institutions must hold with the Eurosystem are calculated by applying the 2% reserve ratio to the credit institutions' reserve base. In 2004 reserve requirements represented 44% of the total liquidity needs of the euro area banking system. The average level of aggregate required reserves held by credit institutions in the euro area increased from €130.9 billion in 2003 to €136.5 billion in 2004 in line with the expansion of the reserve base. Credit institutions' average current account holdings in excess of their average reserve requirements stood at €0.6 billion in 2004, compared with €0.7 billion in 2003.

Chart 35 Eligible marketable collateral

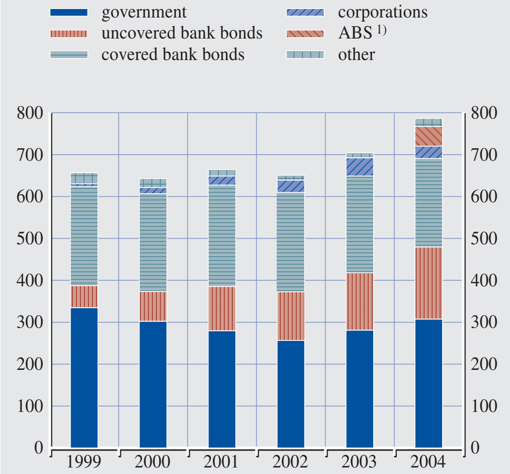
(nominal amount outstanding; EUR billions)



Source: ECB.
1) Separate data for asset-backed securities are only available from 2004; they were previously reported under corporations.
2) This category includes covered and uncovered bonds issued by credit institutions.

Chart 36 Use of marketable collateral

(nominal amount outstanding; EUR billions)



Source: ECB.
1) Separate data for asset-backed securities are only available from 2004; they were previously reported under corporations.

ELIGIBLE ASSETS FOR MONETARY POLICY OPERATIONS

With the aim of protecting the Eurosystem from incurring losses, all Eurosystem credit operations are required to be based on adequate collateral. The range of assets accepted as collateral is broad. The bulk consists of marketable debt instruments which fulfil euro area-wide eligibility criteria and are referred to as "tier one" assets. "Tier two" consists of additional assets, marketable and non-marketable, which have been of particular importance to national financial markets and banking systems.

The average value of marketable collateral eligible for Eurosystem credit operations stood at €7.7 trillion in 2004, compared with €7.1 trillion in 2003 (see Chart 35). The majority of marketable assets took the form of government securities (54%) or covered (i.e. Pfandbrief-style securities) and uncovered bonds issued by credit institutions (28%). In addition, strong growth has been observed in asset-backed securities, which represented 5% of outstanding marketable collateral at the end of 2004. The average value of marketable assets used by counterparties as collateral against Eurosystem credit operations stood at €787 billion in 2004, compared with €704 billion in 2003 (see Chart 36). Relative to the overall eligible amount, government issues and corporate securities were under-proportionally used as collateral in credit operations with the Eurosystem. Conversely, credit institution issues and asset-backed securities were over-proportionally used. For information on the use of eligible assets across national borders, see Section 2 of this chapter.

TOWARDS A SINGLE LIST OF COLLATERAL

The Eurosystem's present two-tier collateral system has contributed to a smooth functioning of the operational framework of the Eurosystem in the first years of its existence. However, against the background of increasing financial market integration in the euro area, the heterogeneity of the assets included in the tier two lists of different euro area NCBs may undermine the level playing-field for counterparties and reduce the transparency of the collateral framework. Moreover, demand for collateral is on an upward trend, not least on account of the fact that the liquidity deficit of the banking sector increased in the course of 2004. The trend in private interbank markets towards secured lending has also augmented counterparties' needs for collateral.

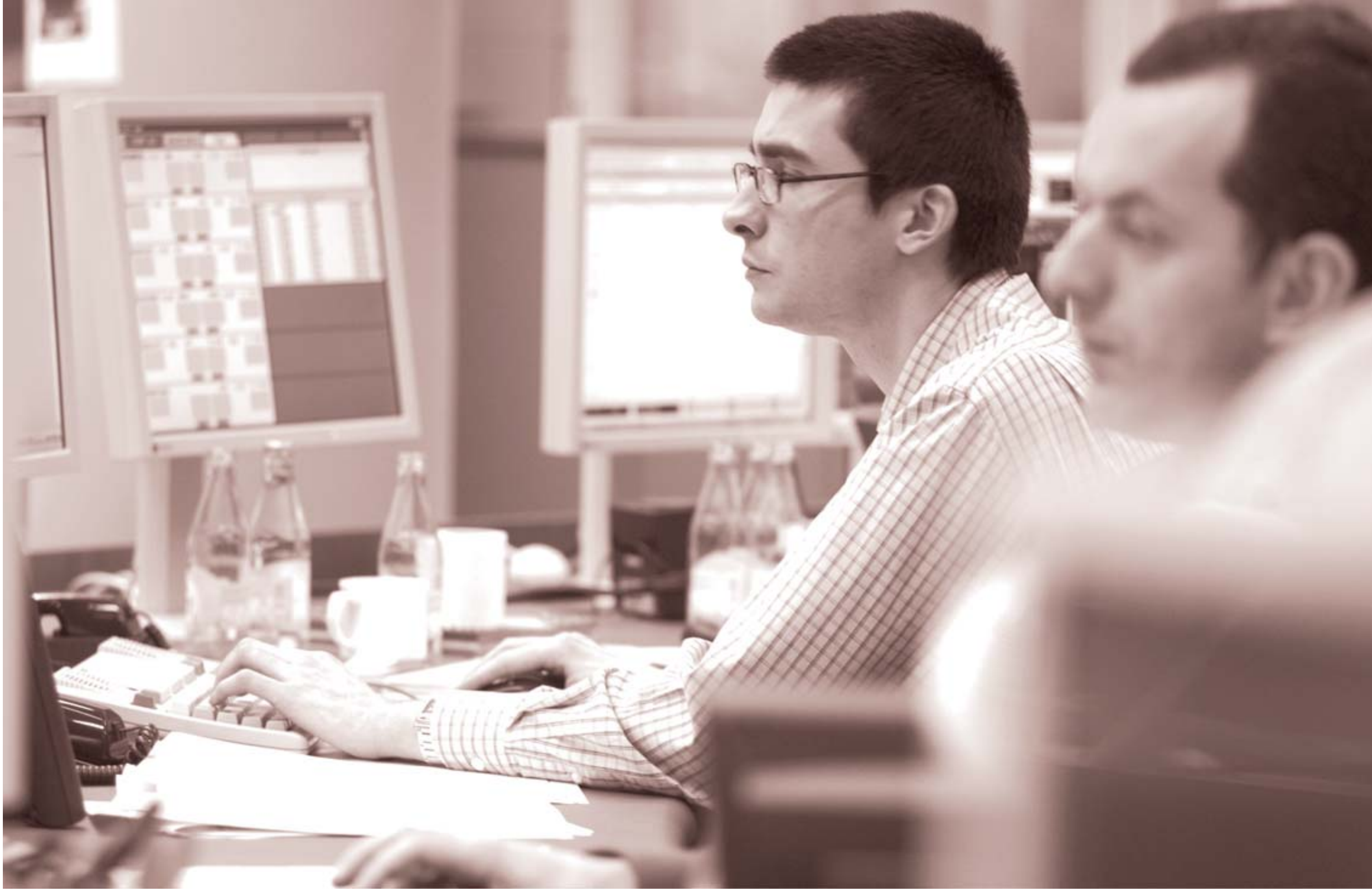
To address these issues, the Eurosystem decided to establish over time a single list of collateral eligible for all Eurosystem credit operations, taking into account the results of a public consultation. This single list will be introduced gradually and will eventually replace the current two-tier system. The first step towards establishing the single list will come into force on 30 May 2005. It consists of three elements:

– The inclusion in tier one of new instruments that are currently ineligible, namely euro-denominated debt instruments issued by entities established in those G10 countries that are not part of the EEA (United States, Canada, Japan and Switzerland).

– Debt instruments which are only listed or quoted on non-regulated markets will become or remain eligible if the respective non-regulated market has been positively assessed by the Eurosystem against the three standards of safety, transparency and accessibility. These standards have been introduced to broaden the number of acceptable markets while at the same time ensuring the smooth and efficient assessment of Eurosystem collateral.

– A very limited number of marketable debt securities will lose their eligibility status and will be phased out over time. In addition, equities have been withdrawn from the list of tier two assets.

As a second step towards a single list of collateral, the Governing Council has approved in principle the inclusion in the single list of



bank loans from all euro area countries, as well as non-marketable retail mortgage-backed debt instruments, which currently only include Irish mortgage-backed promissory notes. The main reason for accepting bank loans is that, despite the increasing role of capital markets, the financial system of the euro area still relies to a large extent on bank intermediation, with bank loans remaining the most important asset class on banks' balance sheets. By accepting bank loans as collateral, the Eurosystem reaffirms its preference for ensuring broad access for counterparties to monetary policy and intraday credit operations.

RISK MANAGEMENT ISSUES

Risk management in the context of the Eurosystem's policy operations (i.e. monetary policy or payment systems credit operations) focuses mainly on the credit risk the Eurosystem incurs when providing central bank funds to a counterparty, although other types of risk are also taken into account.

Extensive analysis was carried out in 2004 on the inclusion of bank loans in the single list of collateral. Since corporate loan issuers are often unrated, alternative credit quality assessment sources for bank loans will need to be used. While those NCBs that already accept bank loans as tier two collateral have established in-house credit assessment systems, additional sources of credit assessment for bank loans will need to be established once bank loans are included in the single list for the whole Eurosystem. The development and implementation of a consistent and efficient Eurosystem credit assessment framework for marketable and, in particular, non-marketable assets is expected to represent a major challenge over the coming years.

1.2 FOREIGN EXCHANGE OPERATIONS

In 2004 the ECB did not undertake any interventions in the foreign exchange market for policy reasons. Its foreign exchange transactions were exclusively related to investment activity. Furthermore, the ECB did not undertake any foreign exchange operations in the non-euro area currencies that participate in ERM II.

The standing agreement between the ECB and the IMF to facilitate the initiation of special drawing rights (SDR) transactions by the IMF on behalf of the ECB with other SDR holders was activated on four occasions in 2004.

1.3 INVESTMENT ACTIVITIES

FOREIGN RESERVE MANAGEMENT

The ECB's foreign reserve portfolio is composed of foreign reserve contributions from the euro area NCBs. Its purpose is to fund the ECB's operations in the foreign exchange market. In particular, the ECB holds the part of the Eurosystem's reserves that can be used directly and without delay to fund foreign exchange interventions, and it can make further calls on the NCBs' foreign reserves in case it needs to replenish its depleted holdings.

The ECB's foreign reserve portfolio mainly consists of US dollars, but also includes Japanese yen, gold and SDRs. In line with the Central Bank Gold Agreement of 26 September 1999, renewed on 8 March 2004, gold holdings were not actively managed in 2004. The value of the ECB's net foreign reserve assets declined from €38.3 billion to €36.3 billion during 2004, mainly due to the depreciation of the US dollar against the euro.

Each euro area NCB currently manages a portion of both the ECB's US dollar and yen portfolios. The Eurosystem reviewed this structure in 2004 with the objective of maintaining its effectiveness, particularly in view of the future enlargement of the euro area. The new system, currently being finalised, will be implemented in 2006 and will entail specialisation among Eurosystem members in terms of the currency denomination of the managed portfolios, with due respect to the principle of decentralisation.

During 2004 work began on expanding the investment universe to include interest rate swaps, currency-hedged instruments and US STRIPs[2]. In addition, quantitative forecasting models for government bond yields increased the sophistication of the analysis of market developments. Finally, a pilot exercise, due to start in 2005, was devised for an automatic securities lending programme in the US dollar portfolio.

OWN FUNDS MANAGEMENT

The ECB's own funds portfolio consists of the paid-up share of the subscribed capital and the general reserve fund. The purpose of this portfolio is to provide the ECB with a reserve to meet possible losses. The objective of its management is to generate returns over the long term in excess of the average main refinancing rate of the ECB. In 2004 the investment options of the own funds portfolio were expanded by adding euro-denominated fixed-income securities issued by some new Member States, some euro area regional government bonds and more covered bonds.

In 2004 the ECB's own funds portfolio grew by €0.3 billion to €6.2 billion. In particular, the paid-up capital portion increased by €63.5 million due to EU enlargement and changes in the ECB's capital key.

RISK MANAGEMENT ISSUES

When managing its investment portfolios (foreign reserves and own funds), the ECB is exposed to financial risks. In order to manage these risks, the ECB defines a framework that reflects its preferences regarding credit, liquidity and market risk. This framework is implemented, inter alia, via a detailed limits system, whereby compliance is monitored and verified on a daily basis. With a view to the future enlargement of the euro area, work was conducted in 2004 with the aim of simplifying the credit and market risk framework.

2 STRIP stands for Separate Trading of Registered Interest and Principal, which is a security created by separating the bond principal from the interest payments in a US government bond.

2 PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The Eurosystem has the statutory task of promoting the smooth operation of payment systems. Its main instrument for carrying out this task – besides the oversight function – is the provision of payment and securities settlement facilities. To this end, the Eurosystem has created the Trans-European Automated Real-time Gross settlement Express Transfer system, known as TARGET, for large-value payments in euro. It has been subject to enhancements over the past few years, and work is under way to develop a second-generation system, TARGET2. On the securities settlement side, the Eurosystem and the market offer a number of channels to facilitate the use of collateral across national borders.

2.1 THE TARGET SYSTEM

The present TARGET system is a "system of systems" made up of the national payment systems of the 15 countries that were members of the EU at TARGET's launch, the ECB payment mechanism (EPM) and an interlinking mechanism that enables the processing of payments between the linked systems. In 2004 TARGET contributed further to the integration of the euro money market and, because the Eurosystem's credit operations are processed via this system, continued to play an important role in the smooth implementation of the single monetary policy. On account of its real-time settlement service in central bank money and its broad market coverage, the TARGET system also attracts a variety of other payments.

TARGET functioned smoothly and successfully in 2004 and continued its trend of settling an increasing number of large-value euro payments. This is in line with the Eurosystem's policy objective of promoting settlement in central bank money as a uniquely safe means of payment. In 2004 88% of the total turnover of large-value payments in euro was executed via TARGET. TARGET is available for all credit transfers in euro between banks located in any of the Member States whose NCBs are linked, directly or indirectly, to TARGET. Such transfers may be made both between banks in the same Member State (intra-Member State traffic) and between those in different Member States (inter-Member State traffic). The latest survey in 2004 revealed that there were 10,483 participants in TARGET. This is about three times higher than the figure for 2002 and mainly reflects the introduction of a new methodology for defining TARGET participants. Overall, around 48,500 institutions, in particular branches of participants, can be addressed through TARGET using a Bank Identifier Code.

TARGET OPERATIONS

In 2004 TARGET processed a daily average of 267,234 payments with a total value of €1,714 billion a day. Compared with 2003, this is an increase of 2% in volume and 4% in value.

Of the total TARGET traffic in 2004, inter-Member State traffic represented 33% in terms of value and 24% in terms of volume, compared with 33% and 23% respectively in 2003. Of that inter-Member State traffic, 95% in terms of value and 49% in terms of volume were interbank payments, the remainder being customer payments. The average value of an inter-Member State interbank payment was €17 million, and the average value of an inter-Member State customer payment was €0.8 million. Further information on payment traffic is provided in Table 12.

In 2004 the overall availability of TARGET, i.e. the extent to which participants were able to use TARGET during its business hours without incident, reached 99.81%. On average, 95.87% of inter-Member State payments were processed within five minutes. Further information is provided in Table 13.

Throughout 2004 the mandatory changes necessary for the migration to the new messaging system, SWIFTNet FIN, continued, and all components of TARGET migrated successfully.

Table 12 Payment traffic in TARGET [1]

Volume (number of transactions)	2003	2004	Change (%)
Overall			
Total	66,608,000	69,213,486	4
Daily average	261,208	267,234	2
Intra-Member State			
Total	51,354,924	52,368,115	2
Daily average	201,392	202,193	0
Inter-Member State			
Total	15,253,076	16,845,371	10
Daily average	59,816	65,040	9
Value (EUR billions)	**2003**	**2004**	**Change (%)**
Overall			
Total	420,749	443,992	6
Daily average	1,650	1,714	4
Intra-Member State			
Total	283,871	297,856	5
Daily average	1,113	1,150	3
Inter-Member State			
Total	136,878	146,137	7
Daily average	537	564	5

Source: ECB.
1) 255 operating days in 2003 and 259 operating days in 2004.

Table 13 Overall availability of TARGET

(percentages)

RTGS system	2004
EPM (ECB)	99.48
ELLIPS (BE)	99.88
KRONOS (DK)	99.85
RTGSplus (DE)	99.37
HERMES euro (GR)	99.80
SLBE (ES)	99.89
TBF (FR)	99.94
IRIS (IE)	99.59
BI-REL (IT)	99.91
LIPS-Gross (LU)	99.97
TOP (NL)	99.98
ARTIS (AT)	99.87
SPGT (PT)	99.86
BOF-RTGS (FI)	99.85
E-RIX (SE)	99.74
CHAPS Euro (UK)	99.95
Overall system availability	99.81

Source: ECB.

PROVISIONS FOR SYSTEMICALLY IMPORTANT PAYMENTS IN TARGET

Owing to the TARGET system's pivotal role in the market and its broad market coverage, suitable protection against a wide range of threats is essential for the reliable and smooth functioning of the system. It is of the utmost importance that systemically important payments – i.e. those that could cause a systemic risk if not processed when due – be carried out without delay, even in abnormal circumstances. The Eurosystem has established contingency measures to ensure that such payments are processed in an orderly manner, even in the event of TARGET malfunctioning. In 2004 a number of trials were carried out by central banks (often involving commercial banks), and these proved the effectiveness of the TARGET contingency measures. They confirmed that the Eurosystem is in a good position to ensure that payment systems and financial markets can continue to function smoothly in a crisis situation.

TARGET CONNECTION FOR THE NEW EU MEMBER STATES

In October 2002 the Governing Council decided that, following EU enlargement, the Eurosystem would connect the real-time gross settlement (RTGS) systems of the NCBs of the new Member States to TARGET at their request. Given the limited remaining lifetime of the current TARGET system and in order to save costs, the Eurosystem developed alternatives to full integration which allow the new Member States' RTGS systems to be connected to the current TARGET system. For instance, the solution envisaged for SORBNET-EURO, Narodowy Bank Polski's euro RTGS system, is a connection via a current euro area NCB. The connection will be provided in 2005 through the Banca d'Italia.

RELATIONS WITH TARGET USERS AND REAL-TIME GROSS SETTLEMENT OPERATORS OF OTHER CURRENCY AREAS

The ESCB maintains close relations with TARGET users in order to ensure that their needs are given due consideration and receive an appropriate response. In 2004, as in previous years, regular meetings were held between the 15 NCBs linked to TARGET and the national TARGET user groups. In addition, joint meetings of the TARGET Management Working Group of the ESCB and the TARGET Working Group of the European banking industry were held to discuss TARGET operational issues. Strategic issues were addressed in the Contact Group on Euro Payments Strategy, a forum in which the senior management of commercial and central banks is represented.

The Eurosystem, as operator of one of the largest RTGS systems in the world, maintains close contacts with the RTGS operators of other currency areas. Increasing interrelations, such as those stemming from Continuous Linked Settlement operations, have created the need for joint discussions on operational issues.

2.2 TARGET2

In December 2004 the Governing Council accepted the joint offer made by the Banca d'Italia, the Deutsche Bundesbank and the Banque de France to build the single shared platform for TARGET2 and to develop and operate it on behalf of the Eurosystem. This decision will result in a fundamental redesign of the architecture of TARGET, which, at present, consists of multiple interlinked RTGS systems which are maintained by the NCBs and the ECB. TARGET2 will offer TARGET users a higher level of service and will allow economies of scale to be made.

The main preparatory work undertaken in 2004 for TARGET2 involved developing the functional specifications. This work was undertaken in close cooperation with TARGET users. The General Functional Specifications (GFS) for TARGET2, which were approved by the Governing Council in July 2004, describe on a general level the features and functions of the system as well as its IT architecture.

TARGET2 will offer comprehensive liquidity management functions that allow credit institutions to better control their euro liquidity. For example, a participant that uses several payment and securities settlement systems settling in central bank money will have the possibility of settling all such positions from a single RTGS account in TARGET2. Furthermore, for RTGS accounts of euro area credit institutions held with euro area central banks, TARGET2 will offer an intraday liquidity pooling feature. It will enable euro area TARGET2 participants to group individual RTGS accounts held with different euro area central banks and to pool the available intraday liquidity for the benefit of all members of the group of accounts. The Eurosystem is working towards the establishment of a robust legal framework for this purpose, which is a precondition for offering this function. TARGET2 will be based on a state-of-the-art business continuity concept that will enable it to cope with wide-scale regional disaster situations.

On the basis of the GFS, the Eurosystem is preparing the User Detailed Functional Specifications (UDFS), which describe the features and functions of TARGET2 at the level of detail required for the start of the technical development and implementation work. As was the case for the GFS, the UDFS have been intensively discussed with TARGET users. The UDFS are expected to be finalised in April 2005.

The Eurosystem is also developing a pricing scheme for the TARGET2 core service which will eliminate the current differences in pricing between domestic and cross-border transactions. It includes an option to be decided on by the Governing Council which would allow participants to choose between paying a transaction fee only or a lower transaction fee plus a periodical fee. Further details of the TARGET2 pricing scheme will be defined in 2005.

Another major area of work in 2004 was the development of the governance structure for TARGET2 and, on the basis of this, an effective project organisation for the next project phases (development, testing and migration). The Governing Council approved internal rules concerning the common governance of TARGET2. These define the roles and responsibilities in the TARGET2 project of, respectively, the Governing Council, the full group of euro area central banks and the three NCBs building and operating the system. The chosen governance structure and project organisation will ensure both the effective organisation of the development work in the project phase and an appropriate level of continued involvement and control by all euro area central banks after the launch of TARGET2.

The development of software and the establishment of the IT infrastructure for TARGET2 will be carried out in 2005. First testing activities with the central banks are planned to start in early 2006. TARGET users will migrate to TARGET2 in different waves and on different predefined dates. Each wave will consist of a group of national banking communities and the migration process will be spread over several months, during which current TARGET components and the new system will coexist. The phased migration will be organised in a way which minimises project risk. Other important considerations when deciding on the concrete migration process will be to minimise potential transition problems and costs for central banks and TARGET users. It is planned that the first group of countries will migrate to TARGET2 on 2 January 2007. The Eurosystem will continue its close cooperation with the TARGET user community during all phases of the project and will report regularly on the progress made.

2.3 CROSS-BORDER USE OF COLLATERAL

Eligible assets may be used across national borders to collateralise all types of Eurosystem credit operation by means of the correspondent central banking model (CCBM) or through eligible links between EU securities settlement systems (SSSs). The CCBM is provided by the Eurosystem, while eligible links are a market-led solution.

The amount of cross-border collateral held by the Eurosystem increased from €305 billion in December 2003 to €370 billion in December 2004. Overall, at the end of 2004 cross-border collateral represented 43.89% of the total collateral provided to the Eurosystem. These figures confirm the trend observed in previous years of increasing integration of financial markets in the euro area and the growing willingness of counterparties to hold in their portfolios assets issued in another euro area country.

THE CORRESPONDENT CENTRAL BANKING MODEL

The CCBM has remained the main channel for transferring cross-border collateral. It accounted for 35.37% of the total collateral provided to the Eurosystem in 2004. Assets held in custody through the CCBM increased from €259 billion at the end of 2003 to €298 billion at the end of 2004.

By the beginning of 2004 NCBs had, as a result of enhancements made in 2003, already achieved the objective of performing internal CCBM procedures within an hour, provided that counterparties (and their custodians) submitted their instructions correctly. The Eurosystem is investigating further improvements and alternatives for the efficient and safe use of cross-border collateral.

Custodian banks often play an important role in the CCBM processing chain by delivering collateral on behalf of counterparties. In January 2004 "best practices" for custodian banks involved in CCBM transactions, established by the major European credit sector associations, were implemented. They aim to optimise the efficiency of the CCBM. Market participants' efforts in implementing these best practices also helped NCBs to perform internal CCBM procedures within an hour. However, deviation from this one-hour benchmark may occur in certain circumstances, for instance in the case of peak traffic.

ELIGIBLE LINKS BETWEEN SECURITIES SETTLEMENT SYSTEMS

SSSs can be linked by means of contractual and operational arrangements to allow the cross-border transfer of eligible securities between systems. Once eligible securities have been transferred via such links to another SSS, they can be used through local procedures in the same way as any domestic collateral. There are currently 59 links available to counterparties, of which only a limited number are actively used in transfers related to Eurosystem credit operations. Furthermore, these links only cover part of the euro area. Links become eligible for Eurosystem credit operations if they fulfil the Eurosystem's nine user standards[3] which focus on the requirements of central banks when settling their operations in SSSs. The Eurosystem assesses any new links or enhancements of eligible links against these standards. In 2004 three existing eligible links were enhanced and positively assessed.

Collateral held through links increased from €46 billion in December 2003 to €72 billion in December 2004, but represented only 8.5% of the total collateral, cross-border and domestic, held by the Eurosystem.

3 "Standards for the use of EU securities settlement systems in ESCB credit operations", January 1998.

3 BANKNOTES AND COINS

3.1 THE CIRCULATION OF BANKNOTES AND COINS

DEMAND FOR EURO BANKNOTES AND COINS

Following an annual growth rate of 22% in 2003, the value of euro banknotes in circulation increased by 15.0% in 2004, from €436.1 to €501.3 billion. The number of euro banknotes in circulation increased by 6.8% (compared with 10.1% in 2003), from 9.0 to 9.7 billion. Chart 37 shows the development of national banknotes and euro banknotes in circulation in terms of value between 2000 and 2004. Chart 38 illustrates the development of the number of euro banknotes in circulation since their introduction.

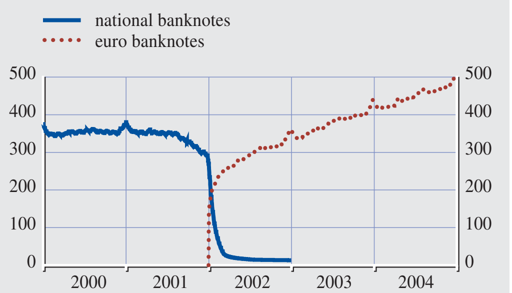
The value of banknotes in circulation has risen more steeply than the number ever since the cash changeover, which reflects the particularly strong increase in the number of high-denomination banknotes in circulation. Chart 39 shows the development of euro banknotes in circulation by denomination between 2002 and 2004. The strongest increase in demand in 2004 was for the €500 banknote, at 28.4%. Demand was also very strong for the €50 and €100 banknotes, which saw circulation growth rates of 12.4% and 13.5% respectively.

Overall growth in the number of €5, €10, €20 and €200 banknotes in circulation has been very moderate since the introduction of the banknotes in 2002, although developments may vary between countries. Only during seasonal peaks has a strong rise in demand been witnessed for the €10 and €20 banknotes, i.e. those denominations which are mainly used for daily cash transactions. In the case of the €50 banknote, both fairly high growth and seasonal fluctuations have been recorded. By contrast, the circulation of the €5 and €100 banknotes has shown only moderate seasonal variation, while that of the €200 and €500 banknotes has followed no seasonal pattern at all. It is clear that demand for transaction purposes within the euro area alone does not explain the lasting upward trend in demand for these denominations, but that other factors must also play a role. One such factor seems to be the growing international demand for euro banknotes. Recent analyses suggest that around 10% to 15% of the banknotes in circulation are held outside the euro area. Another factor is hoarding by the public, partially influenced by the low level of interest rates.

During 2004 the value of euro coins in circulation (i.e. the net circulation excluding stocks held by NCBs) increased by 9.1%, from €14.1 billion to €15.3 billion. The total number

Chart 37 Total value of banknotes in circulation between 2000 and 2004

(EUR billions)



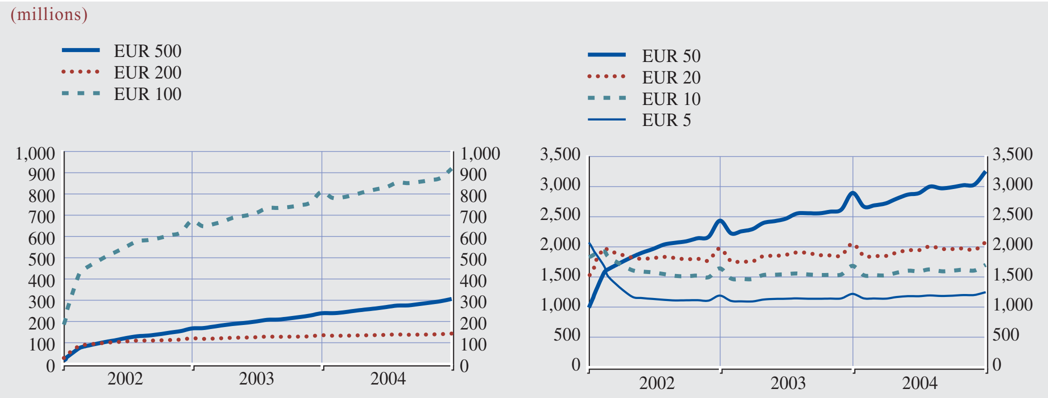
Source: ECB.

Chart 38 Total number of euro banknotes in circulation between 2002 and 2004

(billions)

Source: ECB.

Chart 39 Number of euro banknotes in circulation between 2002 and 2004



Source: ECB.

of euro coins in circulation grew by 14.8% to stand at 56.2 billion. There has been a steady growth in the number of euro coins in circulation since the beginning of 2003, when the volume returned to the initial level of 40.4 billion coins issued at the time of the changeover.

BANKNOTE HANDLING BY THE EUROSYSTEM

Deposits and withdrawals of euro banknotes have been quite stable for all euro area NCBs since the second quarter of 2002. Fluctuations in the monthly deposits and withdrawals mainly reflect the usual seasonal variations in banknote demand.

A total of 29.4 billion euro banknotes were processed by euro area NCBs in 2004, which was similar to the figure for 2003. Between January and December 2004 a total of 30.4 billion banknotes were issued and 29.7 billion were returned to the NCBs. The return frequency of banknotes, measured as the ratio of banknotes deposited at NCBs to the number of banknotes in circulation, has remained relatively stable since 2002 and in 2004 stood at around 3.4 times a year. 3.8 billion unfit banknotes were destroyed in 2004.

3.2 BANKNOTE COUNTERFEITING AND COUNTERFEIT DETERRENCE

COUNTERFEIT EURO BANKNOTES

Having risen steadily in 2002 and much of 2003, the rate of euro banknote counterfeiting is now relatively stable. From the last quarter of 2003 to the end of 2004, an average of around 50,000 counterfeits were recovered from circulation each month, with seasonal fluctuations coinciding with those of genuine banknotes, for example during holiday periods. The total number of counterfeits received by National Analysis Centres (NACs)[4] in 2004 was 594,000. This represents an increase of 7.8% compared with 2003, which is substantially lower than the growth rate observed one year earlier. Chart 40 shows the trend in counterfeits recovered from

Table 14 Distribution of counterfeits by denomination

	€5	€10	€20	€50
Percentage	1	5	24	48
	€100	**€200**	**€500**	**Total**
Percentage	17	4	1	100

Source: Eurosystem.

4 Centres established in each EU Member State for the initial analysis of counterfeit euro banknotes at the national level.

circulation, with figures taken at half-yearly intervals since the banknotes were launched.

Table 14 shows that the €50 banknote remains the counterfeiters' biggest target, although some evidence emerged during the year that organised crime is increasingly targeting the €100, €200 and €500 banknotes. A small quantity of better than average counterfeits have been produced in these denominations.

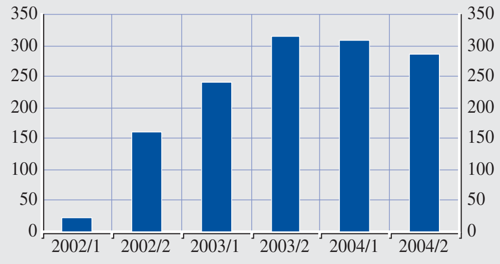
Overall, it is evident that the number of counterfeits (594,000 in 2004) is a tiny fraction of the average number of genuine banknotes in circulation (8.9 billion in 2004). The public can continue to have confidence in the security of the euro: it remains a well protected currency, in terms of both the sophistication of its security features and the effectiveness of European and national law enforcement authorities. However, the public should continue to be watchful. The "feel-look-tilt" test remains sufficient to detect counterfeits in almost all cases.

COUNTERFEIT DETERRENCE

In addition to cooperating with the NCBs, Europol and the European Commission (in particular the European Anti-Fraud Office, OLAF), the ECB concluded an agreement with Interpol in 2004 on the protection of the euro and the fight against counterfeiting. Further cooperation agreements were established with the central banks of two of the EU's neighbouring countries (Ukraine and Bulgaria), and similar agreements with other countries are envisaged for the future. The Eurosystem was active in training cash-handling professionals, both in the EU and beyond, in recognising and handling counterfeit banknotes. The Counterfeit Analysis Centre at the ECB and the NACs collaborated with the police in the fight against counterfeiting, and technicians from the NACs provided, upon request, legal authorities with expert advice and technical reports.

Chart 40 Number of counterfeit euro banknotes recovered from circulation between 2002 and 2004

(thousands)



Source: ECB.

The International Counterfeit Deterrence Centre, hosted by the ECB, continued to evaluate new reproduction equipment and counterfeit deterrence systems and to support the Central Bank Counterfeit Deterrence Group, a joint initiative of 27 central banks worldwide.

3.3 BANKNOTE ISSUANCE AND PRODUCTION

THE EUROSYSTEM'S ROLE IN THE CASH CYCLE

In December 2004 the Governing Council agreed on common principles and objectives in respect of the Eurosystem's role and responsibilities in the cash cycle. The definition of its role and responsibilities will contribute to the establishment of the Single Euro Payments Area (see Section 3 of Chapter 3). It also provides a reliable framework for the Eurosystem's partners in the cash cycle (i.e. the banking industry and cash-in-transit companies). In line with the principle of decentralisation, the Governing Council did not establish a fully harmonised system for euro area cash services. While some harmonisation and standardisation under the guidance of the ECB is necessary, the NCBs are responsible for the implementation at the national level, taking into account the respective national economic environment and banking structures, the existing NCB branch network and the relative share of cash payments and/or long-term agreements.

ECB FRAMEWORK FOR THE DETECTION OF COUNTERFEITS AND FITNESS SORTING

Following consultations with the banking and cash-in-transit industries, in December 2004 the ECB adopted a framework for the detection of counterfeits and the sorting of banknotes by quality (known as "fitness sorting") by credit institutions and other professional cash-handlers. The principal objectives of this framework are to implement a common policy for banknote handling and processing by credit institutions and other professional cash-handlers as well as to provide them with assistance in fulfilling their obligations according to Article 6 of Council Regulation (EC) No 1338/2001 regarding the detection and withdrawal of counterfeit euro banknotes. NCBs will implement this framework within their jurisdiction by the end of 2006 at the latest. There will be a two-year transition period, ending no later than the end of 2007, for the adaptation of procedures and existing machines in operation by credit institutions and other professional cash-handlers.

PRODUCTION ARRANGEMENTS

A total of 1.6 billion banknotes were produced in 2004, compared with 3.1 billion in 2003. This significant reduction in the 2004 production requirement was primarily due to a lower actual replacement need than expected in 2003.

Table 15 Allocation of euro banknote production in 2004

Denomination	Quantity (millions of banknotes)	NCB commissioning production
€5	-	-
€10	378	DE, FR, GR, IE, AT
€20	290	FR, PT
€50	683	BE, DE, ES, IT, NL
€100	124	IT, FI
€200	-	-
€500	124	DE, LU
Total	1,599	

Source: ECB.

Since 2002 the production of euro banknotes has been allocated to the NCBs in accordance with a decentralised production scenario with pooling. Under this arrangement, each euro area NCB is responsible for the procurement of an allocated share of the total requirement for certain denominations. Table 15 summarises the 2004 production allocation.

The arrangements for future banknote procurement are laid down in Guideline ECB/2004/18, adopted by the Governing Council in September 2004. The Guideline establishes a single Eurosystem tender procedure for the production of euro banknotes, which will be implemented by 1 January 2012 at the latest. The implementation of this procedure will be preceded by a transitional period, thus allowing NCBs and the printing works ample time to prepare for the new procedure. This transitional period will start no earlier than 1 January 2008, but the precise starting date – which will be decided by the Governing Council – is dependent on the achievement of a critical mass in terms of both the number of NCBs agreeing to participate in the single Eurosystem tender procedure and the total volume of banknotes to be tendered.

The Guideline has been developed in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in line with EU competition law. In particular, the objectives of the procedure are to ensure equal treatment of all printing works wishing to participate in the single Eurosystem tender procedure, as well as to guarantee transparency and the continued secure production of euro banknotes. The tender rules laid down in the Guideline will apply to the Eurosystem's entire banknote requirement. Those NCBs with in-house printing works or those using public printing works may decide not to participate in the single Eurosystem tender procedure and will then continue to produce the euro banknotes allocated to them in those printing works.

VERY LOW-DENOMINATION BANKNOTES

In response to suggestions from various sources, the Eurosystem examined the potential positive and negative aspects of introducing very low-denomination banknotes, i.e. €1 and/or €2. After careful consideration, the Governing Council decided in November 2004 not to revise the decision it had taken in 1998 on the denominations of euro banknotes and, consequently, not to issue €1 or €2 banknotes. Having assessed all the arguments put forward in the debate, the Governing Council concluded that, on balance, the negative aspects of introducing very low-denomination banknotes outweighed the positive aspects. The insufficient demand for very low-denomination banknotes by the majority of euro area citizens, the increased inefficiency which their introduction would imply for most of the affected third parties – for instance, the retail sector and the vending machine industry – and the high costs of printing and processing contributed in particular to this decision.

4 STATISTICS

The ECB, assisted by the NCBs, collects a wide range of statistics which enable the ESCB to fulfil its tasks. The necessary statistical information is collected either from the competent national authorities or directly from economic agents. In 2004, as in previous years, the provision of statistics proceeded smoothly, while work continued on further improving the statistical framework and new statistics became available in accordance with the ECB's medium-term strategy for statistics. The ECB also held its second conference on statistics, this time focusing on their use for monetary and economic policy-making.

Some outstanding issues, mainly concerning the reliability of data, remain in the field of government finance statistics, which are essential for the implementation of the Stability and Growth Pact and the credibility of budgetary surveillance. The European Commission (Eurostat), assisted by national statistical institutes (NSIs) and NCBs, where applicable, is responsible for the provision of these statistics. The ECB makes intensive use of general economic statistics, most of which are collected and compiled by Eurostat. The provision of these statistics for the euro area has further improved in some fields, for example as regards the timeliness of quarterly GDP data, the quality of the HICP flash estimate and the availability of short-term business indicators. Taking into account the developments in recent years, the ECB published its review of the requirements in the field of general economic statistics in December 2004.

4.1 FURTHER IMPROVEMENTS IN THE STATISTICAL FRAMEWORK FOR THE EURO AREA

Notwithstanding significant achievements with regard to the statistical framework thus far and the good quality of euro area statistics in general, further improvements to the overall statistical framework for the euro area remain necessary. Ongoing economic transformation has to be accommodated in a forward-looking manner and some remaining statistical gaps identified by users inside and outside the ECB have to be filled where feasible. During 2004 the ECB started work on further improving the overall framework. Owing to the long lead times involved in statistical projects, results should be expected in the medium term.

An important element of the statistical framework for the euro area is the design and compilation of a system of quarterly national accounts by institutional sector, which the Eurosystem is preparing together with Eurostat and the NSIs. The sectors covered by this system of accounts are households, non-financial corporations, financial corporations, government and the rest of the world. These statistics will reveal the interrelationships among these different sectors and between the financial and non-financial transactions in the economy. A sufficiently long time series of such sector accounts, published soon after the reference period, makes it possible to trace monetary policy impulses from the financial sector to the non-financial sectors of the euro area and, additionally, to better analyse the impact of economic shocks on the euro area. Such a time series will also enable a wider range of other analyses to be carried out. Various key indicators which are essential for business cycle analysis and for forecasting are also embedded in the quarterly national accounts by institutional sector.

The incorporation of International Accounting Standard 39 (IAS 39) on financial instruments into EU law, which requires its use by all listed companies as of 1 January 2005, has made it necessary to amend the Regulation concerning the consolidated balance sheet of the MFI sector (ECB/2001/13) in order to preserve the conceptual basis of the monetary statistics. The amending Regulation (ECB/2004/21), which entered into force on 1 January 2005, ensures that, irrespective of the specific form in which IAS 39 is finally adopted, MFIs will continue to report their stocks of loans and deposits at nominal value, regardless of changes that may be made to the EU legal accounting framework after that date.

4.2 NEW OR ENHANCED STATISTICS

During 2004 the ECB started publishing some new statistics that are relevant for monetary policy and other ESCB tasks, for economic policy in general, for market participants and for the public at large.

In spring 2004 the ECB, together with the European Commission, for the first time released monthly statistics on long-term interest rates for the ten new EU Member States, which are necessary to assess their achievement of the high degree of convergence required for entry into EMU. Since June 2004 the ECB has also published the monetary presentation of the euro area balance of payments on a monthly basis. In addition, the ECB and Eurostat published a report on foreign direct investment, which proposes improved methods for compiling such statistics. Quarterly current account data of the euro area balance of payments are now available from 1980 onwards. With regard to euro effective exchange rates, the trade weights used for the computation of the indices have been updated, the geographical coverage has been enhanced and new series have been published since September 2004. Statistics on flows and stocks of euro area quoted shares are now released on a monthly basis. The new statistics include gross issues, redemptions and outstanding amounts of all quoted shares issued by euro area residents.

In the framework of the ECOFIN Council's Action Plan on EMU Statistical Requirements, the ECB made available in 2004 a comprehensive set of quarterly non-financial and financial accounts for the government sector. Work has already started on integrating these statistics into the quarterly national accounts by institutional sector.

In 2004 the ECB also improved its legal framework to enable the publication of new statistics in the future. The ECB Guideline and Recommendation on the statistical reporting requirements in the field of balance of payments and international investment position statistics and the international reserves template were revised. The ECB started publishing enhanced statistics in this field, including a geographical breakdown, in January 2005. Furthermore, the ECB published guidance notes on MFI balance sheet statistics relating to EU enlargement. These guidance notes aim to promote a clear and consistent understanding of the requirements and standards of Regulation ECB/2003/10.

In 2004 efforts were made to improve the dissemination and accessibility of statistics. Both the ECB's redesigned Monthly Bulletin, published for the first time in January 2004, and the new version of the ECB's website, which went live in June 2004, incorporate improved statistical sections.

4.3 GOVERNMENT FINANCE STATISTICS

During 2004 serious concerns arose about the reliability of the statistics for budgetary surveillance under the Treaty and the Stability and Growth Pact. The ECB fully supported the statement on good standards in statistics made after the informal ECOFIN Council meeting in

Scheveningen on 11 September 2004. These standards should reinforce the independence, integrity and accountability of the NSIs. The ECB is working closely with the European Commission on this issue, in particular via the Committee on Monetary, Financial and Balance of Payments Statistics, which comprises senior statisticians from Eurostat, the NSIs, the NCBs and the ECB. The implementation of the ECB Guideline on government finance statistics, adopted by the Governing Council in February 2005, will further enhance the quality of euro area government finance aggregates and will be an additional step in establishing the quality of and standards for a more complete set of government finance data for fiscal surveillance.

5 ECONOMIC RESEARCH

The objective of economic research at the ECB is to provide a strong conceptual and empirical basis for policy-making. Economic research within the Eurosystem thus focuses on increasing knowledge of the functioning of the euro area economy and providing analyses, models and other tools relevant to the conduct of the ECB's monetary policy and the fulfilment of other tasks of the Eurosystem.

Five years after its establishment the ECB asked three independent external experts to evaluate the economic research activities at the ECB against high academic standards and to assess the extent to which research conducted at the ECB since 1998 has contributed to the achievement of its objectives. The experts' report,[5] which is available on the ECB's website, gave a positive overall assessment of the research conducted at the ECB in terms of scientific quality and value added, relevance for the conduct of monetary policy and for the other tasks and functions of the ECB, and influence on the academic community and on other policy-making institutions. As requested in their terms of reference, the evaluators also made a number of recommendations to further improve research activities. Recommendations were made in five areas: incentives for staff to conduct high-quality research; long-term management of human capital; coverage and coordination of research activities in the different ECB business areas; research support; and communication and dissemination of research. Many of the suggestions for improvement coincided with the ECB's own assessment, and measures have been taken to implement these improvements.

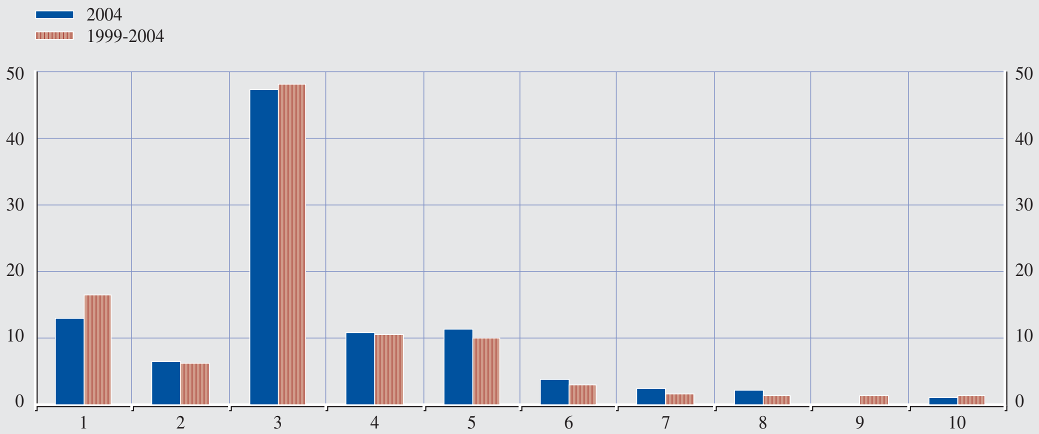
5.1 RESEARCH AGENDA

The research agenda in 2004 can be broken down into six main areas: macroeconomics and monetary economics; international macroeconomics and finance; financial stability; financial integration; the macroeconometric

5 M. Goodfriend, R. König and R. Repullo, "External evaluation of the economic research activities of the European Central Bank", 2004.

Chart 41 ECB Working Paper series: Journal of Economic Literature classification

(percentages)



1 Mathematical and quantitative methods
2 Microeconomics
3 Macroeconomics and monetary economics
4 International economics
5 Financial economics
6 Public economics
7 Labour and demographic economics
8 Industrial organisation
9 Economic development, technological change and growth
10 Others

Source: ECB.

modelling of the euro area; and general economic and structural issues. Considerable efforts were also directed towards research on euro area enlargement and the economies of the new EU Member States. In this context, preparatory work for the subsequent enlargement of the euro area was carried out, in particular with regard to the analytical tools used for macroeconomic projections.

Most of the results of the research activities carried out within or in cooperation with the ECB were presented in the ECB's Working Paper series and – to a lesser extent – the ECB's Occasional Paper series, as well as at various conferences and workshops. 126 ECB Working Papers were published in 2004 (as compared with 97 in 2003). A considerable number of the Working Papers released since the series was launched in 1999 have already been published or are forthcoming in academic journals (130) or books (30). Given the long lags in publication resulting from the peer review process, this already significant proportion is expected to increase in 2005. Chart 41 illustrates the clear focus on policy-relevant research at the ECB. It categorises ECB Working Papers by topic, using the Journal of Economic Literature classification types. "Macroeconomics and monetary economics" is the most common topic covered in the series, followed by "mathematical and quantitative methods", "financial economics" and "international economics".

Throughout 2004 the ECB hosted a number of conferences and workshops, such as the third ECB Central Banking Conference on "The new EU Member States: convergence and stability", which covered three main topics: the economic and structural transformation of the new EU Member States; international links and the macroeconomic performance of the new EU Member States; and macroeconomic adjustment in these countries. Together with the BIS and the G10 central banks, the ECB has launched a new publication entitled the "International Journal of Central Banking" (see Chapter 6).

5.2 RESEARCH NETWORKS

ECB research is often conducted within the framework of organised networks. These are groups of researchers jointly engaged in broad, multi-purpose projects and may include economists from the ECB, euro area NCBs, other central banks and policy-making organisations, as well as academics. The ECB provides coordination and organisational support for these networks, alone or with other institutions.

The Eurosystem Inflation Persistence Network, which brings together researchers from all Eurosystem central banks, was created in 2003 for the purpose of analysing the dynamics of inflation in the euro area and in the national economies. A wide range of data is being used to study the phenomenon, including individual and sectoral data on consumer and producer prices, macroeconomic inflation rates and survey results, with the final results of the analysis expected in 2005. In 2004 a large proportion of the empirical analysis was performed, a sub-set of results was released in the ECB's Working Paper series and feedback from the academic community was collected. A selection of results was also presented at several international workshops and conferences, including a conference organised by the network in December 2004 and hosted by the

ECB. The input received at these events will be used in the concluding phase of the network's analysis. The network has so far found that prices of individual consumer goods and services change relatively infrequently in the euro area, namely once a year on average. When price adjustments occur, they tend to be large and almost equally divided between price increases and price decreases. Price rigidities are more widespread in the services sector than in the goods sector, and they tend to be higher on average in the euro area than in the United States. Furthermore, the network's findings suggest that inflation persistence may depend on the inflation and monetary policy regimes in place, and that, other things being equal, it tends to be lower when expectations of price stability are well rooted in the economy.

The Euro Area Business-Cycle Network, organised in collaboration with the Centre for Economic Policy Research (CEPR), provides a forum for the study of the euro area business cycle. It brings together researchers from academia, central banks and other policy institutions. In 2004 the network organised a second training school on factor models and methodologies for the analysis of the business cycle, hosted by the Nationale Bank van België/Banque Nationale de Belgique and Bocconi University. Two workshops were also organised, one on the business cycle in the new Member States and acceding countries, hosted by the Oesterreichische Nationalbank, and the second on recent advances in forecasting combination, hosted by the Nationale Bank van België/Banque Nationale de Belgique. Since early 2004 a substantial part of the network's output has been channelled through a new discussion paper series jointly launched with the CEPR.

The Research Network on Capital Markets and Financial Integration in Europe, launched in 2002 by the ECB and the Center for Financial Studies (CFS), aims to stimulate policy-relevant research on the integration of the financial systems in Europe and their international links. The network concluded its first two years of work with a symposium in Frankfurt am Main in May 2004 (see Box 12). The ECB and the CFS have decided to continue the activities of the network until 2007, adding three priority areas: (i) the relationship between financial integration and financial stability, (ii) EU accession, financial development and financial integration and (iii) financial system modernisation and economic growth in Europe. The "Lamfalussy Fellowship" research programme, established within the framework of the network, was also extended to these areas.

5.3 MACROECONOMETRIC MODELLING OF THE EURO AREA

A notable development in the field of macroeconometric modelling in 2004 was the work launched on a new generation of the ECB's Area-Wide Model. The model is being revised in line with the latest developments in macroeconomic theory and estimation methods. In contrast to earlier models, the new generation of macroeconometric models, known as dynamic stochastic general equilibrium models, are based to a much larger extent on microeconomic foundations. With the contribution of research undertaken at the ECB, they are now sufficiently sophisticated to be used in the policy realm.[6] They are rapidly becoming the standard for policy analysis and, increasingly, forecasting in central banks and policy organisations. To facilitate the construction of the new Area-Wide Model, the ECB has established a forum for cooperation with the Board of Governors of the Federal Reserve System and with the IMF, institutions that are engaged in the construction and use of similar models. The ECB and the Federal Reserve System cooperate through the International Research Forum on Monetary

6 Eurosystem staff have made key contributions in this area. See F. Smets and R. Wouters, "An estimated stochastic dynamic general equilibrium model of the euro area", ECB Working Paper 171, published in *Journal of the European Economic Association*, vol. 1, issue 5, 2003, pp. 1,123-1,175. This work was awarded the European Economic Association's prestigious Hicks-Tinbergen Medal for outstanding research.

Policy, an initiative that promotes research on monetary policy issues that are relevant from a global perspective. It is expected that the technical work on the Area-Wide Model will continue throughout 2005 and that the final results will be made public at an open conference.

6 OTHER TASKS AND ACTIVITIES

6.1 COMPLIANCE WITH THE PROHIBITIONS OF MONETARY FINANCING AND PRIVILEGED ACCESS

Pursuant to Article 237(d) of the Treaty, the ECB is entrusted with the task of monitoring the fulfilment by the 25 EU NCBs and the ECB of their obligations under Articles 101 and 102 of the Treaty and Council Regulations (EC) Nos 3603/93 and 3604/93. Article 101 prohibits the ECB and the NCBs from providing overdraft facilities or any other type of credit facility to governments and Community institutions or bodies, as well as from purchasing debt instruments directly from them. Article 102 prohibits any measure, not based on prudential considerations, which establishes privileged access by governments and Community institutions or bodies to financial institutions. In parallel with the ECB, the European Commission monitors Member States' compliance with the above provisions.

The ECB also monitors the EU central banks' secondary market purchases of debt instruments issued by both the domestic public sector and the public sector of other Member States. According to the recitals of Council Regulation (EC) No 3603/93, the acquisition of public sector debt instruments in the secondary market must not be used to circumvent the objective of Article 101 of the Treaty. Such purchases should not become a form of indirect monetary financing of the public sector.

6.2 ADVISORY FUNCTIONS

Article 105(4) of the Treaty and Article 4 of the Statute of the ESCB require that the ECB be consulted by the relevant Community institution and the responsible national authorities,[7] as appropriate, on any proposed Community or national legislation which falls within the ECB's fields of competence. The limits and conditions applicable to the consultation of the ECB by national authorities in respect of draft legislation are set out in Council Decision 98/415/EC of 29 June 1998. All ECB opinions are published on the ECB's website. As of January 2005 opinions on draft national legislation are, as a rule, published immediately following their adoption and subsequent transmission to the consulting authority, as was already the case for opinions on draft EU legislation.

In total 41 consultations were initiated in 2004, 32 by a national authority and nine by the EU Council. A list of the opinions adopted in 2004 is annexed to this Annual Report. The following opinions adopted at the request of national authorities warrant specific mention:

The ECB was consulted by a number of Member States, in particular Hungary and Italy, on legislative proposals that, in the ECB's view, required modification in order to ensure the compliance of NCBs' statutes with the provisions of central bank independence laid down in the Treaty and the Statute of the ESCB, including the personal independence of the members of NCBs' decision-making bodies.[8]

The ECB was consulted by Italy, the Netherlands and Slovakia on significant legislative reforms of the financial supervisory framework. The ECB examined draft legislative proposals in Italy and the Netherlands that were based on a "twin peaks" financial supervisory model whereby the NCB would be responsible for prudential supervision of the entire financial sector and a national financial markets authority would be responsible for the supervision of market conduct.[9] The ECB welcomed the proposed institutional framework in both countries,

7 In accordance with the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, as annexed to the Treaty, Article 105(4) of the Treaty and Article 4 of the Statute of the ESCB shall not apply to the United Kingdom. Hence, the obligation to consult the ECB does not extend to the national authorities of the United Kingdom.

8 CON/2004/16; CON/2004/35.

9 CON/2004/16; CON/2004/21.

noting in its opinion on the Dutch proposal that this approach recognised the distinct character of the two goals of financial stability and investor protection, taking into account widening systemic risk due to the closer links between credit institutions, insurance companies, investment firms and pension funds. The ECB considered that the legislative proposal in Slovakia, which would extend the NCB's supervisory powers by making it directly and fully responsible for the supervision of Slovakia's entire financial market, would establish a supervisory structure that – although currently unique within the EU – was fully compatible with the ESCB-related tasks of an NCB.[10]

The ECB was consulted by Belgium on a proposed "Tobin tax" which would take the form of a tax on all foreign exchange transactions in Belgium, provided that comparable legislation were to be introduced by other Member States or at the Community level.[11] Although the ECB acknowledged the good intentions underlying the draft law, it concluded that the economic and monetary usefulness of such a tax was highly questionable. Moreover, in the form proposed by the draft Belgian legislation, the tax would be incompatible with Article 56 of the Treaty on the free movement of capital and payments between Member States, and between Member States and third countries.

The ECB was consulted by France on draft legislation authorising inflation-indexed loans from credit institutions.[12] The ECB expressed its understanding of the objective to extend the freedom of contract and allow economic agents to hedge against inflation risk, but stressed that widespread use of the indexation clause would give rise to considerable concern, as a widespread indexation in wage and price-setting might generate excessive rigidity in the relative price system and would risk fuelling inflation spirals.

The ECB also delivered an opinion, pursuant to Article 112(2)(b) of the Treaty and Article 11.2 of the Statute of the ESCB, concerning a recommendation from the EU Council on the appointment of a new member of the Executive Board of the ECB.

6.3 ADMINISTRATION OF THE BORROWING AND LENDING OPERATIONS OF THE EUROPEAN COMMUNITY

In accordance with Article 123(2) of the Treaty and Article 9 of Council Regulation (EC) No 332/2002 of 18 February 2002, the ECB continues to have responsibility for the administration of the borrowing and lending operations of the European Community under the Medium-Term Financial Assistance mechanism. In 2004 the ECB did not perform any administration tasks. There was no outstanding balance at the end of 2003 and no new operations were initiated during 2004.

10 CON/2004/31.
11 CON/2004/34.
12 CON/2004/20.

Box 11

EUROSYSTEM RESERVE MANAGEMENT SERVICES

In 2004 the Eurosystem completed the work started in 2003 on a new framework for the provision of a comprehensive set of reserve management services in euro to central banks, monetary authorities and government agencies located outside the euro area, and international organisations. The new framework, developed in response to the continuously increasing use of the euro as an international reserve currency, builds on the well-established reserve management services and experience of individual Eurosystem central banks. The services range from the provision of custody accounts and related custodian (safekeeping) and settlement services to cash and investment services. Examples of key services covered by the new framework include (i) the provision of an automatic overnight investment facility which enables customers to invest funds directly with the respective service provider and/or in the market at attractive remuneration rates, (ii) the facilitation of automatic securities lending programmes and (iii) the execution of orders and standing instructions in line with customers' specific investment preferences.

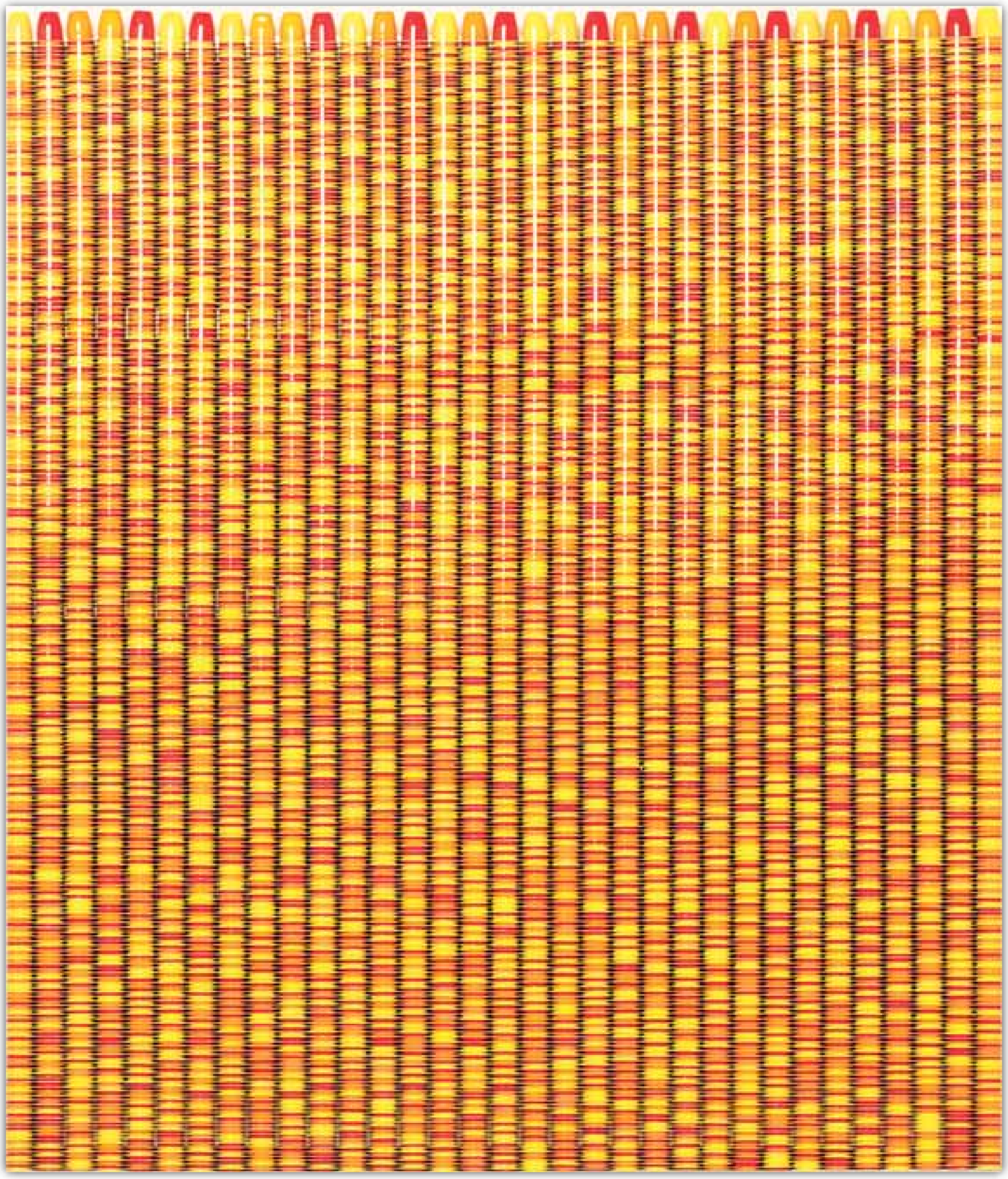
One of the key aspects of the new framework is the provision of high-quality services for customers' euro-denominated reserve assets through a single access point in the euro area. This concept is comparable to the way in which reserve management services are offered by leading central banks around the world. The individual Eurosystem central banks that act as single access points are known as "Eurosystem service providers" and offer the complete set of reserve management services covered by the new framework. As a result of the implementation of the single access point concept, customers can now settle and hold in safekeeping an extensive range of fixed income euro-denominated securities, issued across the entire euro area, using one single custody account. A high degree of harmonisation has been established, with each of the Eurosystem service providers offering the same set of reserve management services subject to harmonised terms and conditions and in line with general market standards.

There are currently six Eurosystem service providers, namely the Deutsche Bundesbank, the Banco de España, the Banque de France, the Banca d'Italia, the Banque centrale du Luxembourg and De Nederlandsche Bank. The remaining Eurosystem central banks may offer some of the services covered by the new framework. Furthermore, both Eurosystem service providers and the other central banks of the Eurosystem may offer additional reserve management services in euro on an individual basis. The ECB performs an overall coordination role, ensuring the smooth functioning of the framework.

In line with the way in which reserve management services have been provided for many years, the new framework is based on the core principles characterising the management of official reserves, such as financial and legal security and, most importantly, confidentiality. The reserve management services under the new framework are offered to traditional central bank customers, thus meeting the special needs and concerns of those institutions that operate in the same area of central banking activity as the Eurosystem itself.

The new framework, launched on 1 January 2005, will be a flexible and constantly evolving one, closely following the latest developments in the financial industry and promptly responding to customers' needs for a comprehensive and up-to-date set of euro-denominated reserve management services.

Artist
Jacob Dahlgren
Title
Krakow, 2002
Material
Yoghurt pots mounted on aluminium
Format
184 × 148 × 10 cm



CHAPTER 3

FINANCIAL STABILITY AND INTEGRATION

1 FINANCIAL STABILITY

The Eurosystem contributes to the smooth conduct of policies pursued by the competent national authorities relating to the prudential supervision of credit institutions and the stability of the financial system. It also offers advice to these authorities and the European Commission on the scope and implementation of Community legislation in these fields.

1.1 FINANCIAL STABILITY MONITORING

The ECB, in collaboration with the ESCB's Banking Supervision Committee (BSC), monitors risks to financial stability in order to assess the financial system's shock-absorbing capacity.[1] The focus is on banks, as they continue to be the main intermediaries in the channelling of funds from depositors to borrowers in the euro area and as such are an important channel through which risks may spread to the rest of the financial system. However, owing to the increasing importance of other financial institutions and markets and their interlinkages with banks, vulnerabilities in these components of the financial system may spread to banks. Thus the monitoring also covers developments in these other components.

CYCLICAL DEVELOPMENTS

In 2004 the capacity of the euro area financial system to absorb shocks improved. Financial institutions benefited from a better than expected strengthening of global economic activity, a bolstering of the balance sheets of large firms and a continued appetite for risk on the part of investors. As a result, the profitability of banks and insurance companies improved. However, earlier signs of fragility in global financial markets remained, resulting from the perceived risk of long-term interest rates rising from very low levels.

In the euro area banking sector, large banks consolidated the trend started in 2003, continuing to show signs of improved profitability. The main sources of improvement in 2004 were continued cost-cutting and reduced loan loss provisioning. Profitability increases were broadly based, with the weakest-performing banks also managing to improve their return on equity.

To support their profitability, cost control was a priority for banks. Costs were primarily cut by reducing the size of branch networks and staff numbers. Provisioning for loan losses fell in 2004, as in 2003. The main underlying factor appeared to be a more favourable assessment of credit risk by banks owing to the economic recovery. This reappraisal appeared to reflect expectations of a consolidation of corporate sector profitability and of further balance sheet strengthening by large euro area firms. However, there were indications that the outlook for small and medium-sized enterprises continued to be less favourable than for large firms.

Notwithstanding the improvement in profitability, net interest income – the core component of banking sector profitability – continued to decline in 2004. This was despite initial signs of a pick-up in corporate lending and the continued buoyancy of lending to households for house purchase. The decline in net interest income was mainly a product of the low interest rate environment and a flattening of the market yield curves which, while boosting loan demand, weighed on euro area banks' lending and deposit margins. As for banks' non-interest income, the exceptional trading profits recorded by many institutions in 2003 thanks to buoyant stock markets and narrowing credit spreads were not repeated in 2004. There were indications that some major euro area banks increased their market risk in the course of 2004. Banks enjoyed stronger fee income, mostly due to increased activity associated with financial markets, both on their own account and from wealth management.

1 In 2004 the ECB published, for the first time, a report on the stability of the euro area financial system entitled "Financial Stability Review". It also published the third edition of "EU banking sector stability", which presents the main findings of the regular monitoring by the BSC of banking sector stability. These publications are available on the ECB's website.

The key regulatory solvency ratios of large euro area banks improved further in 2004. It is notable that the banks with the weakest solvency ratios managed to put their solvency onto a more solid footing. The improved shock-absorbing capacity of these banks contributed positively to financial system stability in the euro area.

The financial performance of insurance companies also improved further in 2004. In the non-life sector, the main factor was the strength of net premium income, driven by more risk-sensitive pricing and stricter underwriting conditions. This improvement in core business allowed the already comfortable solvency position of non-life firms to be further strengthened. Life insurers in most countries witnessed growth in premium income that was underpinned by an increased demand for products whose performance is linked to the stock market. Together with growing net investment income, this contributed to an improvement in their solvency position. However, the financially weakest life insurance companies still remain under pressure.

The global hedge fund industry continued to grow in 2004. Despite the low returns that were achieved in 2004, there were no clear signs that investors withdrew their money. The financial stability implications of the growth in this industry stem mainly from its links with the banking sector. Strong competition among prime brokers improved the access of hedge funds to credit. Prime brokers are typically banks and securities firms that provide financing, brokerage and other services to hedge funds, with some large players coming from the euro area. The prime brokers' counterparty risk management, which improved after the near-failure of Long-Term Capital Management in 1998, benefited from the extensive use of Value-at-Risk measures and stress tests.

STRUCTURAL DEVELOPMENTS

Structural changes in the banking industry can have important consequences for financial stability in the longer term. Strategic choices made by banks affect the risk/profitability trade-off, ultimately having a bearing on the shock-absorbing capacity of the financial system. In addition to the changes in the regulatory and supervisory environment (see Section 2 of this chapter), the most important structural developments in 2004 continued to concern consolidation, internationalisation, intermediation and outsourcing.[2]

The euro area banking sector has been characterised by a continuous process of consolidation over recent years. In the period 1997-2004 nearly 2,300 credit institutions disappeared. This consolidation has been partly due to mergers and acquisitions (M&As), but also to the internal restructuring of banking groups. Restructuring may help banks to maintain or improve their profitability, which should ultimately lead to a more resilient banking system. However, to the extent that this leads to the creation of large and complex financial institutions that are systemically relevant, the ultimate impact may be more ambiguous. This highlights the need for enhanced mechanisms for internal risk control as well as for efficient supervision.

M&A activity has been mostly confined to domestic deals. Over the past ten years, cross-border European banking deals accounted for only 15% of the total volume of mergers in the banking sector, against an average of around 40% in the industrial sector. This continued domestic orientation may be due to, inter alia, the possibility of achieving greater cost synergies through domestic consolidation, as well as differences in tax rules, consumer protection standards and corporate cultures.

2 A more detailed analysis of the structural developments can be found in the BSC's report entitled "Review of structural developments in the EU banking sector", November 2004.

Despite the relatively low cross-border M&A activity, the process of internationalisation is continuing. The assets held by euro area banks in their branches and subsidiaries in other countries of the area now represent more than 10% of the area's unconsolidated banking assets. Furthermore, banks have increasingly been providing financial services on a cross-border basis without having a local establishment in the country where the recipient is located. Progress has been most visible in the interbank and wholesale areas, whereas the volume of retail activity performed on a cross-border basis remains very low.

The importance of retail operations has grown over the past few years, in particular owing to the rapidly rising demand for loans for house purchase. This underscores the importance for euro area banks of focusing on core activities and improving their knowledge of their customer base.

In 2004 the outsourcing of activities continued to gain in importance. Two types of outsourcing are taking place: outsourcing to external suppliers and intra-group outsourcing. Typically, support and back-office activities are outsourced externally, while core activities remain within the bank. In larger group structures, some core activities are carried out by specialised affiliates and their products are distributed by other group entities. Outsourcing is mainly driven by the desire to reduce costs, but the acquisition of professional management and expertise and the freeing-up of resources for core activities are often additional motives. There is a need to monitor the financial stability implications of this development, particularly where multiple financial institutions are outsourcing to a single service provider.

1.2 COOPERATION IN CRISIS SITUATIONS

The framework for cooperation among central banks and banking supervisory authorities in the area of crisis management continued to be enhanced. In June 2004 the central banks and banking supervisors of the new Member States agreed to adhere to the Memorandum of Understanding (MoU) on cooperation in crisis management situations, which had been signed by the other EU central banks and banking supervisors in March 2003. This MoU consists of a set of principles and procedures for cross-border cooperation between these institutions in crisis situations.

Moreover, the BSC and the Committee of European Banking Supervisors (CEBS) set up a joint task force on crisis management comprising representatives from all EU banking supervisors and central banks. Its task is to develop proposals for further enhancing cooperation, particularly in terms of identifying best practices for handling financial crises in a cross-border context. It will also contribute to the work of the Economic and Financial Committee in the field of crisis management.

2 FINANCIAL REGULATION AND SUPERVISION

2.1 BANKING

In the field of banking supervision, the reform of the capital adequacy framework remained a major issue in 2004. In June the central bank governors and the heads of the banking supervisory authorities of the G10 countries endorsed the new framework, known as the New Basel Capital Framework, or Basel II. This was a major achievement as it brings close to completion the five-year-long effort by the Basel Committee on Banking Supervision (BCBS) and its member authorities in this area. The new framework will be implemented as of end-2006. However, the use of the most advanced approaches to calculating banks' capital requirements will only be allowed one year later.

Following the endorsement of the new framework, the focus of international and European activities in this area has shifted towards implementation issues and the work carried out by the BCBS's Accord Implementation Group. A number of countries, both within the G10 and beyond, are expected to carry out a fourth quantitative impact study (known as the "QIS4"). The results should be available at the end of 2005 and may lead to further quantitative adjustments of the framework in 2006. The BCBS has also identified technical areas that require additional work. The ECB will continue to support this process of implementation and contribute to it through its participation as an observer in the BCBS and its main sub-structures, including the Accord Implementation Group.

At the European level, the new EU capital adequacy framework, which will be based on Basel II, will be introduced into EU legislation by amending the Codified Banking Directive and the Capital Adequacy Directive. In contrast to Basel II, which applies only to internationally active banks, the EU capital framework will apply to all credit institutions on a consolidated and individual basis, as well as to investment firms. The EU framework provides for improved cooperation and coordination among banking supervisory authorities by enhancing the role of the "consolidating supervisor". This is, as a rule, the national supervisory authority of the Member State where the group's parent institution received its banking licence and which is responsible for the top level of supervision of an EU cross-border banking group. The role of this supervisor would be enhanced by making it responsible for the coordination of the processing and approval of an EU cross-border group's application to use the more sophisticated approaches to calculating capital requirements. Strengthening the role of the consolidating supervisor would therefore reduce the overall supervisory burden on such a banking group.

After being consulted by the EU Council, the ECB delivered an opinion on the new EU capital framework in which it generally supported the thrust of the new set of rules. The ECB placed emphasis on the parallel implementation of the new EU framework and the revised Basel framework, which is essential to ensure a level playing-field between European banks and their competitors from other countries. The ECB also stressed the need for enhanced cooperation among supervisory authorities to pursue consistent transposition and implementation of EU legislation into national laws and practices. In the latter field, the CEBS is expected to play a major role.

2.2 SECURITIES

As one of the most significant measures of the Financial Services Action Plan (FSAP), the EU Council adopted in May 2004 the Financial Instruments Markets Directive, replacing the regime set up by the Investment Services Directive of 1993. The new Directive lays down a comprehensive set of rules concerning all trading venues, namely regulated markets, multilateral trading facilities and intermediaries that execute client orders internally. This Directive reinforces the cooperation among financial regulators with the purpose of achieving an effective supervisory framework across the EU.

Work is under way to further harmonise disclosure rules applicable to companies with securities listed on European capital markets. The EU Council reached a political agreement on a new directive, known as the Transparency Directive, in May 2004. The introduction of harmonised and enhanced disclosure standards will have beneficial effects on the European economy.

In view of their importance for the integration of European financial markets and the enhancement of financial stability, the Eurosystem fully supports both regulatory initiatives and has followed the related legislative process closely. The ECB also contributed to the process via input provided to the European Securities Committee.

2.3 ACCOUNTING

The Eurosystem has an interest in the development of a harmonised accounting framework in the EU because of its potential impact on banks and ultimately on financial stability. The Eurosystem also supports the development of the new standards as they will foster further financial integration and contribute to the increased efficiency of financial markets in Europe. During 2004 the International Accounting Standards Board (IASB) continued its work on the new accounting standards, and especially on International Accounting Standard 39 (IAS 39) dealing with the use of fair values for financial instruments, which account for a large part of banks' balance sheets.

The concerns regarding the potential financial stability implications voiced mainly by the Governing Council and prudential supervisors prompted the IASB to issue a revised exposure draft on IAS 39, which introduced certain restrictions on the optional use of fair values for financial instruments. The assessment of the exposure draft by the Governing Council, which was also based on quantitative elements, was broadly supportive of this initiative, on the assumption that banks implement the fair value option in a prudent manner. This assessment was conveyed in a letter sent by the President of the ECB to the IASB in September 2004, which also called for the fair value option to be limited to reducing artificial volatility.[3] The dialogue with the IASB will continue in 2005.

3 The letter, together with the annex containing the main findings of the empirical analysis, is available on the ECB's website.

3 FINANCIAL INTEGRATION

The ESCB is committed to the integration of European financial markets and market infrastructures because of their key role in the transmission of monetary policy and in financial stability. Moreover, the integration of financial markets should help to create a level playing-field for all economic agents regardless of their location within the EU. In addition, Article 105 of the Treaty states that without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community, among which financial integration occupies a prominent position. This support takes the form of direct action and catalysis of collective action by market participants.

CONTRIBUTION TO THE EU FINANCIAL SERVICES POLICY

The FSAP, launched by the European Commission in May 1999, aimed to complete the necessary legislative regime to enable the effective exercise of market freedoms in financial services throughout the EU. The adoption of 39 of the 42 Community measures listed in the FSAP by the end of the term of the European Parliament in mid-2004 led to a substantive improvement in EU financial sector regulation and represents an important step forward in the process of integration of European financial markets and market infrastructures. In June 2004 the ECB contributed to the high-level conference on European financial integration organised by the European Commission, which was a first stocktaking exercise on the FSAP's achievements. The ECB's view, widely shared by other participants, was that the extent to which the FSAP would contribute to the effective establishment of a single financial market would hinge on the consistent implementation and enforcement of its measures by the Member States. It is likely that the impact of the FSAP on financial institutions and markets will take some time to fully manifest itself, as a significant number of the key measures have been adopted only recently and most still require implementation at the national level.

Regarding future work, the ECB considers that a streamlined regulatory framework for financial institutions should be developed as a matter of priority. Such a framework should be both more harmonised across Member States than the current set-up and flexible enough to adapt to a changing environment. This project should be complemented by a considerable effort to converge supervisory practices, to be achieved through enhanced cooperation between national authorities, inter alia in the Level 3 committees. This should also be accompanied by a thorough analysis of the relationship between financial integration and financial stability. In particular, the impact of the development of cross-border banking on the home country control approach, which is central to the EU regulatory framework, should be further analysed. Competition policy should also be part of the post-FSAP environment, as it is crucial for the development of a pan-European market. A larger role for the private sector, via self-regulation, could also be effective in fostering integration. The ECB will contribute to the definition of post-FSAP initiatives. This contribution will benefit from the ECB's research activities on financial integration issues (see Box 12).

THE SHORT-TERM EUROPEAN PAPER INITIATIVE

The private sector can contribute to financial integration via collective action aimed at promoting the convergence of market practices. The ECB can act as a catalyst in this process, as exemplified by its role in the Short-Term European Paper (STEP) initiative. The ACI, the Financial Markets Association, launched this initiative to foster the convergence of standards and practices prevailing in the fragmented European short-term securities markets. This convergence will be achieved through market players' voluntary compliance with standards set out in a market convention, which will cover information disclosure, documentation, settlement and the provision of data to the ESCB for the production of statistics. The ACI will grant a STEP label to existing issuance programmes that meet these standards. However, the label

Box 12

RESEARCH NETWORK ON CAPITAL MARKETS AND FINANCIAL INTEGRATION IN EUROPE

In 2002 the ECB and the Center for Financial Studies (CFS) launched a research network to promote research on capital markets and financial integration in Europe. The network was initially set up for a period of two years, which ended in May 2004 with a symposium organised around its five priority areas.

Research presented in the priority area of European bond markets was particularly insightful. The introduction of a common pan-European electronic trading platform (Euro MTS) reduced transaction costs substantially. Not only did it improve the integration of this market segment, it also resulted in higher liquidity and lower yields, in particular for regularly issued Treasury bills. However, some cross-country differences in yield spreads remain, notably for longer-term bonds, and are largely explained by an international risk factor. Liquidity differentials only play a role in conjunction with this latter factor. The dynamically developing corporate bond market exhibits a relatively high level of integration, while factors related to the country where a bond is issued account for only a marginal part of corporate bond yield spreads.

The work done by the research network in its first two years helped to identify three key policy areas: (i) addressing the structural features of clearing and settlement systems that are hampering further integration, (ii) actively using competition policy to prevent practices that discriminate against foreign financial service providers and (iii) removing the remaining differences in national financial regulations that make the pan-European provision of financial services more costly than necessary.

Following the successful conclusion of the first phase, the ECB and the CFS decided that the activities of the network would continue until 2007. The scope of the network has been extended to the new EU Member States for this second phase. Possible areas for study in this second phase are the initial effects of the FSAP on the functioning of the European financial system, as well as a number of areas that were not addressed in the first phase. The main priorities of the network have been broadened to include three areas not addressed in the first phase: (i) the relationship between financial integration and financial stability, (ii) EU accession, financial development and financial integration, and (iii) financial system modernisation and economic growth in Europe.[1]

1 Comprehensive summaries of the results from the first phase of the network were published in the report entitled "Research Network on capital markets and financial integration in Europe: Results and experiences after two years", ECB and CFS, 2004, and in a special issue of the Oxford Review of Economic Policy, vol. 20(4), 2004, on "European financial integration", produced in cooperation with the network.

will not refer to the financial soundness of the issuer, the liquidity of the assets or the accuracy of information provided in the information memorandum. Moreover, national rules applicable to the debt instruments will continue to apply. The initiative's promoters set out their recommendations in a report published in March 2004, which also included some recommendations addressed to the ESCB.

The Governing Council assessed the ACI's recommendations and took an overall favourable attitude towards them. With respect to the recommendations addressed to the ESCB, it was decided that under certain conditions the ESCB would technically support the activities pertaining to the introduction of a STEP label during the first two years after its launch. However, responsibility for the STEP label would rest with the STEP Market Committee. Such a technical contribution to the labelling process would not lead to the ESCB taking any action, such as prohibition or suspension of issuance, in the event of an issuer not complying with the convention's requirements. In such a case, the only consequence would be that the ACI would withdraw the STEP label from the issuance programme. The Governing Council also decided to act on the recommendation to produce and publish statistics on yields and volumes, subject to a check regarding the efficiency of the collection process. The ACI is currently carrying out the STEP project, taking into account the Governing Council's decisions.

SINGLE EURO PAYMENTS AREA

The ECB also plays a catalyst role in the establishment of a Single Euro Payments Area (SEPA), a project that was launched by the European banking industry in 2002. The objective is to enable cross-border payments to be made from a single bank account throughout the euro area as easily and safely as domestic payments can be made. All payments should reach a level of safety and efficiency at least as high as in the best-performing national payment systems. The ECB participates as an observer in the European Payments Council (EPC), set up by the European banking industry to steer this project. Throughout 2004 the Eurosystem continued to cooperate closely with market participants through the Contact Group on Euro Payments Strategy. It also worked closely with the European Commission in view of the complementary roles played by the Commission and the Eurosystem in facilitating the SEPA.

In a third progress report on the SEPA, the Governing Council formally assessed the banking sector's achievements in this area.[4] It welcomed the objective of the banking sector to have a fully-fledged SEPA infrastructure by end-2010 and recommended that a SEPA for citizens should be achieved by as early as 2008 by offering citizens and commercial enterprises the chance to use pan-European instruments and standards also for national payments. The EPC is responsible for defining the SEPA objectives and the overall strategy, but the implementation may differ depending on local conditions. In order to drive national implementation, the Eurosystem has invited euro area banking communities to present to the EPC during 2005 national plans for the gradual transition to a SEPA before end-2010.

E-PAYMENTS

E-payments are payments that are generated and handled electronically. Eurosystem activities related to e-payments comprise promoting cooperation and consensus-building in the e-payments market, monitoring its development, fostering its security and improving related statistical information. In 2004 the ECB continued to operate the website of the e-Payment Systems Observatory (ePSO)[5]. It held a conference entitled "E-payments without frontiers" in November 2004, prior to which an issues paper was published for public comments. Although some progress has been made overall, considerable effort is still needed to achieve secure, user-friendly and efficient cross-border e-payment schemes. This is particularly the case for electronic retail payment transactions, where operational features, charges and regulations still differ substantially.

CARD PAYMENT SCHEMES

The Eurosystem attaches great importance to payment cards as one of the most prominent cashless payment instruments, in particular in a cross-border context. The ECB carried out a survey to gain more information on the structure of the card payment business in

4 "Towards a Single Euro Payments Area – Third progress report", ECB, December 2004.
5 ePSO is a platform for sharing information on electronic payments. Its website can be found at www.e-pso.info.

Europe and on the different ways in which card payments are processed and settled. The survey covered aspects related to governance, issuing and acquiring, the general technical infrastructure, as well as risk management and the legal set-up. The ECB also organised a Payment Card Roundtable, which brought together the major stakeholders and players in this field. At this event, the Eurosystem expressed its increasing interest in this field as part of its actions to promote a SEPA, and a number of issues were identified as requiring follow-up, such as interchange fees, card acceptance, the regulatory framework and fraud prevention.

SECURITIES CLEARING AND SETTLEMENT INFRASTRUCTURE

In April 2004 the European Commission released a communication on clearing and settlement for public consultation, outlining the actions that it intends to take to foster European integration and efficiency in this area. The Eurosystem responded positively to this consultation.[6]

The ECB fosters the integration and reform of securities clearing and settlement through its participation in the Clearing and Settlement Advisory and Monitoring Experts Group, which the Commission set up in 2004. In this way, it contributes to the coordination of private and public sector initiatives and liaises with the market, with a view to supporting the removal of the technical barriers identified by the Giovannini Group, a forum of financial experts which advises the Commission on financial sector issues. Furthermore, the ECB held a joint meeting with the European Central Securities Depositories Association and the Central and Eastern European Central Securities Depositories Association, which focused on the integration of the EU clearing and settlement industry. The ECB would welcome further steps towards the creation of a single European association for central securities depositories.

The process of consolidation of the European securities infrastructure continued in 2004 with the merger between the Finnish and Swedish central securities depositories. The long-term plan of the new group is to use a common technological platform.

MONITORING FINANCIAL INTEGRATION

The ECB has been developing various indicators to measure the degree of financial integration in the euro area. A set of such indicators was included in an ECB Occasional Paper published in 2004.[7] The indicators serve as a basis for evaluating the progress of integration in various financial markets. Box 13 provides further information on the integration of the euro area credit market. The ECB intends to continue measuring progress in financial integration in the future.

6 "Communication on clearing and settlement – the Eurosystem's response", ECB, July 2004.

7 See L. Baele et al., "Measuring financial integration in the euro area", ECB Occasional Paper No 14, May 2004.

Box 13

FINANCIAL INTEGRATION IN THE EURO AREA CREDIT MARKET

The comparison of interest rates across countries provides an important indication of integration in the retail banking market. As integration increases, interest rate differentials for similar banking products can be expected to decrease across countries. However, differences in products and institutions make it difficult to verify in practice whether differentials actually do decrease. This is especially true in retail banking, as markets remain predominantly local in the euro area. Apart from geographical barriers, there are many other reasons for cross-country differentials, such as economic, structural and institutional factors. These factors relate, for example, to differences in regulation, competition, bank-customer relationships and the overall development of the financial system.

The ECB's harmonised interest rate statistics can be used to measure integration in the euro area credit market. However, when interpreting the data, it should be borne in mind that, within each interest rate category, there might still be considerable heterogeneity among national series. This is due, for example, to the aggregation of various instruments within the currently defined maturity bands and the aggregation of secured and unsecured loans within the same category. Taking into account the data limitations, several measures of integration based on the dispersion of interest rates across euro area countries indicate that the degree of integration varies significantly across different market segments. For instance, it seems to be higher for loans to households for house purchase and for short-term loans to non-financial corporations, and lower for bank overdrafts to non-financial corporations and for loans to households for consumption.

4 OVERSIGHT OF MARKET INFRASTRUCTURES

One of the statutory roles of the Eurosystem is to exercise oversight over payment and clearing systems. The oversight aims to ensure that the general organisation of payment flows within the economy is efficient and safe. The Eurosystem also takes a general interest in other infrastructures which are used for the transfer of securities, such as securities clearing and settlement systems, because failures during the settlement of collateral could jeopardise the implementation of monetary policy and the smooth functioning of payment systems.

4.1 OVERSIGHT OF LARGE-VALUE EURO PAYMENT SYSTEMS AND INFRASTRUCTURES

The oversight role of the Eurosystem extends to all euro payment systems, including those managed by the Eurosystem itself. The Eurosystem applies the same oversight standards to both its own systems and those that are privately operated. These standards are the Core Principles for Systemically Important Payment Systems adopted by the Governing Council in 2001 as the basis for its oversight policy on systemically important payment systems.

TARGET AND OTHER LARGE-VALUE EURO PAYMENT SYSTEMS

The oversight framework for TARGET has been further developed through the definition of minimum methodological requirements with which all NCBs and the ECB should comply in conducting TARGET oversight. TARGET overseers have also started looking at TARGET2 from an oversight perspective.

In 2004 large-value euro payment systems were assessed against the Core Principles on the basis of the situation in mid-2003. The overall results were published in May 2004. It was found that all TARGET components achieve a high degree of compliance with the Core Principles. A small number of enhancements to be made were identified in the areas of economic efficiency and business continuity arrangements. These issues will be followed up by TARGET overseers and operators. The TARGET overseers acknowledged the important role played by TARGET operators in ensuring the safe operation of TARGET through risk management. The overseers' assessment of the status report prepared by the TARGET operators on the risk situation in TARGET was generally positive. The review of the privately owned large-value euro payment systems did not reveal any major shortcomings.

EURO 1

Oversight of EURO 1 focused on plans by EBA Clearing (EBA), the operator of EURO 1, to further develop the Flexible Settlement Mechanism, allowing banks to settle their STEP 2 positions in EURO 1 without becoming direct members/shareholders of EURO 1. STEP 2 is EBA's retail payment system. Subject to the ECB's approval as overseer, EBA envisages extending this function, which is specifically limited at present to "pre-fund participants" in EURO 1, to allow all EURO 1 members to transfer central bank money to EURO 1 via the TARGET system in order to increase their processing capacity in EURO 1.

CONTINUOUS LINKED SETTLEMENT SYSTEM

The Continuous Linked Settlement (CLS) system settles foreign exchange transactions on a payment versus payment basis, thus eliminating foreign exchange settlement risk to a very large extent. It currently settles transactions in 15 internationally traded currencies, including, since December 2004, the Hong Kong dollar, the New Zealand dollar, the Korean won and the South African rand.

In December 2004 CLS processed an average of 69,000 trades per day with an average daily value of USD 960 billion.[8] According to a survey conducted by the BIS in April 2004, CLS was covering about one-quarter of the

8 Each trade consists of two transactions, one in each currency involved. Thus, in December 2004 CLS settled transactions with an average daily value equivalent to USD 1,920 billion.

entire foreign exchange market at the time of the survey. After the US dollar, the euro is the most important currency for settlement. In December 2004 euro settlements in CLS averaged €309 billion per day and accounted for 22% of total settlements in terms of value (US dollar settlements represented 46%). The share of the euro decreased slightly by comparison with 2003 as a result of the higher number of currencies settled in CLS as well as valuation effects.

The ECB performs a dual role with regard to CLS. It is involved in the oversight of the system and it provides settlement services. The ECB participates in the cooperative oversight of CLS, which is performed by the G10 and non-G10 central banks of the currencies settled in the system, with the Federal Reserve System acting as lead overseer. In 2004 the ECB devoted most of its oversight attention to further strengthening the resilience of CLS and to ensuring the development of an objective framework for adding new currencies.

The ECB considers CLS a very convincing solution for the reduction of foreign exchange settlement risk for euro transactions. However, only a minority of the wholesale foreign exchange transactions involving the euro are settled in CLS. Therefore, banks have been invited to review their settlement practices for foreign exchange transactions and to assess whether their methods of reducing this risk are appropriate.

SWIFT

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a messaging network provider which facilitates the secure exchange of financial messages between financial institutions. Although it is not a bank or a financial institution itself, it is overseen by central banks because of its importance to the smooth functioning of the worldwide financial system. The ECB contributes to the oversight of SWIFT, which is carried out by means of cooperation between the G10 central banks, with the Nationale Bank van België/Banque Nationale de Belgique as lead overseer. In 2004 the oversight arrangements were strengthened in order to ensure the adequate involvement of all G10 overseers and to allow for more streamlined reporting and communication between SWIFT and its overseers. Oversight attention focused on SWIFT's resilience to crises, internal risk management processes and the replacement of SWIFT's old messaging network with SWIFTNet, an internet-based technology infrastructure.

CORRESPONDENT BANKING

Banks often have arrangements to provide one another with payment services and related facilities, primarily for payments across national borders. Such arrangements are referred to as correspondent banking. In 2004 the Eurosystem conducted its fourth survey on correspondent banking, which confirmed that euro correspondent banking is highly concentrated among a few players in the EU. At present this does not pose any immediate systemic risk; however, the Eurosystem will continue to monitor developments in this field in view of its interest in the stability of the financial system as a whole.

4.2 RETAIL PAYMENT SERVICES

OVERSIGHT OF RETAIL PAYMENT SYSTEMS

On the basis of the "Oversight standards for euro retail payment systems" adopted by the Governing Council in 2003, a classification exercise carried out in 2004 identified 15 euro retail payment systems which fall within the scope of the Eurosystem's oversight. Six were classified as being of systemic importance and thus have to comply with all ten Core Principles. Seven are considered to be of prominent importance and are thus required to comply with the Eurosystem Retail Standards (a sub-set of the Core Principles). Two did not fall into either category and will be subject to oversight standards as and when defined for them by the relevant overseer. The systems of systemic and prominent importance are assessed against the oversight standards by the relevant NCBs, while the ECB is responsible for assessing EBA's STEP 2 system. The overall assessment exercise and cross-country consistency is coordinated at the Eurosystem level.

E-MONEY SYSTEMS

Following the definition of the electronic money system security objectives in 2003 and based upon voluntary assessments by some e-money schemes, the Eurosystem in 2004 started to fine-tune the methodological requirements and terms of reference for the assessment of relevant schemes which is planned in 2005.

4.3 SECURITIES CLEARING AND SETTLEMENT SYSTEMS

The Eurosystem plays two roles in the smooth functioning of securities clearing and settlement systems and their oversight. First, the Governing Council assesses the compliance of EU securities settlement systems (SSSs) with nine specific user standards.[9] Second, the Eurosystem cooperates with other authorities responsible for the regulation and oversight of securities clearing and settlement systems at the EU level. In this context, the ECB encouraged debate about the development of a pan-European regulatory framework for clearing and settlement through its participation in the Commission's Clearing and Settlement Advisory and Monitoring Experts Group. The ESCB's cooperation with the Committee of European Securities Regulators (CESR) has been central to the development of pan-European standards which will apply to clearing and settlement. Furthermore, the ECB contributed to the Group of Thirty, an international think-tank, with a view to ensuring that the Group's recommendations concerning clearing and settlement, published in 2003, were implemented in such a way as to be consistent with EU initiatives. The ECB also shaped the Commission's initiative to update the Settlement Finality Directive first adopted in 1998. Finally, the ECB contributed to the recommendations for central counterparties developed by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO).

ASSESSMENT OF SECURITIES SETTLEMENT SYSTEMS

All Eurosystem credit operations have to be covered by adequate collateral in the form of eligible assets. These include securities which are provided to the Eurosystem via SSSs, i.e. service providers that specialise in the transfer of legal ownership of, or equivalent rights in, eligible securities from one party to another. To ensure that it is not exposed to undue risk in this process, the Eurosystem annually assesses the SSSs that it uses against the nine user standards.[10] The 2004 assessment exercise covered 18 SSSs. It concluded that the compliance of these SSSs with the user standards was high and that efforts were being made to introduce further improvements. Some systems have increased their operational reliability, and measures to improve the financial soundness of system operators have been taken. The Eurosystem monitors and welcomes all efforts to improve the efficiency and safety of the SSSs used in its credit operations.

COOPERATION WITH THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

In 2001 the Governing Council approved a framework for cooperation on securities clearing and settlement systems between the ESCB and CESR. A working group was set up, composed of a representative from each central bank of the ESCB and from each securities regulator in CESR. This working group drew up a report on "Standards for securities clearing and settlement in the European

9 In the absence of harmonised EU oversight standards, the user standards have been regarded as de facto common standards for EU SSSs and, therefore, are dealt with in this chapter. Nevertheless, the user standards are not intended to be a comprehensive set of standards for the oversight or supervision of SSSs.

10 "Standards for the use of EU securities settlement systems in ESCB credit operations", January 1998.

Union"[11], which was approved by both the Governing Council and CESR in October 2004. Using as a basis the recommendations for SSSs made by the CPSS and IOSCO (known as the "CPSS-IOSCO Recommendations"), the ESCB-CESR report contains 19 standards that aim to increase the safety, soundness and efficiency of securities clearing and settlement in the EU (see Box 14). In comparison with the CPSS-IOSCO Recommendations, the ESCB-CESR standards seek to deepen and strengthen requirements in some areas on account of the specific features of the European markets. The overall objective of the ESCB-CESR standards is to promote the integration of EU capital markets, and they thus place greater emphasis on common solutions and interoperability. The Commission's work in this area has been taken into account.

The working group has conducted its work in an open and transparent manner. Interested parties in the field of securities clearing and settlement were invited to comment on the work on a number of occasions. The contributions received were considered carefully and the working group has made every effort to ensure that the views expressed have been addressed in the standards. The standards will become

applicable once the methodology for assessing the systems has been developed as a follow-up to the report. Since October 2004 the group has continued its work in the following four fields: (i) developing the assessment methodology for the standards for SSSs, (ii) developing standards and a methodology for the assessment of central counterparties, (iii) analysing issues relating to significant custodians and (iv) analysing the topics of interest for cooperation among regulatory, supervisory and oversight authorities.

11 Available on the ECB's website.

Box 14

STANDARDS FOR SECURITIES CLEARING AND SETTLEMENT IN THE EUROPEAN UNION

Standard 1: Legal framework
Securities clearing and settlement systems and links between them should have a well-founded, clear and transparent legal basis in the relevant jurisdictions.

Standard 2: Trade confirmation and settlement matching
Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.
Settlement instructions should be matched as soon as possible and, for settlement cycles that extend beyond T+0, this should occur no later than the day before the specified settlement date.

Standard 3: Settlement cycles and operating times
Rolling settlement should be adopted in all securities markets. Final settlement should occur

no later than T+3. The benefits and costs of EU-wide settlement cycles shorter than T+3 should be evaluated.
CSDs and, where relevant, CCPs should harmonise their operating hours and days and be open at least during the TARGET operating times for transactions denominated in euro.

Standard 4: Central counterparties (CCPs)
The benefits and costs of establishing a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

Standard 5: Securities lending
Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for avoiding settlement failures and expediting the settlement of securities. Barriers that inhibit the practice of lending securities for this purpose should be removed. The arrangements for securities lending should be sound, safe and efficient.

Standard 6: Central securities depositories (CSDs)
Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest possible extent. To safeguard the integrity of securities issues and the interests of investors, the CSD should ensure that the issue, holding and transfer of securities are conducted in an adequate and proper manner.

Standard 7: Delivery versus payment (DVP)
Principal risk should be eliminated by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

Standard 8: Timing of settlement finality
Intraday settlement finality should be provided through real-time and/or multiple-batch processing in order to reduce risks and allow effective settlement across systems.

Standard 9: Credit and liquidity risk controls
For systemic stability reasons, it is important that CSDs operate without interruption. Therefore, when allowed by national legislation to grant credit, CSDs should limit their credit activities exclusively to what is necessary for the smooth functioning of securities settlement and asset servicing. CSDs that extend credit (including intraday and overnight credit) should fully collateralise their credit exposures whenever practicable. Uncollateralised credit should be restricted to a limited number of well-identified cases and subject to adequate risk control measures including limits on risk exposure, the quality of the counterparty and the duration of credit.
Most custodians are subject to EU banking regulations. For those that manage significant arrangements for settling securities transactions, and in order to contain the systemic risks that are linked to their securities settlement activity, national securities regulators, banking supervisors and overseers should examine the risk management policies applied by those custodians to assess whether they are in line with the risks created for the financial system. In particular, the possibility of increasing the level of collateralisation of credit exposures, including intraday credit, should be investigated.

Operators of net settlement systems should institute risk controls that, as a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and lending limits.

Standard 10: Cash settlement assets
Assets used to settle payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect the participants in the system from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Standard 11: Operational reliability
Sources of operational risk arising in the clearing and settlement process should be identified, monitored and regularly assessed. This risk should be minimised through the development of appropriate systems and effective controls and procedures. Systems and related functions should (i) be reliable and secure, (ii) be based on sound technical solutions, (iii) be developed and maintained in accordance with proven procedures, (iv) have adequate, scalable capacity, (v) have appropriate business continuity and disaster recovery arrangements, and (vi) be subject to frequent and independent audit of the procedures that allow for the timely recovery of operations and the completion of the settlement process.

Standard 12: Protection of customers' securities
Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of the creditors of all entities involved in the custody chain.

Standard 13: Governance
Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and market participants.

Standard 14: Access
CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk.

Standard 15: Efficiency
While maintaining safe and secure operations, securities clearing and settlement systems should be efficient.

Standard 16: Communication procedures, messaging standards and straight-through processing (STP)
Entities providing securities clearing and settlement services, and participants in their systems should use or accommodate the relevant international communication procedures and standards for messaging and reference data in order to facilitate efficient clearing and settlement across systems. This will promote straight-through processing (STP) across the entire securities transaction flow.

Service providers should move towards STP in order to help achieve timely, safe and cost-effective securities processing, including confirmation, matching, netting, settlement and custody.

Standard 17: Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and accurately evaluate the risks and costs associated with securities clearing and settlement services.

Significant custodians should provide sufficient information to enable their customers to identify and accurately evaluate the risks associated with securities clearing and settlement services.

Standard 18: Regulation, supervision and oversight

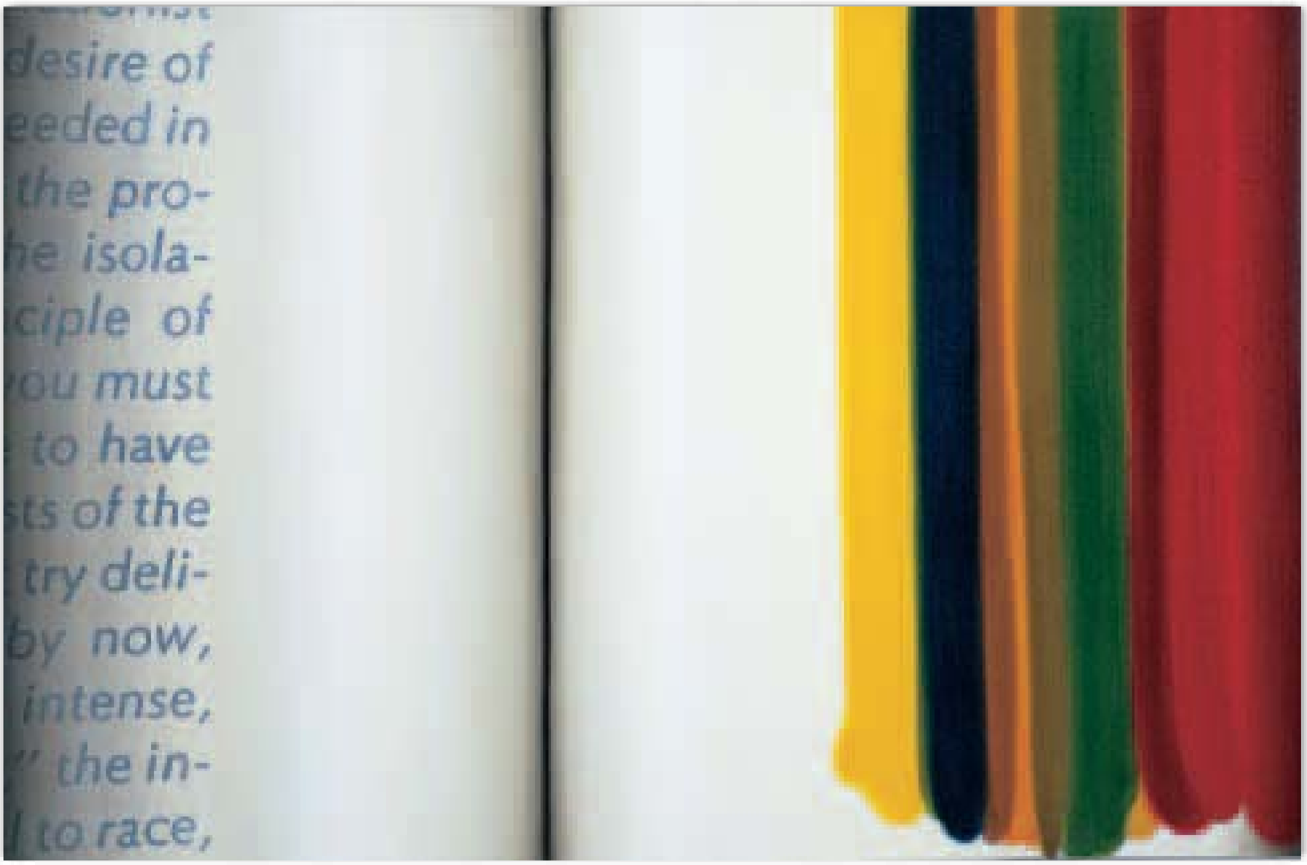
Entities providing securities clearing and settlement services should be subject to, as a minimum, transparent, consistent and effective regulation and supervision. Securities clearing and settlement systems/arrangements should be subject to, as a minimum, transparent, consistent and effective central bank oversight. Central banks, securities regulators and banking supervisors should cooperate with each other, both nationally and across borders (in particular within the European Union), in an effective and transparent manner.

Standard 19: Risks in cross-system links[1]

CSDs that establish links to settle cross-system trades should design and operate such links so that they effectively reduce the risks associated with cross-system settlements.

1 This standard does not cover links established by CCPs. This issue will be covered by the future work of the ESCB-CESR on CCPs.

Artist
Ana Luísa Ribeiro
Title
Untitled, 2002
Material
Oil on canvas
Format
150 × 230 cm



CHAPTER 4

EUROPEAN AND INTERNATIONAL RELATIONS

1 EUROPEAN ISSUES

1.1 POLICY ISSUES

THE STABILITY AND GROWTH PACT

In 2004 two euro area countries, namely Greece and the Netherlands, and six of the ten new EU Member States, namely the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia, were found to be in a situation of excessive deficit (see also Section 2.5 of Chapter 1). The excessive deficit procedures launched in 2003 for France and Germany continued to apply, although they were de facto held in abeyance following the ECOFIN Council conclusions of 25 November 2003. These conclusions stated that France and Germany should correct their excessive deficits by 2005, instead of 2004 as foreseen in the recommendations for these countries issued by the ECOFIN Council itself under Article 104(7) of the Treaty. The excessive deficit procedure for Portugal was abrogated.

In July 2004 the European Court of Justice annulled the ECOFIN Council's conclusions of 25 November 2003 with regard to France and Germany in so far as they contained a decision to hold the excessive deficit procedures in abeyance and to modify the earlier recommendations for the two countries. The Court stressed that the rules and procedures foreseen in the Treaty and the Stability and Growth Pact and the Commission's right of initiative must always be respected.

The ECB expressed its satisfaction that the judgement confirmed the need for the rules and procedures foreseen in the Treaty and the Pact to be fully applied. It called upon the institutions concerned to undertake the necessary steps to ensure the full implementation of the rules and procedures.

In September 2004 the Commission issued a communication on strengthening economic governance and clarifying the implementation of the Stability and Growth Pact. This communication set out a number of proposals to reform the Pact. Proposals regarding the preventive arm of the Pact included ensuring earlier actions to correct inadequate developments through a more timely and active use of early warnings, redefining the medium-term objectives for budget balances to allow for country-specific circumstances and placing greater emphasis on debt and sustainability in the surveillance of budgetary positions. Proposals regarding the corrective arm included modifying the definition of the exceptional circumstances under which a deficit ratio above the reference value of 3% of GDP is not excessive, changing the adjustment path for the correction of an excessive deficit and clarifying the debt criterion.

In the debate on the reform of the Stability and Growth Pact, the Governing Council expressed the view that improvements in the implementation of the Pact were possible and would be beneficial. In this regard, the European Commission's proposals for improving the implementation of the preventive arm of the Pact were useful. At the same time, the Governing Council warned against changes to the Pact and, in particular, to the excessive deficit procedure. It considered the credibility of the 3% deficit limit essential to anchoring expectations of fiscal discipline.

In September 2004 Greece reported deficit and debt figures for the period from 2000 to 2003 which were considerably higher than the previously released figures. The deficit ratio exceeded the 3% of GDP reference value. Subsequently, revised figures for the period from 1997 to 1999 were released, which also showed deficits in excess of 3% of GDP (see also Section 2.5 of Chapter 1). The ECB sees the reliable compilation and the accurate and timely reporting of government finance statistics as being of vital importance to the credibility of budgetary surveillance and of EMU in general. The European accounting rules must be fully respected when recording all types of expenditure and revenue, and applied in a manner that is consistent and stable over time and homogeneous across Member States.

THE LISBON STRATEGY

At its meeting in Lisbon in March 2000, the European Council set out a ten-year strategy – the Lisbon strategy – which, by 2010, was to render the EU "the most dynamic and competitive knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion". The results achieved under the Lisbon strategy by 2004 were mixed. Advances had been made in some areas, for example regarding labour markets. However, in most respects, progress was mediocre. It was clear that the pace of reform would have to be significantly stepped up if the Lisbon targets were to be achieved by 2010.

Against this background, the European Council decided at its spring 2004 meeting to undertake a mid-term review of the Lisbon strategy. As a first step, it invited the Commission to establish a high-level group – chaired by Wim Kok – to carry out an independent assessment of the progress made under the Lisbon strategy, which would serve as the basis for the mid-term review by the Commission and the EU Council. The review is scheduled to be completed in time for the spring European Council of March 2005.

The high-level group presented its report, entitled "Facing the challenge", in November 2004. The report stressed that, in the face of the twin challenges of global competition and ageing populations, maintaining the status quo is not an option for the EU, especially if it is to safeguard its social model. The report concluded that the ambitious objectives of the Lisbon strategy, as well as the 2010 deadline for achieving these objectives, should therefore be upheld. It called for a better prioritisation of objectives and urgent action in five key policy areas: the knowledge society, the internal market, the business climate, the labour market and environmental sustainability.

The ECB has repeatedly endorsed the ambitions of the Lisbon strategy and has expressed its support for the efforts undertaken by governments and social partners. It has also called for faster implementation of the required measures and for more effective benchmarking of reform progress. Reform is essential to ensure future growth and employment opportunities and to enhance the euro area's ability to adjust to economic shocks. Reforms in labour, capital, goods and services markets in particular can promote investment, and reduce inflation persistence through increased competition. The EU should take advantage of the mid-term review to revitalise the Lisbon strategy and increase the pace of structural reform.

1.2 INSTITUTIONAL ISSUES

THE EUROPEAN CONSTITUTION

At the final meeting of the Intergovernmental Conference (IGC) on 17-18 June 2004, the Heads of State or Government reached agreement on the Treaty establishing a Constitution for Europe (the European Constitution). The European Constitution was signed in Rome on 29 October 2004. Once ratified by all 25 Member States in accordance with their national procedures, it will enter into force on 1 November 2006. In a number of Member States, ratification procedures will involve holding a referendum.

The ECB monitored the IGC closely and made both formal and informal contributions to the negotiations on issues of relevance to the tasks and mandate of the ECB, the Eurosystem and the ESCB. In accordance with Article 48 of the Treaty on European Union, the ECB was consulted and the Governing Council on 19 September 2003 adopted an opinion on the draft Treaty establishing a Constitution for Europe[1]. In addition, the President of the ECB sent letters to the President of the EU Council in November 2003 and April 2004 to expand on this opinion.

The ECB welcomed the efforts made by the European Convention on the Future of Europe and the subsequent IGC to simplify, streamline and clarify the legal and institutional framework of the EU. It also made it clear that the current provisions governing EMU were sound in terms of both their objectives and the allocation of responsibilities.

In particular, the ECB considered it essential that price stability should remain not only the primary objective of the ECB and the ESCB but also a stated objective of the EU. The European Constitution fully confirms this view.

The ECB also deemed it indispensable to the successful performance of its tasks that the special institutional features of the ECB and the ESCB, which set the ECB apart from other European institutions, be preserved. The European Constitution preserves these special institutional features by confirming the independence of the ECB, the ESCB and the NCBs as well as the legal personality and regulatory powers of the ECB. It further underlines the special character of the ECB by classifying it as one of the "other Union Institutions and advisory bodies". The ECB is thus listed separately from the "Union's Institutions", namely the European Parliament, the European Council, the Council of Ministers, the European Commission and the Court of Justice of the European Union, which are categorised as the EU's "institutional framework".

At the specific request of the ECB, the term "Eurosystem" has been introduced in the European Constitution. This term, which refers to the ECB and the NCBs of the euro area and was adopted by the Governing Council in 1999, helps to distinguish between the ESCB, which comprises all EU central banks, and the central banking system of the euro area. The term "Eurosystem" also appropriately reflects the fact that the ECB and the euro area NCBs are integral parts of one system (see also Chapter 8).

In view of the above, the ECB considers that the European Constitution confirms the existing EU monetary framework. It would welcome the successful completion of the ratification process.

THE NEW WORKING METHODS OF THE EUROGROUP

During the informal ECOFIN Council meeting of 10-11 September 2004 in Scheveningen (the Netherlands), the ministers of economy and finance of the euro area agreed on new working methods for the Eurogroup. These new methods are intended to improve the Eurogroup's efficiency and effectiveness.

The new methods include more forward-looking strategic discussions, in particular on structural reform, and the creation of a stable Eurogroup presidency for a period of two years instead of a rotating presidency of six months. The Eurogroup President is elected by a simple majority of the Eurogroup members. In Scheveningen, the Prime Minister and Finance Minister of Luxembourg, Jean-Claude Juncker, was elected as the first Eurogroup President for a two-year period from 2005 to 2006.

The ECB, which is regularly invited to take part in the meetings of the Eurogroup, participated in the review of its working methods. The ECB took the view that these new working methods, including the creation of a stable Eurogroup presidency, would help to make the functioning

1 CON/2003/20.

of the Eurogroup more efficient and effective. The new methods do not imply any changes in the allocation of tasks between the ECB and the euro area finance ministers in the framework of EMU. However, they underline the common responsibility of governments for the conduct of sound fiscal and structural policies, which are necessary for the continued success of the single currency.

2 INTERNATIONAL ISSUES

2.1 KEY DEVELOPMENTS IN THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

SURVEILLANCE OF MACROECONOMIC POLICIES IN THE GLOBAL ECONOMY

Macroeconomic policies in the global economy, in particular the policies conducted by major industrial countries, are an essential element of the international environment which the ECB has to take into account in the conduct of its monetary policy and other tasks. The Eurosystem participates in the surveillance of these macroeconomic policies by international financial institutions and fora, which takes place mainly at meetings of the IMF Executive Board, the Organisation for Economic Co-operation and Development (OECD), the G7 finance ministers and central bank governors, and the G10 central bank governors. The aim of the ECB is to exchange views and review policy options conducive to a stable macroeconomic environment, sound macroeconomic policies and price stability in the euro area.

The global policy environment in 2004 was characterised by strong economic growth and mostly contained inflationary pressures. There was a welcome rebound in output in many advanced economies, as well as in Latin America, coinciding with continued strong growth rates in emerging markets in Asia and eastern Europe. On the downside, however, global imbalances – including external imbalances of the US economy – persisted or even widened further.

On various occasions, the ECB stressed the risks and uncertainties related to the continuation of such imbalances. Overall, the ECB shares the view of the international community that there are three key requirements for the adjustment process: addressing the savings/investment shortfall in the deficit countries; fostering higher sustainable growth through structural reforms in countries with relatively low potential growth; and promoting exchange rate flexibility for major countries and regions that lack such flexibility. With regard to exchange rate developments, the G7 communiqués in 2004 and February 2005 emphasised that exchange rates should reflect economic fundamentals and that excess volatility and disorderly movements in exchange rates were undesirable for economic growth.

The increasing relevance of East Asian countries for the global economy, as reflected in their remarkable contribution to world output growth and trade, was a major issue in 2004. The ECB closely monitored developments in these countries and strengthened its direct relations with Asian central banks by organising, together with the Monetary Authority of Singapore, a high-level seminar bringing together the 11 governors from the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)[2], the governors of the euro area NCBs and the President of the ECB. The event, which took place in Singapore in July 2004, focused on the growing economic weight of many East Asian countries, the role of international currencies, and regional integration and cooperation.

Capital flows to emerging market economies, which the ECB continuously monitors on account of their relevance for international financial stability, remained robust in 2004, as did the economic performance of these countries in general. Crucial factors were favourable external financing conditions, high international prices of export commodities and a pick-up in import demand from advanced economies. As a result, current account surpluses were recorded and external debt levels generally decreased, although indebtedness remained high in a number of countries. Accommodative financing conditions induced public and private emerging market borrowers to strongly tap international bond markets, locking in low interest rates. Having temporarily widened in

2 The EMEAP countries are Australia, China, Hong Kong SAR, Indonesia, Japan, Malaysia, New Zealand, the Philippines, Korea, Singapore and Thailand.

the second quarter of 2004, emerging market bond spreads returned to low levels by historical standards later in the year.

Finally, the euro area itself was examined as part of the international policy surveillance exercises. Both the IMF and the OECD conducted their regular reviews of the monetary, financial and economic policies of the euro area, in addition to their reviews of the individual euro area countries. The Article IV consultations of the IMF and the review by the OECD's Economic and Development Review Committee provided an opportunity for a fruitful exchange of views between these international organisations and the ECB, the Eurogroup presidency and the European Commission. Following these discussions, the IMF and the OECD each produced a report containing an assessment of euro area policies.[3] Special attention was paid to the accession of ten new Member States to the EU on 1 May 2004 in both reviews conducted in 2004.

INTERNATIONAL FINANCIAL ARCHITECTURE

In view of the high degree of integration of the EU in the global economy, the ESCB and the Eurosystem have an interest in the smooth functioning of the global financial system. Therefore, they actively contribute to ongoing discussions on the international financial architecture, including through participation in the relevant international institutions and fora. In some of these institutions and fora the ECB participates directly, and in others it has been granted observer status. The ESCB also takes part in this work at the European level, in particular in the Economic and Financial Committee.

In the context of work by the G10 finance ministers and central bank governors, the ECB welcomed the increasing inclusion of collective action clauses (CACs) – contractual provisions designed mainly to facilitate the orderly restructuring of defaulted debts – in sovereign bond issues. Within less than two years, the use of CACs has become the market standard for the issuance of sovereign bonds under New York law, although without fully meeting the G10 recommendations.

The ECB also discussed other aspects of private sector involvement in the resolution of financial crises and reviewed the experience with various instruments for promoting such involvement. Furthermore, it monitored progress in the development of the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets", which were released in November 2004 by a group of emerging market sovereign issuers and private sector creditors. Previously known as the "Code of Conduct", these principles aim to promote disclosure of information on indebtedness, regular dialogue between debtors and creditors, debt restructuring negotiations in good faith and fair treatment of all affected creditors. The principles, which were welcomed by the G20 finance ministers and central bank governors, address some remaining gaps in the architecture of global finance. Once implemented, they should substantially contribute to the longer-term efforts to build a system which promotes global cooperation, growth and financial stability.

Another topic monitored by the ECB was the IMF's financial position. At their meeting in October 2004, the G10 finance ministers and central bank governors noted that the IMF's strong financial position, which was essential for the fulfilment of its responsibilities, would face challenges in the context of an evolving world economy. Coping with these challenges would require a number of policy measures, among which were strengthened surveillance, more emphasis on debt sustainability in lending decisions, strict adherence to the recently agreed exceptional access framework as well as possible further changes in the IMF's financial structure to promote timely repayment and fewer successor arrangements.

3 IMF: "Euro Area Policies: Staff Report", August 2004; OECD: "Economic Survey – Euro Area 2004", July 2004.

REGIONAL INTEGRATION AND COOPERATION

As the EU is the outcome of a lengthy process of regional economic integration itself, the ECB has become a natural partner to monetary authorities in several regional groupings in the world, which call on the ECB to share its experience with policy-makers and, occasionally, academics. In this context, the ECB is interested not only in explaining the European case, especially in the field of monetary cooperation, but, equally importantly, in understanding regional economic integration outside the EU.

In September 2004 a G20 workshop on regional economic integration in a global framework took place in Beijing, organised by the People's Bank of China and the ECB. Among the issues examined were the preconditions for regional cooperation arrangements, the optimal sequencing of the processes of integration and monetary and financial cooperation, and the compatibility between regional trade integration and World Trade Organization rules.

In 2004 the ECB also strengthened its relations with regional monetary institutions in Africa. In this respect, the ECB, together with a number of euro area NCBs, has extended technical assistance to the Western African Monetary Institute (based in Accra, Ghana), the body undertaking the technical preparations for monetary integration among English-speaking countries in West Africa.

INTERNATIONAL ROLE OF THE EURO

In 2004 the role of the euro remained largely stable in international capital and foreign exchange markets and as an anchor, reserve and intervention currency. There was some evidence of increased use of the euro as an invoicing and settlement currency in the international trade of selected euro area countries. For most of these countries, the use of the euro appears to be more widespread in the case of exports than in the case of imports and, within exports, it is higher for goods than for services. For most of the new EU Member States and for the candidate countries, a notable increase in the share of the euro in international trade was also observed (on the basis of data for 2003). The increase in the use of the euro in many cases exceeded the increase in trade relations with the euro area, suggesting that the euro is being increasingly used in the international trade of those countries with non-euro area trading partners.[4]

The ECB continued to develop the statistical coverage required for its analysis of the euro's international role. On the basis of previous research, two new datasets were constructed to identify salient features of the market for euro-denominated bonds issued by non-euro area residents.

2.2 COOPERATION WITH COUNTRIES OUTSIDE THE EU

The Eurosystem continued to build up its contacts within the central banking community outside the EU, mainly through the organisation of seminars and workshops but also through technical assistance. The objective is to gather information and exchange views on economic and monetary developments in different regions of the world with a potential bearing on

4 See "Review of the international role of the euro", ECB, December 2004.

the global economic environment or developments in the euro area.

The Eurosystem's technical assistance project with the Central Bank of the Russian Federation (CBR), funded by the EU within the framework of its Technical Assistance for the Commonwealth of Independent States (TACIS) programme, is being implemented as planned. Launched in November 2003, the aim of the two-year project is to further strengthen the CBR's banking supervision function as a key measure to foster a more stable financial environment in Russia. The project's training plan, which was agreed in January 2004 between the CBR on the one hand, and nine euro area NCBs, three supervisory authorities and the ECB on the other, foresees 64 courses, eight study visits and four high-level seminars. By end-2004, 34 courses, four study visits and two seminars had taken place. Roughly 400 CBR staff took part in this training plan. In addition to the TACIS project, in May 2004 the Eurosystem held its first bilateral high-level seminar with the CBR in Helsinki, coordinated by Suomen Pankki – Finlands Bank and the ECB. This seminar focused on monetary and exchange rate policies, free capital mobility, economic links between the EU and Russia, including trade policies, as well as banking system developments and financial sector stability issues.

The Eurosystem has established a framework for cooperation with central banks in the Mediterranean region. In January 2004 its first high-level seminar with central bank governors of the Barcelona partner countries[5] took place in Naples, jointly organised by the ECB and the Banca d'Italia. Following a technical workshop in September 2004, the second high-level seminar took place in Cannes in February 2005, jointly organised by the ECB and the Banque de France. This seminar focused on recent financial and monetary developments in the Mediterranean region, economic linkages between the euro area and the Mediterranean countries (with a particular focus on workers' remittances), as well as central bank independence.

In the western Balkans, the ECB has initiated relations with central banks at senior management level through a number of visits, including to the Central Bank of Bosnia and Herzegovina and the National Bank of Serbia. These visits served the purpose of developing a dialogue between the ECB and the central banks of these countries, given that they are potential EU candidate countries.

The Eurosystem also aimed to improve its understanding of developments in systemically important economies in Latin America. To this end, the ECB, together with the Banco Central do Brasil, the Banco de Portugal and the Banco de España, organised the second high-level seminar of the Eurosystem and Latin American central banks, which took place in Rio de Janeiro in November 2004 and was preceded by a preparatory technical workshop held in Lisbon. Participants discussed the possible constraints on the conduct of monetary policy arising from fiscal policies, debt vulnerabilities and financial system characteristics.

In the Middle East, the ECB further developed its relations with the Secretariat General of the Gulf Cooperation Council (GCC) and GCC member states' monetary agencies and central banks in view of the plan to introduce a single currency in the GCC member states[6] by 2010.

5 Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, the Palestinian Authority, Syria, Tunisia and Turkey.
6 The six member states of the GCC are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

Artist
Xenia Hausner
Title
Traumspiel, 2004
Material
Chromolithograph on handmade paper (ed. 16/25)
Format
96 × 129 cm

CHAPTER 5

ACCOUNTABILITY

1 ACCOUNTABILITY VIS-À-VIS THE GENERAL PUBLIC AND THE EUROPEAN PARLIAMENT

Accountability can be understood as the legal and institutional obligation of an independent central bank to explain its decisions clearly and thoroughly to citizens and their elected representatives, thereby enabling them to hold the central bank responsible for achieving its objectives. Accountability thus constitutes an important counterpart to the independence of a central bank.

From its inception, the ECB has acknowledged the fundamental importance of its accountability obligations and has maintained a regular dialogue with citizens and their elected representatives. The Treaty lays down a number of reporting requirements for the ECB, ranging from the publication of an annual report, a quarterly report and a weekly consolidated financial statement to appearances before the European Parliament. The ECB fully complies with these requirements and even exceeds them, for instance by publishing a Monthly Bulletin rather than a quarterly report, by holding monthly press conferences and, since December 2004, by making public on a monthly basis Governing Council decisions taken in addition to interest rate decisions (see also Section 1 of Chapter 6). At the institutional level, the Treaty assigns a prominent role to the European Parliament with regard to the accountability of the ECB.

The members of the Governing Council continued during 2004 to deliver numerous speeches throughout the euro area in order to explain the ECB's policies to the public. In line with the provisions of Article 113 of the Treaty, the ECB also continued to report regularly to the European Parliament on the decisions taken in the field of monetary policy and on its other tasks. As in past years, the quarterly testimonies by the President of the ECB before the Committee on Economic and Monetary Affairs served as the main forum for these regular exchanges of views. The President also presented the ECB's Annual Report 2003 to the Committee and to the plenary of the European Parliament.

The Committee on Economic and Monetary Affairs also invited another member of the Executive Board to present the ECB's views on the economic environment and key issues in the area of structural reform. In addition, the ECB participated in a hearing organised by the Committee on the issue of the Single Euro Payments Area.

Beyond the scope of its Treaty obligations, the ECB continued its voluntary practice of replying to written questions submitted by members of the European Parliament on issues related to the ECB's mandate. Furthermore, as in previous years, a delegation of members of the Committee on Economic and Monetary Affairs visited the ECB for informal discussions on a variety of issues with the members of the Executive Board.

Article 112 of the Treaty provides that the European Parliament will give its opinion on nominees to the Executive Board prior to their appointment by common accord by the Heads of State or Government of the Member States that have adopted the euro. Following a recommendation by the EU Council, the European Parliament invited José Manuel González-Páramo to appear before the Committee on Economic and Monetary Affairs to present his views and answer questions from Committee members. Following this hearing, the plenary of the European Parliament endorsed his appointment as successor to Eugenio Domingo Solans in the Executive Board.

2 VIEWS OF THE ECB ON SELECTED TOPICS RAISED AT MEETINGS WITH THE EUROPEAN PARLIAMENT

During the President's appearances before the European Parliament, a wide variety of issues were addressed. The main focus was on the assessment of economic and monetary developments and the conduct of the ECB's monetary policy. Some of the issues raised by the European Parliament during its exchanges of views with the ECB and in its resolution on the Annual Report 2003, adopted in October 2004, are discussed below.

THE CONTRIBUTION OF THE SINGLE MONETARY POLICY TO THE GENERAL ECONOMIC POLICIES IN THE COMMUNITY

The contribution of the single monetary policy to the general economic policies in the Community was a key issue raised during the appearances of the President before the European Parliament. While some members of the Committee on Economic and Monetary Affairs took the view that maintaining price stability did not suffice to support growth and employment and that a trade-off existed between inflation and unemployment, other Committee members felt that the provisions set out in Article 105 of the Treaty were fully appropriate and that the maintenance of price stability should remain the primary objective of the single monetary policy.

The President pointed out that by credibly pursuing price stability and by solidly anchoring medium and long-term inflation expectations, the ECB makes its best possible contribution to creating an economic environment conducive to sustainable growth. In its resolution on the ECB's Annual Report 2003, the European Parliament endorsed this view and commended the ECB for concentrating on the maintenance of price stability.

FINANCIAL INTEGRATION AND REGULATION

Within the framework of the quarterly testimonies, the members of the Committee on Economic and Monetary Affairs also asked the President for the ECB's views on issues related to financial integration and regulation. In particular, the European Parliament paid close attention to the activities of the ESCB and the Committee of European Securities Regulators (CESR) in the field of securities clearing and settlement. More specifically, the resolution on the ECB's Annual Report 2003 expressed concern that the standards proposed by the ESCB and CESR might pre-empt the upcoming legislative process in this area.

The President stressed that the proposed standards were not intended to pre-empt future legislative acts. He stated that if a directive on clearing and settlement were to be adopted at a later stage, the standards would need to be assessed from the point of view of their conformity with the provisions of such a directive and, if warranted, adapted accordingly (see also Section 4 of Chapter 3).

ACCOUNTABILITY AND TRANSPARENCY OF THE ECB

In its resolution on the ECB's Annual Report 2003, the European Parliament considered the dialogue with the ECB a success, as the regular exchanges of views made the ECB's monetary policy more transparent and accessible to the public. At the same time, the ECB and the European Parliament continued to hold diverging views on some issues related to accountability and transparency. In its resolution, the European Parliament reiterated its call for the publication of minutes and the balance of votes in Governing Council meetings.

As regards the request for the publication of minutes, the President emphasised that the communication channels chosen by the ECB were more effective in terms of timeliness. In particular, the monthly press conferences held immediately after Governing Council meetings provide, in real time, a comprehensive account of the reasons underpinning the Governing Council's decisions, and thus essentially serve the same purpose as minutes. Furthermore, the reasoning of the Governing Council is made available to the public at a much earlier stage than would be the case for formally adopted minutes. These press conferences, together with additional communication tools such as the Monthly Bulletin and the monthly communication on Governing Council decisions taken in addition to interest rate decisions, make the ECB one of the most transparent central banks in the world.

With regard to the request for the disclosure of information on the voting behaviour of Governing Council members, the President recalled that, in view of the specific institutional environment in which the single monetary policy operates, the publication of votes carries the risk of putting undue national pressure on members of the Governing Council to deviate from the euro area perspective. The ECB therefore continues its policy of not providing any indications of individual views or voting behaviour. This approach helps to focus public attention on the economic rationale of policy decisions rather than on individual voting behaviour and is consistent with the collegial nature of the Governing Council and its euro area perspective.

COUNTERFEITING AND BANKNOTE SECURITY

The members of the Committee on Economic and Monetary Affairs also addressed the issue of euro counterfeiting. In its resolution on the ECB's Annual Report 2003, the European Parliament called upon the ECB to be very alert with regard to counterfeiting and to take experience into account in the design of a new generation of banknotes.

During his appearances before the Committee on Economic and Monetary Affairs, the President stressed that the ECB took the issue of counterfeiting very seriously and continuously sought to improve its policies against counterfeiting. In this respect, cooperation agreements in the fight against counterfeiting have been concluded with various national and international authorities. Moreover, the experience with counterfeit banknotes is guiding the research and development of new security features for the new generation of banknotes. Information on all counterfeit euro banknotes is stored in an ECB database which is accessible to all EU central banks and national law enforcement authorities (see also Section 3 of Chapter 2).

Artist
Philippe Cognée
Title
Foule, Place St Pierre de Rome, Pâques, 1999
Material
Encaustic on canvas
Format
154 × 153 cm

CHAPTER 6

EXTERNAL COMMUNICATION

1 COMMUNICATION POLICY

Communication is an integral part of the ECB's monetary policy and the performance of its other tasks. Two key elements – openness and transparency – guide the ECB's communication activities. Both contribute to the effectiveness, efficiency and credibility of the ECB's monetary policy. They also support the ECB's efforts to give full account of its actions, as explained in more detail in Chapter 5.

In the field of communication, the ECB has set high standards. Monetary policy decisions are explained at a press conference immediately after the Governing Council has taken them. A comprehensive introductory statement is made and the President and Vice-President are at the media's disposal to answer questions. The concept of real-time, regular and detailed explanations of the ECB's monetary policy assessment and decisions, which was introduced in 1999, represents a uniquely open and transparent approach to central bank communication.

Moreover, communication on other decisions has been further enhanced. Since December 2004 a text presenting decisions taken by the Governing Council in addition to interest rate decisions has been published every month on the websites of the Eurosystem central banks.

As part of the institutional framework of the EU, the ECB has to make its legal acts and statutory publications available in all official Community languages, the number of which increased from 11 to 20 with the enlargement of the EU on 1 May 2004. The statutory publications are the Annual Report, the quarterly version of the Monthly Bulletin, the weekly consolidated financial statement of the Eurosystem and the Convergence Report. For the purposes of accountability and transparency vis-à-vis the European citizens and their elected representatives, the ECB also publishes other documentation in all official languages, in particular press releases on monetary policy decisions, Eurosystem staff macroeconomic projections and policy positions of relevance to the general public. The preparation, publication and distribution of the national language versions of the ECB's key publications are undertaken in collaboration with the NCBs.

2 COMMUNICATION ACTIVITIES

The ECB's communication relies on several publications and tools, which are constantly being refined in order to inform the general public and interested parties more effectively.

The Annual Report presents a comprehensive review of the ECB's activities in the previous year and thus helps to hold the ECB accountable for its actions. The Monthly Bulletin provides a continual update of the ECB's assessment of economic and monetary developments and detailed information underlying its decisions. It also contains articles on general central banking topics. The ECB contributes to the dissemination of research findings by publishing working papers and occasional papers and by organising academic conferences, seminars and workshops.

Together with the BIS and the G10 central banks, the ECB launched a new publication entitled the "International Journal of Central Banking" in 2004. It features policy-relevant articles on the theory and practice of central banking, with special emphasis on research related to monetary policy and financial stability. The first quarterly issue will be published in 2005.

All members of the Governing Council directly take part in the efforts to enhance public knowledge and understanding of the ECB's tasks and policies through testimonies before the European Parliament and national parliaments, public speeches and the media. In 2004 the six Executive Board members gave around 220 speeches and numerous interviews, as well as contributing articles to journals, magazines and newspapers. Visits by the President and other members of the Executive Board to EU Member States and other countries throughout 2004 helped to bring the messages of the ECB directly to the citizens of Europe and beyond. The ECB's communication efforts were increasingly directed towards audiences in the new EU Member States, both before and after their accession to the EU in 2004.

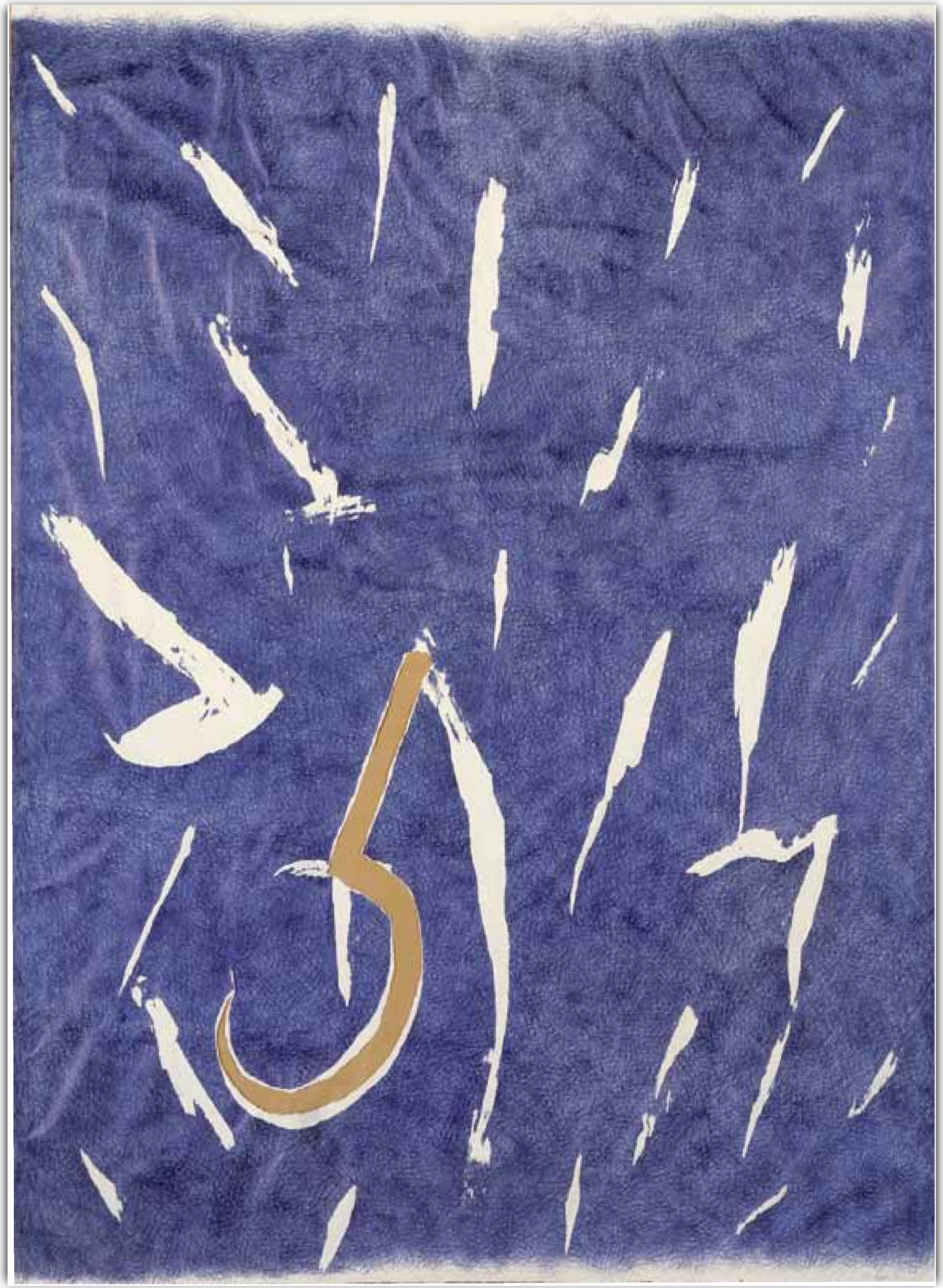
The euro area NCBs also play an important role in ensuring the dissemination at the national level of information on the euro and the activities of the Eurosystem to the general public and interested parties. They address a variety of regional and national audiences in their own languages and environments.

A further important channel for providing information to financial markets is the ECB's automated information system. This system provides real-time information to a number of news agencies, which display on their screens pages showing the key ECB interest rates, market operations and liquidity conditions in the euro area. The pages are provided and regularly updated by the ECB. Following an application procedure, the number of news agencies granted access to this system by the ECB rose from three to five in 2004.

All documents published by the ECB and its various activities are presented on the ECB's website (www.ecb.int). In 2004 a new version of the website was launched. Its design has been modernised and contents restructured in order to make it more user-friendly. The website also serves as a contact point for queries from the public and as a platform for the launch of ECB public consultations. Around 47,000 queries were received through various channels and handled in 2004.

The ECB also practices openness in a literal sense, by welcoming visitor groups to its premises in Frankfurt. In 2004 around 8,000 visitors received first-hand information in the form of lectures and presentations given by ECB staff. University students and professionals from the financial sector made up the majority of visitors.

Artist
Jan Fabre
Title
Untitled, 1987
Material
Ballpoint ink on paper
Format
200 × 158 cm



CHAPTER 7

ENLARGEMENT OF THE EUROPEAN UNION

1 SUCCESSFUL ACCESSION OF TEN NEW MEMBER STATES

On 1 May 2004 ten countries of central and eastern Europe and the Mediterranean – the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia – joined the EU. The NCBs of the new Member States were integrated into the ESCB and their governors became full members of the General Council. Experts from these NCBs have full-member status in the meetings of the ESCB committees whenever they deal with matters that fall within the field of competence of the General Council.

The integration of the new members into the ESCB went smoothly. On the basis of the ECB's Accession Master Plan, set out in 2003, preparations were undertaken in particular in the fields of central bank operations, payment and settlement systems, statistics, banknotes, and IT infrastructure and applications. The relevant ESCB IT infrastructure was enhanced and now connects all 25 NCBs and the ECB, providing increased reliability and enhanced security services. The key for subscription to the ECB's capital was expanded and the NCBs of the new Member States paid up a percentage of their subscribed capital as a contribution to the operational costs of the ECB.

The fifth high-level seminar on the accession process, held in Paris in March 2004, marked the final phase of the preparations for accession. The seminar, jointly organised by the ECB and the Banque de France, brought together the governors and high-level representatives of the central banks of the ESCB, the ten acceding countries and the two candidate countries – Bulgaria and Romania – which were about to finalise negotiations for accession to the EU. The seminar focused on monetary and exchange rate policies and the practical functioning of ERM II, budgetary discipline in the context of the Stability and Growth Pact, and issues relating to financial standards, accounting regulations and corporate governance.

The practical experience gained during the enlargement process has been assessed and will be taken into account in the preparations for future enlargements of the EU and the euro area.

On 20 October 2004 the European Commission and the ECB published their respective Convergence Reports on the progress made in the fulfilment of the obligations regarding the achievement of EMU by the Member States with a derogation status, including the new Member States. The ECB's Convergence Report concluded that none of the countries assessed fulfilled all the conditions for adopting the euro, including the legislative requirements for safeguarding effective independence of the NCBs.

In terms of the number of countries joining, this enlargement was the most important in the history of European integration. However, the economic weight of the new Member States is relatively small compared with previous enlargements. As a result, the accession of the new Member States has not fundamentally changed the key characteristics of the EU economy. Economic diversity within the EU has increased, however, as the institutional and structural features of the new Member States are in many respects different from those of the other Member States. The majority of the new Member States have been engaged in a transition process from a centrally planned to a market economy, involving fundamental institutional and structural changes in their economies. Over a longer time horizon, enlargement is likely to contribute positively to economic growth in the EU; indeed, a positive impact was already observed during the decade of preparations for enlargement. This section presents a number of key macroeconomic features of the EU before and after the accession of the new Member States together with corresponding data for the United States and Japan.

POPULATION AND ECONOMIC ACTIVITY

As indicated in Table 16, the 2004 enlargement increased the population of the EU by almost 20%, bringing the total population to 457.7

million. Measured in these terms, the EU continues to be the largest entity in the industrialised world.

Economic activity in the countries forming the EU25, as measured by GDP, was €9,752 billion in 2003, to which, on the basis of current exchange rates, the accession of the new Member States contributed 4.5%. From a historical perspective, the economic size of this enlargement was relatively limited. For example, the accession of Spain and Portugal to the European Community in 1986 (which at the time consisted of ten countries) raised the Community's total GDP by slightly more than 8%, and the enlargement to Austria, Finland and Sweden in 1995 increased economic output by just over 7%. On the basis of GDP data and exchange rates for 2003, the accession of the new Member States led to a rise in the EU's share of global GDP from 30.4% to 31.8%. It should be noted, however, that these international comparisons are heavily influenced by developments in exchange rates. One way to overcome the variability and potential distortions associated with market prices is to use a comparison on the basis of purchasing power parities (PPPs), even if these measures have their own caveats. In PPP terms and on the basis of 2003 data, the most recent enlargement increased the EU's GDP by 9.5%, making it larger than that of the United States.

As the new Member States have a relatively large population in relation to their current level of economic activity, their accession

Table 16 Key characteristics of the EU economy including and excluding the new Member States

	Reporting period	Unit	EU15	EU25	United States	Japan
Population	2004	millions	384.5	457.7	293.9	127.5
GDP (share of world GDP) 1)	2003	%	30.4	31.8	30.4	11.9
GDP	2003	€ billions	9,310	9,752	9,673	3,800
	2003	PPP billions	9,310	10,193	9,957	3,254
GDP per capita	2003	€ thousands	24.2	21.3	32.9	29.8
	2003	PPP thousands	24.3	22.3	34.2	25.5
Exports of goods and services	2003	% of GDP	14.0	12.4	9.3	12.2
Imports of goods and services	2003	% of GDP	13.3	12.1	13.8	10.6
Sectors of production 2)						
Agriculture, fishing, forestry	2003	% of GDP	2.0	2.1	0.8	1.2
Industry (including construction)	2003	% of GDP	26.6	26.8	19.7	29.2
Services	2003	% of GDP	71.4	71.1	79.5	69.6
Unemployment rate	2003	%	8.1	9.1	6.0	5.3
Labour force participation rate 3)	2003	%	70.0	69.3	75.8	78.2
Employment rate 4)	2003	%	64.4	63.0	71.2	68.4
General government 5)						
Surplus (+) or deficit (-)	2003	% of GDP	-2.7	-2.8	-4.6	-7.5
Expenditure	2003	% of GDP	48.5	48.5	34.4	39.1
Revenue	2003	% of GDP	45.8	45.6	29.8	31.6
Gross debt	2003	% of GDP	64.2	63.2	63.1	156.9
Bank deposits 6)	2003	% of GDP	83.9	82.4	47.8	120.2
Stock of loans to the private sector 7)	2003	% of GDP	99.2	96.3	51.4	118.8
Stock market capitalisation	2003	% of GDP	66.3	65.2	126.7	61.6

Sources: Eurostat, European Commission, IMF, BIS, ECB and ECB calculations.
1) GDP shares are based on country GDPs in current US dollars.
2) Based on gross value added at current prices.
3) Defined as the ratio of the labour force to the working age population (those aged between 15 and 64).
4) Defined as the ratio of the number of employed persons to the working age population (those aged between 15 and 64).
5) Based on the ESA 95.
6) EU15 and EU25: total deposits with MFIs; United States: demand, time and savings deposits with banking institutions; Japan: demand and time deposits with deposit money banks.
7) EU15 and EU25: MFI loans to other residents; United States: loans by commercial banks, savings institutions and credit unions; Japan: loans to the private sector.

implies a decline in the average level of GDP per capita in the EU. This, however, is expected to change gradually in line with progress in the catching-up process. Compared with the United States and Japan, GDP per capita in the EU25 is relatively low, although the difference vis-à-vis Japan is much more limited in PPP terms (on the basis of figures for 2003).

The accession of the new Member States will also have a longer-term effect on economic activity as it affects incentives for and impediments to the flow of goods, services, capital and persons (the "four freedoms") between the new Member States and the other EU countries, although migration flows will be restricted for a number of years. For example, the extension of the Single Market, by increasing the scope for these four freedoms to 25 countries, is likely to enhance competition and create economies of scale. The extent of these effects and the speed at which they materialise will, however, depend on many factors, such as the future economic policies of EU Member States.

INTERNATIONAL TRADE

Following enlargement, EU15 trade with the new Member States and trade among those Member States is naturally recorded as intra-EU trade instead of international trade. By contrast, trade between the new Member States and the rest of the world excluding the EU15 countries now counts as extra-EU25 trade. The accession of the new Member States has slightly reduced the trade openness of the EU, despite the fact that most new Member States are very open economies, as EU15 trade with the new Member States is more significant than the new Member States' trade with countries outside the EU. According to data for 2003, exports of goods and services represented 12.4% of GDP in the enlarged EU, compared with 9.3% and 12.2% for the United States and Japan respectively.

PRODUCTION STRUCTURE

The structure of production in the new Member States is characterised by a larger share of agriculture (3.2%) and industry (31.9%) and a smaller share of services (64.9%) in GDP than the average of the other EU countries. Sectoral differences tend to be more pronounced in the new Member States than in the EU15 in terms of the distribution of employment across these sectors. Nevertheless, enlargement has resulted in only slight changes in the shares of these broad sectors in the EU's GDP and the distribution of employment. Relative to other major economic blocs, the agricultural sector in the EU is large by comparison with that of the United States and Japan, whereas the EU's industrial sector is larger than that of the United States but smaller than that of Japan. Its services sector is larger than that of Japan but smaller than that of the United States.

LABOUR MARKET

The average unemployment rate in the new Member States is higher than that in the EU15 countries, and enlargement has thus led to a somewhat higher average unemployment rate for the EU25. Despite falling during the late 1990s, the unemployment rate in both the EU15 and the EU25, at 8.1% and 9.1% respectively in 2003, remains significantly higher than in the United States and Japan, where it stood at 6.0% and 5.3% respectively. In the new central and eastern European Member States, unemployment rates have risen and regional unemployment differences have grown during the past decade, owing to structural adjustments associated with the transition to a market economy. Prospects for employment could improve in the years ahead, however, as job-cutting associated with business restructuring may ease. In the longer run, the new Member States' potential for catching up in terms of GDP per capita may also contribute to favourable employment trends and lower unemployment.

The accession of the new Member States has lowered the employment rate in the EU by 1.4 percentage points, so that it now stands at 63.0%. A breakdown of the employment rate in the new Member States suggests that the participation rate of men in particular is considerably below the level in the EU15 countries, whereas the gap for women is less pronounced. The employment rate of older workers (i.e. those aged between 55 and 64) is also substantially lower in the new Member States than in the EU15. In comparison with the United States and Japan, the EU labour force participation rate is low. The combination of a lower participation rate and a higher unemployment rate in the EU is reflected in an employment rate which is below that of the United States and Japan.

FISCAL POSITION AND THE SIZE OF THE GOVERNMENT SECTOR

The accession of the new Member States has not substantially changed the weighted average government deficit ratio in the EU, despite the fact that most new Member States have high fiscal deficits (see also Section 2.5 of Chapter 1). The public expenditure and revenue shares in GDP are somewhat smaller in most of the new EU countries, although they are high in relation to their income levels. The small size of the new Member States' economies means that the share of the general government sector in the EU25 is nevertheless broadly unchanged compared with the EU15. As the public debt ratio in the new Member States is generally significantly below the level in the EU15, the average EU debt-to-GDP ratio is somewhat lower than before enlargement.

The general government deficit, which stood at 2.8% in the EU25 in 2003, is currently lower than in the United States and Japan. At the same time, the general government sector makes up a larger share of the economy in the EU25 than in the United States and Japan. In the EU25, the government expenditure ratio stands at almost 49% and the government revenue ratio at just below 46%. In the United States, the general government sector accounts for somewhat more than 34% of GDP in terms of expenditure and slightly less than 30% of GDP in terms of revenue. In Japan, the large public deficit is accounted for by a government expenditure ratio of just over 39% of GDP and a government revenue ratio of almost 32%. The past accumulation of public deficits has led to similarly high public debt ratios in the EU and the United States, but they are nonetheless significantly lower than in Japan.

FINANCIAL STRUCTURE

Enlargement has not involved significant changes to the financial structure of the EU as a whole, although financial intermediation is on average more focused on banks in the new Member States than in the EU15. In most new Member States the financial sector is relatively small, as measured by total banking sector assets and securities market capitalisation. However, the level of financial intermediation, i.e. the channelling of new funds by financial institutions into new claims to finance investment, has recently advanced fairly rapidly in some new Member States. In comparison with the United States, the EU's financial sector continues to be more oriented towards the banking sector, whereas the role of stock markets in financial intermediation is less important. By comparison with Japan, however, the banking sector plays a smaller role in the EU's financial sector, while stock markets are more significant.

2 RELATIONS WITH EU CANDIDATE COUNTRIES

There are currently four countries which have the status of candidate for EU membership: Bulgaria, Croatia, Romania and Turkey. Following the successful completion of the accession negotiations with Bulgaria and Romania, the European Council in December 2004 called for the Accession Treaty with these two countries to be finalised with a view to signing it in April 2005. Bulgaria and Romania would then be expected to join the EU in January 2007. Croatia has been a candidate country since June 2004 and, provided that there is full cooperation with the International Criminal Tribunal for the former Yugoslavia, negotiations for EU accession will start in March 2005. Turkey was granted the status of candidate country by the Helsinki European Council in 1999. In December 2004 the European Council decided that, in the light of a Commission report and recommendation, Turkey sufficiently fulfils the Copenhagen political criteria to open accession negotiations provided that it brings into force specific pieces of legislation. Against this background, the European Council requested the Commission to prepare a proposal for a framework for negotiations with a view to opening negotiations on 3 October 2005.

The Eurosystem continued to monitor monetary and economic developments in the candidate countries and paid particular attention to the disinflation process, financial sector issues and structural convergence towards the EU.

The ECB further strengthened its bilateral relations with the central banks of Bulgaria and Romania. The first visits to the Bulgarian National Bank and the National Bank of Romania by the ECB at the Executive Board level took place in October. The main purpose of these visits was to discuss future cooperation with the Eurosystem, which will include a pre-accession dialogue between the ECB and the central banks of countries negotiating accession. Following the signing of the Accession Treaty, the governors of these central banks will be invited to attend the meetings of the General Council in an observer capacity. Experts from these central banks will be granted observer status in the ESCB committees whenever the committees deal with matters that fall within the field of competence of the General Council. A visit to the Croatian National Bank is expected to take place in March 2005.

The ECB also continued its high-level policy dialogue with the Central Bank of the Republic of Turkey, including annual meetings at the Executive Board level. The discussions focused on Turkey's macroeconomic stabilisation process, the Central Bank of the Republic of Turkey's monetary and exchange rate policy and the economic situation in the euro area. In addition to the policy dialogue, technical cooperation between business areas of the ECB and the Central Bank of the Republic of Turkey continued.

Artist
Reinhold A. Goelles
Title
Untitled
Material
Acrylic on canvas
Format
152 × 100 cm

CHAPTER 8

INSTITUTIONAL FRAMEWORK, ORGANISATION AND ANNUAL ACCOUNTS

I DECISION-MAKING BODIES AND CORPORATE GOVERNANCE OF THE ECB

1.1 THE EUROSYSTEM AND THE EUROPEAN SYSTEM OF CENTRAL BANKS

The Eurosystem is the central banking system of the euro area. It comprises the ECB and the NCBs of the 12 Member States whose common currency is the euro. The Governing Council adopted the term "Eurosystem" in order to facilitate understanding of the structure of central banking in the euro area. The term underlines the shared identity, teamwork and cooperation of all of its members and has also been introduced into the Treaty establishing a Constitution for Europe, which was signed in Rome on 29 October 2004. The Governing Council has also approved a mission statement for the Eurosystem together with strategic intents and organisational principles for the fulfilment of the Eurosystem functions by all members of the Eurosystem (see Box 15).

The ESCB is composed of the ECB and the NCBs of all EU Member States (25 since 1 May 2004), i.e. it includes the NCBs of the Member States which have not yet adopted the euro. As long as there are Member States which have not yet adopted the euro, it will be necessary to make a distinction between the Eurosystem and the ESCB.

The ECB has legal personality under public international law. It was established as the core of the Eurosystem and the ESCB and ensures that their respective tasks are carried out either through its own activities or via the NCBs.

Each NCB has legal personality according to the national law of its respective country. The euro area NCBs, which form an integral part of the Eurosystem, carry out the tasks conferred upon the Eurosystem in accordance with the rules established by the ECB's decision-making bodies. The NCBs also contribute to the work of the Eurosystem and the ESCB through their participation in the various Eurosystem/ESCB committees (see Section 1.5 of this chapter). They may perform non-Eurosystem functions on their own responsibility, unless the Governing Council finds that such functions interfere with the objectives and tasks of the Eurosystem.

The Eurosystem and the ESCB are governed by the decision-making bodies of the ECB: the Governing Council and the Executive Board. Decision-making within the Eurosystem and the ESCB is centralised. However, the ECB and the euro area NCBs jointly contribute, strategically and operationally, to attaining the common goals, with due respect to the principle of decentralisation in accordance with the Statute of the ESCB. The General Council is constituted as a third decision-making body of the ECB, for as long as there are Member States which have not yet adopted the euro. The functioning of the decision-making bodies is governed by the Treaty, the Statute of the ESCB and the relevant Rules of Procedure[1]. In 2004, with a view to adapting these rules to developments since 1999 and to anticipate the changes resulting from ESCB enlargement, both the Rules of Procedure of the ECB and the Rules of Procedure of the General Council of the ECB were reviewed.

1 For the ECB's Rules of Procedure, see Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the European Central Bank, OJ L 80, 18.3.2004, p. 33; Decision ECB/2004/12 of 17 June 2004 adopting the Rules of Procedure of the General Council of the ECB, OJ L 230, 30.6.2004, p. 61; and Decision ECB/1999/7 of 12 October 1999 concerning the Rules of Procedure of the Executive Board of the ECB, OJ L 314, 8.12.1999, p. 34. These rules are also available on the ECB's website.

Box 15

THE EUROSYSTEM MISSION STATEMENT

In January 2005 the Eurosystem mission statement was published. Its adoption by the Governing Council, which followed the adoption by the Executive Board of the mission statement of the ECB in August 2003, builds on the experience since 1999 with a common central banking system for the euro area and the specific expertise and indispensable contributions of all the central banks of the Eurosystem. The mission statement reads as follows:

"*The Eurosystem, which comprises the European Central Bank and the national central banks of the Member States whose currency is the euro, is the monetary authority of the euro area. We in the Eurosystem have as our primary objective the maintenance of price stability for the common good. Acting also as a leading financial authority, we aim to safeguard financial stability and promote European financial integration.*

In pursuing our objectives, we attach utmost importance to credibility, trust, transparency and accountability. We aim for effective communication with the citizens of Europe and the media. We are committed to conducting our relations with European and national authorities in full accordance with the Treaty provisions and with due regard to the principle of independence.

We jointly contribute, strategically and operationally, to attaining our common goals, with due respect to the principle of decentralisation. We are committed to good governance and to *performing our tasks effectively and efficiently, in a spirit of cooperation and teamwork. Drawing on the breadth and depth of our experiences as well as on the exchange of know-how, we aim to strengthen our shared identity, speak with a single voice and exploit synergies, within a framework of clearly defined roles and responsibilities for all members of the Eurosystem.*"

This mission statement sets out what the Eurosystem central banks aim to achieve together and the way they interact and cooperate on the basis of shared values. It is based on an agreed set of organisational principles and a number of strategic intents (more information can be found on the ECB's website). It also seeks to provide clear guidance to all members of staff and inform the public on how the Eurosystem performs the tasks and achieves the objectives that the Treaty and the Statute of the ESCB entrust to it.

1.2 THE GOVERNING COUNCIL

The Governing Council comprises all the members of the Executive Board and the governors of the NCBs of the Member States which have adopted the euro. According to the Treaty, its main responsibilities are:

– to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem;

– to formulate the monetary policy of the euro area, including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the Eurosystem, and to establish the necessary guidelines for their implementation.

The Governing Council meets, as a rule, twice a month at the ECB's premises in Frankfurt am Main, Germany. It conducts, inter alia, an in-depth assessment of monetary and economic developments and takes related decisions specifically at its first meeting of the month, while the second meeting usually focuses on issues related to other tasks and responsibilities of the ECB and the Eurosystem. In 2004 two meetings were held outside Frankfurt: one was hosted by Suomen Pankki – Finlands Bank in Helsinki and the other by the Nationale Bank van België/ Banque Nationale de Belgique in Brussels.

When taking decisions on monetary policy and on other tasks of the ECB and the Eurosystem, the members of the Governing Council do not act as national representatives, but in a fully independent personal capacity. This is reflected by the principle of "one member, one vote" applied within the Governing Council.

Pursuant to the "enabling clause" contained in the Treaty of Nice, the EU Council, meeting in the composition of Heads of State or Government, on the basis of an ECB recommendation, unanimously adopted a Decision to amend Article 10.2 of the Statute of the ESCB (voting modalities in the Governing Council) on 21 March 2003. After being ratified by all Member States, this Decision entered into force on 1 June 2004. In accordance with this Decision, all members of the Governing Council will continue to attend meetings and participate in the deliberations. However, the number of NCB governors holding a voting right at any one time will not exceed 15. When the number of NCB governors in the Governing Council exceeds 15, they will exercise a voting right on the basis of a rotation system. The 15 voting rights will rotate among the governors according to pre-established rules. The six members of the Executive Board will each maintain a permanent voting right.

THE GOVERNING COUNCIL

Back row (left to right):
Klaus Liebscher, Nout Wellink, Erkki Liikanen, Tommaso Padoa-Schioppa, Antonio Fazio, Jaime Caruana

Middle row (left to right):
Axel A. Weber, Nicholas C. Garganas, Christian Noyer, Vítor Constâncio, José Manuel González-Páramo, Guy Quaden

Front row (left to right):
Gertrude Tumpel-Gugerell, Lucas D. Papademos, Jean-Claude Trichet, Yves Mersch, Otmar Issing, John Hurley

Jean-Claude Trichet
President of the ECB
Lucas D. Papademos
Vice-President of the ECB
Jaime Caruana
Governor of the Banco de España
Vítor Constâncio
Governor of the Banco de Portugal
Eugenio Domingo Solans (until 31 May 2004)
Member of the Executive Board of the ECB
Antonio Fazio
Governor of the Banca d'Italia
Nicholas C. Garganas
Governor of the Bank of Greece
José Manuel González-Páramo
(from 1 June 2004)
Member of the Executive Board of the ECB
John Hurley
Governor of the Central Bank and Financial Services Authority of Ireland
Otmar Issing
Member of the Executive Board of the ECB
Klaus Liebscher
Governor of the Oesterreichische Nationalbank
Erkki Liikanen (from 12 July 2004)
Governor of Suomen Pankki – Finlands Bank
Matti Louekoski
(from 1 April to 11 July 2004)
Acting Governor of Suomen Pankki – Finlands Bank
Yves Mersch
Governor of the Banque centrale du Luxembourg
Christian Noyer
Governor of the Banque de France
Tommaso Padoa-Schioppa
Member of the Executive Board of the ECB
Guy Quaden
Governor of the Nationale Bank van België/ Banque Nationale de Belgique
Jürgen Stark (from 7 to 29 April 2004)
Acting President of the Deutsche Bundesbank
Gertrude Tumpel-Gugerell
Member of the Executive Board of the ECB
Matti Vanhala (until 31 March 2004)
Governor of Suomen Pankki – Finlands Bank
Axel A. Weber (from 30 April 2004)
President of the Deutsche Bundesbank
Nout Wellink
President of De Nederlandsche Bank
Ernst Welteke (until 6 April 2004)
President of the Deutsche Bundesbank

On 29 September 2004 Matti Vanhala, member of the Governing Council (1998-2004), passed away. On 9 November 2004 Eugenio Domingo Solans, member of the Executive Board and the Governing Council (1998-2004), passed away.

1.3 THE EXECUTIVE BOARD

The Executive Board comprises the President and Vice-President of the ECB and four other members appointed by common accord by the Heads of State or Government of the Member States which have adopted the euro. The main responsibilities of the Executive Board, which as a rule meets once a week, are:

– to prepare the meetings of the Governing Council;
– to implement the monetary policy of the euro area in accordance with the guidelines and decisions laid down by the Governing Council and, in doing so, to give the necessary instructions to the euro area NCBs;
– to manage the current business of the ECB;
– to exercise certain powers delegated to it by the Governing Council, including some of a regulatory nature.

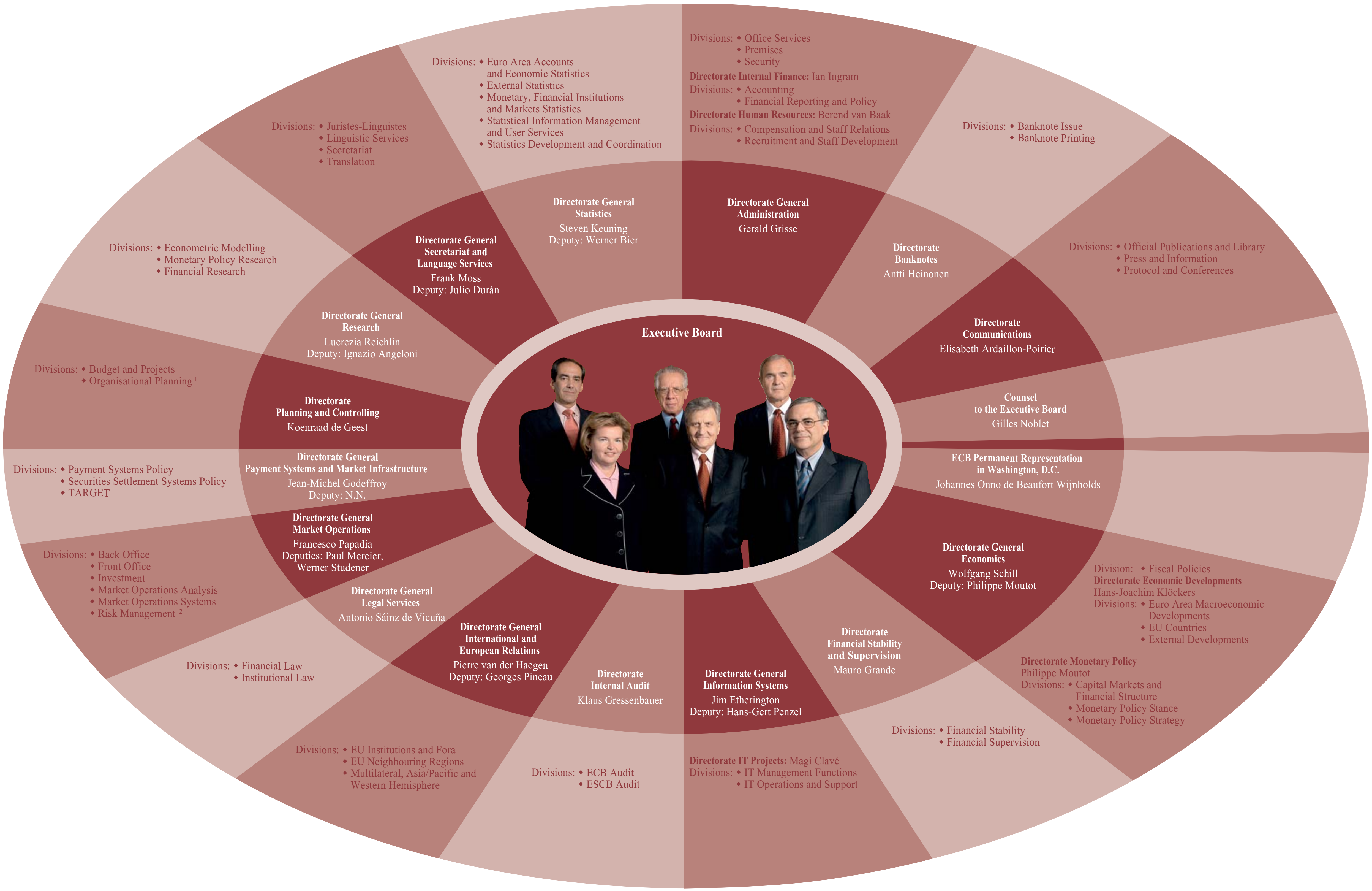
The Management Committee, which is chaired by a member of the Executive Board, advises and assists the Executive Board with regard to the ECB's management, business planning and annual budget process.

Back row (left to right):
José Manuel González-Páramo,
Tommaso Padoa-Schioppa,
Otmar Issing

Front row (left to right):
Gertrude Tumpel-Gugerell,
Jean-Claude Trichet,
Lucas D. Papademos

Jean-Claude Trichet
President of the ECB
Lucas D. Papademos
Vice-President of the ECB
Eugenio Domingo Solans (until 31 May 2004)
Member of the Executive Board of the ECB
José Manuel González-Páramo
(from 1 June 2004)
Member of the Executive Board of the ECB

Otmar Issing
Member of the Executive Board of the ECB
Tommaso Padoa-Schioppa
Member of the Executive Board of the ECB
Gertrude Tumpel-Gugerell
Member of the Executive Board of the ECB



Executive Board

Back row (left to right): José Manuel González-Páramo, Tommaso Padoa-Schioppa, Otmar Issing

Front row (left to right): Gertrude Tumpel-Gugerell, Jean-Claude Trichet (President), Lucas D. Papademos (Vice-President)

[1] Includes the data protection function.
[2] Reports directly to the Executive Board on specific issues.

1.4 THE GENERAL COUNCIL

The General Council is composed of the President and the Vice-President of the ECB and the governors of the NCBs of all EU Member States. It carries out those tasks taken over from the EMI which still have to be performed by the ECB on account of the fact that not all the Member States have adopted the euro. In 2004 the General Council met five times. On 17 June 2004 the governors of the central banks of the new Member States, who had been attending, as from the date of the signing of the Accession Treaty, the meetings of the General Council in an observer capacity, participated for the first time as members in a meeting of the General Council.

Back row (left to right):
Vahur Kraft, Lars Heikensten, Reinoldijus Šarkinas, Guy Quaden, Zdeněk Tůma, Nicholas C. Garganas, Nout Wellink

Middle row (left to right):
Christian Noyer, Axel A. Weber, Vítor Constâncio, Ilmārs Rimšēvičs, Leszek Balcerowicz, Bodil Nyboe Andersen, Klaus Liebscher, Mitja Gaspari, Jaime Caruana, Antonio Fazio

Front row (left to right):
Erkki Liikanen, Zsigmond Járai, Christodoulos Christodoulou, Michael C. Bonello, Lucas D. Papademos, Jean-Claude Trichet, Yves Mersch, Marián Jusko, John Hurley

Jean-Claude Trichet President of the ECB
Lucas D. Papademos Vice-President of the ECB
Bodil Nyboe Andersen
Governor of Danmarks Nationalbank
Leszek Balcerowicz
President of Narodowy Bank Polski
Michael C. Bonello
Governor of the Central Bank of Malta
Jaime Caruana
Governor of the Banco de España
Christodoulos Christodoulou
Governor of the Central Bank of Cyprus
Vítor Constâncio
Governor of the Banco de Portugal
Antonio Fazio Governor of the Banca d'Italia
Nicholas C. Garganas
Governor of the Bank of Greece
Mitja Gaspari Governor of Banka Slovenije
Lars Heikensten
Governor of Sveriges Riksbank
John Hurley
Governor of the Central Bank and Financial Services Authority of Ireland
Zsigmond Járai
President of Magyar Nemzeti Bank
Marián Jusko (until 31 December 2004)
Governor of Národná banka Slovenska
Mervyn King Governor of the Bank of England
Vahur Kraft Governor of Eesti Pank
Klaus Liebscher
Governor of the Oesterreichische Nationalbank
Erkki Liikanen (from 12 July 2004)
Governor of Suomen Pankki – Finlands Bank
Matti Louekoski
(from 1 April to 11 July 2004)
Acting Governor of Suomen Pankki – Finlands Bank
Yves Mersch
Governor of the Banque centrale du Luxembourg
Christian Noyer
Governor of the Banque de France
Guy Quaden
Governor of the Nationale Bank van België/ Banque Nationale de Belgique
Ilmārs Rimšēvičs Governor of Latvijas Banka
Reinoldijus Šarkinas
Chairman of the Board of Lietuvos bankas
Ivan Šramko (from 1 January 2005)
Governor of Národná banka Slovenska
Jürgen Stark (from 7 to 29 April 2004)
Acting President of the Deutsche Bundesbank
Zdeněk Tůma
Governor of Česká národní banka
Matti Vanhala (until 31 March 2004)
Governor of Suomen Pankki – Finlands Bank
Axel A. Weber (from 30 April 2004)
President of the Deutsche Bundesbank
Nout Wellink President of De Nederlandsche Bank
Ernst Welteke (until 6 April 2004)
President of the Deutsche Bundesbank

1.5 EUROSYSTEM/ESCB COMMITTEES AND THE BUDGET COMMITTEE

EUROSYSTEM/ESCB COMMITTEES, BUDGET COMMITTEE AND THEIR CHAIRPERSONS

Accounting and Monetary Income Committee (AMICO) Ian Ingram	**International Relations Committee (IRC)** Hervé Hannoun
Banking Supervision Committee (BSC) Edgar Meister	**Legal Committee (LEGCO)** Antonio Sáinz de Vicuña
Banknote Committee (BANCO) Antti Heinonen	**Market Operations Committee (MOC)** Francesco Papadia
External Communications Committee (ECCO) Elisabeth Ardaillon-Poirier	**Monetary Policy Committee (MPC)** Wolfgang Schill
Information Technology Committee (ITC) Jim Etherington	**Payment and Settlement Systems Committee (PSSC)** Jean-Michel Godeffroy
Internal Auditors Committee (IAC) Klaus Gressenbauer	**Statistics Committee (STC)** Steven Keuning

Budget Committee (BUCOM)
Liam Barron

The Eurosystem/ESCB committees have continued to play an important role in assisting the ECB's decision-making bodies in the performance of their tasks. At the request of both the Governing Council and the Executive Board, the committees have provided expertise in their fields of competence and have facilitated the decision-making process. Membership of the committees is usually restricted to staff of the Eurosystem central banks. However, the NCBs of the Member States which have not yet adopted the euro take part in the meetings of a committee whenever it deals with matters that fall within the field of competence of the General Council. Where appropriate, other competent bodies, such as national supervisory authorities in the case of the Banking Supervision Committee, may also be invited. At present there are 12 Eurosystem/ESCB committees, all of which were established under Article 9 of the Rules of Procedure of the ECB.

The Budget Committee, which was established under Article 15 of the Rules of Procedure of the ECB, assists the Governing Council in matters related to the ECB's budget.

1.6 CORPORATE GOVERNANCE

In addition to the decision-making bodies, the corporate governance of the ECB encompasses a number of external and internal control layers, as well as rules concerning public access to ECB documents.

EXTERNAL CONTROL LAYERS

The Statute of the ESCB provides for two layers, namely the external auditor[2], which is appointed to audit the annual accounts of the

2 Following a tender procedure in 2002, KPMG Deutsche Treuhand-Gesellschaft AG Wirtschaftsprüfungsgesellschaft was appointed as the ECB's external auditor with a five-year mandate covering financial years 2003 to 2007.

ECB (Article 27.1 of the Statute of the ESCB), and the European Court of Auditors, which examines the operational efficiency of the management of the ECB (Article 27.2). The annual report of the European Court of Auditors, together with the ECB's reply, is published in the Official Journal of the European Union and on the ECB's website.

In August 2002 the Governing Council decided that, in order to give the fullest public assurance as to the independence of the ECB's external auditor, the principle of audit firm rotation should be applied. This decision was implemented as part of the procedure for the appointment of the ECB's external auditor.

INTERNAL CONTROL LAYERS

In 2004 the ECB's internal auditors continued to perform audit missions under the responsibility of the Executive Board. Their mandate is defined in the ECB Audit Charter.[3] The internal auditors assess and evaluate, on an ad hoc basis, the adequacy and effectiveness of the ECB's system of internal control and the quality of the ECB's performance in carrying out assigned responsibilities. They adhere to the International Standards for the Professional Practice of Internal Auditing established by the Institute of Internal Auditors.

A Eurosystem/ESCB committee, the Internal Auditors Committee, which is composed of the heads of internal audit at the ECB and the NCBs, is responsible for the coordination of audit coverage for Eurosystem/ESCB joint projects and operational systems.

The internal control structure of the ECB is based on a functional approach. Each organisational unit (section, division, directorate or directorate general) is responsible for its own internal control and efficiency. In this respect, organisational units implement operational control procedures within their area of responsibility. For example, a set of rules and procedures – known as a Chinese wall – are in place to prevent inside information, for instance originating in the areas responsible for monetary policy, from reaching the areas responsible for the management of the ECB's foreign reserves and own funds portfolio. In addition to the controls implemented by each organisational unit, the Directorate Planning and Controlling, the Risk Management Division and the Directorate Internal Audit make proposals on control issues affecting the ECB as a whole.

The members of the Governing Council adhere to a Code of Conduct, which reflects their responsibility to safeguard the integrity and reputation of the Eurosystem and to maintain the effectiveness of its operations.[4] The Governing Council has also appointed an adviser to provide guidance to its members on some aspects of professional conduct. In addition, the Code of Conduct of the ECB gives guidance to, and sets benchmarks for, the staff of the ECB and the members of the Executive Board, all of whom are expected to maintain high standards of professional ethics in the performance of their duties.[5]

In accordance with the rules against insider trading, the ECB's staff and the members of the Executive Board are prohibited from taking advantage of inside information when conducting private financial activities at their own risk and for their own account, or at the risk and for the account of a third party.[6] An Ethics Adviser appointed by the Executive Board ensures a consistent interpretation of these rules.

3 This Charter is published on the ECB's website to foster the transparency of audit arrangements in place at the ECB.
4 See the Code of Conduct for the members of the Governing Council, OJ C 123, 24.5.2002, p. 9 and the ECB's website.
5 See the Code of Conduct of the European Central Bank in accordance with Article 11.3 of the Rules of Procedure of the European Central Bank, OJ C 76, 8.3.2001, p. 12 and the ECB's website.
6 See Part 1.2 of the ECB Staff Rules containing the rules on professional conduct and professional secrecy, OJ C 92, 16.4.2004, p. 31 and the ECB's website.

ANTI-FRAUD MEASURES

In 1999 the European Parliament and the EU Council adopted a regulation[7] on investigations carried out by the European Anti-Fraud Office (OLAF), in order to step up the fight against fraud, corruption and any other illegal activity detrimental to the Communities' financial interests. This "OLAF Regulation" provides inter alia for the internal investigation of suspected fraud by OLAF within the Community institutions, bodies, offices and agencies.

The OLAF Regulation foresees that each of the latter adopt decisions in order for OLAF to be able to carry out its investigations within each of them. In June 2004 the Governing Council adopted a decision[8] concerning the terms and conditions for investigations by OLAF of the ECB, which entered into force on 1 July 2004. The ECB and OLAF have established contact with a view to ensuring the proper functioning of this framework for OLAF investigations.

PUBLIC ACCESS TO ECB DOCUMENTS

In March 2004 the Governing Council adopted Decision ECB/2004/3 on public access to ECB documents[9]. This Decision aims to ensure that the ECB's legal framework is in line with the objectives and standards applied by other Community institutions and bodies with regard to public access to their documents. It enhances transparency, while at the same time taking into account the independence of the ECB and of the NCBs and ensuring the confidentiality of certain matters specific to the performance of the ECB's tasks.

7 Regulation (EC) No 1073/1999 of the European Parliament and of the Council of 25 May 1999 concerning investigations conducted by the European Anti-Fraud Office (OLAF), OJ L 136, 31.5.1999, p. 1.

8 Decision ECB/2004/11 concerning the terms and conditions for European Anti-Fraud Office investigations of the European Central Bank, in relation to the prevention of fraud, corruption and any other illegal activities detrimental to the European Communities' financial interests and amending the Conditions of Employment for Staff of the European Central Bank, OJ L 230, 30.6.2004, p. 56. This Decision was adopted in response to the judgement of the European Court of Justice on 10 July 2003 in Case C-11/00 Commission v. ECB.

9 OJ L 80, 18.3.2004, p. 42.

2 ORGANISATIONAL DEVELOPMENTS

2.1 HUMAN RESOURCES

STAFFING

The total number of budgeted staff positions for 2004 was 1,362.5 full-time equivalent (FTE) positions. At the end of 2004 the number of staff employed by the ECB on permanent or fixed-term contracts of at least 12 months was 1,314 (which corresponds to 1,309.0 FTE positions). This compares with 1,213.5 FTE positions at the end of 2003. The average number of staff employed by the ECB in 2004 was 1,261, compared with 1,160 in 2003. Of the total of 1,309, 71 are staff members from the ten new EU Member States currently employed on contracts of more than a year. In 2004 137 new staff were recruited and 41 members of staff left the service of the ECB. The number of FTE positions for 2005 has been set at 1,369.5, representing a 0.5% increase over 2004.

In addition 128 experts from NCBs came to the ECB for short periods of approximately five months on average. Of these experts, 63 came from the new EU Member States. These short-term assignments proved particularly useful for both the ECB and the NCBs of the new Member States in preparing for EU enlargement and in supporting the integration of these NCBs into the ESCB.

In 2004 the ECB offered 123 short-term contracts of less than a year to replace staff on maternity, parental and unpaid leave, compared with 113 in 2003.

The ECB provided traineeships to 172 students and graduates, mainly with an economics background, for an average duration of approximately three months. 166 such traineeships were offered in 2003. In 2004 54 of the trainees were nationals of one of the new Member States, and a further six were from Romania or Bulgaria. Of the 172 traineeships, 11 (12 in 2003) were offered in the framework of the Graduate Research Programme, which is aimed at highly talented research students at an advanced stage of their doctoral studies.

Under the Research Visitors Programme, which focuses on specific high-level research projects in the field of monetary policy, 18 research visitors were welcomed in 2004, compared with 24 in 2003.

INTERNAL MOBILITY

In 2004 95 staff members took up new positions after successfully applying for internal vacancies. In addition, the ECB encouraged temporary internal mobility. 51 staff members took on another job for a limited period in order to gain work experience or to address an urgent but temporary business need, subsequently returning to their previous position.

EXTERNAL MOBILITY

Under the External Work Experience Scheme, set up in 2003 to support staff development, staff may be seconded to NCBs and other relevant international and European institutions. Seven staff members participated in this scheme during 2004 for a period of four to ten months. In addition, the ECB accepts applications for unpaid leave for up to three years for staff who want to take up employment at other related financial organisations. In 2004 12 staff members took advantage of this option. The Eurosystem's organisational principles approved by the Governing Council and published in January 2005 state that "the exchange of personnel, know-how and experience shall be promoted by and among all members of the Eurosystem".

ECB IN MOTION

In October 2003 the Executive Board set up a programme office to monitor and assess the implementation of measures which it had endorsed in the context of an organisational change programme called ECB in Motion. This initiative aimed to improve the efficiency and effectiveness of the organisation and covers management, professional development, internal communication and bureaucracy issues. In 2004 significant progress was made in all four areas and the programme office submitted its final report. Given that the impact of some measures will only be felt in the

medium term, progress will continue to be monitored.

REVIEW OF THE HUMAN RESOURCES STRATEGY

Since 1998 the ECB's priorities have been the establishment of its functions, the formulation and implementation of the single monetary policy and the introduction of the euro. This has inevitably involved a focus of human resources policy on technical expertise for specific jobs. In the light of this, an in-depth review of the human resources strategy was undertaken and the conclusions were presented in 2004.

The main conclusion was that recruitment policies should emphasise broader competencies. Moreover, staff development and mobility measures should be strengthened in order to increase synergies and broaden expertise within the ECB. Human resources management has been made more flexible by focusing external recruitment on career starters with a more general background and introducing fixed-term contracts for all new staff and new managerial appointments. These measures will be complemented by the establishment of an ECB Graduates' Programme in 2005 aimed at recent graduates with a broad educational background. A new, junior management layer has been created in order to establish a reasonable span of control after a period of rapid staff growth. Leadership skills will be developed by increasing training and coaching for managers. Based on the ECB's mission statement, six common values have been identified and statements explaining their meaning at the ECB have been developed. These values are: competence, effectiveness and efficiency, integrity, team spirit, transparency and accountability, and working for Europe. The values will play an integral role in human resources policies, together with an ECB-wide competency model and competency profiles that are being developed.

DIVERSITY MANAGEMENT

Diversity management seeks to harness differences among staff in order to create a productive and respectful working environment in which talents are fully utilised and organisational goals are met. Diversity management is important for the ECB as it employs staff from all EU Member States, works closely with the 25 NCBs of the EU and serves the European public. The ECB is thus integrating diversity management into its day-to-day business so that the individual competencies of staff are recognised and feed into the high performance necessary for the ECB to fulfil its tasks.

2.2 NEW ECB PREMISES

Decisive progress was made in 2004 in the planning of the new ECB premises. In February an international jury, chaired by the ECB's Vice-President, revealed the three winning design proposals in the architectural design competition. The first prize was awarded to COOP HIMMELB(L)AU from Vienna, the second prize to ASP Schweger Assoziierte from Berlin and the third prize to 54f architekten + ingenieure from Darmstadt in cooperation with T. R. Hamzah & Yeang from Selangor in Malaysia. Of the 12 candidates shortlisted in 2003, these architects best met the criteria set for the competition, namely:

– overall town-planning, architecture and landscape;

– compliance with the main features of the functional and spatial programme;

– feasible energy/environmental concept and compliance with the main features of the ECB's technical requirements; and

– compliance with the relevant regulations, in particular in the field of building law and environmental law.

The new ECB premises will be built on the site of the Grossmarkthalle, a listed building which formerly housed Frankfurt's wholesale fruit and vegetable market. One of the main challenges for the architects was to incorporate the large, red-brick building into a modern office structure without changing its fundamental appearance.

The announcement of the prize-winners was followed by an exhibition at the Deutsches Architektur Museum in Frankfurt in which the design proposals of all 71 architects who submitted designs for the competition were shown to the public.

In March 2004 the Governing Council decided to invite the three prize-winning architects to participate in a revision phase, the main purpose of which was to review the design proposals and take account of the recommendations and requirements of the jury, the ECB and the City of Frankfurt.

Following the wholesalers' move to their new headquarters, the city authorities began to clear the site in and around the Grossmarkthalle, which was purchased by the ECB from the City of Frankfurt in 2002, in preparation for the handover to the ECB. The handover took place in December 2004. In line with the preservation orders, great care was taken to ensure that the central building and the east and west wings were left untouched. Those parts of the site that would be appropriate for a memorial and information space commemorating the deportation of Jewish citizens from the Grossmarkthalle were also retained. The ECB, the Frankfurt Jewish Community and the City of Frankfurt agreed to cooperate closely in conducting a competition for the design of a memorial. It is planned that the competition will be launched by the end of 2005.

The Governing Council reached a decision on the design of the ECB's future home on 13 January 2005. After extensive discussions and careful evaluation, based on the selection criteria, of the strengths and weaknesses of all three prize-winning designs, the Governing Council concluded that the revised design concept of COOP HIMMELB(L)AU best met the functional and technical requirements specified by the ECB, and had features that reflected the ECB's values and translated them into architectural language. This decision confirmed the judgement of the international jury, who had awarded the first prize to this project. The next step will be an "optimisation" phase in which the design will again be reviewed, in particular to ensure the optimal use of resources and to minimise costs. More details on the competition and the winning design can be found on the ECB's website.

3 ESCB SOCIAL DIALOGUE

The ESCB Social Dialogue is a consultative forum involving the ECB and employee representatives from all the central banks of the ESCB and European trade union federations. Its purpose is to provide information and to discuss decisions of the General Council and the Governing Council in so far as they may have a major impact on the employment situation at the central banks of the ESCB.

The ninth meeting of the ESCB Social Dialogue welcomed employee representatives from the NCBs of seven of the new EU Member States. The participants confirmed their commitment to the process of integration within the ESCB in general, and their own involvement in the ESCB Social Dialogue in particular. The ECB encouraged the NCBs of all the new Member States to facilitate the participation of employee representatives in the ESCB Social Dialogue.

The main items on the agenda for both the ninth and tenth meetings of the ESCB Social Dialogue were TARGET2, the production of banknotes and the follow-up to the European Commission's Financial Services Action Plan. There were also discussions on more general topics, such as ways to develop a shared identity and to foster cooperation on the basis of common principles. The ECB emphasised that the ESCB is committed to providing central bank services of a high quality at the lowest possible cost, which requires efficiency and effectiveness. The participants were informed that the Governing Council had adopted a mission statement, strategic intents and organisational principles for the Eurosystem. The employee representatives underscored the importance of their involvement in developing these issues and of respecting differences in culture among the central banks. Finally, at the tenth meeting of the ESCB Social Dialogue, the ECB and the staff representatives reaffirmed the value of this unique consultative forum.

4 ANNUAL ACCOUNTS OF THE ECB

MANAGEMENT REPORT FOR THE YEAR ENDING 31 DECEMBER 2004

1 PRINCIPAL ACTIVITIES

The Bank's activities in 2004 are described in detail in the relevant chapters of the Annual Report.

2 FINANCIAL ACCOUNTS

Under Article 26.2 of the ESCB Statute, the Annual Accounts of the ECB are drawn up by the Executive Board, in accordance with the principles established by the Governing Council. The Accounts are subsequently approved by the Governing Council and published thereafter.

3 FINANCIAL RESULTS

The ECB's Annual Accounts for the year ending 31 December 2004, as set out on pages 180 to 197, show a net loss of €1,636 million, following a net loss of €477 million in 2003. As was the case last year, the loss was mainly due to the continued strengthening of the external value of the euro, which resulted in write-downs in the euro value of the ECB's holdings of US dollar-denominated assets. The net loss is stated after taking into account all income earned by the ECB, including €733 million of income earned on its banknotes in circulation. The ECB's interest income continued to be affected in 2004 by historically low levels of domestic and foreign interest rates.

Since most of the ECB's assets and liabilities are periodically revalued at current market exchange rates and security prices, the ECB's profitability is very dependent on exchange rate movements and, to a lesser extent, interest rate exposures. These exposures stem mainly from its large official holdings of the Eurosystem's foreign reserve assets, which are invested in interest-bearing instruments.

The harmonised accounting policies for the ECB and the Eurosystem, which are described in the notes to the Annual Accounts, have been developed to take these substantial risks into account and are based primarily on the principle of prudence. In particular, they aim to ensure that unrealised gains arising from the revaluation of assets and liabilities are not recognised as income and are therefore not distributable as profit. Conversely, unrealised losses resulting from revaluations are expensed in the profit and loss account at the end of the year.

The bulk of the ECB's foreign reserve assets is held in US dollars, but they also include holdings of Japanese yen, gold and SDRs. The euro appreciated against the US dollar, from USD 1.2630 on 31 December 2003 to USD 1.3621 on 31 December 2004 (some 8%) and to a lesser extent against the Japanese yen. Consequently, the revaluation of the net holdings of these currencies resulted in a decline of €2.1 billion in their euro value.

At the end of 2004, the ECB employed 1,309 staff (including 131 at managerial levels) compared with 1,213 one year earlier. The increase in 2004 was primarily due to the consequences of EU enlargement. For further details, please refer to Chapter 8 of the Annual Report, Section 2 "Organisational Developments" and the Annual Accounts – "Notes on the Profit and Loss Account".

Total administrative expenses of the ECB, including depreciation, rose by 18% from €316 million in 2003 to €374 million in 2004. The main single factor in this increase was the rise in the ECB's pension fund obligations, as calculated by the actuary, which contributed substantially to an increase in staff costs from €130 million to €161 million. In 2004, the emoluments of the Executive Board of the ECB amounted in total to €2.1 million (2003: €2.0 million).

Some €90 million were invested in fixed assets. The principal item (some €61 million) was the capitalisation of the cost of the site of the ECB's new premises, following the final payment.

Funding of the ECB's 2004 reported loss

On 11 March 2005, the Governing Council decided to offset the loss for 2004 by (a) using the entire remaining general reserve fund of some €296 million, and (b) using the NCBs' monetary income of some €1,340 million, in accordance with the provisions of Article 33.2 of the ESCB Statute. The amount of the NCBs' monetary income used came to some 15% of the total monetary income of the Eurosystem. The way in which the loss was to be allocated was authorised, in principle, by the Governing Council before the NCBs had closed their Annual Accounts for 2004, with the result that it affected their profits for that year too. Each NCB contributed a share of its monetary income in accordance with its weighting in the capital key of the ECB.

4 CHANGES IN THE ECB'S CAPITAL STRUCTURE IN 2004

Under Article 29.3 of the ESCB Statute, the capital key for the NCBs' subscriptions to the ECB's capital must be adjusted every five years. The first such adjustment following the establishment of the ECB took place on 1 January 2004. On 1 May 2004, a second change of the ECB's capital key followed as a result of the accession of ten new Member States. Taken together, these two steps had the following effects:

(a) a reduction in the overall weighting of the euro area NCBs in the ECB's capital key;

(b) a concomitant reduction in the euro area NCBs' claims on the ECB that arose from the transfer of foreign reserve assets to the ECB on entry into the euro area; and

(c) an increase in the paid-up capital contributions of the non-euro area NCBs following the accession of ten new Member States, which also reflects an increase from 5% to 7% in the minimal percentage of subscribed capital paid by the 13 non-euro area NCBs.

Details of these changes are contained in note 15 of the Annual Accounts.

5 INVESTMENT ACTIVITIES AND RISK MANAGEMENT

The ECB's foreign reserve portfolio is composed of foreign reserve assets transferred to it by the Eurosystem NCBs in accordance with the provisions of Article 30 of the ESCB Statute and income thereon. Its purpose is to fund the ECB's operations in the foreign exchange market for the purposes set out in the Treaty.

The ECB's own funds portfolio reflects the investment of its paid-up capital, the general reserve fund and income accumulated on the portfolio in the past. Its purpose is to provide the ECB with a reserve to meet possible losses.

The ECB's investment activities and its management of the associated risks are described in greater detail in Chapter 2 of the Annual Report.

6 GOVERNANCE OF THE ECB

Information relating to the governance of the ECB is outlined in Chapter 8 of the Annual Report.

7 EMPLOYEES

The ECB's human resources strategy, together with further information on the number of staff employed, is described in Chapter 8 of the Annual Report.

BALANCE SHEET AS AT 31 DECEMBER 2004

ASSETS	NOTE NUMBER	2004 €	2003 €
Gold and gold receivables	**1**	**7,928,308,842**	**8,145,320,117**
Claims on non-euro area residents denominated in foreign currency	**2**		
Receivables from the IMF		163,794,845	211,651,948
Balances with banks and security investments, external loans and other external assets		26,938,993,980	28,593,384,857
		27,102,788,825	**28,805,036,805**
Claims on euro area residents denominated in foreign currency	**2**	**2,552,016,565**	**2,799,472,504**
Claims on non-euro area residents denominated in euro	**3**		
Balances with banks, security investments and loans		**87,660,507**	**474,743,402**
Other claims on euro area credit institutions denominated in euro	**4**	**25,000**	**25,000**
Intra-Eurosystem claims	**5**		
Claims related to the allocation of euro banknotes within the Eurosystem		40,100,852,165	34,899,471,205
Other claims within the Eurosystem (net)		3,410,918,324	4,599,894,403
		43,511,770,489	**39,499,365,608**
Other assets	**6**		
Tangible fixed assets		187,318,304	128,911,950
Other financial assets		6,428,319,567	5,573,756,258
Accruals and prepaid expenses		770,894,480	590,646,023
Sundry		6,933,022	37,791,421
		7,393,465,373	**6,331,105,652**
Loss for the year		**1,636,028,702**	**476,688,785**
Total assets		**90,212,064,303**	**86,531,757,873**

LIABILITIES	NOTE NUMBER	2004 €	2003 €
Banknotes in circulation	7	**40,100,852,165**	**34,899,471,205**
Liabilities to other euro area residents denominated in euro	8	**1,050,000,000**	**1,065,000,000**
Liabilities to non-euro area residents denominated in euro	9	**137,462,706**	**146,867,501**
Liabilities to euro area residents denominated in foreign currency	10	**4,967,080**	**0**
Liabilities to non-euro area residents denominated in foreign currency	10		
Deposits, balances and other liabilities		**1,254,905,957**	**1,452,432,822**
Intra-Eurosystem liabilities	11		
Liabilities equivalent to the transfer of foreign reserves		**39,782,265,622**	**40,497,150,000**
Other liabilities	12		
Accruals and income collected in advance		1,136,708,542	1,162,299,071
Sundry		327,802,782	174,890,973
		1,464,511,324	**1,337,190,044**
Provisions	13	**110,636,285**	**87,195,777**
Revaluation accounts	14	**1,921,117,190**	**2,176,464,065**
Capital and reserves	15		
Capital		4,089,277,550	4,097,229,250
Reserves		296,068,424	772,757,209
		4,385,345,974	**4,869,986,459**
Total liabilities		**90,212,064,303**	**86,531,757,873**

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDING 31 DECEMBER 2004

	NOTE NUMBER	2004 €	2003 €
Interest income on foreign reserve assets		422,418,698	541,294,375
Interest income arising from the allocation of euro banknotes within the Eurosystem		733,134,472	698,245,187
Other interest income		1,456,650,188	1,449,963,923
Interest income		*2,612,203,358*	*2,689,503,485*
Remuneration of NCBs' claims in respect of foreign reserves transferred		(693,060,433)	(807,683,148)
Other interest expense		(1,229,369,015)	(1,166,693,660)
Interest expense		*(1,922,429,448)*	*(1,974,376,808)*
Net interest income	**18**	**689,773,910**	**715,126,677**
Realised gains/losses arising from financial operations	**19**	136,045,810	525,260,622
Write-downs on financial assets and positions	**20**	(2,093,285,109)	(3,972,689,560)
Transfer to/from provisions for foreign exchange rate and price risks		0	2,568,708,838
Net result of financial operations, write-downs and risk provisions		**(1,957,239,299)**	**(878,720,100)**
Net expense from fees and commissions	**21**	**(261,517)**	**(63,466)**
Other income	**22**	**5,956,577**	**2,911,280**
Total net income		**(1,261,770,329)**	**(160,745,609)**
Staff costs	**23 & 24**	(161,192,939)	(129,886,988)
Administrative expenses	**25**	(176,287,651)	(153,549,282)
Depreciation of tangible fixed assets		(33,655,824)	(30,410,140)
Banknote production services	**26**	(3,121,959)	(2,096,766)
Loss for the year		**(1,636,028,702)**	**(476,688,785)**

Frankfurt am Main, 4 March 2005

EUROPEAN CENTRAL BANK

Jean-Claude Trichet
President

ACCOUNTING POLICIES[1]

FORM AND PRESENTATION OF THE FINANCIAL STATEMENTS

The financial statements of the European Central Bank (ECB) have been designed to present fairly the financial position of the ECB and the results of its operations. They have been drawn up in accordance with the following accounting policies[2], which the Governing Council of the ECB considers to be appropriate to the nature of central bank activity.

ACCOUNTING PRINCIPLES

The following accounting principles have been applied: economic reality and transparency, prudence, recognition of post-balance-sheet events, materiality, the accruals principle, going concern, consistency and comparability.

BASIS OF ACCOUNTING

The accounts have been prepared on a historical cost basis, modified to include market valuation of marketable securities, gold and all other on-balance-sheet and off-balance-sheet assets and liabilities denominated in foreign currency. Transactions in financial assets and liabilities are reflected in the accounts on the basis of the date on which they are settled.

GOLD AND FOREIGN CURRENCY ASSETS AND LIABILITIES

Assets and liabilities denominated in foreign currency are converted into euro at the exchange rate prevailing on the balance sheet date. Income and expenses are converted at the exchange rate prevailing at the time of the transaction. The revaluation of foreign exchange assets and liabilities is performed on a currency-by-currency basis, including on-balance-sheet and off-balance-sheet instruments.

Revaluation to the market price for assets and liabilities denominated in foreign currency is treated separately from the exchange rate revaluation.

Gold is valued at the market price prevailing at the year-end. No distinction is made between the price and currency revaluation differences for gold. Instead, a single gold valuation is accounted for on the basis of the price in euro per fine ounce of gold, which is derived from the exchange rate of the euro against the US dollar on 31 December 2004.

SECURITIES

All marketable securities and similar assets are valued at the mid-market prices prevailing at the balance sheet date on a security-by-security basis. For the year ending 31 December 2004, mid-market prices on 30 December 2004 were used. Non-marketable securities are valued at cost.

INCOME RECOGNITION

Income and expenses are recognised in the period in which they are earned or incurred. Realised gains and losses arising from the sale of foreign exchange, gold and securities are taken to the profit and loss account. Such realised gains and losses are calculated by reference to the average cost of the respective asset.

Unrealised gains are not recognised as income, but are transferred directly to a revaluation account.

Unrealised losses are taken to the profit and loss account if they exceed previous revaluation gains registered in the corresponding revaluation account. Unrealised losses in any one security, currency or in gold are not netted against unrealised gains in other securities, currencies or gold. In the event of an unrealised loss on any item at the year-end, the average cost of that item is reduced to the year-end exchange rate and/or market price.

1 The detailed accounting policies of the ECB are laid down in a Decision of the Governing Council of the ECB of 5 December 2002 (ECB/2002/11), OJ L 58, 3.3.2003, pp. 38-59.

2 These policies are consistent with the provisions of Article 26.4 of the Statute of the ESCB, which require a harmonised approach to the rules governing the accounting and financial reporting of Eurosystem operations.

Premiums or discounts arising on purchased securities are calculated and presented as part of interest income and are amortised over the remaining life of the assets.

REVERSE TRANSACTIONS

Under a repurchase agreement, securities are sold for cash with a simultaneous agreement to repurchase them at an agreed price on a set future date. These agreements to repurchase are reflected on the liability side of the balance sheet and also lead to an interest expense in the profit and loss account. Securities sold under such an agreement remain on the balance sheet of the ECB.

Under a reverse repurchase agreement securities are bought for cash with a simultaneous agreement to sell them back to the counterparty at an agreed price on a set future date. These agreements to sell are recorded on the asset side of the balance sheet, but are not included in the ECB's security holding and give rise to interest income in the profit and loss account.

Reverse transactions (including security lending transactions) conducted under an automated security lending programme are recorded on the balance sheet only where collateral is provided to the ECB in the form of cash over the maturity of the transaction. In 2004 the ECB did not receive any collateral in the form of cash over the maturity of such transactions.

OFF-BALANCE-SHEET INSTRUMENTS

Currency instruments, namely foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, are included in the net foreign currency position for the purpose of calculating foreign exchange gains and losses. Interest rate instruments are revalued on an item-by-item basis. Outstanding interest rate futures positions are recorded in off-balance-sheet accounts. Daily changes in the variation margin are recorded in the profit and loss account.

POST-BALANCE-SHEET EVENTS

Assets and liabilities are adjusted for events that occur between the annual balance sheet date and the date on which the Governing Council of the ECB approves the financial statements, if such events materially affect the condition of assets and liabilities at the balance sheet date.

INTRA-ESCB BALANCES/INTRA-EUROSYSTEM BALANCES

Intra-ESCB transactions are cross-border transactions that occur between two EU central banks. These transactions are processed primarily via TARGET – the Trans-European Automated Real-time Gross settlement Express Transfer system (see Chapter 2) – and give rise to bilateral balances in accounts held between those EU central banks connected to TARGET. These bilateral balances are then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position vis-à-vis the ECB only. This position in the books of the ECB represents the net claim or liability of each NCB against the rest of the ESCB.

Intra-ESCB balances of the euro area NCBs with the ECB (except for the capital of the ECB and positions resulting from the transfer of foreign reserve assets to the ECB) are described as intra-Eurosystem claims or liabilities and are presented in the balance sheet of the ECB as a single net asset or liability position.

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included as a single net asset under "Claims related to the allocation of euro banknotes within the Eurosystem" (see "Banknotes in circulation" in the notes on accounting policies).

Intra-ESCB balances of the non-euro area NCBs (Danmarks Nationalbank, Sveriges Riksbank and the Bank of England) with the ECB are disclosed under "Liabilities to non-euro area residents denominated in euro".

TREATMENT OF FIXED ASSETS

Fixed assets, with the exception of land, are valued at cost less depreciation. Land is valued at cost. Depreciation is calculated on a straight-line basis, beginning in the quarter after acquisition and continuing over the expected economic lifetime of the asset, namely:

Computers, related hardware and software, and motor vehicles	4 years
Equipment, furniture and plant in building	10 years
Capitalised building and refurbishment expenditure	25 years
Fixed assets costing less than €10,000	Written off in the year of acquisition

The depreciation period for capitalised building and refurbishment expenditure relating to the ECB's existing premises has been reduced in order to ensure that these assets are completely written off before the ECB moves to its final premises.

THE ECB'S RETIREMENT PLAN

The assets of the plan, which exist solely for the purpose of providing benefits for members of the plan and their dependants, are included in the other assets of the ECB and are identified separately in the notes on the balance sheet. Valuation gains and losses arising on the assets of the pension fund are recognised as income and expenditure of the retirement plan in the year in which they arise. The benefits payable from the core benefit account, resulting from the contributions of the ECB, have minimum guarantees underpinning the defined contribution benefits.

BANKNOTES IN CIRCULATION

The ECB and the 12 euro area NCBs, which together comprise the Eurosystem, issue euro banknotes.[3] The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last working day of each month in accordance with the banknote allocation key.[4] The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation, which is disclosed under the balance sheet liability item "Banknotes in circulation". The ECB's share of the total euro banknote issue is backed by claims on the NCBs. These claims, which bear interest[5], are disclosed under the sub-item "Intra-Eurosystem claims: claims related to the allocation of euro banknotes within the Eurosystem" (see "Intra-ESCB balances/intra-Eurosystem balances" in the notes on accounting policies). Interest income on these claims is included within the item "Net interest income". The Governing Council has decided that this income shall be distributed separately to the NCBs in the form of an interim distribution after the end of each quarter.[6] It will be distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation, and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of euro banknotes.

OTHER ISSUES

Taking account of the ECB's role as a central bank, the Executive Board of the ECB considers that the publication of a cash flow statement would not provide the readers of the financial statements with any additional relevant information.

In accordance with Article 27 of the Statute of the ESCB, and on the basis of a recommendation of the Governing Council of the ECB, the Council of the European Union

3 ECB Decision of 6 December 2001 on the issue of euro banknotes (ECB/2001/15), OJ L 337, 20.12.2001, pp. 52-54 as amended by ECB/2003/23, OJ L 9,15.01.2004, pp. 40-41 and ECB/2004/9, OJ L 205, 9.06.2004, pp. 17-18.

4 "Banknote allocation key" means the percentages that result from taking into account the ECB's share in the total euro banknote issue and applying the subscribed capital key to the NCBs' share in that total.

5 ECB Decision of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002 (ECB/2001/16), OJ L 337, 20.12.2001, pp. 55-61, as amended by ECB/2003/22, OJ L 9, 15.01.2004, p. 39.

6 ECB Decision of 21 November 2002 on the distribution of the income of the European Central Bank on euro banknotes in circulation to the national central banks of the participating Member States (ECB/2002/9), OJ L 323, 28.11.2002, pp. 49-50.

has approved the appointment of KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft as the external auditors of the ECB for a five-year period up to the end of the financial year 2007.

NOTES ON THE BALANCE SHEET

1 GOLD AND GOLD RECEIVABLES

The ECB holds 24.7 million ounces of fine gold (2003: 24.7 million ounces). No transactions in gold took place in 2004. The balance sheet movement compared with 2003 is due to the year-end revaluation of these holdings (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

2 CLAIMS ON NON-EURO AREA AND EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

Receivables from the IMF

This asset represents the ECB's holdings of Special Drawing Rights (SDRs) as at 31 December 2004. It arises as the result of a two-way SDR buying and selling arrangement with the International Monetary Fund (IMF), whereby the IMF is authorised to arrange sales or purchases of SDRs against euro, on behalf of the ECB, within minimum and maximum holding levels. The SDR is defined in terms of a basket of currencies. Its value is determined as the weighted sum of exchange rates of the four major currencies (euro, Japanese yen, pound sterling and US dollar). For accounting purposes, SDRs are treated as a foreign currency (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

Balances with banks and security investments, external loans and other external assets
Claims on euro area residents denominated in foreign currency

These claims consist of balances with banks, loans denominated in foreign currency and investments in securities, denominated in US dollar and Japanese yen, as follows:

Claims on non-euro area residents	2004 €	2003 €	Change €
Current accounts	2,682,171,017	1,365,187,080	1,316,983,937
Money market deposits	848,227,002	1,197,220,582	(348,993,580)
Reverse repurchase agreements	2,408,046,989	3,834,025,154	(1,425,978,165)
Security investments	21,000,548,972	22,196,952,041	(1,196,403,069)
Total	26,938,993,980	28,593,384,857	(1,654,390,877)

Claims on euro area residents	2004 €	2003 €	Change €
Current accounts	26,506	26,740	(234)
Money market deposits	2,547,022,979	2,799,445,764	(252,422,785)
Reverse repurchase agreements	4,967,080	0	4,967,080
Total	2,552,016,565	2,799,472,504	(247,455,939)

The reduction in these positions in 2004 is primarily due to the year-end revaluation of the ECB's US dollar-denominated assets. The depreciation of the US dollar and, to a lesser extent, the Japanese yen vis-à-vis the euro resulted in a significant decline in their euro equivalent value (see "Gold and foreign currency assets and liabilities" and "Income recognition" in the notes on accounting policies).

3 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO

As at 31 December 2004, this claim consisted of bank deposits with non-euro area residents.

4 OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

As at 31 December 2004, this claim consisted of a bank deposit with a euro area resident.

5 INTRA-EUROSYSTEM CLAIMS

Claims related to the allocation of euro banknotes within the Eurosystem

This item consists of the claims of the ECB vis-à-vis the euro area NCBs relating to the allocation of euro banknotes within the Eurosystem (see "Banknotes in circulation" in the notes on accounting policies).

Other claims within the Eurosystem (net)

This item consists of the TARGET balances of the euro area NCBs vis-à-vis the ECB and amounts due in respect of the interim distributions of the ECB's income derived from banknotes. As at 31 December 2004, an amount of €536 million was due from the euro area NCBs in respect of interim distributions of the ECB's income derived from banknotes. This represents the interim distributions of such income to the euro area NCBs for the first three quarters of the year, which were subsequently recalled (see "Banknotes in circulation" in the notes on accounting policies and note 18 in the "Notes on the Profit and Loss Account").

	2004 €	2003 €
Due from euro area NCBs in respect of TARGET	64,024,554,579	49,646,309,854
Due to euro area NCBs in respect of TARGET	(61,149,859,140)	(45,579,175,620)
Net TARGET position	2,874,695,439	4,067,134,234
Due from/(to) euro area NCBs in respect of the interim distribution of the ECB's income derived from banknotes	536,222,885	532,760,169
Other claims within the Eurosystem (net)	3,410,918,324	4,599,894,403

6 OTHER ASSETS

Tangible fixed assets

These assets comprised the following main items on 31 December 2004:

	Net book value as at 31 Dec. 2004 €	Net book value as at 31 Dec. 2003 €	Change €
Land and buildings	135,997,016	54,929,962	81,067,054
Computers	43,089,388	45,407,622	(2,318,234)
Equipment, furniture, plant in building and motor vehicles	3,809,292	2,149,813	1,659,479
Assets under construction	3,215,050	23,259,861	(20,044,811)
Other fixed assets	1,207,558	3,164,692	(1,957,134)
Total	187,318,304	128,911,950	58,406,354

The principal increase, under the heading "Land and buildings", relates to:

(a) the acquisition of the land for the ECB's final premises. Based on a predefined area of construction floor space, the minimum purchase price was set at €61.4 million, payable in instalments by 31 December 2004 at the latest, when legal title would pass to the ECB. This amount has now been paid in full and is consequently included under "Land and buildings"; and

(b) transfers from the category "Assets under construction" of capitalised refurbishment costs at the ECB's third site, following commencement of use of the assets.

Other financial assets
The main components of this item are as follows:

	2004 €	2003 €	Change €
Securities denominated in euro	5,399,222,333	5,276,052,927	123,169,406
Reverse repurchase agreements in euro	869,977,933	167,100,400	702,877,533
Claims relating to the ECB pension fund	120,243,662	91,727,194	28,516,468
Other financial assets	38,875,639	38,875,737	(98)
Total	6,428,319,567	5,573,756,258	854,563,309

(a) Securities denominated in euro and reverse repurchase agreements in euro constitute the investment of the ECB's own funds (see also note 12).

(b) The investment portfolios relating to the ECB pension fund are valued at €120.2 million (2003: €91.7 million). The assets held represent the investments of accumulated pension contributions by the ECB and the staff of the ECB as at 31 December 2004, and are managed by an external fund manager. The regular contributions of the ECB and members of the plan have been invested on a monthly basis. The assets of the plan are not fungible with other financial assets of the ECB, and net income thereon does not constitute income of the ECB, but is reinvested in the funds concerned, pending payment of benefits. The external fund manager values the assets of the pension fund using year-end market prices.

(c) The ECB holds 3,000 shares in the Bank for International Settlements (BIS) which are included at the acquisition cost of €38.5 million.

Accruals and prepaid expenses
In 2004, this position included accrued interest receivable of €197 million (2003: €165 million) on the ECB's claims related to the allocation of euro banknotes within the Eurosystem for the final quarter (see "Banknotes in circulation" in the notes on accounting policies).

The remainder of this balance consists principally of accrued interest on securities and other financial assets.

Sundry
In 2004 the main component of this item is a claim against the German Federal Ministry of Finance in respect of recoverable value added and other indirect taxes paid. Such taxes are refundable under the terms of Article 3 of the Protocol concerning the Privileges and Immunities of the European Communities, which applies to the ECB by virtue of Article 40 of the Statute of the ESCB.

7 BANKNOTES IN CIRCULATION

This item consists of the ECB's share of the total euro banknotes in circulation (see "Banknotes in circulation" in the notes on accounting policies).

8 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO

This item comprises deposits by members of the Euro Banking Association (EBA) which are used in order to provide the ECB with collateral in respect of the EBA's payments settled through the TARGET system.

9 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN EURO

These liabilities principally represent balances held at the ECB by non-euro area NCBs arising from transactions processed via the TARGET system (see "Intra-ESCB balances/intra-Eurosystem balances" in the notes on accounting policies).

10 LIABILITIES TO EURO AREA AND NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY

The liabilities arising from repurchase agreements conducted with euro area and non-euro area residents in connection with the management of the foreign currency reserves of the ECB are as follows:

Liabilities to euro area residents	2004 €	2003 €	Change €
Repurchase agreements	4,967,080	0	4,967,080

Liabilities to non-euro area residents	2004 €	2003 €	Change €
Repurchase agreements	1,254,905,957	1,452,432,822	(197,526,865)

11 INTRA-EUROSYSTEM LIABILITIES

These represent the liabilities to euro area NCBs that arose from the transfer of foreign reserve assets to the ECB. The liabilities are denominated in euro at a value fixed at the time of their transfer. They are remunerated at the latest available marginal rate for the Eurosystem's main refinancing operations, adjusted to reflect a zero return on the gold component (see note 18 in the "Notes on the Profit and Loss Account").

Given the decrease in the weighting in the ECB capital key of the euro area NCBs on 1 January 2004 and the subsequent change to the ECB capital key on 1 May 2004 (see note 15), the initial total liability of €40,497,150,000 was reduced in two stages to €39,782,265,622 by Decisions of the Governing Council pursuant to Article 30.3 of the ESCB Statute. This adjustment was made in order to provide the necessary headroom to allow NCBs joining the Eurosystem at a future date to make full transfers of foreign reserve assets in proportion to their prevailing shares in the ECB's capital key. The reduction of the euro-denominated liability did not require re-transfers of foreign reserve assets between the ECB and the NCBs.

	Until 31 December 2003 €	From 1 January to 30 April 2004 €	From 1 May 2004 €
Nationale Bank van België/ Banque Nationale de Belgique	1,432,900,000	1,414,850,000	1,419,101,951
Deutsche Bundesbank	12,246,750,000	11,702,000,000	11,761,707,508
Bank of Greece	1,028,200,000	1,080,700,000	1,055,840,343
Banco de España	4,446,750,000	4,390,050,000	4,326,975,513
Banque de France	8,416,850,000	8,258,750,000	8,275,330,931
Central Bank and Financial Services Authority of Ireland	424,800,000	512,700,000	513,006,858
Banca d'Italia	7,447,500,000	7,286,300,000	7,262,783,715
Banque centrale du Luxembourg	74,600,000	85,400,000	87,254,014
De Nederlandsche Bank	2,139,000,000	2,216,150,000	2,223,363,598
Oesterreichische Nationalbank	1,179,700,000	1,150,950,000	1,157,451,203
Banco de Portugal	961,600,000	1,006,450,000	982,331,062
Suomen Pankki – Finlands Bank	698,500,000	714,900,000	717,118,926
Total	**40,497,150,000**	**39,819,200,000**	**39,782,265,622**

12 OTHER LIABILITIES

This item consists mainly of interest due to the NCBs in respect of their claims relating to the foreign reserves transferred (see note 11). The ECB's obligations in respect of the pension fund, including a provision based on the actuary's report (see note 13), amount to €148.8 million (2003: €100.6 million). Also included within this balance are other accruals and outstanding repurchase transactions of €200 million conducted in connection with the management of the ECB's own funds (see note 6).

13 PROVISIONS

This position includes provisions relating to pensions and expenditure on goods and services, together with an appropriate provision against the contractual obligation of the ECB to restore its current premises to their original condition when they are vacated and the ECB moves to its final site.

14 REVALUATION ACCOUNTS

These accounts represent revaluation reserves arising from unrealised gains on assets and liabilities.

	2004 €	2003 €	Change €
Gold	1,853,957,106	2,070,968,381	(217,011,275)
Foreign currency	0	1,901	(1,901)
Securities	67,160,084	105,493,783	(38,333,699)
Total	1,921,117,190	2,176,464,065	(255,346,875)

15 CAPITAL AND RESERVES

Capital

(a) Changes to the ECB's capital key

Under Article 29.3 of the ESCB Statute, the key of NCBs for subscription of the ECB's capital must be adjusted every five years. The first such adjustment following the establishment of the ECB was made on 1 January 2004. On 1 May 2004 a second change in the ECB's capital key followed as a result of the accession of ten Member States. Based on the Council Decision of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the capital of the European Central Bank, the capital keys of NCBs were adjusted as follows on 1 January 2004 and 1 May 2004:

	Until 31 December 2003 %	From 1 January to 30 April 2004 %	From 1 May 2004 %
Nationale Bank van België/ Banque Nationale de Belgique	2.8658	2.8297	2.5502
Deutsche Bundesbank	24.4935	23.4040	21.1364
Bank of Greece	2.0564	2.1614	1.8974
Banco de España	8.8935	8.7801	7.7758
Banque de France	16.8337	16.5175	14.8712
Central Bank and Financial Services Authority of Ireland	0.8496	1.0254	0.9219
Banca d'Italia	14.8950	14.5726	13.0516
Banque centrale du Luxembourg	0.1492	0.1708	0.1568
De Nederlandsche Bank	4.2780	4.4323	3.9955
Oesterreichische Nationalbank	2.3594	2.3019	2.0800
Banco de Portugal	1.9232	2.0129	1.7653
Suomen Pankki – Finlands Bank	1.3970	1.4298	1.2887
Total euro area NCBs	***80.9943***	***79.6384***	***71.4908***

	Until 31 December 2003 %	From 1 January to 30 April 2004 %	From 1 May 2004 %
Česká národní banka	0.0000	0.0000	1.4584
Danmarks Nationalbank	1.6709	1.7216	1.5663
Eesti Pank	0.0000	0.0000	0.1784
Central Bank of Cyprus	0.0000	0.0000	0.1300
Latvijas Banka	0.0000	0.0000	0.2978
Lietuvos bankas	0.0000	0.0000	0.4425
Magyar Nemzeti Bank	0.0000	0.0000	1.3884
Central Bank of Malta/ Bank Ċentrali ta' Malta	0.0000	0.0000	0.0647
Narodowy Bank Polski	0.0000	0.0000	5.1380
Banka Slovenije	0.0000	0.0000	0.3345
Národná banka Slovenska	0.0000	0.0000	0.7147
Sveriges Riksbank	2.6537	2.6636	2.4133
Bank of England	14.6811	15.9764	14.3822
Total non-euro area NCBs	***19.0057***	***20.3616***	***28.5092***
Total euro area and non-euro area NCBs	**100.0000**	**100.0000**	**100.0000**

(b) Capital of the ECB

Due to the overall reduction of 1.3559% in the weighting of the euro area NCBs (with fully paid-up subscriptions) in the ECB's capital of €5 billion, their share in the ECB's subscribed capital decreased from €4,049,715,000 to a total of €3,981,920,000 on 1 January 2004. It was further reduced to €3,978,226,562 on 1 May 2004 as a result of the accession of the ten new Member States.

In accordance with Article 49.3 of the Statute of the ESCB, which was added to the Statute by the Treaty of Accession, the ECB's subscribed capital will in future be automatically increased when a new member joins the EU and its NCB joins the ESCB. The increase is determined by multiplying the prevailing amount of the subscribed capital (i.e. €5 billion) by the ratio, within the expanded capital key, between the weighting of the entering NCB(s) and the weighting of those NCBs that are already members of the ESCB. Therefore, on 1 May 2004, the subscribed capital of the ECB was increased to €5.565 billion.

The 13 non-euro area NCBs are required to pay up a minimal percentage of their subscribed capital as a contribution to the operational costs of the ECB. On 1 May 2004 this percentage was increased from 5% to 7%. Including the amounts received from the ten new non-euro area NCBs, this contribution amounted to a total of €111,050,988 at that date. Unlike the euro area NCBs, the non-euro area NCBs are not entitled to receive any share of the distributable profits of the ECB, including income arising from the allocation of euro banknotes within the Eurosystem, nor are they liable to fund any loss of the ECB.

The combined effect of the above three developments was that the paid-up capital decreased from €4,097,229,250 on 31 December 2003 to €4,032,824,000 on 1 January 2004 and then increased to €4,089,277,550 on 1 May 2004, as shown in the table below:

	Subscribed capital until 31 December 2003 €	Paid-up capital until 31 December 2003 €	Subscribed capital from 1 January to 30 April 2004 €	Paid-up capital from 1 January to 30 April 2004 €	Subscribed capital from 1 May 2004[1] €	Paid-up capital from 1 May 2004 €
Nationale Bank van België/Banque Nationale de Belgique	143,290,000	143,290,000	141,485,000	141,485,000	141,910,195	141,910,195
Deutsche Bundesbank	1,224,675,000	1,224,675,000	1,170,200,000	1,170,200,000	1,176,170,751	1,176,170,751
Bank of Greece	102,820,000	102,820,000	108,070,000	108,070,000	105,584,034	105,584,034
Banco de España	444,675,000	444,675,000	439,005,000	439,005,000	432,697,551	432,697,551
Banque de France	841,685,000	841,685,000	825,875,000	825,875,000	827,533,093	827,533,093
Central Bank and Financial Services Authority of Ireland	42,480,000	42,480,000	51,270,000	51,270,000	51,300,686	51,300,686
Banca d'Italia	744,750,000	744,750,000	728,630,000	728,630,000	726,278,371	726,278,371
Banque centrale du Luxembourg	7,460,000	7,460,000	8,540,000	8,540,000	8,725,401	8,725,401
De Nederlandsche Bank	213,900,000	213,900,000	221,615,000	221,615,000	222,336,360	222,336,360
Oesterreichische Nationalbank	117,970,000	117,970,000	115,095,000	115,095,000	115,745,120	115,745,120
Banco de Portugal	96,160,000	96,160,000	100,645,000	100,645,000	98,233,106	98,233,106
Suomen Pankki – Finlands Bank	69,850,000	69,850,000	71,490,000	71,490,000	71,711,893	71,711,893
Total euro area NCBs	***4,049,715,000***	***4,049,715,000***	***3,981,920,000***	***3,981,920,000***	***3,978,226,562***	***3,978,226,562***
Česká národní banka	0	0	0	0	81,155,136	5,680,860
Danmarks Nationalbank	83,545,000	4,177,250	86,080,000	4,304,000	87,159,414	6,101,159
Eesti Pank	0	0	0	0	9,927,370	694,916
Central Bank of Cyprus	0	0	0	0	7,234,070	506,385
Latvijas Banka	0	0	0	0	16,571,585	1,160,011
Lietuvos bankas	0	0	0	0	24,623,661	1,723,656
Magyar Nemzeti Bank	0	0	0	0	77,259,868	5,408,191
Central Bank of Malta / Bank Ċentrali ta' Malta	0	0	0	0	3,600,341	252,024
Narodowy Bank Polski	0	0	0	0	285,912,706	20,013,889
Banka Slovenije	0	0	0	0	18,613,819	1,302,967
Národná banka Slovenska	0	0	0	0	39,770,691	2,783,948
Sveriges Riksbank	132,685,000	6,634,250	133,180,000	6,659,000	134,292,163	9,400,451
Bank of England	734,055,000	36,702,750	798,820,000	39,941,000	800,321,860	56,022,530
Total non-euro area NCBs	***950,285,000***	***47,514,250***	***1,018,080,000***	***50,904,000***	***1,586,442,685***	***111,050,988***
Total euro area and non-euro area NCBs	**5,000,000,000**	**4,097,229,250**	**5,000,000,000**	**4,032,824,000**	**5,564,669,247**	**4,089,277,550**

1) Individual amounts are shown rounded to the nearest euro. Totals may not add up due to rounding.

Reserves
This position represents the general reserve fund of the ECB, established under Article 33 of the Statute of the ESCB.

OFF-BALANCE-SHEET INSTRUMENTS

16 AUTOMATIC SECURITY LENDING PROGRAMME

As part of the management of the ECB's own funds, the ECB has concluded an automatic security lending programme agreement, whereby an appointed agent enters into security lending transactions on behalf of the ECB with a number of counterparties, designated by the ECB as eligible counterparties. Under this agreement, reverse transactions with a value of €1 billion (2003: €0.4 billion) were outstanding as at 31 December 2004 (see "Reverse transactions" in the notes on accounting policies).

17 INTEREST RATE FUTURES

In 2004 foreign currency interest rate futures were used within the management of the ECB's foreign reserves. As at 31 December 2004, the following transactions were outstanding, stated at nominal value:

Foreign currency interest rate futures	Contract value €
Purchases	1,077,349,366
Sales	91,770,061

NOTES ON THE PROFIT AND LOSS ACCOUNT

18 NET INTEREST INCOME

Interest income on foreign reserve assets
This item includes interest income, net of interest expense, in respect of the assets and liabilities denominated in foreign currency, as follows:

	2004 €	2003 €	Change €
Interest on current accounts	3,744,188	3,679,287	64,901
Money market deposit income	49,854,512	45,699,455	4,155,057
Reverse repurchase agreements	63,759,141	66,206,740	(2,447,599)
Net income on securities	317,073,827	445,357,205	(128,283,378)
Total interest income on foreign reserve assets	434,431,668	560,942,687	(126,511,019)
Interest expense on current accounts	(32,020)	(73,292)	41,272
Repurchase agreements	(11,947,990)	(19,575,020)	7,627,030
Other interest expense (net)	(32,960)	0	(32,960)
Interest income on foreign reserve assets (net)	422,418,698	541,294,375	(118,875,677)

Interest income arising from the allocation of euro banknotes within the Eurosystem
This item consists of the interest income of the ECB relating to its 8% share in the total euro banknote issue. Interest on the claims of the ECB in respect of its share of banknotes is earned at the latest available marginal rate for the Eurosystem's main refinancing operations. This income is distributed to the NCBs as outlined in "Banknotes in circulation" in the notes on accounting policies.

Based on the ECB's estimated financial result for the year ending 31 December 2004, the Governing Council decided in December 2004:

(a) to recall the three interim quarterly distributions already paid to the NCBs during the year, amounting to €536 million in total;

(b) to withhold the final quarterly interim distribution of €197 million.

Remuneration of NCBs' claims in respect of foreign reserves transferred
Remuneration paid to euro area NCBs on their claims on the ECB in respect of the foreign reserve assets transferred under Article 30.1 of the Statute of the ESCB is disclosed under this item.

Other interest income* and *Other interest expense
These positions include interest income and expenses on balances arising from TARGET and in respect of other assets and liabilities denominated in euro.

In 2004, net interest income continued to be affected by low levels of domestic and foreign interest rates.

19 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

Net realised gains arising from financial operations in 2004 were as follows:

	2004 €	2003 €	Change €
Net realised price gains on securities	94,643,135	528,606,147	(433,963,012)
Net realised exchange rate gains/(losses)	41,402,675	(3,345,525)	44,748,200
Realised gains arising from financial operations	136,045,810	525,260,622	(389,214,812)

20 WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS

	2004 €	2003 €	Change €
Unrealised price losses on securities	(28,485,006)	(10,349,709)	(18,135,297)
Unrealised exchange rate losses	(2,064,800,103)	(3,962,339,851)	1,897,539,748
Total	(2,093,285,109)	(3,972,689,560)	1,879,404,451

This expense is primarily due to the write-down of the average acquisition cost of the ECB's US dollar holding to its end-of-year exchange rate as at 31 December 2004, following the depreciation of this currency against the euro over the year.

21 NET EXPENSE FROM FEES AND COMMISSIONS

	2004 €	2003 €	Change €
Income from fees and commissions	297,964	700,271	(402,307)
Expenses relating to fees and commissions	(559,481)	(763,737)	204,256
Net expense from fees and commissions	(261,517)	(63,466)	(198,051)

Income under this heading arose primarily from penalties imposed on credit institutions for non-compliance with the minimum reserve requirements. Expenses primarily relate to fees payable on current accounts and in connection with the execution of foreign currency interest rate futures (see note 17 in the "Notes on the Balance Sheet").

22 OTHER INCOME

Other miscellaneous income during the year arose principally from the transfer of unused administrative provisions to the profit and loss account. As from 2004, this item also includes the contribution by the NCBs of the ten new Member States to the local annual service fees, resulting from their local connection, on their accession, to the secure ESCB IT infrastructure. In the first instance, these costs are borne centrally by the ECB.

NCBs' contributions will cease on the respective Member States' entry into the euro area.

23 STAFF COSTS

Salaries, allowances and staff insurance costs of €120.0 million (2003: €108.2 million) and employer's contributions to the ECB's pension fund are included under this heading. The emoluments of the Executive Board of the ECB amounted to a total of €2.1 million (2003: €2.0 million). No pensions were paid to former members of the Executive Board or their dependants during the year. Transitional payments were made to departing members of the Executive Board. Salaries and allowances, including the emoluments of holders of senior management positions, are modelled in essence on, and are comparable with, the remuneration scheme of the European Communities.

The increase in this item in 2004 is primarily due to an increase in the ECB's obligation in respect of the pension fund, as calculated by the actuary (see also note 24).

At the end of 2004 the ECB employed 1,309 staff, of whom 131 held managerial positions. The change in the number of staff during 2004 was as follows:

	2004	2003
As at 1 January	1,213	1,105
New staff	137	149
Resignations	41	41
As at 31 December	1,309	1,213
Average number of staff employed	1,261	1,160

24 THE ECB'S RETIREMENT PLAN

In accordance with the rules of the ECB's retirement plan, a triennial full actuarial valuation is required. The latest full actuarial valuation was carried out as at 31 December 2003, assuming all members left service, and pensionable service ceased, on that date.

The pension cost relating to the plan is assessed in accordance with the advice of a qualified actuary. The total pension cost to the ECB including a provision for disability and post-retirement benefits was €41.1 million (2003: €21.7 million). This cost includes a provision for pensions to members of the Executive Board of €1.8 million (2003: €1.9 million) and any supplementary contributions. The required rate of future service contributions by the ECB is 16.5% of pensionable earnings of all staff.

25 ADMINISTRATIVE EXPENSES

These cover all other current expenses relating to the renting and maintenance of premises, goods and equipment of a non-capital nature, professional fees and other services and supplies, together with staff-related expenses including recruitment, relocation, installation, training and resettlement.

26 BANKNOTE PRODUCTION SERVICES

In 2004, as in 2003, this expense related to cross-border transportation costs of euro banknotes between NCBs to meet unexpected fluctuations in demand. These costs are borne centrally by the ECB.

NOTE ON THE ALLOCATION OF LOSSES

This note is not part of the financial statements of the ECB for the year 2004. It is published in the Annual Report for information purposes only.

INCOME RELATED TO THE ECB'S BANKNOTE ISSUE

Following a decision by the Governing Council of the ECB, the amount of €733 million was retained by the ECB to ensure that the total profit distribution for the year did not exceed the ECB's net profit for the year. This amount represents the full income relating to the ECB's share of total euro banknotes in circulation for 2004.

COVERAGE OF ECB LOSSES

Under Article 33.2 of the Statute of the ESCB, in the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks in accordance with Article 32.5 of the Statute.[1]

On 11 March 2005, the Governing Council of the ECB decided to cover the loss for the year ending 31 December 2004 as follows:

	2004 €	2003 €
Loss for the year	(1,636,028,702)	(476,688,785)
Withdrawals from general reserve fund	296,068,424	476,688,785
Transfer from monetary income pooled	1,339,960,278	0
Total	0	0

1 Under Article 32.5 of the Statute of the ESCB, the sum of the national central banks' monetary income is to be allocated to the national central banks in proportion to their paid-up shares in the capital of the ECB.

KPMG

Marie-Curie-Straße 30
D-60439 Frankfurt am Main

Postfach 50 05 20
D-60394 Frankfurt am Main

Telefon (0 69) 95 87-0
Telefax (0 69) 95 87-10 50

Auditor's report

President and Governing Council
of the European Central Bank

Frankfurt am Main

We have audited the accompanying balance sheet of the European Central Bank as of 31 December 2004 and the related profit and loss account for the year then ended as well as the notes. These annual accounts are the responsibility of the European Central Bank's Executive Board. Our responsibility is to express an opinion on these annual accounts based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the annual accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the annual accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the annual accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the annual accounts give a true and fair view of the financial position of the European Central Bank as of 31 December 2004 and of the results of its operations for the year then ended in accordance with the accounting policies as described in the first part of the notes.

Frankfurt am Main, 4 March 2005

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

(Wohlmannstetter)
Wirtschaftsprüfer

(Dr. Lemnitzer)
Wirtschaftsprüfer

5 CONSOLIDATED BALANCE SHEET OF THE EUROSYSTEM AS AT 31 DECEMBER 2004

(EUR MILLIONS)

ASSETS	31 DECEMBER 2004	31 DECEMBER 2003
1 Gold and gold receivables	**125,730**	**130,344**
2 Claims on non-euro area residents denominated in foreign currency	**153,856**	**175,579**
2.1 Receivables from the IMF	23,948	29,130
2.2 Balances with banks and security investments, external loans and other external assets	129,908	146,449
3 Claims on euro area residents denominated in foreign currency	**16,974**	**17,415**
4 Claims on non-euro area residents denominated in euro	**6,849**	**6,049**
4.1 Balances with banks, security investments and loans	6,849	6,049
4.2 Claims arising from the credit facility under ERM II	0	0
5 Lending to euro area credit institutions related to monetary policy operations denominated in euro	**345,112**	**298,163**
5.1 Main refinancing operations	270,000	253,001
5.2 Longer-term refinancing operations	75,000	45,000
5.3 Fine-tuning reverse operations	0	0
5.4 Structural reverse operations	0	0
5.5 Marginal lending facility	109	134
5.6 Credits related to margin calls	3	28
6 Other claims on euro area credit institutions denominated in euro	**3,763**	**729**
7 Securities of euro area residents denominated in euro	**70,244**	**54,466**
8 General government debt denominated in euro	**41,317**	**42,686**
9 Other assets	**120,479**	**109,365**
Total assets	**884,324**	**834,796**

Totals/subtotals may not add up due to rounding.

LIABILITIES	31 DECEMBER 2004	31 DECEMBER 2003
1 Banknotes in circulation	**501,256**	**436,128**
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**138,735**	**147,328**
2.1 Current accounts (covering the minimum reserve system)	138,624	147,247
2.2 Deposit facility	106	80
2.3 Fixed-term deposits	0	0
2.4 Fine-tuning reverse operations	0	0
2.5 Deposits related to margin calls	5	1
3 Other liabilities to euro area credit institutions denominated in euro	**126**	**257**
4 Debt certificates issued	**0**	**1,054**
5 Liabilities to other euro area residents denominated in euro	**42,187**	**39,865**
5.1 General government	35,968	34,106
5.2 Other liabilities	6,219	5,759
6 Liabilities to non-euro area residents denominated in euro	**10,912**	**10,279**
7 Liabilities to euro area residents denominated in foreign currency	**247**	**499**
8 Liabilities to non-euro area residents denominated in foreign currency	**10,679**	**11,205**
8.1 Deposits, balances and other liabilities	10,679	11,205
8.2 Liabilities arising from the credit facility under ERM II	0	0
9 Counterpart of special drawing rights allocated by the IMF	**5,573**	**5,761**
10 Other liabilities	**51,791**	**54,757**
11 Revaluation accounts	**64,581**	**67,819**
12 Capital and reserves	**58,237**	**59,844**
Total liabilities	**884,324**	**834,796**

ANNEXES

LEGAL INSTRUMENTS ADOPTED BY THE ECB

The following table lists the legal instruments that were adopted by the ECB in 2004 and early 2005 and published in the Official Journal of the European Union. Copies of the Official Journal can be obtained from the Office for Official Publications of the European Communities. For a list of all the legal instruments adopted by the ECB since its establishment and published in the Official Journal, see the ECB's website.

Number	Title	OJ reference
ECB/2004/1	Guideline of the European Central Bank of 13 February 2004 amending Guideline ECB/2003/2 concerning certain statistical reporting requirements of the European Central Bank and the procedures for reporting by the national central banks of statistical information in the field of money and banking statistics	OJ L 83, 20.3.2004, p. 29
ECB/2004/2	Decision of the European Central Bank of 19 February 2004 adopting the Rules of Procedure of the European Central Bank	OJ L 80, 18.3.2004, p. 33
ECB/2004/3	Decision of the European Central Bank of 4 March 2004 on public access to European Central Bank documents	OJ L 80, 18.3.2004, p. 42
ECB/2004/4	Guideline of the European Central Bank of 21 April 2004 amending Guideline ECB/2001/3 on a Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET)	OJ L 205, 9.6.2004, p. 1
ECB/2004/5	Decision of the European Central Bank of 22 April 2004 on the national central banks' percentage shares in the key for subscription to the European Central Bank's capital	OJ L 205, 9.6.2004, p. 5
ECB/2004/6	Decision of the European Central Bank of 22 April 2004 laying down the measures necessary for the paying-up of the European Central Bank's capital by the participating national central banks	OJ L 205, 9.6.2004, p. 7
ECB/2004/7	Decision of the European Central Bank of 22 April 2004 laying down the terms and conditions for transfers of the European Central Bank's capital shares between the national central banks and for the adjustment of the paid-up capital	OJ L 205, 9.6.2004, p. 9
ECB/2004/8	Decision of the European Central Bank of 22 April 2004 laying down the measures necessary for the contribution to the European Central Bank's accumulated equity value, for adjusting the national central banks claims equivalent to the transferred foreign reserve assets, and for related financial issues	OJ L 205, 9.6.2004, p. 13

Number	Title	OJ reference
ECB/2004/9	Decision of the European Central Bank of 22 April 2004 amending Decision ECB/2001/15 of 6 December 2001 on the issue of euro banknotes	OJ L 205, 9.6.2004, p. 17
ECB/2004/10	Decision of the European Central Bank of 23 April 2004 laying down the measures necessary for the paying-up of the European Central Bank's capital by the non-participating national central banks	OJ L 205, 9.6.2004, p. 19
ECB/2004/11	Decision of the European Central Bank of 3 June 2004 concerning the terms and conditions for European Anti-Fraud Office investigations of the European Central Bank, in relation to the prevention of fraud, corruption and any other illegal activities detrimental to the European Communities' financial interests and amending the Conditions of Employment for Staff of the European Central Bank	OJ L 230, 30.6.2004, p. 56
ECB/2004/12	Decision of the European Central Bank of 17 June 2004 adopting the Rules of Procedure of the General Council of the European Central Bank	OJ L 230, 30.6.2004, p. 61
ECB/2004/13	Guideline of the European Central Bank of 1 July 2004 on the Eurosystem's provision of reserve management services in euro to non-European Union central banks, countries outside the European Union and international organisations	OJ L 241, 13.7.2004, p. 68
ECB/2004/14	Decision of the European Central Bank of 9 July 2004 amending Decision ECB/2003/15 of 28 November 2003 on the approval of the volume of coin issuance in 2004	OJ L 248, 22.7.2004, p. 14
ECB/2004/15	Guideline of the European Central Bank of 16 July 2004 on the statistical reporting requirements of the European Central Bank in the field of balance of payments and international investment position statistics, and the international reserves template	OJ L 354, 30.11.2004, p. 34
ECB/2004/16	Recommendation of the European Central Bank of 16 July 2004 on the statistical reporting requirements of the European Central Bank in the field of balance of payments and international investment position statistics, and the international reserves template	OJ C 292, 30.11.2004, p. 21
ECB/2004/17	Recommendation of the European Central Bank of 30 July 2004 to the Council of the European Union on the external auditors of the Banca d'Italia	OJ C 202, 10.8.2004, p. 1
ECB/2004/18	Guideline of the European Central Bank of 16 September 2004 on the procurement of euro banknotes	OJ L 320, 21.10.2004, p. 21

Number	Title	OJ reference
ECB/2004/19	Decision of the European Central Bank of 14 December 2004 on the approval of the volume of coin issuance in 2005	OJ L 379, 24.12.2004, p. 107
ECB/2004/20	Guideline of the European Central Bank of 16 December 2004 amending Guideline ECB/2004/13 of 1 July 2004 on the Eurosystem's provision of reserve management services in euro to non-European Union central banks, countries outside the European Union and international organisations	OJ L 385, 29.12.2004, p. 85
ECB/2004/21	Regulation of the European Central Bank of 16 December 2004 amending Regulation ECB/2001/13 concerning the consolidated balance sheet of the monetary financial institutions sector and Regulation ECB/2001/18 concerning statistics on interest rates applied by monetary financial institutions to deposits and loans vis-à-vis households and non-financial corporations	OJ L 371, 18.12.2004, p. 42
ECB/2005/1	Guideline of the European Central Bank of 21 January 2005 amending Guideline ECB/2001/3 on a Trans-European Automated Real-time Gross settlement Express Transfer system ("TARGET")	OJ L 30, 3.2.2005, p. 21
ECB/2005/2	Guideline of the European Central Bank of 3 February 2005 amending Guideline ECB/2000/7 on monetary policy instruments and procedures of the Eurosystem	Not yet published in the Official Journal
ECB/2005/3	Recommendation of the European Central Bank of 11 February 2005 to the Council of the European Union on the external auditors of the Banco de Portugal	OJ C 50, 26.2.2005, p. 6
ECB/2005/4	Guideline of the European Central Bank of 15 February 2005 amending Guideline ECB/2003/2 concerning certain statistical reporting requirements of the European Central Bank and the procedures for reporting by the national central banks of statistical information in the field of money and banking statistics	Not yet published
ECB/2005/5	Guideline of the European Central Bank of 17 February 2005 on the statistical reporting requirements of the European Central Bank and the procedures for exchanging statistical information within the European System of Central Banks in the field of government finance statistics	Not yet published

OPINIONS ADOPTED BY THE ECB

The following table lists the opinions adopted by the ECB in 2004 and early 2005 under Article 105(4) of the Treaty and Article 4 of the Statute of the ESCB, Article 112(2)(b) of the Treaty and Article 11.2 of the Statute. For a list of all the opinions adopted by the ECB since its establishment, see the ECB's website.

(a) ECB opinions following a consultation by a Member State[1]

Number[2]	Originator	Subject
CON/2004/1	Finland	Measures affecting Suomen Pankki's financial position and provisions relating to its power to issue norms
CON/2004/2	Sweden	MFIs' reporting of money and banking statistics
CON/2004/3	Luxembourg	Establishment of a specific legal framework for securitisation transactions
CON/2004/5	Austria	Supplementary supervision in a financial conglomerate
CON/2004/6	France	Cover for exchange losses suffered by the Banque de France
CON/2004/8	France	Legal framework for recycling euro coins and banknotes
CON/2004/9	Belgium	Insolvency and bankruptcy proceedings of credit institutions, clearing institutions and investment undertakings
CON/2004/15	France	Negotiable debt securities
CON/2004/16	Italy	Protection of savings
CON/2004/17	Sweden	Old banknotes and coins ceasing to be legal tender
CON/2004/18	Portugal	Reorganisation and winding up of credit institutions
CON/2004/20	France	Inflation indexed loans from credit institutions
CON/2004/21	Netherlands	Financial sector supervision
CON/2004/22	France	Transfer of ownership of financial instruments
CON/2004/23	Germany	Statistical reporting requirements in relation to cross-border transactions between residents and non-residents
CON/2004/24	Austria	Collection of statistics concerning imports and exports of services
CON/2004/25	Estonia	Regulatory authorities for e-money institutions
CON/2004/26	Austria	Balance of payments reporting with the exception of services and transfers

1 In December 2004 the Governing Council decided that ECB opinions issued at the request of national authorities would, as a rule, be published immediately following their adoption and subsequent transmission to the consulting authority.
2 Consultations are numbered in the order in which the Governing Council adopted them.

Number[2]	Originator	Subject
CON/2004/27	Belgium	Financial collateral arrangements
CON/2004/28	Sweden	Circulation of banknotes and coins
CON/2004/29	Malta	Exemption to the Maltese minimum reserves regime
CON/2004/30	France	Completion of the legal framework for securitisation funds
CON/2004/31	Slovakia	Supervision of the financial market by Národná banka Slovenska
CON/2004/33	Hungary	Statistical reporting requirements for the central bank's information system
CON/2004/34	Belgium	Tax on foreign exchange transactions
CON/2004/35	Hungary	Monetary policy decision-making
CON/2004/36	Czech Republic	Programme of statistical surveys for 2005
CON/2004/37	Czech Republic	Introduction of e-money institutions
CON/2004/38	Denmark	Creation of a specific legal and supervisory basis for hedge funds
CON/2004/39	Spain	New management structure for the clearing system for retail payments
CON/2005/3	Hungary	Cash processing and distribution
CON/2005/5	Malta	The Central Bank of Malta's statistical reporting requirements for credit institutions

(b) ECB opinions following a consultation by a European Institution[3]

Number[4]	Originator	Subject	OJ reference
CON/2004/4	Council	Compilation of quarterly non-financial accounts by institutional sector	OJ C 42, 18.2.2004, p. 23
CON/2004/7	Council	New EU financial services committee organisational structure, extending the Lamfalussy process to all financial sectors	OJ C 58, 6.3.2004, p. 23
CON/2004/10	Council	Conversion rates between the euro and the currencies of Member States adopting the euro	OJ C 88, 8.4.2004, p. 20
CON/2004/11	Council	Appointment of a new member of the ECB's Executive Board	OJ C 87, 7.4.2004, p. 37
CON/2004/12	Council	Agreement on monetary relations with Andorra	OJ C 88, 8.4.2004, p. 18
CON/2004/13	Council	Medals and tokens similar to coins	OJ C 134, 12.5.2004, p. 11
CON/2004/14	Council	Compilation and transmission of data on the quarterly government debt	OJ C 134, 12.5.2004, p. 14
CON/2004/19	Council	Short-term statistics	OJ C 158, 15.6.2004, p. 3
CON/2004/32	Council	Opening of negotiations concerning an agreement on monetary relations with Andorra	OJ C 256, 16.10.2004, p. 9
CON/2005/2	Council	Prevention of the use of the financial system for money laundering and terrorist financing	OJ C 40, 17.2.2005, p. 9
CON/2005/4	Council	Capital adequacy framework for credit institutions and investment firms	OJ C 52, 2.3.2005, p. 37

3 Also published on the ECB's website.
4 Consultations are numbered in the order in which the Governing Council adopted them.

DOCUMENTS PUBLISHED BY THE EUROPEAN CENTRAL BANK SINCE JANUARY 2004

This list is designed to inform readers about selected documents published by the European Central Bank since January 2004. For Working Papers, the list only refers to publications released between December 2004 and February 2005. The publications are available to interested parties free of charge from the Press and Information Division. Please submit orders in writing to the postal address given on the back of the title page.

For a complete list of documents published by the European Central Bank and by the European Monetary Institute, please visit the ECB's website (http://www.ecb.int).

ANNUAL REPORT

"Annual Report 2003", April 2004.

MONTHLY BULLETIN ARTICLES

"EMU and the conduct of fiscal policies", January 2004.
"Opinion survey on activity, prices and labour market developments in the euro area: features and uses", January 2004.
"Measuring and analysing profit developments in the euro area", January 2004.
"The acceding countries' economies on the threshold of the European Union", February 2004.
"Developments in private sector balance sheets in the euro area and the United States", February 2004.
"The impact of fair value accounting on the European banking sector – a financial stability perspective", February 2004.
"Fiscal policy influences on macroeconomic stability and prices", April 2004.
"Future developments in the TARGET system", April 2004.
"The Barcelona partner countries and their relations with the euro area", April 2004.
"The EU economy following the accession of the new Member States", May 2004.
"The natural real interest rate in the euro area", May 2004.
"Risk mitigation methods in Eurosystem credit operations", May 2004.
"Labour productivity developments in the euro area: aggregate trends and sectoral patterns", July 2004.
"Accounting for the resilience of the EU banking sector since 2000", July 2004.
"The European Constitution and the ECB", August 2004.
"Properties and use of general government quarterly accounts", August 2004.
"Euro banknotes: first years of experience", August 2004.
"Monetary analysis in real time", October 2004.
"Economic integration in selected regions outside the European Union", October 2004.
"Oil prices and the euro area economy", November 2004.
"Extracting information from financial asset prices", November 2004.
"Developments in the EU framework for financial regulation, supervision and stability", November 2004.
"The new Basel Capital Accord: main features and implications", January 2005.
"Financial flows to emerging market economies: changing patterns and recent developments", January 2005.
"Bank market discipline", February 2005.
"Initial experience with the changes to the Eurosystem's operational framework for monetary policy implementation", February 2005.

"Euro area balance of payments and international investment position vis-à-vis main counterparts", February 2005.

STATISTICS POCKET BOOK

Available monthly since August 2003.

OCCASIONAL PAPER SERIES

9 "Fiscal adjustment in 1991-2002: stylised facts and policy implications" by M. G. Briotti, February 2004.
10 "The acceding countries' strategies towards ERM II and the adoption of the euro: an analytical review" by a staff team led by P. Backé and C. Thimann and including O. Arratibel, O. Calvo-Gonzalez, A. Mehl and C. Nerlich, February 2004.
11 "Official dollarisation/euroisation: motives, features and policy implications of current cases" by A. Winkler, F. Mazzaferro, C. Nerlich and C. Thimann, February 2004.
12 "Understanding the impact of the external dimension on the euro area: trade, capital flows and other international macroeconomic linkages" by R. Anderton, F. di Mauro and F. Moneta, April 2004.
13 "Fair value accounting and financial stability" by a staff team led by A. Enria including L. Cappiello, F. Dierick, S. Grittini, A. Maddaloni, P. Molitor, F. Pires and P. Poloni, April 2004.
14 "Measuring financial integration in the euro area" by L. Baele, A. Ferrando, P. Hördahl, E. Krylova and C. Monnet, April 2004.
15 "Quality adjustment of European price statistics and the role for hedonics" by H. Ahnert and G. Kenny, May 2004.
16 "Market dynamics associated with credit ratings: a literature review" by F. Gonzalez, F. Haas, R. Johannes, M. Persson, L. Toledo, R. Violi, M. Wieland and C. Zins, June 2004.
17 "Corporate 'excesses' and financial market dynamics" by A. Maddaloni and D. Pain, July 2004.
18 "The international role of the euro: evidence from bonds issued by non-euro area residents" by A. Geis, A. Mehl and S. Wredenborg, July 2004.
19 "Sectoral specialisation in the EU: a macroeconomic perspective" by an MPC task force of the ESCB, July 2004.
20 "The supervision of mixed financial services groups in Europe" by F. Dierick, August 2004.
21 "Governance of securities clearing and settlement systems" by D. Russo, T. Hart, M. C. Malaguti and C. Papathanassiou, October 2004.
22 "Assessing potential output growth in the euro area – a growth accounting perspective" by A. Musso and T. Westermann, January 2005.
23 "The bank lending survey for the euro area" by J. Berg, A. Van Rixtel, A. Ferrando, G. de Bondt and S. Scopel, February 2005.
24 "Wage diversity in the euro area – an overview of labour cost differentials across industries" by V. Genre, D. Momferatou and G. Mourre, February 2005.

WORKING PAPER SERIES

419 "The design of fiscal rules and forms of governance in European Union countries" by M. Hallerberg, R. Strauch and J. von Hagen, December 2004.

420 "On prosperity and posterity: the need for fiscal discipline in a monetary union" by C. Detken, V. Gaspar and B. Winkler, December 2004.

421 "EU fiscal rules: issues and lessons from political economy" by L. Schuknecht, December 2004.

422 "What determines fiscal balances? An empirical investigation in determinants of changes in OECD budget balances" by M. Tujula and G. Wolswijk, December 2004.

423 "Price setting in France: new evidence from survey data" by C. Loupias and R. Ricart, December 2004.

424 "An empirical study of liquidity and information effects of order flow on exchange rates" by F. Breedon and P. Vitale, December 2004.

425 "Geographic versus industry diversification: constraints matter" by P. Ehling and S. Brito Ramos, January 2005.

426 "Security fungibility and the cost of capital: evidence from global bonds" by D. P. Miller and J. J. Puthenpurackal, January 2005.

427 "Interlinking securities settlement systems: a strategic commitment?" by K. Kauko, January 2005.

428 "Who benefits from IPO underpricing? Evidence from hybrid bookbuilding offerings" by V. Pons-Sanz, January 2005.

429 "Cross-border diversification in bank asset portfolios" by C. M. Buch, J. C. Driscoll and C. Ostergaard, January 2005.

430 "Public policy and the creation of active venture capital markets" by M. Da Rin, G. Nicodano and A. Sembenelli, January 2005.

431 "Regulation of multinational banks: a theoretical inquiry" by G. Calzolari and G. Loranth, January 2005.

432 "Trading European sovereign bonds: the microstructure of the MTS trading platforms" by Y. Chung Cheung, F. de Jong and B. Rindi, January 2005.

433 "Implementing the Stability and Growth Pact: enforcement and procedural flexibility" by R. Beetsma and X. Debrun, January 2005.

434 "Interest rates and output in the long run" by Y. Aksoy and M. León-Ledesma, January 2005.

435 "Reforming public expenditure in industrialised countries: are there trade-offs?" by L. Schuknecht and V. Tanzi, February 2005.

436 "Measuring market and inflation risk premia in France and in Germany" by L. Cappiello and S. Guéné, February 2005.

437 "What drives international bank flows? Politics, institutions and other determinants" by E. Papaioannou, February 2005.

438 "Quality of public finances and growth" by A. Afonso, W. Ebert, L. Schuknecht and M. Thöne, February 2005.

439 "A look at intraday frictions in the euro area overnight deposit market" by V. Brousseau and A. Manzanares, February 2005.

440 "Estimating and analysing currency options' implied risk-neutral density functions for the largest new EU Member States" by O. Castrén, February 2005.

441 "The Phillips curve and long-term unemployment" by R. Llaudes, February 2005.

442 "Why do financial systems differ? History matters" by C. Monnet and E. Quintin, February 2005.

443 “Explaining cross-border large-value payment flows: evidence from TARGET and EURO 1 data” by S. Rosati and S. Secola, February 2005.
444 “Keeping up with the Joneses, reference dependence, and equilibrium indeterminacy” by L. Stracca and A. al-Nowaihi, February 2005.
445 “Welfare implications of joining a common currency” by M. Ca’Zorzi, R. A. De Santis and F. Zampolli, February 2005.
446 “Trade effects of the euro: evidence from sectoral data” by R. E. Baldwin, F. Skudelny and D. Taglioni, February 2005.
447 “Foreign exchange option and returns-based correlation forecasts: evaluation and two applications” by O. Castrén and S. Mazzotta, February 2005.

OTHER PUBLICATIONS

“Assessment of accession countries’ securities settlement systems against the standards for the use of EU securities settlement systems in Eurosystem credit operations”, January 2004.
“The monetary policy of the ECB”, January 2004.
“The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures”, February 2004.
“Guidance notes on the MFI balance sheet statistics relating to EU enlargement as laid down in Regulation ECB/2003/10”, February 2004.
“Comments on the communication from the Commission to the Council and the European Parliament concerning a new legal framework for payments in the internal market (consultative document)”, February 2004.
“Foreign direct investment task force report”, March 2004.
“External evaluation of the economic research activities of the European Central Bank”, April 2004.
“Payment and securities settlement systems in the accession countries – Addendum incorporating 2002 figures” (“Blue Book”), April 2004.
“Payment and securities settlement systems in the European Union – Addendum incorporating 2002 figures” (“Blue Book”), April 2004.
“TARGET compensation claim form”, April 2004.
“Letter from the ECB President to the President of the Council of the European Union: negotiations on the draft Treaty establishing a Constitution for Europe”, April 2004.
“The use of central bank money for settling securities transactions”, May 2004.
“TARGET Annual Report 2003”, May 2004.
“Assessment of euro large-value payment systems against the Core Principles”, May 2004.
“Credit risk transfer by EU banks: activities, risks and risk management”, May 2004.
“Risk management for central bank foreign reserves”, May 2004.
“Comparison of household saving ratios, euro area/United States/Japan”, June 2004.
“The development of statistics for Economic and Monetary Union” by P. Bull, July 2004.
“ECB staff macroeconomic projections for the euro area”, September 2004.
“Letter from the ECB President to the Chairman of the International Accounting Standards Board of 6 September 2004: Exposure draft of proposed amendments to IAS 39 – the fair value option”, September 2004.
“Institutional provisions: Statute of the ESCB and of the ECB; Rules of Procedure”, October 2004.
“Convergence Report 2004”, October 2004.

“Standards for securities clearing and settlement in the European Union”, October 2004.
“The European Central Bank – History, role and functions”, October 2004.
“E-payments without frontiers”, October 2004.
“European Union balance of payments/international investment position statistical methods”, November 2004.
“Bond markets and long-term interest rates in non-euro area Member States of the European Union and in accession countries”, November 2004.
“Report on EU banking structure 2004”, November 2004.
“EU banking sector stability 2004”, November 2004.
“Letter from the ECB President to the President of the European Parliament”, November 2004.
“Letter from the ECB President to Mr Paolo Cirino Pomicino, Member of the Committee on Economic and Monetary Affairs”, November 2004.
“Eurosystem staff macroeconomic projections for the euro area”, December 2004.
“Towards a single euro payments area – third progress report”, December 2004.
“The euro bond market study 2004”, December 2004.
“Financial Stability Review”, December 2004.
“Review of the requirements in the field of general economic statistics”, December 2004.
“Research network on capital markets and financial integration in Europe – results and experience after two years”, December 2004.
“Recycling of euro banknotes: framework for the detection of counterfeits and fitness sorting by credit institutions and other professional cash handlers”, January 2005.
“Review of the international role of the euro”, January 2005.
“Euro area balance of payments and international investment position statistics – Annual quality report”, January 2005.
“Banking structures in the new EU Member States”, January 2005.
“Progress report on TARGET2”, February 2005.
“The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures”, February 2005.
“Review of the application of the Lamfalussy framework to EU securities markets legislation”, February 2005.
“Payment and securities settlement systems in the European Union – Addendum incorporating 2003 figures” (“Blue Book”), February 2005.

INFORMATION BROCHURES

“Information guide for credit institutions using TARGET”, July 2003.
“TARGET2 – the future TARGET system”, September 2004.
“TARGET – the current system”, September 2004.

CHRONOLOGY OF MONETARY POLICY MEASURES OF THE EUROSYSTEM[1]

8 JANUARY 2004

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

12 JANUARY 2004

The Governing Council of the ECB decides to increase the allotment amount for each of the longer-term refinancing operations to be conducted in 2004 from €15 billion to €25 billion. This increased amount takes into consideration the higher liquidity needs of the euro area banking system anticipated for 2004. The Eurosystem will, however, continue to provide the bulk of liquidity through its main refinancing operations. The Governing Council may decide to adjust the allotment amount again at the beginning of 2005.

5 FEBRUARY, 4 MARCH 2004

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

10 MARCH 2004

In accordance with the Governing Council's decision of 23 January 2003, the maturity of the Eurosystem's main refinancing operations is reduced from two weeks to one week and the maintenance period for the Eurosystem's required reserve system is redefined to start on the settlement day of the main refinancing operation following the Governing Council meeting at which the monthly assessment of the monetary policy stance is pre-scheduled, rather than on the 24th day of the month.

1 APRIL, 6 MAY, 3 JUNE, 1 JULY, 5 AUGUST, 2 SEPTEMBER, 7 OCTOBER, 4 NOVEMBER, 2 DECEMBER 2004 AND 13 JANUARY 2005

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

14 JANUARY 2005

The Governing Council of the ECB decides to increase the allotment amount for each of the longer-term refinancing operations to be conducted in 2005 from €25 billion to €30 billion. This increased amount takes into consideration the higher liquidity needs of the euro area banking system anticipated for 2005. The Eurosystem will, however, continue to provide the bulk of liquidity through its main refinancing operations. The Governing Council may decide to adjust the allotment amount again at the beginning of 2006.

3 FEBRUARY, 3 MARCH 2005

The Governing Council of the ECB decides that the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 2.0%, 3.0% and 1.0% respectively.

1 The chronology of monetary policy measures of the Eurosystem taken between 1999 and 2003 can be found on pages 176 to 180 of the ECB's Annual Report 1999, on pages 205 to 208 of the ECB's Annual Report 2000, on pages 219 and 220 of the ECB's Annual Report 2001, on pages 234 and 235 of the ECB's Annual Report 2002 and on pages 217 and 218 of the ECB's Annual Report 2003 respectively.

GLOSSARY

This glossary contains selected terms that are used in the Annual Report. A more comprehensive and detailed glossary can be found on the ECB's website.

Acceding countries: refers to those ten countries which signed the EU Accession Treaty in 2003 before they joined the EU on 1 May 2004: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.

Balance of payments (b.o.p.): a statistical statement that summarises, for a specific time period, the economic transactions of an economy with the rest of the world. The transactions considered are those involving goods, services and income; those involving financial claims on, and liabilities to, the rest of the world; and those (such as debt forgiveness) that are classified as transfers.

Benchmark portfolio: in relation to investments, a reference portfolio or index constructed on the basis of the objectives for the liquidity and risk of, as well as the return on, the investments. The benchmark portfolio serves as a basis for comparison of the performance of the actual portfolio.

Bond market: the market in which longer-term **debt securities** are issued and traded.

Central counterparty: an entity that interposes itself between the **counterparties** to trades, acting as the buyer to every seller and the seller to every buyer.

Central government: the government as defined in the **European System of Accounts 1995** but excluding regional and local governments (see also **general government**).

Central securities depository (CSD): an entity that holds and administrates securities and enables securities transactions to be processed by book entry. Securities can be held in a physical (but immobilised) or dematerialised form (i.e. so that they exist only as electronic records). In addition to the safekeeping and administration of securities, a CSD may incorporate clearing and settlement functions.

Collateral: assets pledged (e.g. by **credit institutions** with central banks) as a guarantee for the repayment of loans, as well as assets sold (e.g. to central banks by credit institutions) under **repurchase agreements**.

Consolidated balance sheet of the MFI sector: a balance sheet obtained by netting out inter-**MFI** positions (e.g. inter-MFI loans and deposits) in the aggregated MFI balance sheet. It provides statistical information on the MFI sector's assets and liabilities vis-à-vis residents of the **euro area** not belonging to this sector (i.e. **general government** and other euro area residents) and vis-à-vis non-euro area residents. It is the main statistical source for the calculation of monetary aggregates, and it provides the basis for the regular analysis of the counterparts of **M3**.

Corporate governance: procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.

Counterparty: the opposite party in a financial transaction (e.g. any party transacting with a central bank).

Credit institution: (i) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account; or (ii) an undertaking or any other legal person, other than those under (i), which issues means of payment in the form of electronic money.

Credit risk: the risk that a **counterparty** will not settle an obligation at full value, either when it becomes due or at any time thereafter. Credit risk includes replacement cost risk and principal risk. It also includes the risk of settlement bank failure.

Debt security: a promise on the part of the issuer (i.e. the borrower) to make one or more payment(s) to the holder (the lender) at a specified future date or dates. Such securities usually carry a specific rate of interest (the coupon) and/or are sold at a discount to the amount that will be repaid at maturity.

Deposit facility: a **standing facility** of the **Eurosystem** which **counterparties** may use to make overnight deposits, remunerated at a pre-specified interest rate, at an NCB (see also **key ECB interest rates**).

Direct investment: cross-border investment for the purpose of obtaining a lasting interest in an enterprise resident in another economy (assumed, in practice, for ownership of at least 10% of the ordinary shares or voting power).

ECOFIN Council: the EU Council meeting in the composition of the ministers of economy and finance.

Economic analysis: one pillar of the **European Central Bank**'s framework for conducting a comprehensive analysis of the risks to **price stability**, which forms the basis for the **Governing Council**'s monetary policy decisions. The economic analysis focuses mainly on the assessment of current economic and financial developments and the implied short to medium-term risks to price stability from the perspective of the interplay between supply and demand in goods, services and factor markets at those horizons. In this respect, due attention is paid to the need to identify the nature of shocks affecting the economy, their effects on cost and pricing behaviour and the short to medium-term prospects for their propagation in the economy (see also **monetary analysis**).

Economic and Financial Committee (EFC): a consultative Community body which contributes to the preparation of the work of the EU Council. Its tasks include reviewing the economic and financial situation of the Member States and of the Community, and budgetary surveillance.

Economic and Monetary Union (EMU): the **Treaty** describes the process of achieving EMU in the EU in three stages. Stage Three, the last stage, started on 1 January 1999 with the transfer of monetary competence to the **European Central Bank** and the introduction of the euro. The cash changeover on 1 January 2002 completed the process setting up EMU.

Effective exchange rates (EERs) of the euro (nominal/real): weighted averages of bilateral euro exchange rates against the currencies of the **euro area**'s important trading partners. The **European Central Bank** publishes nominal EER indices for the euro against two groups of trading partners: the EER-23 (comprising the 13 non-euro area EU Member States and 10 main trading partners outside the EU) and the EER-42 (composed of the EER-23 and 19 additional countries). The weights used reflect the share of each partner country in euro area trade and account for competition in third markets. Real EERs are nominal EERs deflated by a weighted average of foreign, relative to domestic, prices or costs. They are thus measures of price and cost competitiveness.

EONIA (euro overnight index average): a measure of the effective interest rate prevailing in the euro interbank overnight market. It is calculated as a weighted average of the interest rates on unsecured overnight lending transactions denominated in euro, as reported by a panel of contributing banks.

Equities: securities representing ownership of a stake in a corporation. They comprise shares traded on stock exchanges (quoted shares), unquoted shares and other forms of equity. Equities usually produce income in the form of dividends.

Equity market: the market in which **equities** are issued and traded.

ERM II (exchange rate mechanism II): the exchange rate arrangement that provides the framework for exchange rate policy cooperation between the **euro area** countries and the EU Member States not participating in Stage Three of **Economic and Monetary Union**.

EURIBOR (euro interbank offered rate): the rate at which a prime bank is willing to lend funds in euro to another prime bank, computed daily for interbank deposits with different maturities of up to 12 months.

Euro area: the area encompassing those Member States in which the euro has been adopted as the single currency in accordance with the **Treaty** and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **European Central Bank**. The euro area currently comprises Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

European Central Bank (ECB): the ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)** and has legal personality under Community law. It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the Statute of the ESCB. The ECB is governed by the **Governing Council** and the **Executive Board**, and, as a third decision-making body, by the **General Council**.

European Monetary Institute (EMI): a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. It went into liquidation following the establishment of the **European Central Bank** on 1 June 1998.

European System of Accounts 1995 (ESA 95): a system of uniform statistical definitions and classifications aimed at achieving a harmonised quantitative description of the economies of the Member States. The ESA 95 is the Community's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): composed of the **European Central Bank (ECB)** and the NCBs of all 25 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States that have not yet adopted the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

Eurosystem: the central banking system of the **euro area**. It comprises the **European Central Bank** and the NCBs of the Member States that have adopted the euro in Stage Three of **Economic and Monetary Union**.

Excessive deficit procedure: the provision set out in Article 104 of the **Treaty** and specified in Protocol No 20 on the excessive deficit procedure requires EU Member States to maintain budgetary discipline, defines the criteria for a budgetary position to be considered an excessive deficit and regulates steps to be taken following the observation that the requirements for the budgetary balance or government debt have not been fulfilled. This is supplemented by Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, which is one element of the **Stability and Growth Pact**.

Executive Board: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and four other members appointed by common accord by the Heads of State or Government of the countries that have adopted the euro.

Fine-tuning operation: a non-regular **open market operation** executed by the **Eurosystem** mainly in order to deal with unexpected liquidity fluctuations in the market.

Foreign exchange swap: simultaneous spot and forward transactions exchanging one currency against another.

General Council: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and the governors of all EU NCBs.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council: the supreme decision-making body of the **European Central Bank (ECB)**. It comprises all the members of the **Executive Board** of the ECB and the governors of the NCBs of the countries that have adopted the euro.

Harmonised Index of Consumer Prices (HICP): a measure of consumer prices that is compiled by Eurostat and harmonised for all EU Member States.

Implied volatility: a measure of expected volatility (standard deviation in terms of annualised percentage changes) in the prices of, for example, bonds and stocks (or of corresponding futures contracts), which can be extracted from **option** prices.

International investment position (i.i.p.): the value and composition of an economy's outstanding net financial claims on (or financial liabilities to) the rest of the world.

Key ECB interest rates: the interest rates, set by the **Governing Council**, which reflect the monetary policy stance of the **European Central Bank**. They are the **minimum bid rate** on the **main refinancing operations**, the interest rate on the **marginal lending facility** and the interest rate on the **deposit facility**.

Liquidity risk: the risk that a **counterparty** will not settle an obligation at its full value when due but on some unspecified date thereafter.

Longer-term refinancing operation: a regular **open market operation** executed by the **Eurosystem** in the form of **reverse transactions**. Such operations are carried out through a monthly standard tender and normally have a maturity of three months.

M1: a narrow monetary aggregate that comprises currency in circulation plus overnight deposits held with **MFIs** and **central government** (e.g. at the post office or treasury).

M2: an intermediate monetary aggregate that comprises **M1** plus deposits redeemable at a period of notice of up to and including three months (i.e. short-term savings deposits) and deposits with an agreed maturity of up to and including two years (i.e. short-term time deposits) held with **MFIs** and **central government**.

M3: a broad monetary aggregate that comprises **M2** plus marketable instruments, in particular **repurchase agreements**, **money market** fund shares/units and **debt securities** with a maturity of up to and including two years issued by **MFIs**.

Main refinancing operation: a regular **open market operation** executed by the **Eurosystem** in the form of **reverse transactions**. As of 10 March 2004 such operations are carried out through a weekly standard tender and normally have a maturity of one week.

Maintenance period: the period over which **credit institutions**' compliance with **reserve requirements** is calculated. As of 10 March 2004 the maintenance period begins on the settlement day of the first **main refinancing operation** following the meeting of the **Governing Council** at which the monthly assessment of the monetary policy stance is pre-scheduled. The **European Central Bank** publishes a calendar of the reserve maintenance periods at least three months before the start of the year.

Marginal lending facility: a **standing facility** of the **Eurosystem** which **counterparties** may use to receive overnight credit from an NCB at a pre-specified interest rate against eligible assets (see also **key ECB interest rates**).

MFIs (monetary financial institutions): financial institutions which together form the money-issuing sector of the **euro area**. These include the **European Central Bank**, the NCBs of the euro area countries, and **credit institutions** and **money market** funds located in the euro area.

MFI credit to euro area residents: MFI loans granted to non-MFI **euro area** residents (including the **general government** and the private sector) and MFI holdings of securities (shares, other equity and **debt securities**) issued by non-MFI euro area residents.

MFI interest rates: the interest rates that are applied by resident **MFIs**, excluding central banks and **money market** funds, to euro-denominated deposits and loans vis-à-vis households and non-financial corporations resident in the **euro area**.

MFI longer-term financial liabilities: deposits with an agreed maturity of over two years, deposits redeemable at a period of notice of over three months, **debt securities** issued by **euro area MFIs** with an original maturity of more than two years and the capital and reserves of the euro area MFI sector.

MFI net external assets: the external assets of the **euro area MFI** sector (such as gold, foreign currency banknotes and coins, securities issued by non-euro area residents and loans granted to non-euro area residents) minus the external liabilities of the euro area MFI sector (such as non-euro area residents' deposits and **repurchase agreements**, as well as their holdings of **money market** fund shares/units and **debt securities** issued by MFIs with a maturity of up to and including two years).

Minimum bid rate: lower limit to the interest rates at which **counterparties** may submit bids in the variable rate tenders of the **main refinancing operations**. This is one of the **key ECB interest rates** reflecting the stance of monetary policy.

Monetary analysis: one pillar of the **European Central Bank**'s framework for conducting a comprehensive analysis of the risks to **price stability**, which forms the basis for the **Governing Council**'s monetary policy decisions. Monetary analysis helps to assess medium to long-term trends in inflation, in view of the close relationship between money and prices over extended horizons. The monetary analysis takes into account developments in a wide range of monetary indicators including **M3**, its components and counterparts, notably credit, and various measures of excess liquidity (see also **economic analysis**).

Monetary income: income accruing to the NCBs in the performance of the **Eurosystem**'s monetary policy function, derived from assets earmarked in accordance with guidelines established by the **Governing Council** and held against banknotes in circulation and deposit liabilities to **credit institutions**.

Money market: the market in which short-term funds are raised, invested and traded using instruments which generally have an original maturity of up to and including one year.

Open market operation: an operation executed on the initiative of the central bank in the financial market. With regard to their aims, regularity and procedures, **Eurosystem** open market operations can be divided into four categories: **main refinancing operations**; **longer-term refinancing operations**; **fine-tuning operations**; and structural operations. As for the instruments used, **reverse transactions** are the main open market instrument of the Eurosystem and can be employed in all four categories of operations. In addition, the issuance of debt certificates and outright transactions are available for structural operations, while outright transactions, **foreign exchange swaps** and the collection of fixed-term deposits are available for the conduct of fine-tuning operations.

Option: a financial instrument that gives the owner the right, but not the obligation, to buy or sell specific assets (e.g. a bond or a stock) at a predetermined price (the strike or exercise price) at or up to a certain future date (the exercise or maturity date).

Portfolio investment: euro area residents' net transactions and/or positions in securities issued by non-residents of the euro area ("assets") and non-residents' net transactions and/or positions in securities issued by euro area residents ("liabilities"). Included are equity securities and **debt securities** (bonds and notes, and **money market** instruments), excluding amounts recorded in **direct investment** or reserve assets.

Price stability: the maintenance of price stability is the primary objective of the **Eurosystem**. The **Governing Council** defines price stability as a year-on-year increase in the **Harmonised Index of Consumer Prices** for the **euro area** of below 2%. The Governing Council has also made it clear that, in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term.

Primary balance: government net borrowing or net lending excluding interest payments on consolidated government liabilities.

Projections: the results of exercises conducted four times a year to project possible future macroeconomic developments in the **euro area**. **Eurosystem** staff projections are published in June and December whereas ECB staff projections are published in March and September. They form part of the **economic analysis** pillar of the monetary policy strategy of the **European Central Bank** and are thus one of several inputs into the **Governing Council**'s assessment of the risks to **price stability**.

Real-time gross settlement (RTGS) system: a settlement system in which processing and settlement take place on an order-by-order basis (without netting) in real time (continuously) (see also **TARGET**).

Reference value for M3 growth: the annual growth rate of **M3** over the medium term that is consistent with the maintenance of **price stability**. At present, the reference value for annual M3 growth is 4½%.

Repurchase agreement: an agreement to sell an asset and to repurchase it at a specified price on a predetermined future date or on demand. Such an agreement is similar to collateralised borrowing, although it differs in that the seller does not retain ownership of the assets.

Reserve base: the sum of the eligible balance sheet items (in particular liabilities) that constitute the basis for calculating the **reserve requirement** of a **credit institution**.

Reserve ratio: the ratio defined by the central bank for each category of eligible balance sheet items included in the **reserve base**. The ratio is used to calculate **reserve requirements**.

Reserve requirement: the minimum amount of reserves a **credit institution** is required to hold with the **Eurosystem**. Compliance is determined on the basis of the average of the daily balances over a **maintenance period** of around one month.

Reverse transaction: an operation whereby the central bank buys or sells assets under a **repurchase agreement** or conducts credit operations against **collateral**.

Securities settlement system (SSS): a system which permits the holding and transfer of securities, either free of payment or against payment (delivery versus payment) or against another asset (delivery versus delivery). It comprises all the institutional and technical arrangements required for the settlement of securities trades and the safekeeping of securities. The system can operate on a real-time gross settlement, gross settlement or net settlement basis. A settlement system allows for the calculation (clearing) of the obligations of participants.

Settlement risk: a general term used to designate the risk that settlement in a transfer system will not take place as expected. This risk may comprise both **credit** and **liquidity risk**.

Stability and Growth Pact: consists of two Council Regulations, namely (i) Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and (ii) Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the **excessive deficit procedure**, and of a European Council Resolution on the Stability and Growth Pact adopted at the Amsterdam summit on 17 June 1997. It is intended to serve as a means of safeguarding sound government finances in Stage Three of **Economic and Monetary Union** in order to strengthen the conditions for **price stability** and for strong, sustainable growth conducive to employment creation. More specifically, budgetary positions close to balance or in surplus are required as the medium-term objective for Member States.

Standing facility: a central bank facility available to **counterparties** on their own initiative. The **Eurosystem** offers two overnight standing facilities: the **marginal lending facility** and the **deposit facility**.

Straight-through processing (STP): the automated end-to-end processing of trades/payment transfers including the automated completion of generation, confirmation, clearing and settlement of instructions.

Systemic risk: the risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and, as a result, could threaten the stability of or confidence in markets.

TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system): the **real-time gross settlement (RTGS) system** for the euro. It is a decentralised system consisting of 15 national RTGS systems, the ECB payment mechanism (EPM) and the interlinking mechanism.

Treaty: refers to the Treaty establishing the European Community ("Treaty of Rome"). The Treaty has been amended on several occasions, in particular by the Treaty on European Union ("Maastricht Treaty") which laid the foundations for **Economic and Monetary Union** and contained the Statute of the **ESCB**.