EUROPEAN CENTRAL BANK

ANNUAL REPORT 2005

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In 2006 all ECB publications will feature a motif taken from the €5 banknote.

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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
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 seven pages which separate the chapters of this Annual Report show a selection of works from this collection.

FOREWORD

I would like to begin by paying tribute to my predecessor Wim Duisenberg, our first President, who passed away last year. As I said on several occasions, in Amsterdam, Frankfurt and many other cities across Europe, this institution, the European Central Bank, its staff, my colleagues and I on the Executive Board, the Governing Council and the General Council, we all owe an immense debt of gratitude to Wim. His memory will always be with us or, as Chateaubriand would have said, “death has not defeated him; it has only made him invisible”.

***

In 2005 the euro area saw real GDP rise by 1.4%, compared with 1.8% in 2004 and 0.7% in 2003. The pace of economic activity was moderate in the first half of the year, but tended to accelerate during the second half, benefiting from the continued strong growth in global demand, robust growth in corporate earnings and very favourable financing conditions. Economic activity therefore proved to be relatively resilient against a background of high and volatile oil prices. However, owing to large increases in commodity and energy prices and, to a lesser extent, rises in administered prices and indirect taxes, annual HICP inflation in 2005 was 2.2% – slightly higher than the rate of 2.1% observed in the two preceding years. Nonetheless, domestic inflationary pressures remained under control as continued moderate wage developments and favourable trends in prices of imported manufactured goods offset to some extent the increase in commodity and energy prices.

***

In the context of subdued domestic inflationary pressures, the Governing Council kept key ECB interest rates unchanged at the historically low level of 2% for most of the year, while continuing to closely monitor longer-term inflation expectations. As the year progressed, the ECB’s economic analysis suggested that upside risks to medium-term price stability were increasing, an assessment which was confirmed by the monetary analysis, given strong monetary and credit growth in a situation of already ample liquidity. Towards the end of 2005, regular cross-checking of the economic and monetary analyses indicated that an adjustment of the accommodative stance of the ECB’s monetary policy was warranted in order to address these risks. Therefore, on 1 December 2005 the Governing Council decided to increase the key ECB interest rates by 25 basis points, after having kept them unchanged for two and a half years.

Inflation expectations for the euro area as a whole are solidly anchored at levels in line with price stability, as reflected in surveys and financial indicators. This has contributed to safeguarding the low level of risk premia embodied in nominal interest rates across the whole maturity spectrum, thereby leading to lower levels of both short and long-term interest rates. The ECB’s high level of credibility and its stability-oriented policy have thus helped to maintain very favourable financing conditions for investors, thereby supporting economic growth and job creation. They have also contributed to preserving the purchasing power of consumers, which is of great importance to all euro area residents, not least those on lower incomes. It is essential that this asset of the euro area economy be preserved. To this end, the Governing Council will continue to closely monitor all relevant developments so as to ensure that medium to long-term inflation expectations remain solidly anchored at levels in line with price stability.

***

The success of EMU also depends on sustainable fiscal policies and comprehensive structural reforms aimed at increasing the economy's growth potential. Such a combination of policies not only promotes the cohesion and flexibility of the euro area economy but also supports monetary policy in its task of maintaining price stability, thereby enhancing its effectiveness and contributing to sustainable output growth and job creation.

Compliance with the agreed fiscal rules strengthens the sustainability of public finances, which is crucial not least because of the expected budgetary impact of ageing populations. This is why the Eurosystem has always strongly supported the Stability and Growth Pact. A rigorous and consistent implementation of the revised rules is conducive to fiscal discipline and helps to restore the credibility of the EU's fiscal framework as well as confidence in prudent fiscal policies. Reliable compilation and timely reporting of government finance statistics is also essential for the European fiscal framework and the effective functioning of mutual surveillance.

Some progress with structural reforms has been made in recent years, but the mid-term review of the Lisbon strategy undertaken in March 2005 showed that much greater efforts are needed to improve Europe's growth and employment potential. More flexible labour, product and financial markets encourage a better allocation of resources, and a more stimulative business environment fosters the ability to innovate, invest and create jobs. There is also the challenge of completing the internal market, including for services, thus allowing firms to benefit from economies of scale and increasing economic efficiency. Overall, the opportunities arising from globalisation and rapid technological change can best be seized by allowing and speeding up structural change. This offers the best prospect for the future prosperity of Europe's citizens.

***

The Eurosystem pays close attention to developments related to financial integration in Europe. Financial integration contributes to the smooth implementation of the single monetary policy throughout the euro area, as well as to the efficient allocation of financial resources and thus to economic growth. It has implications for the Eurosystem's task of preserving financial stability and is also important for the effective operation and smooth functioning of payment and settlement systems. In September 2005 the ECB published its first report presenting a set of indicators on financial integration in the euro area. These indicators suggested an increase in financial integration, although to varying degrees in the different market segments. Finally, the ESCB supports, without prejudice to the objective of price stability, the general objectives of the EU, which include financial integration.

Integration has already been fully achieved in the field of real-time gross settlement systems, through the TARGET system. The Eurosystem is actively preparing the TARGET2 system, which will offer enhanced services and a new pricing framework for core services. TARGET2 will go live on 19 November 2007 for the first group of countries to migrate. All central banks participating in TARGET2, together with their national banking communities, are expected to be using the new system by May 2008.

As regards retail payment systems, the creation of a Single Euro Payments Area (SEPA) remains a crucial objective. Within the SEPA, customers will be able to make payments throughout the whole euro area from a single bank account, using a single set of payment instruments, as efficiently and safely as in the national context today. It is envisaged that this option will be available to citizens by 2008. The Eurosystem fully supports this deadline, which requires the strong commitment of all the parties involved.

Following the signing of the Treaty establishing a Constitution for Europe (European Constitution) in October 2004, Member States started the necessary ratification procedures. So far 15 Member States have ratified the European Constitution or are very close to formal completion. In France and the Netherlands, the Constitution did not achieve majority support. In the view of the ECB, the European Constitution clarifies the legal and institutional framework of the EU and enhances the Union's ability to act at both the European and the international level, while confirming the existing monetary framework. It should be stressed that the ratification process has no bearing on the functioning of Monetary Union and does not affect the stability of the euro. The ECB, whether operating under the current Treaty or under the European Constitution, will continue to ensure the credibility of the euro and to deliver price stability, which is a prerequisite for a non-inflationary macroeconomic environment conducive to economic growth and employment creation.

In 2005 four EU Member States joined the exchange rate mechanism (ERM II) with a view to joining the euro area when all convergence criteria have been met on a sustainable basis. The ECB, as well as the European Commission, will issue its regular biennial convergence report in autumn 2006. It is worth underlining that Member States will be judged on a case-by-case basis according to their individual economic and monetary performance, in full respect of the principle of equal treatment. Under such conditions, enlargement of the euro area will be beneficial to both the current euro area and the countries joining it.

***

In 2005 the ECB earned a surplus of €992 million. An equivalent amount was set aside in a provision against foreign exchange rate, interest rate and gold price risks, leaving a declared net profit for 2005 of exactly nil. The provision will be used to cover losses arising from exposure to such risks, in particular valuation losses not covered by the revaluation accounts. The surplus in 2005 follows a net loss of €1,636 million in 2004, which was mainly due to the appreciation of the euro against the US dollar. In 2005 the euro depreciated against this currency.

The total number of staff positions in the ECB's budget for 2005 was 1,369.5 full-time equivalent positions, as compared with 1,362.5 in 2004. At the end of 2005 the number of staff employed by the ECB on permanent or fixed-term contracts of at least one year was 1,360, which corresponded to 1,351 full-time equivalent positions. After 15 May 2005 the ECB started accepting applications from nationals of the two acceding countries, Bulgaria and Romania. The implementation of the new human resources strategy initiated in 2004 continued throughout 2005. In addition to promoting mobility, the strategy focuses on the development of ECB management and on the continuous acquisition and development of skills and competencies by staff members. Furthermore, the six ECB values identified in 2004 were gradually embedded in the human resources policies and will continue to guide all staff members in their day-to-day work.

Human resources issues are also addressed at the Eurosystem level. With the aim of further promoting the cooperation and team spirit among Eurosystem/ESCB central banks in this field, the Governing Council established a Human Resources Conference (HRC) in 2005. Without prejudice to the exclusive competence of the NCBs and the ECB in this area, the HRC will allow experience, expertise and information to be exchanged on relevant human resources policies and practices, contributing inter alia to identifying opportunities for common training activities and developing measures to foster staff exchange. The HRC, together with the Eurosystem/ESCB Communications Committee, has also been mandated to implement the concrete measures aimed at promoting the Eurosystem mission statement that was published in January 2005. Giving a concrete meaning to the mission statement for Eurosystem employees in their day-to-day work will be an ongoing process that will enhance the team spirit between the ECB and the NCBs of the euro area.

As a public institution, the ECB is committed to delivering the best services at the lowest cost. In view of this permanent commitment, the Executive Board decided to review the ECB's effectiveness and efficiency by conducting a zero-based budgeting assessment (ZBB) in which its staff and management were actively involved. Based on the ZBB findings, the Executive Board decided that a substantial number of positions could be saved or re-oriented without laying off staff. A temporary recruitment freeze was put in place. The Executive Board adopted a number of other measures covering a wider range of organisational issues within and across the various business areas of the ECB, which will allow the institution to increase its effectiveness and efficiency. The organisational changes triggered by the ZBB – such as the restructuring of certain business areas to better exploit synergies, the concentration of expertise and analytical capabilities, the simplification of business processes and a refocusing on medium-term strategic planning – are being progressively implemented. The impulse provided by the ZBB will lead to a strengthened managerial culture aimed at making the best use of existing resources.

Following the selection in early 2005 of an architect for the design of the ECB's future premises, the Governing Council decided to review the overall requirements and dimension of the project. This optimisation phase led to a significant reduction in the estimated construction costs. The Governing Council approved the revised design and launched the planning phase of the project in December 2005. The ECB is committed to handling and monitoring this project with utmost care as regards the overall cost and the timely achievement of the various milestones.

Frankfurt am Main, March 2006

Jean-Claude Trichet

Artist
Peter Sauerer
Title
Großmarkthalle, 2004
Material
Wood and string
Format
90 x 20 x 15 cm

CHAPTER I

ECONOMIC DEVELOPMENTS AND MONETARY POLICY

1 MONETARY POLICY DECISIONS

Economic growth in the euro area moderated in the second half of 2004 and the first half of 2005, partly on account of rising oil prices, a temporary slowdown in world trade and the lagged effects of the past appreciation of the euro. In the second half of 2005, however, the expansion of economic activity in the euro area strengthened again, benefiting from the persistently strong growth of global demand, robust growth in corporate earnings and very favourable financing conditions. Overall, real GDP – adjusted, albeit only partially, for the number of working days – rose by 1.4% in 2005, compared with 1.8% in 2004 and 0.7% in 2003. Against the background of high and volatile oil prices, economic activity thus proved to be relatively resilient in 2005.

Despite large increases in commodity and energy prices, domestic inflationary pressures remained contained against the backdrop of recovering but still relatively moderate economic growth. In particular, wage developments remained moderate. Inflationary pressures were also limited by favourable trends in prices of imported manufactured goods. Long-term inflation expectations in the euro area remained well-anchored at levels consistent with price stability. Nonetheless, headline inflation remained somewhat elevated in 2005, mainly owing to large increases in energy prices and, to a lesser extent, rises in administered prices and indirect taxes. Overall, annual HICP inflation stood at 2.2% in 2005 – slightly higher than the rate of 2.1% observed in the two preceding years. Upside risks continued to prevail, in particular with regard to potential second-round effects in wage and price-setting resulting from higher oil prices.

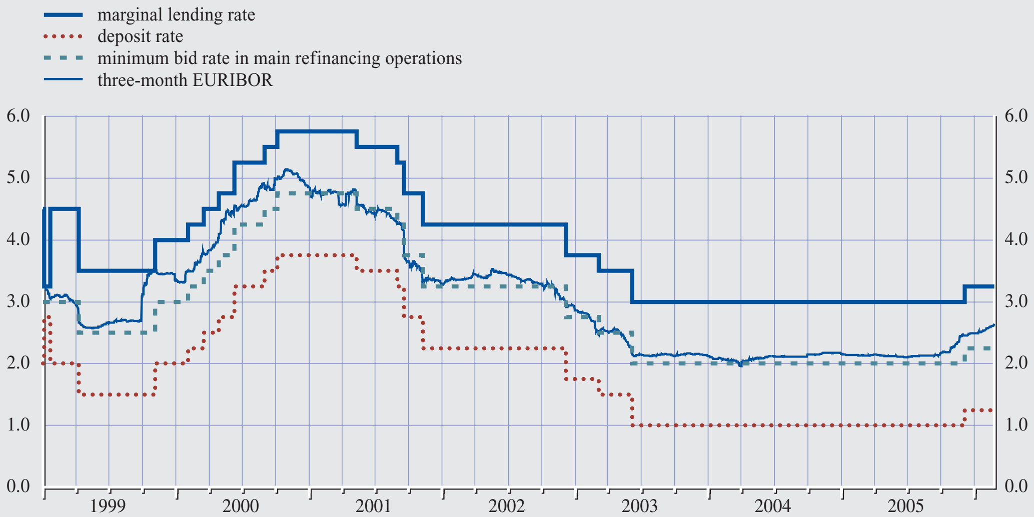
Monetary dynamics, which had started to strengthen in mid-2004, gained further momentum in 2005, before moderating somewhat in the last three months of the year. This increase in momentum partly reflected the stimulative effect of the prevailing low level of interest rates on demand for money and credit. Strong monetary growth contributed further to the already ample liquidity in the euro area, pointing towards upside risks to price stability over the medium to longer term.

Against this background, the minimum bid rate on the Eurosystem's main refinancing operations remained unchanged at the historically low level of 2% for most of the year. Early in the year the economic analysis pointed to underlying domestic inflationary pressures being contained. However, given an environment of strong monetary growth and ample liquidity, the Governing Council voiced a need for vigilance with regard to upside risks to price stability. Moreover, inflation projections were progressively revised upwards in the course of the year, in part because it was becoming apparent that the surge in oil prices would continue for longer than initially anticipated, confirming the existence of upside risks to price stability. By December 2005 the regular economic and monetary analyses and their cross-checking led to the view that an adjustment of the accommodative stance of monetary policy was warranted in order to address these risks. The Governing Council therefore decided on 1 December 2005 to increase the key ECB interest rates by 25 basis points, after having kept these rates unchanged for two and a half years. The minimum bid rate on the Eurosystem's main refinancing operations was raised to 2.25%, while the rates on the deposit facility and the marginal lending facility were raised to 1.25% and 3.25% respectively (see Chart 1).

Looking more closely at monetary policy decisions in 2005, it is useful to divide the year into two parts. Starting with the first half of the year, the data available in the first few months of 2005 gave reason to believe that the weakening of real GDP growth observed in the second half of 2004 would be short-lived. However, largely as a result of persistently high and volatile oil prices, that assessment became somewhat more pessimistic in the second quarter of 2005, as heightened uncertainties with regard to the short-term evolution of domestic demand were identified. In June 2005 the Eurosystem staff macroeconomic

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.

projections for real GDP growth were consequently revised downwards in comparison with those of December 2004. Annual real GDP growth was projected to moderate from 1.8% in 2004 to between 1.1% and 1.7% in 2005, and to rise to between 1.5% and 2.5% in 2006. Forecasts by international and private organisations gave similar indications. Nevertheless, the conditions for a strengthening of economic activity were seen to have remained in place despite downside risks to growth related to low consumer confidence, high and volatile oil prices and global imbalances. On the external side, the growth of the world economy remained strong, thereby supporting euro area exports. On the domestic side, very favourable financing conditions, robust corporate earnings and business restructuring provided a positive environment for investment. Private consumption growth was expected to benefit from an anticipated increase in real disposable income in the context of stronger growth in employment and lower inflation. Revised statistics (which became available only later in the year) indicate that real GDP growth, while remaining moderate, actually recovered gradually in the first half of 2005 (from 0.2% in the last quarter of 2004 to 0.3% and 0.4% in the first and second quarters of 2005 respectively), mainly reflecting a stronger contribution from net exports.

Regarding price developments, annual HICP inflation eased to 2.0% on average in the first half of 2005, from around 2.3% in the second half of 2004. However, this decline mainly reflected base effects. The surge in oil prices continued to exert significant upward pressure on inflation dynamics. Nonetheless, wage developments remained moderate, so there was no evidence of underlying domestic inflationary pressures building up in the euro area. Accordingly, the Eurosystem staff macroeconomic projections of June 2005 expected average annual HICP inflation to range between 1.8% and 2.2% in 2005 and between 0.9% and 2.1% in 2006. While underlying domestic inflationary pressures remained contained in the baseline scenario, upside risks to these projections were identified, which related, in particular, to future oil price developments and potential rises in indirect taxes and administered prices. Moreover, the Governing Council emphasised that continued vigilance was required with regard to potential second-round effects in wage and price-setting that could result from higher oil prices.

The strengthening of monetary dynamics, which had started in mid-2004, continued in the first half of 2005. In contrast with the previous period of strong monetary growth seen between 2001 and mid-2003, monetary growth was driven by the most liquid components of M3 and was associated, on the counterparts side, with an expansion of credit to the private sector. These developments reflected to a large extent the stimulative effect of the historically very low level of interest rates in the euro area. As a result of strong M3 growth in recent years, the stock of liquidity in the euro area was significantly greater than that needed to finance non-inflationary economic growth. Moreover, demand for loans for house purchase continued to be robust, contributing to strong house price dynamics in some regions of the euro area, while the annual growth rate of loans to non-financial corporations gradually picked up again.

All in all, the Governing Council came to the conclusion that, while it remained appropriate against the background of subdued domestic inflationary pressures to keep interest rates at their historically low levels, the cross-checking of the economic analysis with the monetary analysis supported the case for continued vigilance with regard to the materialisation of risks to price stability over the medium to longer term. In that context, developments in longer-term inflation expectations were monitored particularly closely.

In the second half of 2005 the economic analysis gradually confirmed the strengthening of economic activity that had been expected in the Eurosystem staff projections of June of that year. Real GDP growth in the euro area rose to 0.7%, quarter on quarter, in the third quarter of 2005. In addition, the conditions for continued growth identified in the previous Eurosystem staff projections remained in place. On that basis, the Eurosystem staff projections published in December 2005 pointed towards real GDP growth of between 1.2% and 1.6% in 2005 and between 1.4% and 2.4% in both 2006 and 2007, i.e. real GDP growth broadly in line with the projections made in June. Forecasts by international and private organisations painted a similar picture. At the same time, the outlook for economic activity remained subject to downside risks, related mainly to higher than expected oil prices, global imbalances and consumer confidence that, although increasing, remained weak.

With regard to price developments, HICP inflation rates rose to levels significantly above 2% in the second half of 2005, peaking at 2.6% in September, mainly as a result of increases in energy prices. In addition, contrary to what had been expected earlier in 2005, it became increasingly apparent that the upward shift in oil prices would be fairly protracted. Accordingly, while the projections and forecasts available in early 2005 pointed to a relatively marked decline in HICP inflation in 2006, this view changed substantially in the course of the year. In the second half of 2005 it was seen as likely that average annual HICP inflation in 2006 could remain above 2%, even on the assumption, as maintained, that wage increases would remain contained. Notably, the Eurosystem staff projections in December 2005 saw average HICP inflation between 1.6% and 2.6% in 2006 and between 1.4% and 2.6% in 2007. Forecasts by international and private organisations offered a broadly similar picture. Moreover, the Governing Council confirmed that this scenario remained subject to previously identified upside risks.

In the second half of 2005 monetary analysis continued to point towards upside risks to price stability over the medium to longer term. Liquidity in the euro area was ample by all plausible measures. Furthermore, the strengthening of monetary growth seen from mid-2004 gained further momentum in the third quarter of 2005. The growth of the broad monetary aggregate M3 continued to be driven by its most liquid components in a context of very low interest rates. Furthermore, the expansion of borrowing – especially in the form of mortgage loans – remained very robust. In that context, price dynamics in a number of housing markets needed to be monitored closely.

Consequently, in the second half of 2005 the Governing Council expressed increasing concern about upside risks to price stability and emphasised the need for strong vigilance with regard to developments in longer-term inflation expectations. Indeed, by December an adjustment of the accommodative stance of monetary policy was warranted, taking into account the risks to price stability that had been identified in the economic analysis and confirmed by cross-checking with the monetary analysis. Against this background, the Governing Council decided on 1 December to increase the key ECB interest rates by 25 basis points. The Governing Council took the view that this decision would contribute to keeping medium to longer-term inflation expectations in the euro area soundly anchored at levels consistent with price stability. Such anchoring of inflation expectations is a prerequisite for monetary policy to offer ongoing support to economic growth in the euro area. After the decision of 1 December 2005 interest rates across the entire maturity spectrum in the euro area remained very low in both nominal and real terms. The monetary policy of the ECB thus continued to be accommodative and to lend considerable support to economic activity and job creation. The Governing Council stressed that it would continue to monitor all developments closely with regard to risks to price stability.

2 MONETARY, FINANCIAL AND ECONOMIC DEVELOPMENTS

2.1 THE GLOBAL MACROECONOMIC ENVIRONMENT

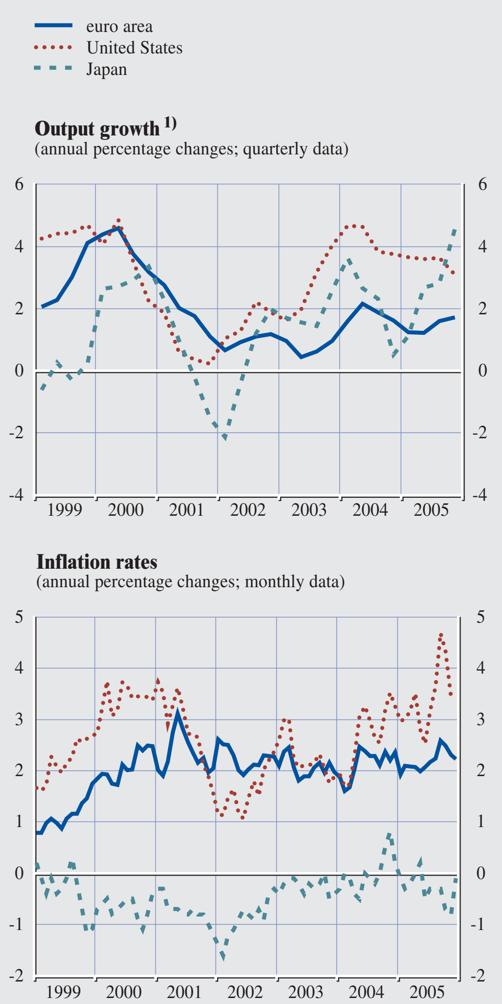
WORLD ECONOMY CONTINUED ITS ROBUST EXPANSION

In 2005 the global economy continued to expand at a robust pace, slowing only slightly from the exceptionally high levels of growth observed in 2004. As in 2004, growth was especially strong in Asia. In particular, the Chinese economy continued to expand at a more or less unabated rate, while the Japanese economy gained momentum. Global activity continued to benefit from favourable financing conditions and robust corporate profitability in many countries. Global growth also continued to be supported by the strength of the US economy.

Reflecting to a large extent the robust expansion of the global economy and the associated increase in the demand for energy, together with the progressive erosion of spare capacity throughout the oil supply chain, oil prices continued to rise through most of the year, with the price of Brent crude oil reaching a historical high of USD 67.5 per barrel in early September. The effect of elevated oil prices on global growth and inflation, however, appears so far to have been relatively muted. While the headline CPI was affected by the rise in the energy component, underlying inflationary pressures remained fairly well-contained in most countries. For the countries of the Organisation for Economic Co-operation and Development (OECD), annual headline CPI inflation was 2.7% for the year as a whole.

In the United States, economic activity expanded at a strong pace in 2005, with real GDP growing by 3.5% for the year as a whole. Growth in real GDP was underpinned by continued strong private consumption and investment spending, while net trade made a small negative contribution to growth. Private consumption remained brisk for most of the year, supported by favourable financing conditions, rising residential house prices and a continued improvement in employment conditions. With wage growth remaining relatively subdued, the rise in energy prices moderated growth in real disposable income, contributing to a further decline in the already low personal savings rate. Meanwhile, household debt as a percentage of disposable income rose further in 2005. Business investment grew rapidly, buttressed by the favourable financing conditions and high levels of corporate profitability. Notwithstanding high oil prices and an increase in the cost of raw materials, modest wage increases, combined with vigorous, albeit moderating, growth in

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. GDP figures have been seasonally adjusted.

productivity, contributed to rising profit margins during the year.

The external balance of the United States deteriorated further in 2005, with the current account deficit recording a historical high of 6.4% of GDP. The growth of imports exceeded that of exports, leading to a further widening of the external deficit.

Consumer prices rebounded temporarily in the third quarter of the year owing to the negative effects of hurricane-related disruptions and the prolonged rise in energy prices. However, price pressures receded by the end of the year, with annual CPI inflation standing at 3.4%. Inflation excluding energy and food remained relatively contained at 2.2%. Despite increases in oil prices and raw material costs, as well as the negative effects of the hurricanes, a dollar appreciation in nominal effective terms and a moderate increase in unit labour costs helped to keep price pressures in check, while, at the same time, inflation expectations remained contained.

The Federal Open Market Committee (FOMC) of the Federal Reserve System increased the federal funds rate target by 200 basis points in 2005. This increase was carried out in eight consecutive 25 basis point steps, bringing the target for the federal funds rate to 4.25% by the end of the year. In the statement following the last meeting of the year the FOMC noted that some further measured policy firming was likely to be necessary. As regards fiscal policy, the federal budget deficit declined in the fiscal year 2005 compared with 2004, primarily owing to increased corporate and personal tax revenues. The federal budget deficit stood at 2.6% of GDP in the fiscal year 2005.

In Japan, the economic recovery continued in 2005, with real GDP growing at a rate above potential for the second consecutive year (2.8%, after 2.3% in 2004). Economic activity rapidly gained momentum at the start of 2005, supported by a strong expansion in private consumption and non-residential investment. The robust growth observed in consumer spending reflected continuing improvements in income and employment conditions, while the rapid expansion in non-residential capital expenditure was supported by favourable financing conditions, healthy corporate profits and improved financial positions, and the replacement of ageing capital stock. While domestic demand remained the main driver of economic growth in 2005, early signs of a recovery in exports (notably to China) became evident towards the end of the year. Over the year the banking sector benefited from the gradual recovery in macroeconomic conditions and improved credit risk conditions.

Deflationary concerns eased further in 2005. The annual rate of change of consumer prices was slightly negative for the year as a whole (-0.3%, compared with 0.0% in 2004) and, towards the end of the year, the consumer price level excluding fresh food ceased falling. The Bank of Japan left its target for the outstanding balance on current accounts unchanged at around JPY 30-35 trillion in 2005. However, in late 2005 the Bank of Japan indicated that it was likely to end its quantitative easing policy (which has been in place since March 2001) during the fiscal year 2006 if favourable projections for price developments materialise (the Bank of Japan has indicated that a continued increase in consumer prices is a prerequisite for the ending of its current monetary policy strategy).

In non-Japan Asia, growth, while remaining strong, declined somewhat in 2005 from the very high rates recorded in the previous year, mainly owing to a slowdown in external demand, less robust domestic demand and higher oil prices. As regards price developments, elevated oil prices resulted in high inflation rates in a number of major economies in the region – with the exception of China – and monetary authorities started to gradually raise interest rates. The Chinese economy continued to grow strongly, supported by buoyant external demand and robust domestic demand. The macroeconomic tightening measures slowed investment momentum, particularly in the real estate sector, and stabilised inflation. The transition to a more flexible (but still tightly controlled) exchange rate regime in July 2005 does not seem to have had any significant impact on the economy. In December, following China's first comprehensive nationwide economic survey, China's National Bureau of Statistics (NBS) revised upwards its GDP level for 2004 by CNY 2.3 trillion, or 16.8% of previously reported nominal GDP. The NBS also revised China's GDP growth figures for 1993 onwards, increasing them by an average of around 0.5 percentage point. This revision was prompted mainly by the improved measurement of China's services sector, which turned out to be almost 50% larger than previously calculated. In 2005 as a whole Chinese GDP grew by 9.9%.

In Latin America, the economic situation continued to show a solid improvement, albeit at a slightly slower pace than in 2004. The region benefited from a highly favourable external environment and higher commodity prices, which allowed the reduction of financial vulnerabilities. Growth in the region, while driven by strong export growth, also benefited from improving demand for consumption and the opening-up of opportunities for new investment. Argentina experienced rapid real output growth, while the pace of economic expansion in the region's two largest countries, Brazil and Mexico, was moderate.

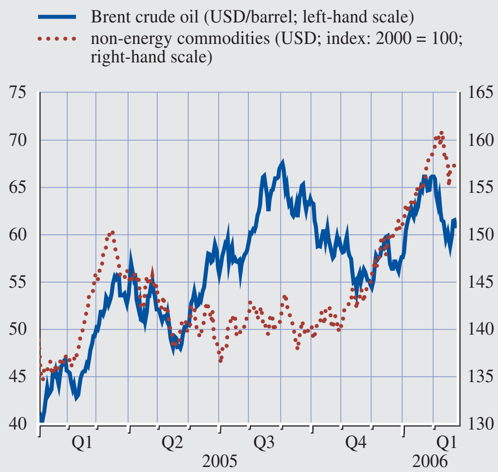
COMMODITY PRICES ROSE STRONGLY IN 2005

Oil prices soared for a second year in a row in 2005. The price of Brent crude oil increased to a new all-time high of USD 67.5 per barrel in early September. Oil prices eased somewhat thereafter and reached USD 58 at the end of the year. For the year as a whole, the price of Brent crude oil averaged USD 55, which is 45% above the average for 2004.

While oil demand growth eased in 2005, spare capacity throughout the oil supply chain was eroded further. Oil prices remained very sensitive to changes in supply and demand conditions. Low non-OPEC oil supply growth contributed to the tightening of oil market fundamentals. Production growth in the Commonwealth of Independent States (the main source of non-OPEC supply growth in previous years) eased and North Sea oil production decreased in 2005. In addition, extreme weather (i.e. hurricanes) severely disrupted production in the US Gulf of Mexico. Demand for OPEC's oil, the "call on OPEC", increased as a result. However, the increase in OPEC production was unable to ease prices, as dwindling spare OPEC production capacity kept market participants concerned about the lack of a safety cushion against the possibility of future supply disruptions.

Rising demand for refined oil products squeezed spare refining capacity and bottlenecks also increased because of the lack of sufficient capacity to process heavy and sour grades of crude oil. The quality mismatch between the marginal barrel of oil supplied and demanded also supported the prices of light and sweet grades of crude oil such as Brent. Geopolitical concerns regarding the security of future oil supplies put additional pressure on oil prices, as threats (re-)emerged in various oil-producing countries.

Chart 3 Main developments in commodity markets



Sources: Bloomberg and Hamburg Institute of International Economics.

The prices of non-energy commodities, as measured by the Hamburg Institute of International Economics index, have been buoyant since 2003 and peaked in March 2005. Overall non-energy commodity prices eased somewhat in April and May and broadly levelled off in the following six months. Non-energy commodity prices have surged again since November 2005. In US dollar terms, overall non-energy commodity prices increased by an average of 9.5% in 2005. Gold prices in 2005 increased to their highest level since 1981, reaching USD 538 per troy ounce in December 2005.

2.2 MONETARY AND FINANCIAL DEVELOPMENTS

M3 DYNAMICS CONTINUED TO STRENGTHEN IN AN ENVIRONMENT OF LOW INTEREST RATES

In 2005 monetary growth strengthened substantially, driven by the stimulative effect of the low level of interest rates in the euro area. At the same time, the offsetting, dampening effect on M3 growth associated with the normalisation of euro area residents' portfolio allocation behaviour (following their strong preference for liquidity between 2001 and mid-2003) lost momentum, especially in the first half of the year. Overall, the strengthening of monetary growth during 2005 added to the already ample liquidity situation in the euro area.

After increasing in the second half of 2004, M3 growth remained robust in the first few months of 2005. From April 2005 the strengthening of monetary growth resumed in earnest, with the annual growth rate of M3 rising to 8.0% in the third quarter of 2005. Shorter-term monetary dynamics were particularly strong in the middle of the year, with the six-month annualised growth rate of M3 reaching, in September 2005, its highest level since the start of Stage Three of EMU. In the last quarter of 2005 monetary growth showed some signs of moderation, although M3 still grew at a robust rate of 7.8% on an annual basis.

On the components side, the largest contribution to overall M3 growth came from the most liquid assets within M3 contained in the narrow aggregate M1. On the counterparts side, monetary expansion was driven largely by MFI credit to the private sector. Both these developments suggest that the prevailing low level of interest rates in the euro area, implying low opportunity costs of holding liquid balances and reduced borrowing costs, was a key driving factor behind monetary dynamics in 2005.

These developments also imply that the substantial strengthening in M3 growth as from mid-2004 was of a different nature to the strengthening observed between 2001 and early 2003. During the earlier period, which was characterised by heightened economic and financial uncertainty, the increase in annual M3 growth was accompanied by a steady decline in the annual rate of growth of loans to the private sector (see Chart 4). By contrast, the strengthening in monetary dynamics observed since mid-2004 has been associated with an increase in growth of loans to the private sector. It is thus more likely to reflect fundamental factors, in particular the low level of interest rates, rather than the impact of portfolio shifts induced by volatility in financial markets, such as those seen between 2001 and mid-2003. (For an analysis of the driving forces behind M3 growth since mid-2004, see Box 1 entitled "The changing nature of strong monetary dynamics in recent years".)

The normalisation of the portfolio allocation behaviour of euro area residents following their heightened preference for liquidity between 2001 and mid-2003 continued throughout 2005, although only at a very slow pace. Portfolios were shifted from money into longer-term assets, exerting some dampening effect on M3 growth, although of a much more modest size than would have been expected on the basis of past regularities. In particular, the euro area money-holding sector continued to demonstrate a reluctance to invest in foreign assets, which contrasted with the willingness of foreigners to invest in euro area assets. However, towards the

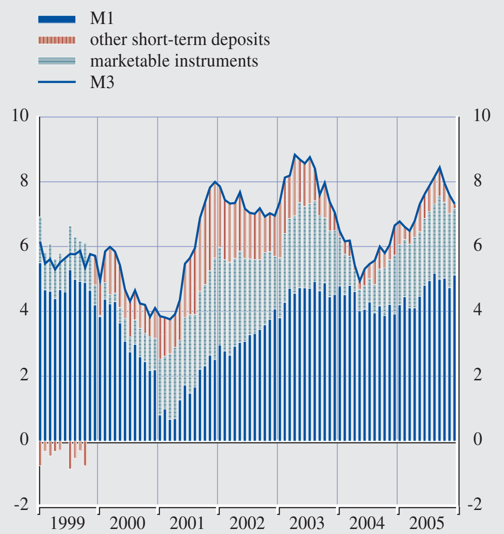
Chart 4 M3 and loans to the private sector

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

Source: ECB.

Chart 5 Contributions to annual M3 growth

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



Source: ECB.

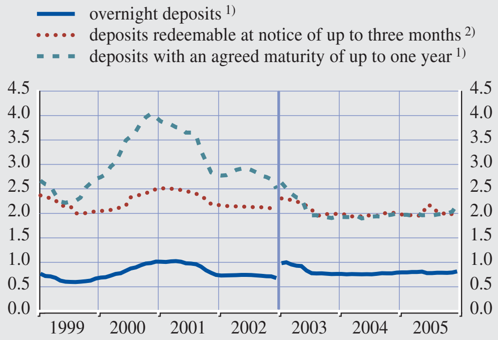
end of the year there were tentative signs of a possible resumption of the unwinding of past portfolio shifts into money, as reflected in the behaviour of MFI net external assets. To the extent that this unwinding dampens monetary growth, it would imply that the official M3 growth series tends to understate the underlying rate of monetary expansion.

As was the case in 2003 and 2004, the main contribution to annual M3 growth in 2005 came from its most liquid components contained in M1 (see Chart 5). The continued strong overall contribution from M1 concealed some differences in the development of the underlying components. On the one hand, the annual growth rate of holdings of currency in circulation moderated over the course of 2005, to stand at 13.7% in December 2005, down from 18.5% in January 2005. This development was in line with expectations of a drawn-out process of adjustment of holdings of banknotes and coins following the euro cash changeover in January 2002. On the other hand, 2005 witnessed a strengthening in the annual growth rate of overnight deposits, supported by the very low opportunity costs of holding these instruments in an environment of very low interest rates. The average interest rate on overnight deposits for households and non-financial corporations remained broadly unchanged from its level at the end of 2003, standing at 0.81% at the end of 2005 (see Chart 6). At the same time, financial innovations, such as highly liquid and highly remunerated internet deposit accounts, which are partly recorded as overnight deposits, may also have played a role.

While M1 made the largest overall contribution to M3 growth in 2005, the strengthening of annual M3 growth in 2005 was in large part attributable to developments in short-term deposits other than overnight deposits (see Chart 5). Their average contribution to annual M3 growth was around 2.1 percentage points in 2005, almost double the figure for 2004. This large contribution reflected a sustained increase in the annual growth rate of short-term time deposits (i.e. deposits with an agreed maturity of up to and including two years), while that of short-term savings deposits (i.e. deposits

Chart 6 Short-term interest rates on deposits

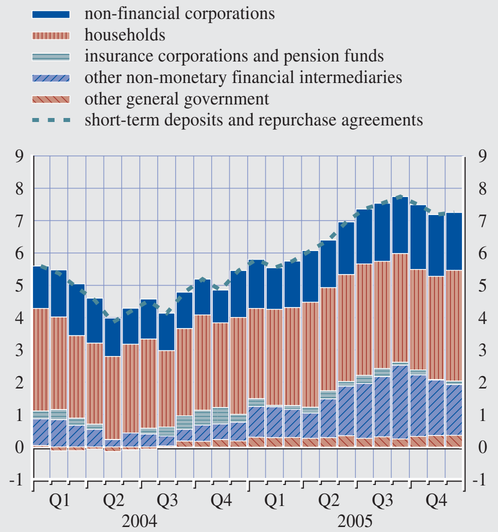
(percentages per annum)



Source: ECB.
Notes: Data on retail interest rates up to December 2002 and on MFI interest rates on new business excluding bank overdrafts from January 2003 (weight-adjusted as from December 2003). For more information on MFI interest rate statistics and on weight adjustment, see Box 2 in the December 2003 issue and Box 3 in the August 2004 issue of the ECB's Monthly Bulletin respectively.
1) Before 2003, the interest rate on deposits from enterprises. From January 2003 onwards, the interest rate on deposits from households and non-financial corporations.
2) Before 2003, the interest rate on deposits from enterprises. From January 2003 onwards, the interest rate on deposits from households.

Chart 7 Contributions to the annual rate of growth of short-term deposits and repurchase agreements

(annual percentage changes; contributions in percentage points; not adjusted for seasonal or calendar effects)



Source: ECB.
Note: The reporting sector comprises MFIs excluding the Eurosystem and central government.

redeemable at notice of up to and including three months) gradually declined over the year. Overall, the relative strength of demand for short-term deposits other than overnight deposits is likely to reflect the low opportunity cost of holding these relatively poorly remunerated but also relatively liquid assets in a low interest rate environment.

With regard to marketable instruments, their average contribution to the annual growth rate of M3 only increased slightly to 0.6 percentage point in 2005, from 0.5 percentage point in the previous year. This increase concealed divergent developments in the components. On the one hand, the annual growth rate of money market fund shares/units remained at a relatively subdued level. As these assets are often held by households and firms as a safe savings vehicle in times of economic and financial uncertainty, their moderate growth was consistent with an ongoing but slow normalisation of the portfolio allocation behaviour of euro area residents in 2005. On the other hand, demand for debt securities with a maturity of up to two years strengthened significantly, possibly reflecting the emergence of new structured products which combine these securities with derivative instruments that involve some exposure to developments in equity markets, while protecting investors from large capital losses. The average annual growth rate of repurchase agreements also increased strongly in 2005 compared with the previous year, although growth in these instruments can be highly volatile.

A sectoral breakdown of short-term deposits and repurchase agreements (i.e. the largest aggregation of components of M3 for which a reliable sectoral breakdown is available) suggests that the strengthening in monetary growth over the course of 2005 was, to a large extent, attributable to deposit holdings of financial intermediaries other than MFIs (see Chart 7). In particular, non-monetary financial intermediaries excluding insurance corporations and pension funds (known as other financial intermediaries or OFIs) were in large part responsible for the upward M3 dynamics observed during most of 2005, despite accounting for only a small part of the total stock of money holdings. The increased importance of OFIs in recent years as a money-holding sector may, to a large extent, reflect financial deregulation and liberalisation as well as the associated development of deeper and more liquid securities markets.

At the same time, the contribution of deposits held by non-financial corporations to the growth in short-term deposits and repurchase agreements also increased somewhat compared with 2004. In the case of non-financial corporations, these holdings are typically concentrated in the most liquid types of deposits, suggesting that they are generally held for transaction purposes and associated with short-term financing and working capital needs. In addition, the stronger growth of corporate deposits might also reflect precautionary motives, as non-financial corporations may hold liquid deposits to avoid opportunity costs related to foregone investment possibilities and/or the costs of obtaining external finance, should unanticipated cash needs arise.

Finally, data on the sectoral breakdown of short-term deposits and repurchase agreements indicate that households remained the main contributors to the strong growth of these instruments throughout 2005.

Box 1

THE CHANGING NATURE OF STRONG MONETARY DYNAMICS IN RECENT YEARS

Monetary developments in recent years have been characterised by two periods of significant strengthening in the annual rate of growth of M3. The first period starts with the doubling of annual M3 growth from rates of around 4% to around 8% during 2001 and ends with a further rise to almost 9% in the first half of 2003. The second period begins in the middle of 2004, since when annual M3 growth rates have risen from around 5% to a peak of 8% in the third quarter of 2005. This box uses information contained in the components and counterparts of M3 and the sectoral breakdown of deposits to illustrate the differing nature of the strengthening of monetary growth in the two periods.

The main drivers of stronger M3 growth between 2001 and the first half of 2003 were the heightened geopolitical, economic and, especially, financial uncertainties that prevailed at the time, associated with a series of large shocks to the world economy.[1] These shocks included a substantial fall in equity prices, the terrorist attacks in the United States on 11 September 2001, a spate of accounting scandals on both sides of the Atlantic in the aftermath of the equity market correction, and the wars in Afghanistan in late 2001 and in Iraq in early 2003. Seeking a "safe haven" for savings in the face of these shocks, the money-holding sector (mainly households and non-financial corporations) shifted their wealth portfolios from risky and longer-term assets into safe and liquid monetary assets, thus raising monetary growth. In the period since mid-2004, by contrast, strong monetary growth appears to have been more fundamental in nature, driven by the low level of interest rates and hence the low opportunity costs of holding money.

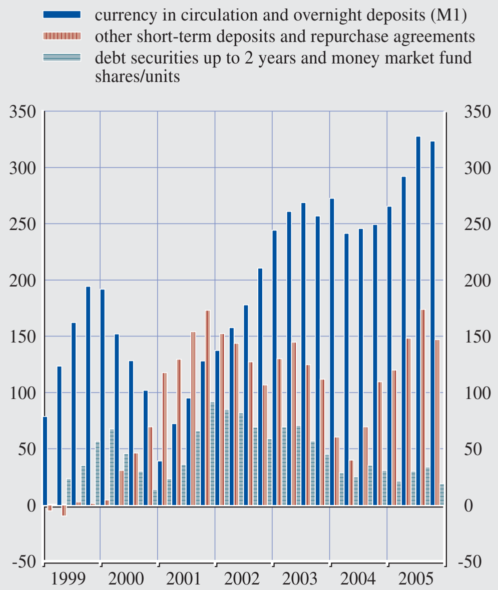
A detailed look at the components of M3 reveals that the portfolio shifts from risky assets into money between 2001 and mid-2003 boosted the inflows into debt securities with a maturity of

1 See the article entitled "Money demand and uncertainty" in the October 2005 issue of the ECB's Monthly Bulletin.

up to two years and money market fund shares/units, which are held by households and firms in order to “park” liquidity at times of heightened uncertainty. As a consequence, developments in these two components exerted a significant influence on overall monetary dynamics, while the contribution of the most liquid components played a subordinate role. By contrast, high M3 growth since the middle of 2004 has been driven by the most liquid components contained in the narrow aggregate M1. At the same time, the annual flow into debt securities with a maturity of up to two years and money market fund shares/units has been modest (see Chart A).

Chart A Components of M3

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

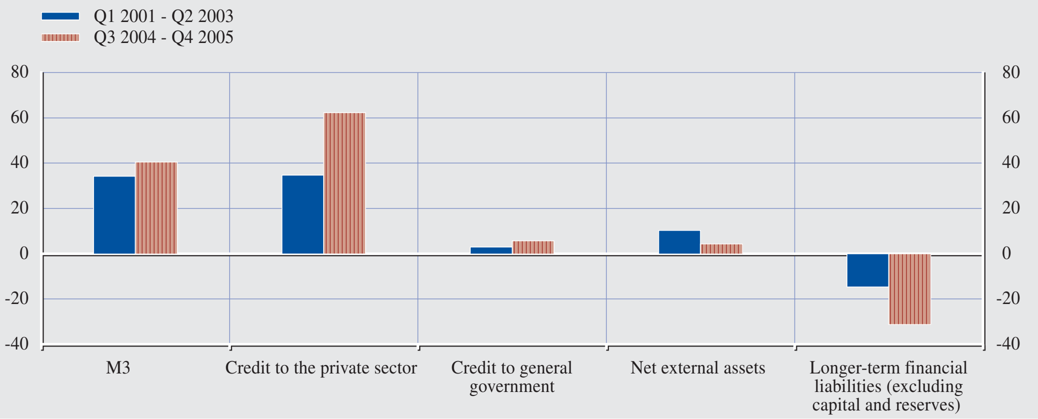


Source: ECB.

Turning to the counterparts of M3, the differing nature of strong monetary growth in the two periods is apparent from developments in loans to the private sector (see Chart 4 in the main text). Between 2001 and mid-2003, the strengthening of M3 growth was accompanied by a steady decline in the annual rate of growth of loans to the private sector. In other words, during the prolonged period of heightened economic and financial uncertainty the growth rates of M3 and private borrowing moved in opposite directions. By contrast, the period since the middle of 2004 has been characterised by a strengthening of both monetary growth and growth in loans to the private sector, reflecting the low opportunity costs of holding monetary assets and the favourable financing conditions implied by the low level of interest rates.

Chart B Movements in M3 and its counterparts

(monthly flows; period averages; EUR billions; adjusted for seasonal and calendar effects)



Source: ECB.
Notes: M3 is shown for reference only. Longer-term financial liabilities (excluding capital and reserves) are shown with an inverted sign, since they are liabilities of the MFI sector.

Chart B illustrates the essential role played by the strong capital flows into the euro area in the strengthening of monetary dynamics from 2001 to mid-2003 (represented by the changes in net external assets over this period). In the environment of heightened financial market and geopolitical uncertainty, euro area residents repatriated funds previously invested in foreign equity, as they searched for a safe haven from the shocks affecting the global economy. In the period since mid-2004, the change in the net external asset position has played a far more modest role in the strengthening of monetary dynamics, even though it has remained positive. While this suggests that the euro area money-holding sector has remained reluctant to invest in foreign assets (at least relative to non-euro area residents' demand for euro area assets), the impact of this on M3 growth has been modest when compared with the impetus provided by loan expansion.

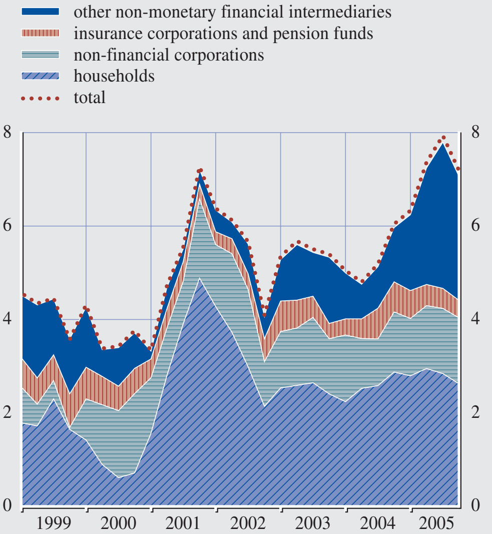
As regards the overall development of the counterparts of M3, the period between 2001 and mid-2003 can be characterised by a shift from risky longer-term assets into shorter-term monetary assets as illustrated by the modest flow into MFI longer-term financial liabilities. In the period since mid-2004, in the context of an expansion of the overall consolidated MFI balance sheet, substantial inflows into MFI longer-term financial liabilities could be observed in parallel to strong monetary dynamics.

Looking finally at the sectoral breakdown of deposits across all maturities (the aggregate for which a sectoral breakdown is available since 1999, which includes longer-term deposits outside M3), it can be seen that, during the first period, the strengthening of demand for deposits (including repurchase agreements) originated predominantly in the household sector (see Chart C). This reflects households' increased risk aversion and liquidity preference after the bursting of the stock market bubble and the emergence of geopolitical uncertainties. In the second period, the strengthening in deposit growth across all maturities is characterised by a rising contribution from the "other non-monetary financial intermediaries" sector, with the impact of household deposits being modest. However, the data for short-term deposits and repurchase agreements (i.e. those components of M3 for which a sectoral breakdown is available but which have only been collected since 2003) indicate that the contribution of households in this period is more pronounced for deposits contained in M3 than for overall deposit holdings.

In summary, the analysis of the sectoral breakdown of deposits, and the components and counterparts of M3, confirms that the two periods of strong M3 growth in recent years, from 2001 to the first half of 2003 and since mid-2004, were of a different nature. In

Chart C Sectoral composition of deposits of the private sector

(annual percentage changes; contributions in percentage points; not adjusted for seasonal and calendar effects)



Source: ECB.
Note: The reporting sector comprises MFIs excluding the Eurosystem.

particular, the strength of the growth in the most liquid components and the dynamism of demand for credit suggest that during the latter period a key driving factor of monetary growth has been the low level of interest rates. With regard to the implications for price stability, the earlier surge in M3 growth, in an environment of exceptional financial and geopolitical uncertainty leading to a heightened preference for liquidity, appears to reflect changes in portfolio allocation behaviour and can be seen as relatively benign in terms of the outlook for price developments, while the different nature of the strong monetary developments since mid-2004 implies a higher risk of inflationary pressures over the medium to longer term.

GROWTH OF MFI CREDIT TO THE PRIVATE SECTOR STRENGTHENED FURTHER

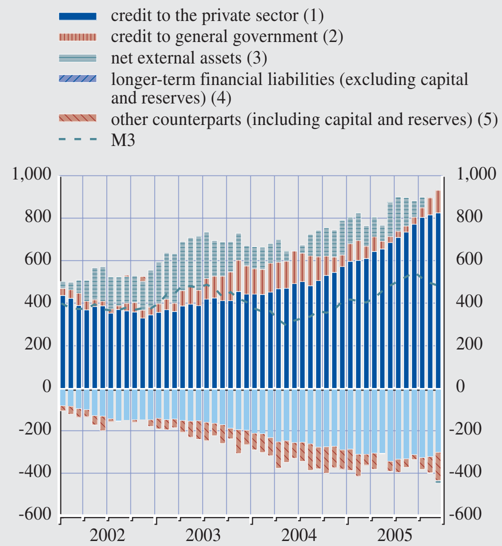
On the counterparts side, monetary dynamics were driven by a continuous strengthening in MFI credit to the private sector (see Chart 8). This reflected a strong increase in the annual growth rate of MFI loans to the private sector, in an environment of low interest rates, improved credit supply conditions (as reported by the bank lending survey for the euro area) and strong asset price rises, particularly in the housing market. At the end of 2005 the annual growth rate of loans to the private sector had increased to 9.1%, from 7.1% in December 2004. The dynamism of MFI loans to the private sector in 2005 was broadly based across the main money-holding sectors. While the largest contribution to private sector loan growth was attributable to the household sector, reflecting mainly loans for house purchase, the continued strengthening in loan growth also reflected, to a large extent, developments in loans to both non-financial corporations and other financial intermediaries.

Among the other counterparts of M3, the dynamics of MFI longer-term financial liabilities (excluding capital and reserves) remained robust in 2005, after strengthening substantially in the previous year. This pointed to a continued inclination on the part of the euro area money-holding sector to invest in longer-term euro assets. However, given the lack of an acceleration in MFI longer-term financial liabilities in 2005 compared with 2004, the developments also suggested some loss in the momentum of the normalisation of euro area residents' portfolio allocation behaviour, which was characterised by a shift from liquid monetary assets into instruments with a longer maturity.

Developments in MFI net external assets were, for the greater part of 2005, still characterised by positive annual flows, which exerted upward pressure on M3 dynamics (see Chart 8). Balance of payments data suggest that this phenomenon reflected the greater propensity of non-euro area residents to invest in euro area equity and bonds compared with that of euro area residents to

Chart 8 Counterparts of M3

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



Source: ECB.
Notes: M3 is shown for reference only (M3 = 1+2+3-4+5). Longer-term financial liabilities (excluding capital and reserves) are shown with an inverted sign, since they are liabilities of the MFI sector.

invest abroad. During the first half of the year, this investment pattern may have been related to developments in the euro exchange rate.[1]

The second half of the year instead saw a succession of month-on-month net capital outflows from the euro area, possibly due to the further widening of the interest rate differential between the United States and the euro area at the short end of the yield curve. This may have been associated with some unwinding of past portfolio shifts into monetary assets, with such funds being reinvested in riskier foreign securities, following an apparent decline in the reluctance of euro area investors to invest abroad. These developments gradually reduced the annual flow of euro area MFI net external assets, eventually leading this counterpart to turn negative in November 2005, for the first time since December 2001. Towards the end of the year, the dampening effect on M3 growth stemming from the developments in net external assets and longer-term financial liabilities more than offset the strengthening in credit growth.

LIQUIDITY REMAINED AMPLE

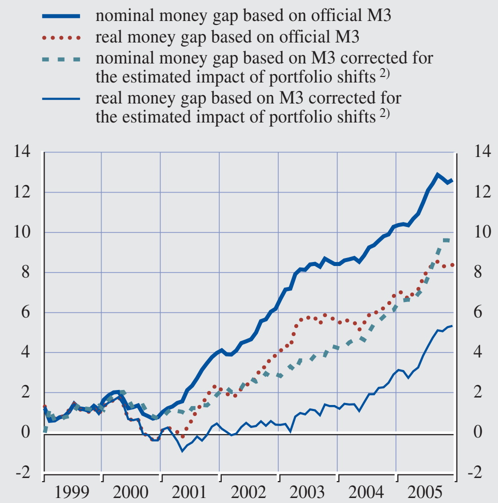
The strengthening of M3 dynamics over the course of 2005 added to the already ample stock of liquidity in the euro area. Available estimates of the liquidity situation (as represented by the nominal money gap and the real money gap), which attempt to measure the liquidity available beyond the amount needed to finance non-inflationary growth, rose further in 2005 (see Chart 9). 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% since December 1998, while the real money gap 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). Towards the end of the year, both measures showed some sign of stabilisation, albeit at still high levels.

The ECB has also regularly published money gaps constructed on the basis of an adjusted M3 series, which attempts to correct for the estimated impact of portfolio shifts into monetary assets triggered by the heightened economic and financial uncertainty between 2001 and 2003.[2] These adjusted measures showed the same upward movement in 2005, but remained substantially lower than the corresponding money gaps based on official M3.

When assessing these liquidity measures, it should, however, be kept in mind that they are imperfect estimates of the liquidity situation. Because the choice of the base period is to some

Chart 9 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% since December 1998. 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.

1 For more details on the link between developments in the exchange rate and MFI net external assets, see the box entitled "Recent developments in MFI net external assets" in the July 2005 issue of the ECB's Monthly Bulletin.
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.

extent arbitrary, the levels of these measures are surrounded by considerable uncertainty and should thus be treated with caution. Moreover, it cannot be entirely ruled out that the current liquidity situation, 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. Finally, the estimate of M3 corrected for portfolio shifts is surrounded by a considerable degree of uncertainty related to the estimation of the corrections made to M3 itself.

These considerable uncertainties are well reflected in the wide range of estimates shown by the four liquidity measures discussed here. However, notwithstanding these uncertainties, the overall picture painted by these measures is that liquidity conditions in the euro area remained ample over the course of 2005. Viewed from a medium to longer-term perspective, ample liquidity poses risks to price stability. In addition, strong monetary and credit growth in a context of already ample liquidity implies a need to monitor asset price developments closely, particularly in housing markets, given the potential for misalignments to emerge.

AFTER REMAINING STABLE, MONEY MARKET INTEREST RATES ROSE TOWARDS THE END OF THE YEAR

For most of 2005 the Governing Council decided to keep its key policy rates unchanged. On 1 December 2005 key ECB interest rates were increased by 25 basis points but remained at low levels by historical standards. Money market rates at the short end of the yield curve (such as the one-month EURIBOR shown in Chart 10) closely mirrored this development in the key ECB interest rates. Money market interest rates remained broadly stable at levels slightly above 2% until November, when they rose amid expectations of an increase in key ECB interest rates.

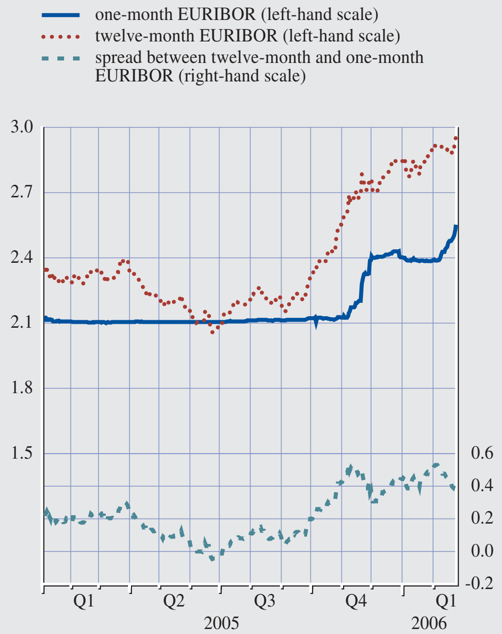
Money market interest rates at longer maturities remained broadly stable in the first quarter of 2005, at levels somewhat above rates at shorter maturities. In the second quarter of 2005, the twelve-month EURIBOR started to decline, with the result that by the end of June it had reached the same level as – and had briefly even fallen below – rates at the short end of the money market yield curve. This downward movement reversed towards the end of July 2005, and, from the start of the fourth quarter, the upward trend in longer-maturity rates accelerated, a development which persisted into the beginning of 2006.

These developments were reflected in the slope of the money market yield curve. Towards the end of May 2005 some expectations of a lowering of key ECB interest rates triggered a downward movement in rates, especially at the longer end of the money market yield curve. The slope of the money market yield curve – as measured by the difference between the twelve-month and one-month EURIBOR – became negative in June and reached a trough of -5 basis points on 23 June 2005. However, market expectations of a further reduction in key ECB interest rates subsided quickly as prospects for euro area economic growth improved. This resulted in a steepening of the money market yield curve, which continued until mid-November, when short-term rates reacted to the rising expectations of an increase in key policy rates and the yield curve flattened somewhat. After the turn of the year, shorter-term money market rates broadly stabilised, whereas longer-term rates continued to increase. As a consequence, the slope of the yield curve steepened in January 2006 to reach levels comparable to those observed in mid-November. In February, however, this movement reversed with shorter-term rates increasing while longer-term rates remained broadly stable, leaving the one-month and twelve-month EURIBOR standing at 2.55% and 2.96% respectively on 24 February. As a result, the slope of the money market yield curve declined again by 10 basis points during February.

The implied volatility derived from options on three-month EURIBOR futures contracts declined substantially between January and May

Chart 10 Short-term interest rates in the euro area and the slope of the money market yield curve

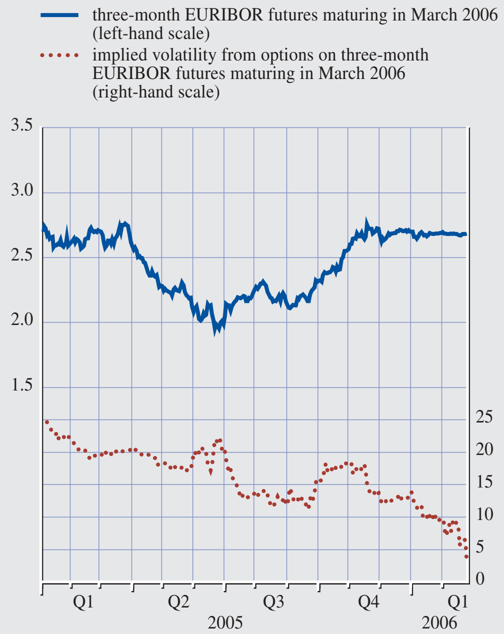
(percentages per annum; percentage points; daily data)



Source: Reuters.

Chart 11 Three-month EURIBOR futures rates and implied volatility derived from options on three-month EURIBOR futures

(percentages per annum; basis points; daily data)



Sources: Reuters and Bloomberg.

2005, indicating that market participants attached very low uncertainty to the expected future path of short-term interest rates. However, from this low level, volatility rose on two subsequent occasions: in June 2005 and, more markedly, during the fourth quarter of 2005. On both occasions, the increase in volatility was associated with the emergence of market expectations of a change in the key ECB interest rates. Towards the end of the year and, in particular, after the Governing Council's decision to increase interest rates on 1 December, volatility first declined and then stabilised. At the beginning of 2006, volatility declined again, reaching very low levels compared with the level observed in 2005 (see Chart 11).

LONG-TERM BOND YIELDS RECORDED HISTORICAL LOWS IN 2005

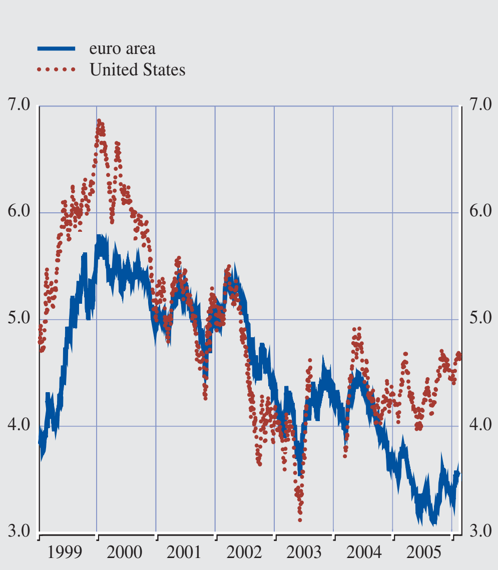
In 2005 long-term bond yields in the euro area recorded the lowest levels seen in a century.[3] Following the historically low level of 3.1% in September 2005, euro area ten-year government bond yields increased to 3.4% by the end of the year, still around 35 basis points below the levels prevailing at the end of 2004 (see Chart 12).

Overall, the low levels of euro area long-term bond yields in 2005 reflected perceptions among market participants of subdued long-term inflationary pressures and low real yields (see Chart 13). Long-term inflation expectations – as reflected in break-even inflation rates – fluctuated within a rather narrow range in the course of 2005 and thus remained well-anchored at relatively low levels. Real long-term bond yields appeared to have been affected not only by downward revisions in long-term growth

3 See the box entitled "Long-term and short-term nominal interest rates in the largest euro area countries from a historical perspective" in the August 2005 issue of the ECB's Monthly Bulletin.

Chart 12 Long-term government bond yields[1)]

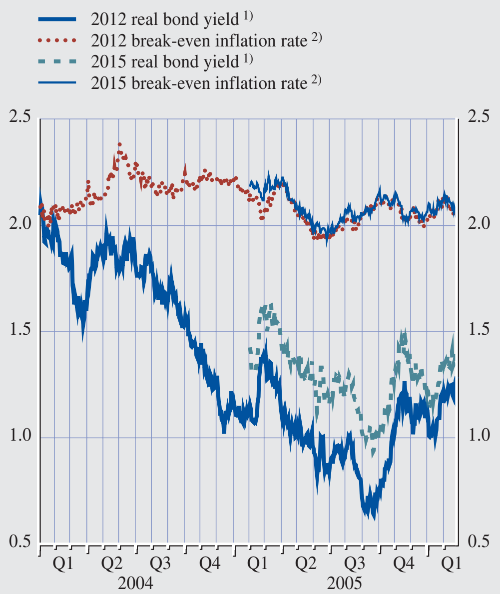
(percentages per annum; daily data)



Sources: Reuters, Bloomberg and Thomson Financial Datastream.
1) Ten-year bonds or the closest available bond maturity.

Chart 13 Euro area real bond yields and break-even inflation rates

(percentages per annum; daily data)



Sources: Reuters and ECB calculations.
1) Derived from the market prices of French government bonds which are indexed to the euro area HICP excluding tobacco.
2) For details of calculation, see Box 2 in the February 2002 issue of the ECB's Monthly Bulletin.

expectations, especially in the context of the upsurge in oil prices (see Box 2 entitled "The impact of increasing oil prices on bond yields and stock prices: a historical comparison for the euro area and the United States"), but also by the high demand for government bonds.

By the end of the first quarter, long-term bond yields in the euro area recorded their highest level in 2005, namely 3.8%, mirroring, in particular, rising US long-term government bond yields amid increased price pressures and generally favourable data releases with regard to the economic outlook in the United States.

From the end of the first quarter to the end of the third, euro area long-term bond yields resumed their tendency to decline, reaching a historically low level of 3.1% by the end of the third quarter of 2005. This decline in long-term bond yields reflected a fall in real yields up to the end of the third quarter, whereas inflationary concerns remained subdued, despite the upsurge in oil prices (see Chart 13). The decline in real yields seemed only in part to be attributable to macroeconomic fundamentals, i.e. long-term growth prospects, and to a larger extent to other factors relating primarily to the unusually high demand for long-term bonds.[4] In the euro area, pension funds in particular increased their holdings of long-term bonds, motivated in part by regulatory changes and the increased need for pension funds to match their assets with their (long-term) liabilities. From a longer-term perspective, another structural development which may have contributed to the low level of bond yields is the increasing savings activity of the baby boom generation and the ageing population in general. Speculative behaviour, such as yield curve carry trades, i.e. borrowing at low short-term interest rates and investing in

4 See the Box entitled "Recent developments in long-term real interest rates" in the April 2005 issue of the ECB's Monthly Bulletin.

longer-term instruments, may have amplified the decline in long-term bond yields.

Low long-term government bond yields were observed in all major markets. This may suggest that bond yields in the euro area declined not only on account of domestic factors but also, and to a large extent, on account of an increased demand for euro area bonds in a global context. In that respect, a strengthening of demand for bonds by oil-exporting countries and continued high demand for bonds by Asian and other central banks, together with a growing foreign exchange reserve diversification, may have played a role. In addition, it cannot be ruled out that the low levels of long-term bond yields in 2005 were also linked to abundant liquidity in the global financial system after an extended period of monetary policy accommodation.

By the end of the third quarter of 2005, the decline in nominal and real bond yields in the euro area had come to an end. The rise in long-term nominal and index-linked bond yields in the fourth quarter of 2005 suggests that markets expected a somewhat increased pace of economic growth in the euro area in the near term. The rise in long-term nominal and real bond yields in the euro area also reflected upward revisions by market participants with regard to the future path of short-term interest rates over the near to medium term, as suggested by the gradual upward shift at the corresponding maturity segments of the implied forward yield curve in the fourth quarter of 2005.

As a result of these developments, nominal ten-year government bond yields in the euro area ended the year at 3.4%, around 35 basis points lower than at the end of 2004. In the United States, by contrast, ten-year government bond yields increased by around 20 basis points over the same period. Consequently, the differential between ten-year interest rates in the United States and in the euro area widened significantly over 2005. Having stood at 55 basis points at the end of 2004, it peaked at 120 basis points at the start of the fourth quarter of 2005. This decoupling of long-term interest rates reflected diverging views among market participants about the macroeconomic prospects and short-term interest rate expectations in the two economies. Longer-term real bond yields declined in the euro area in 2005, whereas in the United States they rose significantly.

In 2005 long-term break-even inflation rates fluctuated within a narrow range of between 1.9% and 2.2% in the euro area, as shown in Chart 13, despite the upsurge in oil prices. The break-even inflation rate based on the 2012 maturity ended the year at 2.0%, which corresponded to a decline of 20 basis points compared with the end of 2004.

In 2005 implied bond market volatility – which provides evidence of market views about the ranges within which bond yields are expected to move in the near term – remained at the low levels observed in the second half of 2004. This indicates that in 2005 market participants expected fairly limited near-term yield fluctuations in the euro area bond market.

In the first two months of 2006, long-term government bond yields in global markets increased. On 24 February ten-year government bond yields in the euro area stood 20 basis points above the prevailing levels at the end of 2005. This increase was reflected in a rise in longer-term indexed-link bond yields, whereas longer-term inflation expectations, as measured by break-even inflation rates, remained broadly unchanged.

Box 2

THE IMPACT OF INCREASING OIL PRICES ON BOND YIELDS AND STOCK PRICES: A HISTORICAL COMPARISON FOR THE EURO AREA AND THE UNITED STATES

This box focuses on the impact of higher oil prices on market expectations of economic growth and inflation as reflected in long-term bond yields and stock prices in the euro area and the United States. The reactions of the financial markets to the most recent surge in oil prices are compared with those of previous episodes of high oil prices. Quite in contrast to past experience, the reaction of euro area and US bond yields and stock prices has been rather muted over the past year.

The "Fisher hypothesis" helps to clarify why and how bond yields react to oil price changes. It says that long-term nominal interest rates can be decomposed into an expected real interest rate and the premium that investors require to compensate for expected inflation over the life of the bond. The real interest rate component can, in turn, be linked to the economy's average growth prospects over the maturity of the bond as perceived by bond market investors, among other things. Higher oil prices usually dampen the short to medium-term growth prospects of non-oil producing economies and at the same time increase inflationary pressures and thus inflation expectations. In theory, the overall reaction of nominal bond yields to higher oil prices through the "expectations channel" is therefore ambiguous, as it depends on the relative strength of its impact on growth expectations and inflation expectations.

In the past, nominal bond yields have tended to increase during oil price spikes, as surging inflation and inflation expectations clearly offset downward pressures on real rates that are associated with the concurrent economic downswing. The first three rows in Table A show the changes in ten-year bond yields during the 12 months leading up to the two oil price peaks reached during the oil shocks of the 1970s (January 1974 and November 1979) and the spike caused by the Gulf war in 1990 (October).[1] Indeed, ten-year government bond yields surged on both sides of the Atlantic, by between 90 and 180 basis points in the case of Germany and between 50 and 150 basis points in the case of the United States. During those historical episodes, actual inflation rose considerably in both economies, triggering heightened inflation expectations among investors. It is most likely that the economic recession that characterised those episodes also exerted downward pressure on the real interest rate. Therefore, the resulting sharp increases in nominal bond yields suggest that the higher inflation expectations more than compensated for the probable declines in long-term real interest rates.

During the most recent oil price spike, however, long-term interest rates reacted very differently, particularly in the euro area (see the fourth row in Table A). In the 12 months prior to the oil price peak in September 2005, ten-year government bond yields declined by

Table A Changes in euro area and US ten-year government bond yields in the 12 months preceding oil price peaks

(basis points)

	euro area	United States
Jan. 1973 - Jan. 1974	91	46
Nov. 1978 - Nov. 1979	117	152
Oct. 1989 - Oct. 1990	176	73
Sep. 2004 - Sep. 2005	-89	20
of which:		
long-term real interest rates	-79	-4
long-term break-even inflation rates	-10	24

Sources: BIS, Reuters and ECB calculations.
Note: For the first three periods in the euro area, German bond data are used.

1 German ten-year government bond yields are taken to represent euro area bond yields in these three periods.

around 90 basis points in the euro area and increased by 20 basis points in the United States. This seems mainly to reflect the fact that, compared with previous oil price shocks, actual and expected inflation have remained rather stable this time. Indeed, as also shown in Table A, ten-year break-even inflation rates – although they are not a perfect measure of inflation expectations – have changed only slightly over the period concerned.[2] Moreover, it seems that the higher oil prices have also led to some downward revisions in market participants' growth expectations and, accordingly, to lower long-term real interest rates. During the period leading up to the oil price peak in September 2005, euro area ten-year index-linked bonds declined by about 80 basis points, whereas in the United States there has been very little evidence of a similar reaction (see Table A). The decline in euro area long-term nominal bond yields over this period therefore mainly reflects lower real bond yields, with inflation expectations remaining basically unchanged. Furthermore, better credibility and predictability of central banks may have contributed to reducing uncertainty, thereby also contributing to the muted movements in bond yields over the past year. However, explaining the link between the recent behaviour of long-term bond yields and oil prices only through the oil price impact on market participants' growth and inflation expectations neglects several other factors which could have directly affected both variables.[3]

Stock prices may also be affected by oil price developments. In theory, the price of a share is equal to the sum of the expected future dividends discounted by the risk-free interest rate and the risk premium that investors require for holding it. Expected future dividends can be replaced by earnings expectations in the valuation, if it is assumed that a certain proportion of the earnings will be paid out in dividends. Changes in oil prices may have an impact on all three components. For instance, higher energy costs may lead to slower expected earnings growth for some corporations, but also to higher expected earnings growth for those companies that tend to benefit from oil price increases, for example oil exploration companies. Long-term real government bond yields are often used as a proxy for the real risk-free rate, and changes in oil prices can also influence this component as explained above. Finally, in periods of high oil prices, investors usually become more uncertain about the outlook for corporate earnings which, in turn, may lead to demand for higher equity risk premia. Even though some of the components may work against each other, high and rising oil prices generally tend to be bad news for stocks, as they are usually overshadowed by the future negative impact on the company's perceived profitability (see the first three rows of Table B).

Table B Changes in euro area and US stock prices in the 12 months preceding oil price peaks

(percentages)

	euro area	United States
Jan. 1973 - Jan. 1974	-2	-19
Nov. 1978 - Nov. 1979	2	3
Oct. 1989 - Oct. 1990	-1	-9
Sep. 2004 - Sep. 2005	30	12

Sources: Datastream, Reuters and ECB calculations.
Note: The stock market index used in the calculation is the Datastream total market index.

Table B depicts the annual return on the euro area and US stock markets for the same four periods of oil price spikes. It also highlights some striking differences in the stock price

2 The index-linked bond market is a rather new feature and thus this decomposition is not possible for the three earlier periods of oil price peaks.
3 For example, it is likely that recent developments in long-term real interest rates were also driven by several factors determining risk premia embedded in bond yields. See the box entitled "Recent developments in long-term real interest rates" in the April 2005 issue of the ECB's Monthly Bulletin.

performance during the most recent period and previous periods leading up to the oil price peaks. Whereas the two oil price shocks in the 1970s and the spike in the early 1990s coincided with relatively poor returns for stock market investors, the period between September 2004 and September 2005 saw stock prices increase, particularly in the euro area. In the most recent episode, market participants therefore seem to have attached less importance to the oil price-related factors that tend to weigh on stock prices.

A reason may be that compared with the 1970s and early 1980s, mature economies are far less dependent on oil, and that the price increases of oil recently have been more demand-driven, spurred by overall healthy global economic activity. Furthermore, risks of escalations in the wage-bargaining process and wage-inflation spirals appear more limited than in previous oil price shocks. With regard to relative performance, the stronger increase in the euro area stock market than in the US stock market in the period 2004-05 reflects, to some extent, the greater decline in long-term real interest rates in the euro area (see again Table A).

To sum up, contrary to the historical episodes of oil price peaks, euro area and US bond and stock markets reacted in a more contained manner during the latest oil price surge. The decline in the real yields offered on euro area index-linked bonds may indicate that the recent height in oil prices may have brought about some concerns about the euro area economic growth outlook, although other structural and short-term factors may have played a role in this period. As regards the stable break-even inflation rate in the euro area, it cannot be excluded that central banks' increased credibility in delivering a low and stable inflation environment has played a key role in the observed resilience of financial asset prices to the most recent oil price shock.

EURO AREA STOCK PRICES CONTINUED TO INCREASE IN 2005

In 2005 euro area stock prices continued the upward trend which began in early 2003 (see Chart 14). The Dow Jones EURO STOXX index ended the year with a gain of 23% compared with the end of the previous year, thus underperforming the Nikkei 225 index but outperforming the Standard & Poor's 500 index, which moved sidewards in 2005. Apart from relative interest rate developments, the US stock market's underperformance can to some extent also be explained by exchange rate developments: in 2005 the US dollar appreciated by 13% and 15% vis-à-vis the euro and the Japanese yen respectively.

The strong stock market performance in the euro area in 2005 seemed to reflect several factors, in particular lower long-term interest rates, which act as a discount factor for future expected cash flows, and sustained double-digit growth in actual earnings per share (see Chart 15). Stock market analysts generally revised their earnings estimates upwards. Continued low stock market volatility, which suggested low uncertainty among market participants about the near-term stock market outlook, also seemed to provide a favourable environment for stock price developments.

Potentially negative factors, such as the less optimistic economic outlook resulting from the surge in oil prices (see Box 2), have only partially attenuated stock price gains.

Turning to a sectoral breakdown, the increase in euro area stock prices in 2005 was most noticeable in the oil and gas sectors (in line with the strong growth of reported earnings resulting, to a large extent, from oil price developments), and in the financial sector. Of the ten economic sectors of the Dow Jones EURO STOXX index, only the

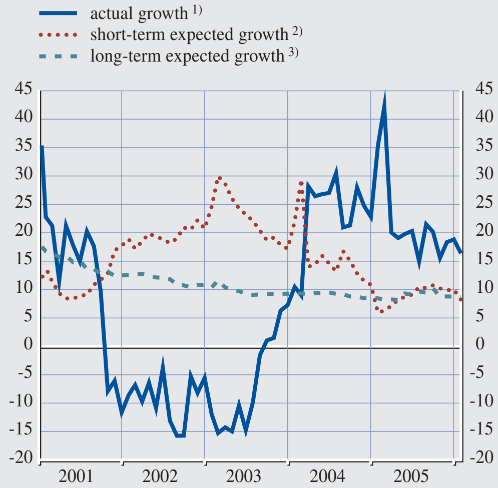
Chart 14 Stock price indices

(index: 31 December 2004 = 100; daily data)

Sources: Reuters and Thomson Financial Datastream.
Note: The indices used are the Dow Jones EURO STOXX broad index for the euro area, the Standard & Poor's 500 index for the United States and the Nikkei 225 index for Japan.

Chart 15 Growth in actual and expected corporate earnings per share

(percentages per annum; monthly data)



Sources: Thomson Financial Datastream and ECB calculations.
Notes: Earnings per share growth of the Dow Jones EURO STOXX index.
1) Refers to the twelve-month trailing earnings per share.
2) Refers to analysts' earnings expectations twelve months ahead.
3) Refers to analysts' earnings expectations three to five years ahead.

telecommunications sector recorded lower stock prices at end-2005 than a year earlier. The consumer services and healthcare sectors also underperformed the overall index in 2005. The underperformance of these sectors suggests that the earnings outlook of companies more dependent on private consumption was comparatively weak in 2005.

In early 2006 global stock prices continued to rise. Up to 24 February 2006 the Dow Jones EURO STOXX index increased by 8% compared with the end of 2005. The Standard & Poor's 500 and the Nikkei 225 rose by less over the same period. These stock price increases can be explained by overall solid corporate profit growth, together with an increase in investors' appetite for equity.

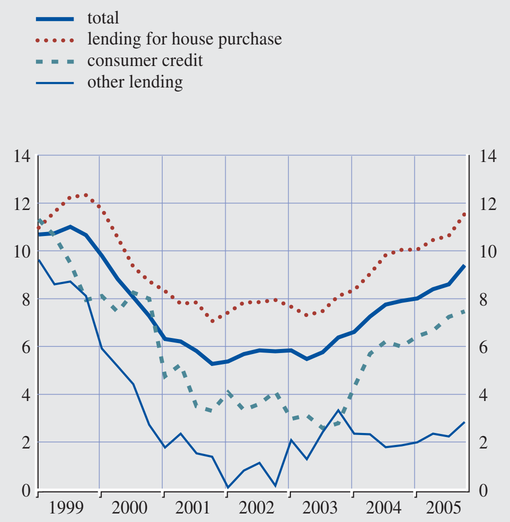
STRONG HOUSEHOLD DEMAND FOR FINANCE

In 2005 household borrowing continued the upward trend observed since mid-2003, reflecting robust growth in loans for house purchase and increasingly strong growth in consumer credit. The annual rate of growth of MFI loans to households increased to 9.4% in December 2005, from 7.9% at the end of 2004. At the same time, developments at the euro area level tend to obscure differences across countries (see Box 3 on "Differences in household loan growth across the euro area countries").

The dynamics of loans to households from other financial intermediaries, which in the previous year had been much stronger than the dynamics of loans from MFIs, slowed considerably in 2005, resulting in a convergence of the annual growth rate of total loans to households with that of MFI loans to households.

Chart 16 MFI loans to households

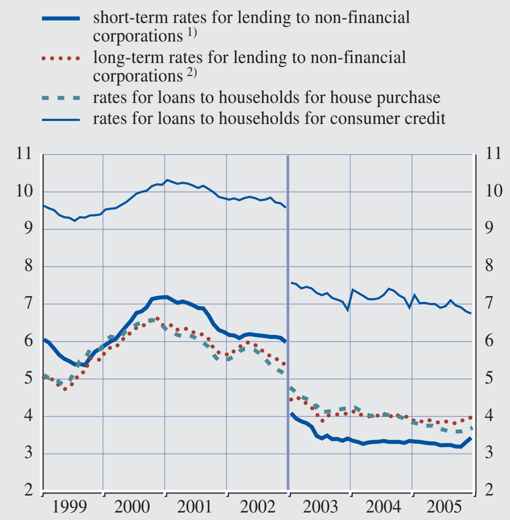
(annual percentage changes)



Source: ECB.

Chart 17 Interest rates for lending to households and non-financial corporations

(percentages per annum)



Source: ECB.
Notes: Data on retail interest rates up to December 2002 and on MFI interest rates on new business excluding bank overdrafts from January 2003 (weight-adjusted as from December 2003). For more information on MFI interest rate statistics and on weight adjustment, see Box 2 in the December 2003 issue and Box 3 in the August 2004 issue of the ECB's Monthly Bulletin respectively.
1) Before 2003, the interest rate for lending to enterprises with a maturity of up to one year. From January 2003 onwards, the interest rate for lending to non-financial corporations with a floating rate and an initial rate of fixation of up to one year.
2) Before 2003, the interest rate for lending to enterprises with a maturity of over one year. From January 2003 onwards, the interest rate for lending to non-financial corporations with an initial rate fixation of over one year.

Looking at the breakdown of MFI loans to households by purpose, the strength of household borrowing seems to have become more broadly based across different loan categories during 2005 compared with the previous year. This notwithstanding, loan dynamics continued to be driven largely by the robust demand for loans for house purchase (see Chart 16). It is likely that the ongoing strength of mortgage borrowing was associated with both the further reduction of mortgage interest rates throughout the euro area and the dynamic housing market developments witnessed in many regions (see Section 2.3 of this chapter).

Mortgage lending rates continued to decline in 2005, from the already low levels reached in previous years (see Chart 17). For instance, MFI interest rates on new loans for house purchase with an initial rate fixation of over five and under ten years declined by 13 basis points over the course of the year, to stand at 3.7% in December 2005.

In addition, the results of the bank lending survey for the euro area suggest that the robust growth in loans for house purchase, albeit mainly driven by strong demand by households, may have also been related to some easing of credit standards applied by banks to the approval of loans for house purchase in the first and third quarters of 2005. This easing of credit standards and the strong demand partly reflected an increasingly favourable assessment of housing market prospects by both banks and borrowers.

Despite relatively subdued growth in nominal consumption spending at the euro area level, the annual growth rate of consumer credit followed an upward trend in 2005, reaching a rate of 7.5% in the last quarter of 2005. This strengthening is in line with the low interest rates on consumer credit prevailing in 2005 and is also corroborated by the results of the bank lending survey for the euro area, which point to an easing of credit conditions.

Box 3

DIFFERENCES IN HOUSEHOLD LOAN GROWTH ACROSS THE EURO AREA COUNTRIES

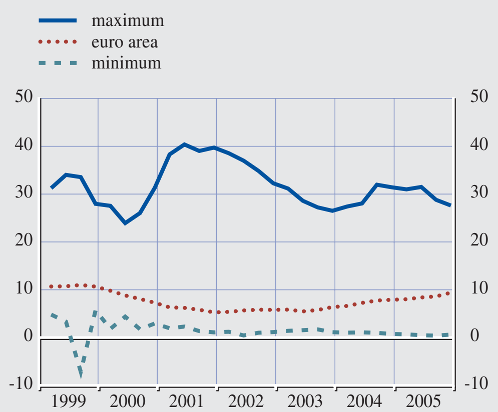
The annual growth rate of MFI loans to households in the euro area has been strengthening at a reasonably steady pace since mid-2003, to stand at 9.4% at the end of 2005. However, these robust loan dynamics at the euro area level tend to conceal sizeable differences in the growth rates across individual euro area countries. This box discusses these differences in terms of statistical dispersion measures and provides some explanations of the cross-country variation.

Measuring differences in household loan growth across the euro area countries

The differences in household loan growth across countries can be analysed along several lines. Chart A shows the range between the highest and lowest annual growth rate of total MFI loans to households among the euro area countries in the period since the start of Stage Three of EMU. This range has typically been very large, exceeding 30 percentage points on several occasions. While annual growth rates in the countries experiencing the most rapid expansion of loans fluctuated between 25% and 40%, in those countries witnessing the slowest growth over the reference period household borrowing dynamics proved very subdued, occasionally falling below zero. Comparing this with the growth rates of between 5% and 10% recorded for the euro area as a whole suggests that the countries accounting for the highest growth rates were "outliers" and/or have only a relatively small weight in the euro area-wide outstanding amount of household loans.

Chart A Range of growth in MFI loans to households across the euro area countries

(annual percentage changes)

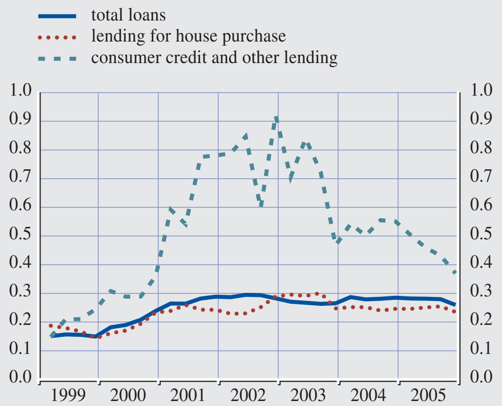


Source: ECB.

Taking into account the weight of the individual countries in the euro area aggregate, Chart B shows the cross-country dispersion of annual loan growth over the period 1999-2005 as measured by the weighted coefficient of variation. This measure has the advantage that it is less subject to the influence of outliers. Nonetheless, in broad terms the evolution of the two dispersion measures since 1999 is quite similar: after peaking in mid-2002, the cross-country dispersion of household loan growth appears to have declined somewhat throughout 2003 and broadly stabilised thereafter at levels above those seen in 1999.

Total MFI loans to households can be decomposed into loans for house purchase, consumer credit and other lending. As shown in Chart B, the weighted coefficient of variation for mortgage loans increased until the end of 2002 but has since remained fairly stable. Given the high share of mortgage loans in the total stock of MFI loans to households (close to 70% at the end of 2005), the dispersion in mortgage loan growth largely determines the dispersion in overall household loan growth. The weighted coefficient of variation for growth in consumer credit and other lending has been much more erratic in the past than that for growth in mortgage loans. However, it also seems to have stabilised recently, albeit at a significantly higher level than the weighted coefficient of variation for growth in mortgage loans.

Chart B Weighted coefficient of variation for the annual growth of MFI loans to households



Source: ECB.
Note: The weighted coefficient of variation of a variable is the ratio of its weighted standard deviation to its weighted mean. The weights are based on a country's share in the corresponding loan category.

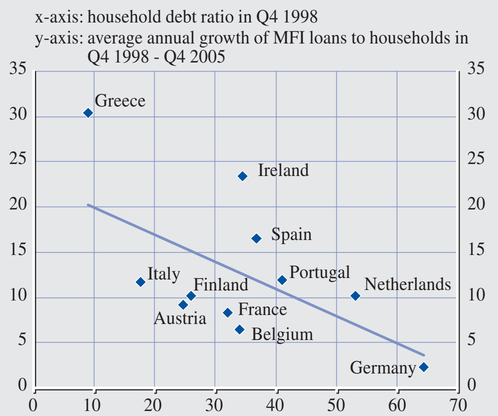
Household loan growth and differences in debt levels across the euro area countries

The differences in household loan growth across countries in past years can reflect a variety of factors, including differences in the financial position of households and the degree of interest rate convergence prior to Monetary Union; differences in the structure of financial markets – especially for mortgage credit; and differences in key economic determinants of household borrowing – notably the dynamics of real estate markets and house prices.

Chart C plots the average annual growth of total MFI loans to households across the euro area countries in the period between the fourth quarter of 1998 and the fourth quarter of 2005 against the level of household indebtedness in the individual countries at the end of 1998. Euro area countries at the start of Stage Three of EMU displayed considerable variation in household indebtedness as measured by the ratio of the stock of MFI loans to GDP. The chart illustrates that the countries with initially lower debt ratios have, on average, experienced stronger loan growth than those countries with a higher initial debt ratio. Part of the discrepancies in average loan growth witnessed since 1999 could therefore reflect a "convergence" process of debt ratios as interest rate and inflation levels converge.

Chart C Growth of MFI loans to households and household indebtedness across the euro area

(x-axis: as a percentage of GDP; y-axis: annual percentage changes)

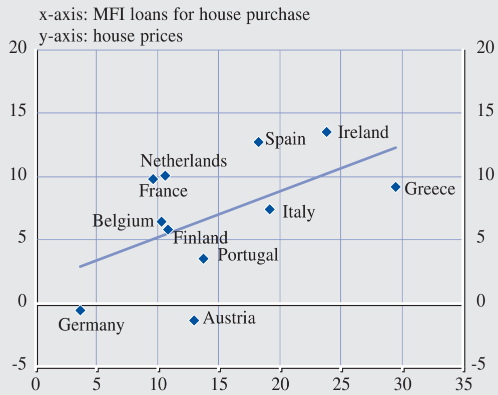


Source: ECB.
Note: Luxembourg has been excluded from the chart due to the high share of cross-border loans in the total household loan stock.

The structure of financial markets also varied substantially across countries in 1999 and is thus likely to have contributed to different initial levels of household indebtedness. In the case of mortgage markets such variation is for instance reflected in the differences of the available products with regard to factors such as the length of contracts, the use of fixed or variable interest rates, as well as average and maximum loan-to-value ratios. While financial market liberalisation and increased competition between financial intermediaries have been pervasive in recent years, the impact of such structural changes in the financial markets has been more profound in some euro area countries than in others, on account of both their starting-point and the pace and scope of reforms made. This has resulted, for instance, in a sharper reduction of interest rate margins and other borrowing costs, as well as a wider range of innovative and diversified mortgage products – for example, the availability of 30 or even 50-year loans and the appearance of "accordion" variable rate and "amortisation free" mortgages – in some countries than in others, thus enabling more households to access financing for house purchase. Cross-country variation in household borrowing dynamics may, in part, thus reflect the heterogeneity of both the level and rate of change of the sophistication and depth of financial markets.

Chart D Housing market dynamics and loans in the euro area in the period 1999-2004

(average annual growth rates in percentages)



Source: ECB.
Note: Luxembourg has been excluded from the chart due to the high share of cross-border loans in the total household loan stock.

While Monetary Union has resulted in a uniform short-term interest rate across countries, cross-country variation in household borrowing dynamics also reflects the heterogeneity of macroeconomic developments across euro area countries. This has been particularly marked in developments in real estate markets. As shown in Chart D, several countries (for example, Ireland and Spain) have experienced very rapid house price increases since 1999, while others (such as Germany and Austria) have been characterised by stable house prices. Since mortgage credit is the largest component of overall household borrowing and is naturally related to the dynamism of housing market developments, the substantial differences in the evolution of real estate prices are reflected in the heterogeneity of household loan growth rates. Differences in consumer credit may in turn stem from diverse patterns of household disposable income and private consumption across countries.

To sum up, there were substantial differences in the annual growth of total MFI loans to households among the euro area countries between 1999 and 2005. The evidence also shows that these cross-country differences have been persistent. While the convergence in the level of inflation and interest rates before the start of EMU – and thus the impact of moving to a credible low inflation environment at the start of Stage Three – may help to explain the cross-country variation, the heterogeneous experience since the introduction of the euro, especially with regard to housing market developments and changes in financial market structure, has also played an important role. Of course, other factors may also have contributed to the variation in household loan growth across countries. They include for instance differences in income and private consumption developments as well as in demographics and attitudes towards owner-occupied housing across countries, while differences in tax deductibility of interest payments, capital gains taxes on housing gains and securitisation of mortgages may also have played a role. Differing advances made in modelling in the financial industry, which have increased the ability of banks to assess market developments and credit risk, may also explain part of the differences.

RISING HOUSEHOLD DEBT

As a result of the continued strong borrowing dynamics, the ratio of household debt to disposable income edged up further in 2005 (see Chart 18). Nonetheless, household indebtedness in the euro area remained below that seen in other industrialised countries, such as the United States, the United Kingdom and Japan. Moreover, despite the rise in indebtedness, the total debt service burden of the household sector (the ratio of interest payments plus principal repayments to disposable income) remained broadly unchanged. The higher debt repayment burden associated with the strong loan growth observed in recent years has been more or less offset by the lower share of income that needs to be devoted to interest payments in a low interest rate environment.

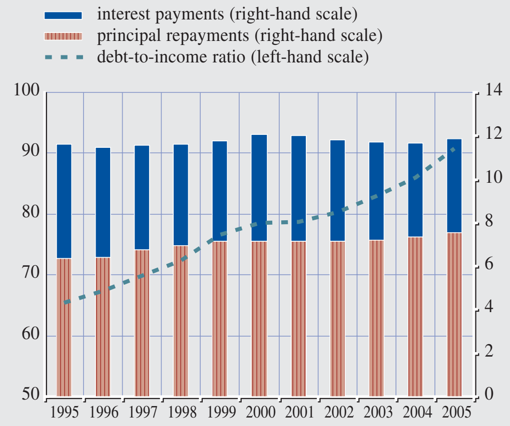
This notwithstanding, the rise in indebtedness has increased households' exposure to changes in interest rates, income and asset prices. Moreover, when assessing these aggregate figures, it should be taken into account that they represent an average for the euro area-wide household sector, and that the debt service ratio for households which have an outstanding mortgage would be higher. In addition, the debt service burden may vary across euro area countries as well as across households in different income categories. Finally, some uncertainty relates to the fact that the share of existing mortgage debt exposed to changes in prevailing interest rate conditions depends on the specific features of the underlying mortgage contracts, which vary substantially across the euro area.

CONTINUED LOW REAL COST OF EXTERNAL FINANCING OF NON-FINANCIAL CORPORATIONS

The overall real cost of external financing of non-financial corporations, as calculated by weighting the different external financing sources on the basis of their amounts outstanding (corrected for valuation effects), continued to

Chart 18 Household debt and debt service burden

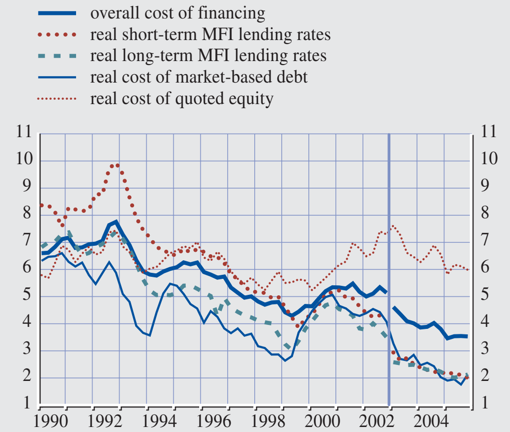
(as a percentage of disposable income)



Source: ECB.
Note: Data for 2005 are estimates.

Chart 19 Real cost of the external financing of euro area non-financial corporations

(percentages per annum)



Sources: ECB, Thomson Financial Datastream, Merrill Lynch and Consensus Economics forecasts.
Notes: The real cost of the external financing of non-financial corporations is calculated as a weighted average of the cost of bank lending, the cost of debt securities and the cost of equity, based on their respective amounts outstanding and deflated by inflation expectations (see Box 4 in the March 2005 issue of the ECB's Monthly Bulletin). The introduction of harmonised MFI lending rates at the beginning of 2003 led to a break in the statistical series.

be low by historical standards throughout 2005 (see Chart 19).[5] There was a marked increase in the debt financing of non-financial corporations on account of its very low cost, while the issuance of quoted shares increased only slightly in the second half of the year.

Regarding the components of the real cost of external financing, real MFI lending rates to non-financial corporations decreased slightly up to the second quarter of 2005 (see Chart 17). This reflected the further decline in short and medium-term government bond yields in the first half of the year. The rise in government bond yields in the second half of the year was only partly reflected in MFI lending rate developments. In the fourth quarter, the real cost of bank lending remained unchanged at low levels after a slight rise in the third quarter. Overall, the low real cost of bank lending reflects a positive credit risk assessment of non-financial corporations by banks. This is also indicated by the results of the bank lending survey for the euro area, which indicated a net easing of or broadly unchanged credit standards for enterprises in 2005.

The real cost of market-based debt was more volatile than the real cost of bank lending during 2005. From a low in the first quarter of 2005, the real cost of market-based debt of non-financial corporations increased up to the middle of the second quarter. This was related to the rise in corporate bond spreads, which was driven mainly by a series of firm-specific events affecting, primarily, the automobile industry. Thereafter, the real cost of market-based debt fell up to the third quarter, mainly owing to the partial reversal in the second and third quarters of the rise in corporate bond spreads, but rose again in the fourth quarter of 2005. This was due largely to the rise in market interest rates in the second half of the year and the increase in corporate bond spreads in the fourth quarter. By the end of 2005, its level was somewhat higher than at the end of 2004, but still very low by historical standards.

In 2005 the real cost of quoted equity of non-financial corporations remained at considerably higher levels than the real cost of debt financing, and was broadly in line with its average for the period since 1995. In the first half of the year, the real cost of quoted equity rose somewhat. This may have reflected the fact that the higher than expected profitability of non-financial corporations was not fully reflected in stock market prices or that there has been a rise in the equity risk premium. Towards the end of the year, however, mainly as a result of favourable stock market developments, the real cost of equity fell to around the same level as at the beginning of the year.

RISE IN THE DEMAND FOR EXTERNAL FINANCING BY NON-FINANCIAL CORPORATIONS

Non-financial corporations increased their demand for external financing considerably in 2005. This occurred within the context of sound corporate profitability levels in 2005 (and the associated rise in internal financing possibilities), after a strong rise in profitability in 2003 and 2004, as indicated by aggregated financial statements of listed non-financial corporations in the euro area (see Chart 20).[6] A key factor in profitability improvements were cuts in operating expenses relative to sales. While rising corporate earnings growth was anticipated for the 12-month period ahead between February and October 2005, towards the end of 2005 stock market-based profitability measures indicated that the profitability growth of large listed corporations was expected to moderate slightly over the next 12 months. At the same time, expected corporate profitability levels remained relatively high.

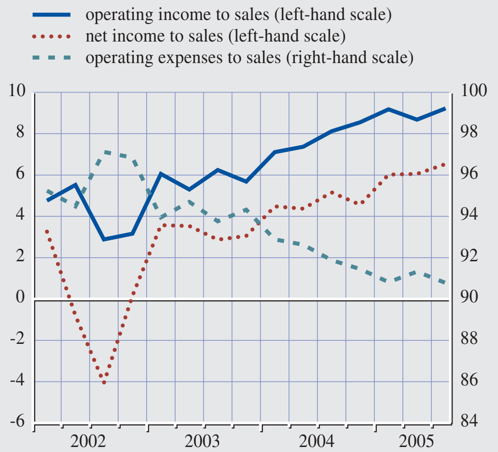
In the course of 2005 the real annual growth rate of external financing of non-financial corporations rose considerably, to 2.8% in the

5 For a detailed description of the measure of the real cost of external financing of euro area non-financial corporations, see Box 4 in the March 2005 issue of the ECB's Monthly Bulletin.

6 For details on the methodology and longer-term developments, see the article entitled "Developments in corporate finance in the euro area" in the November 2005 issue of the ECB's Monthly Bulletin.

Chart 20 Profit ratios of listed euro area non-financial corporations

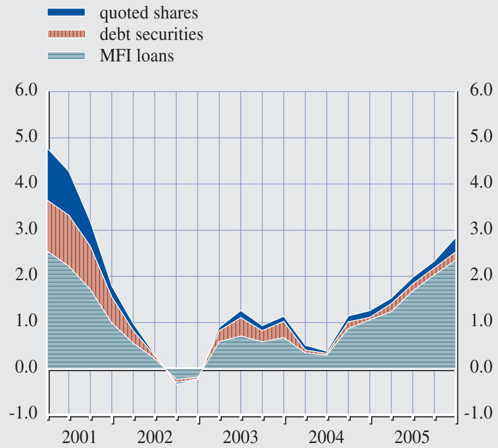
(percentages)



Sources: Thomson Financial Datastream and ECB calculations.
Notes: The calculation is based on aggregated quarterly financial statements of listed non-financial corporations in the euro area. Outliers have been removed from the sample. Compared with the operating income, which is defined as sales minus operating expenses, the net income refers to operating and non-operating income after taxation, depreciation and extraordinary items.

Chart 21 Breakdown of the real annual rate of growth of external financing of non-financial corporations[1)]

(annual percentage changes)



Source: ECB.
1) The real annual growth rate is defined as the difference between the actual annual growth rate and the growth rate of the GDP deflator.

fourth quarter, from 1.3% at the end of 2004. This development was driven mainly by a strong increase in the contribution of loans, whereas the rise in the contributions of debt securities and quoted shares was more modest (see Chart 21).

The annual growth rate of MFI loans to non-financial corporations increased to 8.0% in December, from 5.4% at the end of 2004. In the first half of the year, the rise was largely due to developments in short-term loans. However, in the second half of the year, the annual growth rate of long-term loans picked up strongly. While short-term loans are often used as working capital, long-term loans are generally more closely linked with business investment. In line with this development, the October 2005 and January 2006 bank lending surveys reported that fixed investment contributed to an increase in the net demand for loans or credit lines by enterprises. In addition, the annual growth rate of gross fixed capital formation increased considerably in the second and third quarters of 2005. In this respect, non-financial corporations may have wished to take advantage of the low cost of financing and the relatively accommodative credit standards for business expenditure.

Evidence available for the period up to the end of the third quarter of 2005 indicated that, by contrast with MFI loans, the annual rate of change of non-MFI loans to non-financial corporations remained negative. This may still be attributable to changes in the tax regulations of one euro area country, which gave rise to some replacement of inter-company loans with unquoted equity.

The annual growth rate of debt securities issued by non-financial corporations remained modest overall in 2005. After recovering in the first quarter, partly in relation to a rise in merger and acquisition activity, the annual growth rate declined in the second and third quarters and remained modest in the last quarter of 2005. Possible explanations for the generally relatively low debt securities net issuance activity are a substitution of debt securities by loan financing as well as the rise in the profitability of large listed enterprises. At the same time, while the net issuance of debt securities at fixed rates was subdued in 2005, non-financial corporations strongly increased their long-term debt securities issuance at variable rates. Moreover, 2005 was characterised by a high level of redemptions of debt securities issued in the period 1999-2001, when the euro area corporate bond market was booming.

The annual growth rate of quoted shares issued by non-financial corporations increased slightly in 2005, but remained subdued overall, partly as a result of the fact that the real cost of equity was significantly higher than that of debt financing. However, there was a slight rise in the quoted shares issuance of non-financial corporations in the second half of the year.

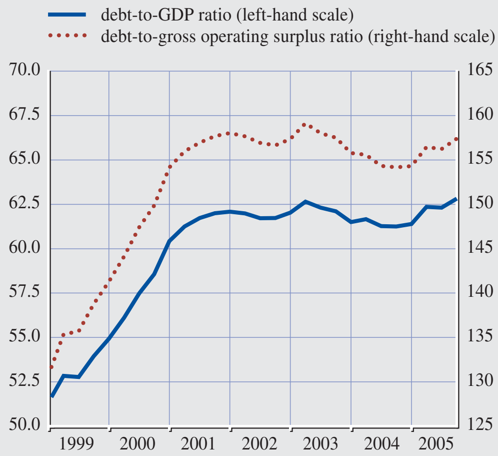
As regards the developments in the balance sheet position of non-financial corporations in the euro area, the rise in the demand for debt financing by non-financial corporations led to a slight increase in the debt ratios of non-financial corporations in 2005, to 63% of GDP at the end of the fourth quarter (see Chart 22). This might indicate that the period of intense balance sheet restructuring of non-financial corporations came to an end in 2005. At the same time, however, it is likely that the situation varies considerably at the individual firm level.

The slight rise in the debt ratios has to be assessed in conjunction with the improved profitability of non-financial corporations and the continued low real cost of external financing by historical standards. In addition, net interest payments of non-financial corporations on their MFI loans and deposits (as a percentage of GDP) remained at a low level.

All in all, despite the slight rise in debt ratios, the balance sheet position of non-financial corporations seems, overall, to have improved in 2005, mainly owing to sound profitability.

Chart 22 Debt ratios of the non-financial corporate sector

(percentages)



Sources: ECB and Eurostat.
Notes: The gross operating surplus relates to gross operating surplus plus mixed income for the whole economy. Debt is reported from the quarterly financial account statistics. It includes loans, debt securities issued and pension fund reserves. Compared with the data compiled on the basis of the annual financial accounts, the debt ratios are somewhat lower here, mainly because of the inclusion of loans granted by banks outside the euro area and a higher coverage of loans granted by non-financial sectors in the annual financial accounts. The last available quarter is estimated.

This is also indicated by the favourable overall developments in credit standards for loans to enterprises, as indicated by the bank lending survey for the euro area, as well as by developments in credit ratings.

2.3 PRICE DEVELOPMENTS

Overall HICP inflation in the euro area averaged 2.2% in 2005, following 2.1% in the previous two years (see Table 1). Underlying domestic inflationary pressures remained low in 2005, partly reflecting the continuation of wage moderation in a context of subdued labour market developments. Higher oil prices were the main factor exerting upward pressures on prices, notably in the second half of the year. However, there were only limited signs of a pass-through of past oil price increases to prices at a later stage of the production chain. At the same time, inflation was dampened by the

Table 1 Price developments

(annual percentage changes, unless otherwise indicated)

	2003	2004	2005	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2005 Dec.	2006 Jan.
HICP and its components										
Overall index	2.1	2.1	2.2	2.3	2.0	2.0	2.3	2.3	2.2	2.4
Energy	3.0	4.5	10.1	8.5	7.6	8.8	12.7	11.1	11.2	.
Processed food	3.3	3.4	2.0	2.8	2.4	1.6	1.8	2.2	1.8	.
Unprocessed food	2.1	0.6	0.8	-0.7	0.5	0.8	0.8	1.4	1.5	.
Non-energy industrial goods	0.8	0.8	0.3	0.8	0.3	0.3	0.1	0.4	0.4	.
Services	2.5	2.6	2.3	2.7	2.4	2.3	2.2	2.1	2.1	.
Other price and cost indicators										
Industrial producer prices 1)	1.4	2.3	4.1	3.8	4.1	3.9	4.2	4.4	4.7	.
Oil prices (EUR per barrel) 2)	25.1	30.5	44.6	34.5	36.6	42.2	50.9	48.6	48.5	52.5
Commodity prices 3)	-4.5	10.8	9.4	1.3	1.9	2.2	11.6	23.2	29.8	23.1

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 euro.

lagged effects of the past euro appreciation and the impact of strong global competition. In addition, the contribution of net indirect taxation and administered prices to HICP inflation was slightly lower in 2005 than in 2004.

HEADLINE INFLATION MAINLY AFFECTED BY OIL PRICE DEVELOPMENTS

The profile of overall HICP inflation was significantly affected in 2005 by developments in the energy component, as oil prices rose strongly (see Chart 23). The average price of a barrel of Brent crude oil in euro increased by around 45% in 2005 compared with 2004. As a consequence, the annual rate of growth in energy prices was 10.1% in 2005, after 4.5% in 2004. The contribution of energy prices to the average annual inflation rate in 2005, 0.8 percentage point, was the highest in five years (see Chart 24).

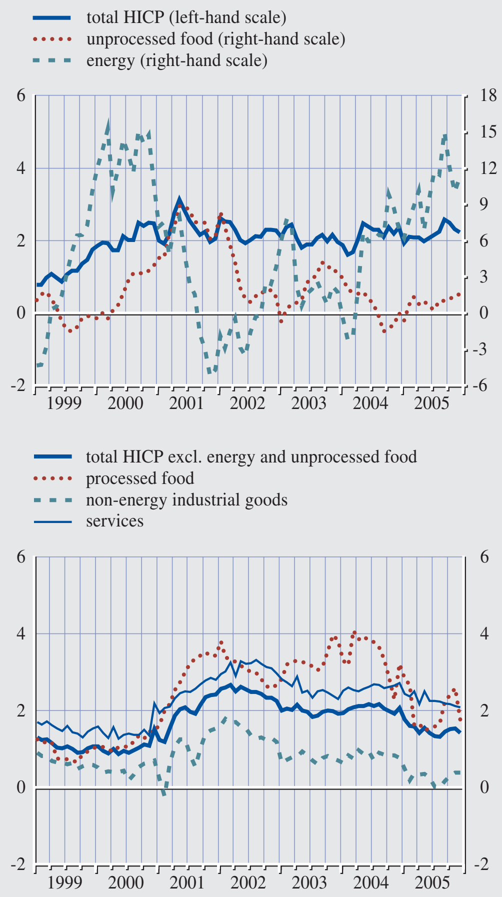
Headline inflation remained close to 2.0% in the first half of 2005. In the second half of the year, largely reflecting developments in oil prices, inflation rose to a peak of 2.6% in September before declining to 2.2% by the end of 2005. The impact of the rise in oil prices on inflation was also reflected in the revisions of inflation expectations in the course of 2005. For example, inflation expectations for 2005 included in the ECB Survey of Professional Forecasters (SPF) increased from 1.9% in the first quarter to 2.2% in the last quarter of 2005. By contrast, SPF long-term inflation expectations remained unchanged at 1.9% in 2005. This pattern was also broadly shared by other survey indicators for short and long-term inflation expectations.

The less volatile components of the HICP played an important role in containing the upward pressures on overall inflation emanating from oil prices. After declining in the first half of 2005, the annual rate of growth of the HICP excluding energy and unprocessed food levelled off in the second half of the year. Overall, the annual rate of growth of the HICP excluding energy and unprocessed food was 1.5% in 2005, down from 2.1% in 2004. Part of this decline is explained by the lower contribution of net indirect taxation and administered prices to overall inflation in 2005, of around 0.4 percentage point, compared with around 0.6 percentage point in 2004.[7] For example, processed food price inflation benefited from favourable base effects in the first half of 2005,

7 For details on the sub-components of HICP used to assess the impact of developments in indirect taxes and administered prices, see the box entitled "The impact of developments in indirect taxes and administered prices on inflation" in the January 2004 issue of the ECB's Monthly Bulletin.

Chart 23 Breakdown of HICP inflation: main components

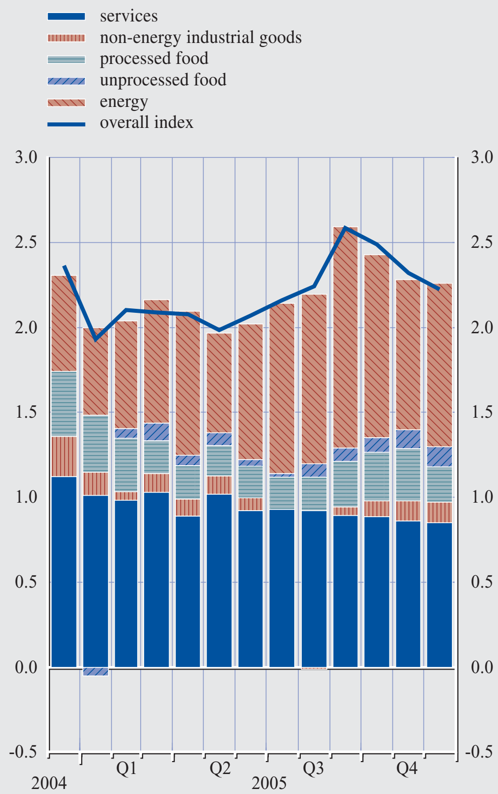
(annual percentage changes; monthly data)



Source: Eurostat.

Chart 24 Contributions to HICP inflation from main components

(annual percentage point contributions; monthly data)



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

reflecting tobacco tax increases in some countries in the first half of 2004. These base effects were only partially offset by a tobacco tax increase in Germany in September 2005. Overall, the annual rate of change of processed food prices was 2.0% in 2005, significantly below the rate of 3.4% in 2004. The annual rate of change in non-energy industrial goods prices also declined, from 0.8% in 2004 to 0.3% in 2005. This historically very low contribution of non-energy industrial goods prices may reflect a downward impact on prices stemming from strong external competition and the lagged effects of the past appreciation of the euro. Despite some short-term variability owing to some volatile components, such as package holidays and transportation services, services price inflation declined in the course of 2005 and was 2.3% on average in 2005, compared with 2.6% in 2004. Overall, in 2005, there was little evidence of significant indirect effects from energy price increases.

The fact that overall HICP inflation was just above 2% in 2005 for the fifth consecutive year highlights the relevance of analysing the determinants of the persistence of inflation. Box 4 presents the main conclusions of the Eurosystem Inflation Persistence Network on inflation persistence and price-setting behaviour in the euro area.

Box 4

RESEARCH NETWORK ON INFLATION PERSISTENCE AND PRICE-SETTING BEHAVIOUR IN THE EURO AREA

The Eurosystem Inflation Persistence Network (IPN) was created in 2003 to analyse the patterns, determinants and implications of inflation persistence and price-setting behaviour in the euro area and in its member countries. Inflation persistence refers to the tendency of inflation to converge only slowly to its long-run value following a shock. The IPN finalised its work in 2005.

The IPN was a joint research project between all the Eurosystem central banks. It used an unprecedented dataset, covering a large amount of information on macroeconomic and sectoral variables and on the price-setting behaviour of individual firms. The individual price records underlying the construction of both consumer and producer price indices were made available for a large number of euro area countries. In addition, the IPN conducted surveys on price-setting behaviour in nine countries. Taken together, these databases constitute a unique opportunity to understand the behaviour of price-setters. They are unprecedented, even by international standards, as the coverage of the data available to the IPN extends well beyond that available for other economies.

The IPN presented its preliminary results at academic conferences in order to receive early feedback from the academic community that could be taken into account in its subsequent work. In the course of 2005 presentations were given at the Annual Meeting of the American Economic Association in Philadelphia and at the Annual Congress of the European Economic Association in Amsterdam. A large number of research papers have been published in the ECB's Working Paper series, with more to follow in the coming months, and some have been released or are forthcoming in peer-reviewed journals.

As to price-setting, the key insights from the IPN are the following. Prices in the euro area are rather sticky, changing on average only once every year.[1] When price adjustments do occur, they tend to be quite large at around 8-10% in the retail sector and about 5% in the producer sector. Interestingly, price increases and price decreases are almost equally frequent and of similar size, with the notable exception of the services sector in which small price increases are common and decreases are very rare. There is marked heterogeneity across sectors, in particular with respect to the frequency of price adjustments. Furthermore, the frequency, size and direction of price changes depend on macroeconomic conditions (such as the inflation rate) and time factors (like seasonality) and are responsive to specific events (such as VAT changes).

Surveys showed that most firms undertake price reviews both at regular intervals and in response to changing economic conditions. Price reviews are more frequent than price changes, which may be because the reviews suggest that there is no need to change prices or because of factors preventing price changes even if the reviews suggest doing so. The surveys conducted by the IPN found evidence of some impediments to changing prices, with explicit or implicit contracts between firms and their customers and the strategic interactions among firms being the most important factors.

1 This is much less frequent than price changes in the United States, for example. For a more detailed overview of these results, see the article entitled "Price-setting behaviour in the euro area" in the November 2005 issue of the ECB's Monthly Bulletin.

A further key finding of the IPN is that the degree of inflation persistence increases with the level of aggregation. Individual or highly disaggregated price series are, on average, much less persistent than aggregate series. Empirical estimates point to a moderate degree of inflation persistence under the current monetary policy regime; it is important, however, to take account of earlier occasional shifts in the mean level of inflation in estimates that cover extended periods. Nevertheless, even when this is done, such estimates continue to be surrounded by a fair degree of uncertainty.

Overall, the results of the IPN have considerably advanced the knowledge of inflation persistence and price-setting behaviour in the euro area. There are important policy implications and consequences for model-building, as several of the most commonly used assumptions in macroeconomic models with microeconomic foundations are strongly challenged by the new findings. With respect to policy, the results highlight how important it is for central banks to ensure that inflation expectations are well-anchored, as this will reduce inflation persistence and thus facilitate the conduct of monetary policy.

DYNAMIC RESIDENTIAL PROPERTY PRICES

Euro area residential property prices, which are not included in the measurement of the HICP, continued to rise in 2005, increasing by 7.7% (year on year) in the first half of 2005 compared with 7.0% for 2004 as a whole (see Chart 25). This strong overall growth, however, masked considerable diversity at the country level. The recent dynamism largely reflects buoyant residential property markets in Spain, France and Italy, whereas residential property prices slightly declined in Germany. Available quarterly data for the second half of 2005 continued to show strong price increases in the case of Spain and France, albeit at a slightly more moderate pace than before.

LIMITED INDIRECT EFFECTS AT LATER STAGES OF THE PRODUCTION CHAIN

The annual rate of growth of industrial producer prices (excluding construction) in the euro area was 4.1% in 2005, significantly above the 2.3% rate recorded in 2004 (see Chart 26). This increase was mainly due to energy prices as the annual rate of growth of industrial producer prices excluding energy (and construction) stood at 1.8% in 2005, compared with 2.0% in 2004.

This overall stability in the annual growth rate of industrial producer prices excluding energy masked diverging developments at the sub-sector level. The annual growth rate of capital goods prices stood at 1.3% in 2005, compared with 0.7% in 2004. These upward pressures were partly offset by a strong deceleration in intermediate goods prices, partly reflecting non-oil raw material price developments and also lagged effects of the past euro appreciation. The annual growth rate of intermediate goods prices dropped from 5.5% in January 2005 to 1.9% in December 2005 and averaged 2.9% in 2005 compared with 3.5% in 2004.

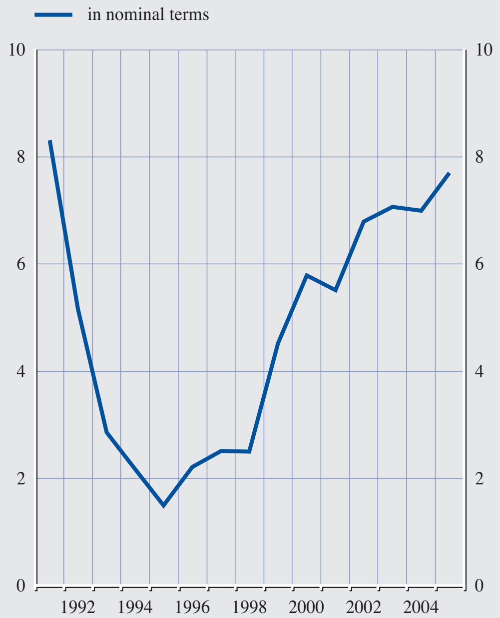
There was little sign of significant price pressures building up at later stages of the production chain. Producer prices of consumer goods grew by 1.1% in 2005, down from 1.3% in 2004. Weak consumer demand, increased external competition and the past appreciation of the euro may have prevented firms from passing on increases in energy and, to a lesser extent, intermediate goods prices.

MODERATE DEVELOPMENTS IN LABOUR COSTS IN 2005

Growth in compensation per employee showed a significant decline in the first three quarters of 2005, with an average annual growth rate of 1.5% compared with 2.0% in 2004 (see Table 2). This decline was mainly driven by wage developments in industry

Chart 25 Residential property prices

(annual percentage changes; annual data)



Source: ECB calculations, based on non-harmonised national data.
Note: Data for 2005 refer to the first half of the year.

Chart 26 Breakdown of industrial producer prices

(annual percentage changes; monthly data)

Source: Eurostat.

excluding construction and, to a lesser extent, in the services sector (see Chart 27). However, within the services sector, developments diverged. While growth in compensation per employee in the market-related services sector increased in the first three quarters of 2005, with an average annual growth rate of 1.8% compared with 1.5% in 2004, the growth in the non-market-related services sector declined significantly, with an average annual growth rate of 0.8% compared with 2.1% in 2004.

Other labour cost indicators also suggest moderate wage growth. The annual growth rate of negotiated wages was 2.1% in 2005, unchanged compared with 2004. In addition, anecdotal evidence from wage-bargaining agreements signed in the period up to late 2005

Table 2 Labour cost indicators

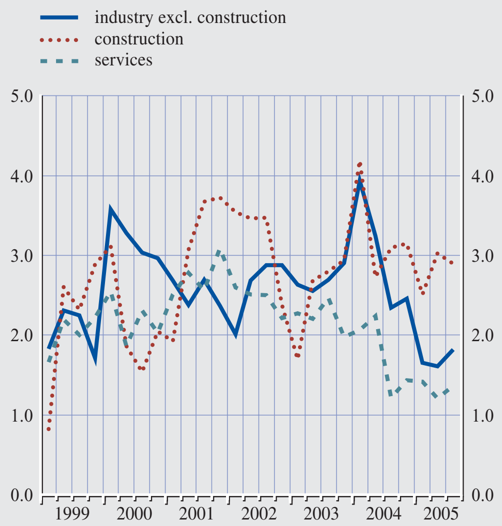
(annual percentage changes, unless otherwise indicated)

	2003	2004	2005	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4
Negotiated wages	2.4	2.1	2.1	2.0	2.2	2.1	2.1	2.0
Total hourly labour costs	3.0	2.5	.	2.4	3.2	2.5	2.2	.
Compensation per employee	2.3	2.0	.	1.7	1.5	1.4	1.6	.
Memo items								
Labour productivity	0.5	1.1	.	0.7	0.4	0.5	0.9	.
Unit labour costs	1.8	0.9	.	1.1	1.1	0.9	0.7	.

Sources: Eurostat, national data and ECB calculations.

Chart 27 Sectoral compensation per employee

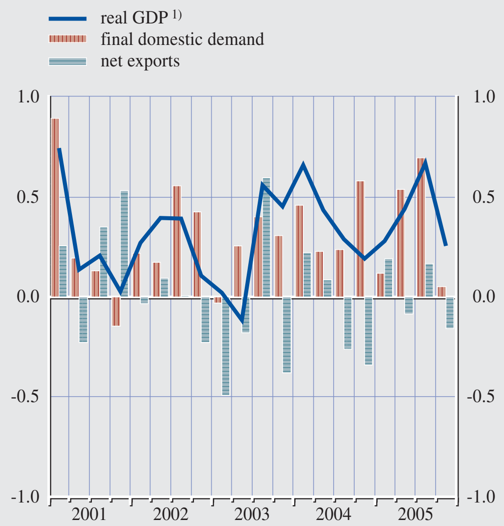
(annual percentage changes; quarterly data)



Sources: Eurostat and ECB calculations.

Chart 28 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.

in several euro area countries did not suggest the emergence of significant second-round effects from higher oil prices beyond the mechanical effects of wage-indexation schemes in countries where they exist. Overall, with ongoing moderate real GDP growth and limited pressure in euro area labour markets, wage developments remained subdued in 2005.

Despite the fall in wage growth, unit labour cost growth remained unchanged in 2005. Unit labour costs grew by an average of 0.9% in the first three quarters of 2005, as in 2004. This reflected the decline in productivity growth rates, which averaged 0.6% in the first three quarters of 2005, compared with 1.1% in 2004.

2.4 OUTPUT, DEMAND AND LABOUR MARKET DEVELOPMENTS

SLOWER ECONOMIC GROWTH IN 2005

Real GDP growth in the euro area (partly adjusted for the number of working days) was 1.4% in 2005, below the 1.8% recorded in the previous year and the trend rate of growth in potential output (see Table 3). The lower than expected performance in 2005, continuing the moderate growth in economic activity observed since mid-2004, reflected oil price strength, the lagged effects of the appreciation of the euro in 2004 and a temporary slowdown in global demand in the first half of 2005.

The pace of the recovery that started in the third quarter of 2003, following the protracted period of slow growth from mid-2001 to mid-2003, has been relatively weak compared with recovery periods in the early 1980s and early 1990s. Several factors may explain this. First, unlike previous recoveries, the current phase

Table 3 Composition of real GDP growth

(percentage changes, unless otherwise indicated; seasonally adjusted)

	Annual rates 1)								Quarterly rates 2)				
	2003	2004	2005	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4
Real gross domestic product	0.7	1.8	1.4	1.6	1.2	1.2	1.6	1.7	0.2	0.3	0.4	0.7	0.3
of which:													
Domestic demand 3)	1.3	1.8	1.6	1.9	1.6	1.7	1.7	1.6	0.5	0.1	0.5	0.5	0.4
Private consumption	1.0	1.4	1.4	1.9	1.3	1.5	1.9	0.8	0.9	0.1	0.3	0.5	-0.2
Government consumption	1.7	1.1	1.3	0.7	0.8	1.2	1.6	1.7	0.0	0.0	0.8	0.9	0.0
Gross fixed capital formation	0.8	1.8	2.2	1.6	1.2	1.9	2.7	3.2	0.4	0.2	1.0	1.1	0.8
Changes in inventories 4)	0.2	0.3	0.1	0.4	0.4	0.2	-0.3	0.1	0.0	0.0	0.0	-0.2	0.4
Net exports 3)	-0.6	0.0	-0.2	-0.3	-0.3	-0.5	-0.1	0.1	-0.3	0.2	-0.1	0.2	-0.2
Exports 5)	1.2	5.9	3.9	5.8	3.1	2.6	4.9	5.1	0.3	-0.9	2.0	3.4	0.5
Imports 5)	3.0	6.2	4.7	7.1	4.3	4.2	5.4	5.0	1.3	-1.5	2.3	3.1	0.9
Real gross value added													
of which:													
Industry excl. construction	0.2	1.6	1.3	0.6	0.4	0.6	1.4	2.6	-0.5	0.2	0.8	0.9	0.6
Construction	0.9	1.8	1.7	1.2	-0.4	1.4	2.4	3.1	0.6	-0.5	1.9	0.5	1.3
Purely market-related services 6)	0.9	1.8	2.1	2.0	2.2	1.9	2.1	2.0	0.3	0.6	0.6	0.5	0.2

Sources: Eurostat and ECB calculations.
Note: The figures reported are seasonally and partly working day-adjusted, as not all euro area countries report quarterly national account series adjusted for the number of working days.
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.

has been marked by very strong oil price increases and a significant appreciation of the euro. Second, there is tentative evidence that potential output growth has declined over recent years, mainly as a result of lower labour productivity growth. Third, it should also be taken into account that the slowdown preceding the recovery was relatively shallow. To the extent that the strength of the rebound tends to depend on the depth of the previous downturn, it is not surprising that the current recovery is to some extent less dynamic than previous recoveries.[8]

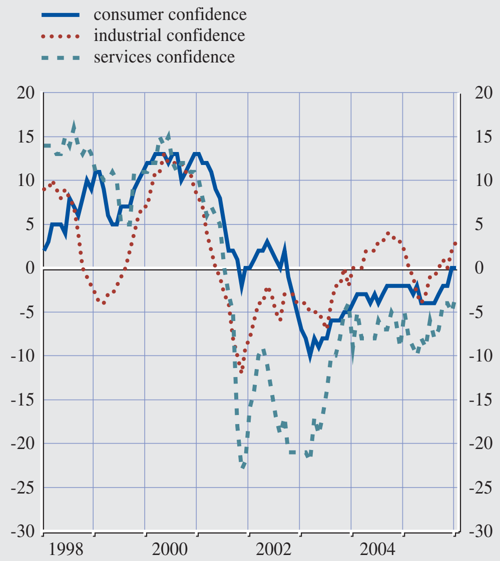
The moderation in growth in 2005 as a whole can be attributed to a lower contribution of both the external sector and internal domestic demand. Growth in both domestic demand and exports in 2005 was below expectations at the end of 2004 (see Chart 28).

As regards the domestic contribution to growth, growth in private consumption continued to be subdued in 2005 (see Table 3). This was partly a result of low increases in real disposable income, reflecting restrained growth in nominal income and the rise in energy prices. These effects were not offset by lower household savings, possibly because employment expectations remained relatively pessimistic. Concerns about the sustainability of pension and healthcare systems may also have played a role, together with the fact that low-income earners, with a higher marginal propensity to consume, may have been disproportionately affected by weak income growth and shocks to the prices of necessity goods and services.

8 See also the box entitled "The current euro area recovery from a historical perspective" in the November 2005 issue of the ECB's Monthly Bulletin.

Chart 29 Confidence indicators

(percentage balances, seasonally adjusted)



Source: European Commission Business and Consumer Surveys.
Notes: All data are seasonally adjusted. Data shown are calculated as deviations from the average over the period since January 1985 for consumer and industrial confidence, and since April 1995 for services confidence.

Consumer confidence remained subdued in 2005, although it showed signs of improvement towards the end of the year (see Chart 29).

Investment growth in the first half of 2005 was significantly below that observed in the second half of 2004. This deceleration was mainly due to lower growth in non-construction investment, predominantly attributable to a negative development in the transportation sector.

However, gross fixed capital formation grew more strongly from mid-2005 onwards. Factors supporting investment in 2005 included improvements in business efficiency, robust corporate earnings, the very favourable financing conditions and growth in global demand.

A sectoral breakdown of economic growth in 2005 shows that value added in industry (excluding construction), construction and the services sector contributed positively to growth. Value added growth in the market services sector was higher than in 2004. However, in industry excluding construction it was lower. Industrial and services confidence deteriorated in the first half of 2005, although it improved in the second half (see Chart 29). The services sector has significantly increased in importance over recent decades and its contribution to the euro area economy is expected to grow further in the years to come. Box 5 describes the sectoral composition of euro area growth, providing a more detailed analysis of developments in the services sector.

Box 5

THE SECTORAL COMPOSITION OF EURO AREA GROWTH

This box provides an overview of sectoral structure of the euro area economy and of sectoral shifts in recent years. It also discusses the contributions to growth of value added in the euro area and to volatility by the main economic sectors in recent years and explores whether the relative weakness of the current recovery in comparison with former upswings is linked to developments in specific sectors.

The sectoral breakdown of value added highlights the prominent role of the services sector in the euro area (see Chart A). With a share of around 70%, the services sector represents by far the largest economic sector in the euro area. The industrial sector, which comprises mainly manufacturing (but also mining and quarrying, and the electricity, gas and water supply industries), accounts for around 20% of euro area value added. Construction and agriculture have shares of only 6% and 2%, respectively.

Chart A Breakdown of total real gross value added [1)]

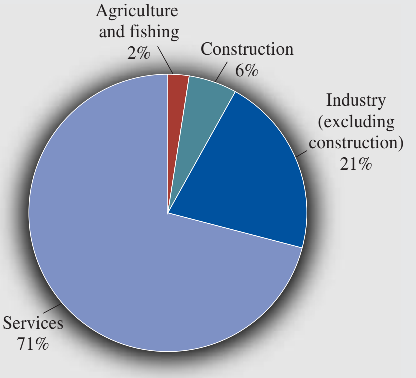
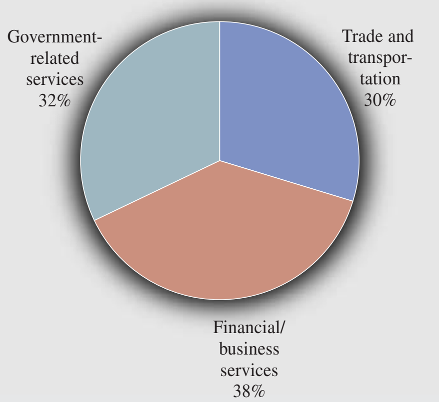


Chart B Breakdown of services real gross value added [1)]



Source: Eurostat.
1) Weights refer to the year 2005.

The services sector, in turn, is generally broken down further into three main categories of roughly equal size, namely trade and transportation, financial and business services and a sector that comprises mainly government-related services (see Chart B). Although this breakdown does not provide for any strict separation between private and public services, the categories comprising trade and transportation, and financial and business services are usually referred to as the market services sectors.

In line with trend developments generally observed for developed economies, the euro area economy has undergone significant structural changes. This is reflected in the fact that the services sector has increased significantly in importance, while the share of the industrial sector has declined continuously. Since 1996, for instance, the share of the services sector in total value added has risen by around 3 percentage points, while that of the industrial sector has decreased by 2 percentage points. A number of factors may account for the rising share of the services sector. These include a shift in consumer demand towards services as income rises, the liberalisation of the services sector, and the increasing participation of women in the labour market, which implies some shifts from household to services activities.

The changes in the share of value added accounted for by individual euro area sectors reflect significant differences in sectoral growth performance. As regards business services, the outsourcing of some activities by firms in the industrial sector may also partly explain the rise in the services sector. This development also strengthens ties between the two sectors. The table shows that, on average since the beginning of the 1990s, real gross value added in the euro area has increased by 0.5%, quarter on quarter. Services grew at the same rate, driven in particular by growth in market services. Industry (excluding construction) expanded by 0.3%, on average, while construction recorded the lowest rate of increase, at just 0.1%. As a result of their size and strong performance, services were the main contributor to the rise in euro area value added. On average since the mid-1990s, services have contributed 0.4 percentage point to the growth of euro area value added, compared with an average contribution of just 0.1 percentage point by the industrial sector.

Sectoral developments in terms of euro area real gross value added

(averages over the respective periods)

	Quarter-on-quarter growth (percentages) (1991 to 2005)	Standard deviation (of quarter-on-quarter growth) (1991 to 2005)	Contributions to quarter-on-quarter growth (percentage points) (1996 to 2005)	Average absolute contributions to the change in quarter-on-quarter growth (percentage points) (1996 to 2005)
Services	0.5	0.3	0.4	0.2
Trade and transportation services	0.5	0.6	0.1	0.1
Financial and business services	0.7	0.4	0.2	0.1
Government-related services	0.4	0.3	0.1	0.0
Industry (excluding construction)	0.3	1.0	0.1	0.2
Construction	0.1	1.7	0.0	0.1
Agriculture	0.4	1.6	0.0	0.0
Total	**0.5**	**0.4**	**0.5**	**-**

Sources: Eurostat and ECB computations.

Significant differences between sectors also arise in terms of the volatility of growth in value added. Growth in value added in services displays far lower volatility than that in other sectors (as measured in terms of the standard deviation). Nevertheless, on account of its size, the services sector has on average contributed about as much to the volatility of growth in value added since the mid-1990s as the industrial sector.

In view of the substantial differences between the average growth performance of the main sectors in the euro area, the question arises as to the extent to which sectoral developments may have contributed to the relative weakness of the current recovery when put in a historical perspective. The recovery that started in mid-2003 lost momentum in the second year of the upswing, before gaining further strength in the third quarter of 2005. Charts C and D compare the developments in the services and industrial sectors in the current recovery with those in the two previous upswings. They show that the relative weakness in the second year of this recovery was not due to weak

Chart C Value added in the euro area services sector

(index, T=100)

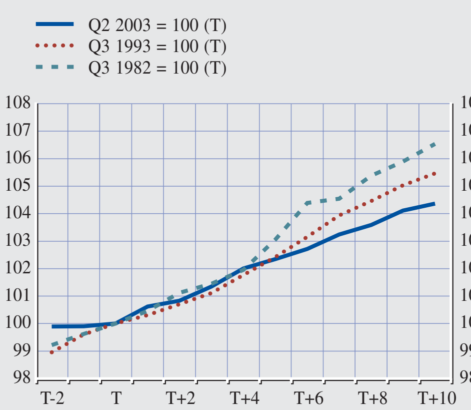
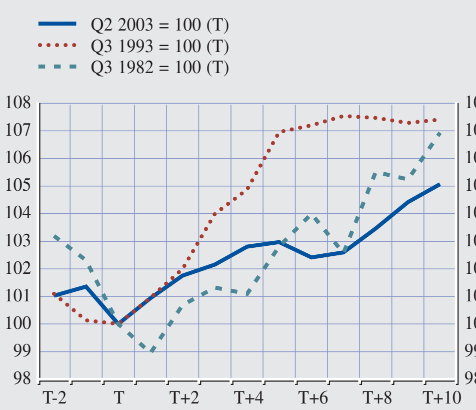


Chart D Value added in the euro area industrial sector

(index, T=100)



Source: ECB calculations based on Eurostat data.
Note: The recovery starts in T+1, where quarter T is the trough as defined by the Euro Area Business Cycle Dating Committee of the Centre for Economic Policy Research (see http://www.cepr.org/data/Dating), except for the latest recovery, which is identified on the basis of the pattern of real quarter-on-quarter GDP growth.

developments in any specific sector. In fact, the pattern of the relative performance in both the industrial and services sectors followed that of overall GDP. In both sectors, there were no clear divergences in the first year of the current recovery in comparison with average developments in the two previous recoveries. In the second year of the recovery, however, the growth of value added in both sectors was weaker than on average in the two previous recoveries. The charts moreover illustrate the much more volatile nature of developments in the industrial sector compared with the services sector. A number of factors are likely to have played a role in the relative weakness of growth in the second year of this recovery, including lower trend output growth, shocks to both the exchange rate of the euro and oil prices, and uncertainties about ongoing reforms in some euro area economies (see Box 5 entitled "The current euro area recovery from a historical perspective" in the November 2005 issue of the ECB's Monthly Bulletin).

Overall, the sectoral composition of growth in euro area value added highlights the importance of the services sector in the euro area. The services sector is by far the largest economic sector in the euro area. It has grown considerably in importance over recent decades, a process which is very likely to continue, and now contributes about as much to overall volatility in the growth of value added as the industrial sector. Accordingly, when compared with previous upturns, the weaker growth in the second year of the current recovery, i.e. from mid-2004 to mid-2005, has been broadly shared by the main euro area sectors.

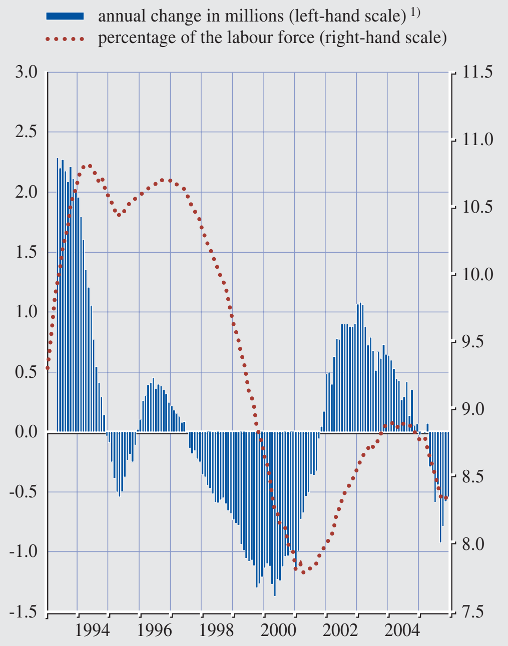
Various dispersion measures indicate that the divergence of real GDP growth rates among euro area countries remained roughly unchanged in 2005. Reflecting in part a moderation in global economic growth and trade and the rise in oil prices, average annual real GDP growth declined or remained practically unchanged in all euro area countries in 2005 compared with the year before, except in Spain, where it increased somewhat and remained relatively strong.

ONGOING IMPROVEMENTS IN THE LABOUR MARKET

Employment rose throughout the year at a similar pace to that recorded in 2004 (see Table 4). At the sectoral level, employment rose strongly in the services and construction sectors while continuing to decline in industry (excluding construction) and in agriculture. Survey indicators for employment prospects in both the services and industrial sectors also increased markedly towards the end of the year. In light of the subdued economic activity in 2005, it is likely that the impact of recent labour market policy

Chart 30 Unemployment

(monthly data; seasonally adjusted)



Source: Eurostat.
Note: Data for all years refer to all 12 euro area countries.
1) Annual changes are not seasonally adjusted.

Table 4 Labour market developments

(percentage changes compared with the previous period; percentages)

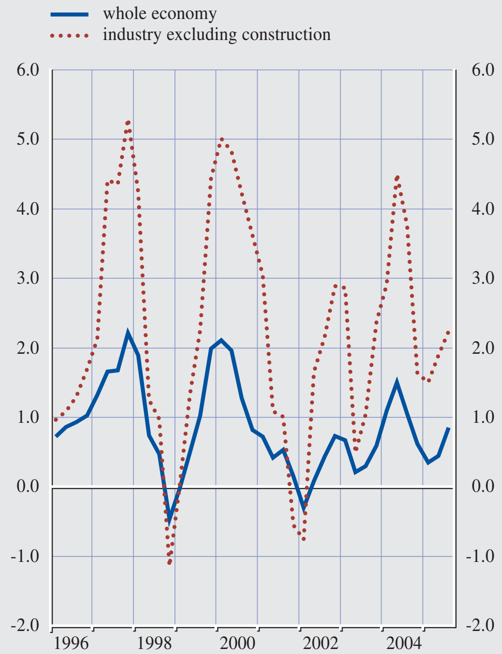
	2003	2004	2005	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4
Labour force	0.8	0.9	.	0.1	0.2	0.2	0.3	0.3	0.2	0.0	0.0	0.0	.
Employment	0.3	0.7	.	0.1	0.1	0.2	0.3	0.3	0.2	0.0	0.2	0.3	.
Agriculture 1)	-2.2	-1.0	.	-0.3	-0.3	-0.3	-0.3	0.1	-0.4	-1.1	-0.2	-0.7	.
Industry 2)	-1.1	-0.9	.	-0.4	-0.4	-0.5	0.2	-0.1	0.0	-0.6	0.0	0.0	.
– excl. construction	-1.5	-1.6	.	-0.5	-0.6	-0.7	0.1	-0.5	0.1	-0.8	-0.1	-0.1	.
– construction	0.0	0.8	.	-0.4	0.1	0.1	0.5	1.1	-0.3	-0.0	0.3	0.4	.
Services 3)	0.9	1.4	.	0.3	0.3	0.5	0.3	0.4	0.4	0.4	0.2	0.4	.
Rates of unemployment 4)													
Total	8.7	8.9	8.6	8.7	8.8	8.9	8.9	8.9	8.8	8.8	8.6	8.4	8.3
Under 25 years	17.6	17.9	17.7	17.6	18.1	17.9	18.1	17.9	18.0	18.3	17.6	17.2	17.5
25 years and over	7.5	7.6	7.3	7.5	7.6	7.6	7.6	7.6	7.6	7.5	7.4	7.2	7.1

Sources: Eurostat and ECB calculations.
1) Also 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.

measures facilitating the expansion of part-time work and self-employment are playing a key role.

Chart 31 Labour productivity

(annual percentage changes)



Source: Eurostat.

The unemployment rate in the euro area declined steadily in 2005, to reach 8.3% at the end of the year (see Chart 30). The unemployment rate for workers under 25 fell significantly. Following an increase in the non-accelerating inflation rate of unemployment (NAIRU) between the 1970s and the mid-1990s, which largely reflected adverse shocks and rigid labour market institutions in most euro area countries, NAIRU estimates have been lowered slightly over the last decade.[9] This reduction has been attributed above all to the impact of labour market reforms in some euro area countries (see Box 6 for further details). While several countries have made significant progress towards making their labour markets more flexible, in many countries more ambitious reforms are needed. Only a more determined commitment to structural labour market reforms will allow unemployment rates to be significantly reduced in the years ahead without endangering price stability.

Labour productivity growth remained subdued in 2005 (see Chart 31). Productivity growth in the industrial sector (excluding construction)

9 See also the box entitled "A longer-term perspective on structural unemployment in the euro area" in the August 2005 issue of the ECB's Monthly Bulletin.

remained above productivity growth for the economy as a whole. Euro area productivity growth in recent years has been disappointing. It has declined from above 2% in the 1990s to slightly above 1% more recently. Lower productivity growth in the euro area has been partly related to higher employment, but it also reflects an insufficient use of new productivity-enhancing technologies. A breakdown of labour productivity growth in recent years also shows that lower labour quality is playing a role in explaining labour productivity growth.[10] Tentative empirical evidence links the relatively poor productivity performance in the euro area countries to a lack of competition and to employment protection legislation.[11] Looking ahead, this suggests that policies in the area of human capital should be geared towards enhancing educational attainment and providing more on-the-job training. There is also a clear need for economic policies that stimulate innovation and promote the use of productivity-enhancing technologies.

10 See G. Schwerdt and J. Turunen, "Growth in euro area labour quality", ECB Working Paper No 575, January 2006.
11 See G. Nicoletti and S. Scarpetta, "Regulation and economic performance: product market reforms and productivity in the OECD", OECD Economics Department Working Paper No 460, November 2005.

Box 6

PROGRESS WITH STRUCTURAL REFORMS IN EU LABOUR AND PRODUCT MARKETS

Intensified competition, rapid technological change and the ageing of the population imply that European countries must tackle new challenges and turn them into opportunities. With regard to labour and product markets, those challenges include increasing labour market flexibility, enhancing the skills of the labour force, completing the Single Market (including for services), promoting innovation and strengthening the business environment. This calls for structural reforms to enhance Europe's economic growth potential, promote job creation, facilitate adjustment and increase resilience to shocks.

In response to these challenges, the spring 2005 European Council agreed that the Commission, the Council and the Member States should relaunch the Lisbon strategy – the ambitious reform agenda introduced in March 2000 – with a renewed focus on sustainable growth and jobs.[1] In this context, and after a proposal from the Commission, the ECOFIN Council adopted in 2005 the "Integrated Guidelines for Growth and Jobs", covering both the new Broad Economic Policy Guidelines and the new Employment Guidelines, for a three-year period (2005-08). These guidelines for economic and employment policies call, inter alia, for structural reforms to improve the functioning of labour and product markets in the EU. Based on the Integrated Guidelines, the Member States have prepared national reform programmes setting out their planned structural reforms for the period 2005-08 (see Section 1 of Chapter 4). A parallel Community Lisbon Programme was adopted by the Commission in July 2005 to complement the national reform programmes, with action to be taken at the European level.

Improving the performance of labour markets is one of the most important priorities in the national reform programmes. With 20 million people still unemployed in the EU, progress in raising employment rates and reducing unemployment rates has so far been slow. Although Member States have announced many reform measures to improve labour market performance, it seems that more urgent action is needed to meet the Lisbon strategy's employment targets. In

1 See the article entitled "The Lisbon strategy – five years on" in the July 2005 issue of the ECB's Monthly Bulletin.

particular, participation and employment rates of female workers, younger workers under the age of 25 and older workers over the age of 55 need to increase. Against this background, in 2005 Member States aimed their labour market policies mainly at affecting labour supply by providing incentives for more people to enter the labour market. Most of the policy measures concerned labour taxation, active labour market policies and unemployment and welfare-related benefits. Most measures adopted in the field of labour taxation were aimed at reducing the tax burden on labour so as to stimulate employment by lowering labour costs. With regard to active labour market policies, several countries restructured their public employment services. In the area of unemployment and welfare-related benefits, various measures were taken, aiming at more targeted interventions, tighter controls and stricter eligibility conditions. Some EU countries have so far reported overall positive effects on their labour markets from opening up their borders to migrant workers from the new Member States. At the same time, few reforms were launched with regard to early retirement schemes.

Europe also risks losing ground if the business climate is not improved in terms of competition and regulation. Goods, services and energy markets, including the network industries, are still not fully competitive. Generally, the process of improving regulation at the national and EU levels has gained momentum. With regard to services, the implementation of the Directive on services in the internal market will constitute an important step towards completing the internal market. However, more action is needed to remove barriers to entry and to ensure a proper functioning of markets, including for the network industries.

Labour and product market reforms need to be complemented by reforms creating the right climate for knowledge development and innovation. In terms of R&D spending, however, the EU is low in international rankings. Spending as a share of GDP has been more or less stagnant since 2001, at around 1.9% of GDP. This is well below the Lisbon target of 3%. While in their national reform programmes many Member States plan a significant increase in overall R&D expenditure by 2010, in the medium to long run more efforts are needed to promote private R&D spending in particular. Regarding education, this area needs more emphasis in order to keep developments in labour quality consistent with the aims of the Lisbon strategy.

To sum up, some further progress with structural reforms was made in 2005. The reform measures initiated in the context of the renewed Lisbon strategy, as subsequently announced in the Community Lisbon Programme and the national reform programmes, are a welcome additional step in the right direction. On the basis of these programmes, the overall pace of reform now needs to be stepped up.

2.5 FISCAL DEVELOPMENTS

BUDGETARY DEVELOPMENTS DISAPPOINTING IN 2005

Fiscal developments in the euro area throughout 2005 showed very little progress towards a position of sound public finances. According to the latest data available from Member States' updated stability programmes, the euro area deficit shrank slightly to 2.5% of GDP, which was not sufficient to prevent a further increase in the average debt-to-GDP ratio (see Table 5). The estimated budgetary outcome for 2005 reflected some fiscal tightening in an environment of moderate economic growth.

Several countries missed the budgetary targets set out in their updated stability programmes at the end of 2004 and in the first half of 2005. The expected outcomes fell short of the target values by an average of 0.2 percentage point of GDP, partly as a result of lower than expected economic

Table 5 Fiscal positions in the euro area

(as a percentage of GDP)

General government surplus (+)/deficit (-)	2002	2003	2004	Stability programme data for 2005
Euro area	**-2.5**	**-3.0**	**-2.7**	**-2.5**
Belgium	0.0	0.1	0.0	0.0
Germany	-3.8	-4.1	-3.7	-3.3
Greece	-4.9	-5.7	-6.6	-4.3
Spain	-0.3	0.0	-0.1	1.0
France	-3.3	-4.1	-3.7	-3.0
Ireland	-0.6	0.2	1.4	0.3
Italy	-2.7	-3.2	-3.2	-4.3
Luxembourg	2.1	0.2	-1.2	-2.3
Netherlands	-2.0	-3.2	-2.1	-1.2
Austria	-0.4	-1.2	-1.0	-1.9
Portugal	-2.8	-2.9	-3.0	-6.0
Finland	4.3	2.5	2.1	1.8

General government gross debt	2002	2003	2004	Stability programme data for 2005
Euro area	**69.2**	**70.4**	**70.8**	**71.0**
Belgium	105.8	100.4	96.2	94.3
Germany	61.2	64.8	66.4	67.5
Greece	111.6	108.8	109.3	107.9
Spain	53.2	49.4	46.9	43.1
France	58.8	63.2	65.1	65.8
Ireland	32.4	31.5	29.8	28.0
Italy	108.3	106.8	106.5	108.5
Luxembourg	6.8	6.7	6.6	6.4
Netherlands	51.3	52.6	53.1	54.4
Austria	66.7	65.1	64.3	63.4
Portugal	56.1	57.7	59.4	65.5
Finland	42.3	45.2	45.1	42.7

Sources: European Commission (for 2002-04), 2005-06 updated stability programmes (for 2005) and ECB calculations.
Note: Data are based on the excessive deficit procedure definition. Budget balances exclude proceeds from the sale of UMTS licences.

growth, but also because of some consolidation shortfalls and spending overruns in certain countries. The estimated shortfalls were particularly pronounced in some of the countries which already had large deficits. The deterioration of budgetary positions in 2005 is also apparent in the increase in the number of countries that registered deficit ratios above the reference value of 3% of GDP as compared with the 2004 stability programme updates. Four countries' deficits are estimated to have been above the reference value (i.e. those of Germany, Greece, Italy and Portugal), although the stability programmes had foreseen only two countries being above this level. With the exception of Portugal, where significant temporary measures were used to keep the deficit at or below 3% of GDP between 2002 and 2004, these countries have been recording deficits above the reference value for the greater part of the period since the introduction of the euro in 1999. Germany is expected to record a deficit ratio of 3.3% of GDP for 2005, while France is expected to post 3.0%. The German deficit thus remained above 3% of GDP for the fourth year in a row. Following substantial statistical revisions in 2004, it became apparent that, according to ESA 95 methodology, Greece had been recording deficits above the reference value since 1997, and a deficit level of 4.3% of GDP is expected for 2005. Italy also exceeded the reference value by a significant margin in 2005, estimating a deficit ratio of 4.3% of GDP. Portugal virtually doubled its deficit by comparison with 2004, reaching 6.0% of GDP after its significant temporary policy measures had come to an end.

The budgetary outcome for the euro area as a whole showed a somewhat restrictive fiscal policy stance. Estimated real GDP growth was below potential, implying that the business cycle had a negative impact on budgetary developments. Interest payments remained stable, reflecting historically low interest rates and a favourable financial environment.

While consolidation needs varied widely across the euro area, with cyclically adjusted fiscal balances for individual countries estimated to have ranged from a surplus of around 2.5% of GDP to a deficit of around 5% of GDP, structural improvements in the public finance position continued to fall short of the required level in a number of countries. Deficit-reducing temporary measures and one-off effects blur the picture somewhat – although less than in previous years – and, by definition, have not led to sustained improvements. For the euro area as a whole, both government expenditure and revenue are estimated to have risen slightly as a percentage of GDP. Cuts in direct taxes and social contributions broadly offset the limited degree of spending restraint and the increases in indirect taxes observed in 2005.

The euro area debt-to-GDP ratio is expected to have increased in 2005 for the third year in a row, standing at 71.0% of GDP. That increase was driven by a low primary surplus ratio, by the fact that economic growth was lower than the implicit average interest rate on public debt and, in some cases, by debt-increasing stock-flow adjustments. The majority of euro area countries recorded debt ratios above the reference value of 60% of GDP. In many cases, the debt-to-GDP ratio continued to rise. Italy, with debt estimated at 108.5% of GDP, had the highest ratio in the euro area. Greece's debt ratio fell only marginally, with debt remaining above 100% of GDP in 2005. Three other countries above the reference value of 60% of GDP (i.e. Germany, France and Portugal) are not expected to have reduced their debt-to-GDP ratios. While Belgium is estimated to have recorded a balanced budget again in 2005, partly owing to temporary measures, the reduction in its debt ratio slowed considerably owing to sizeable deficit-debt adjustments. The continuation of significant budgetary imbalances and the adverse debt dynamics in the euro area were also reflected in the volume of issuance of general government debt securities (see Box 7).

Box 7

DEVELOPMENTS IN GENERAL GOVERNMENT DEBT SECURITIES ISSUANCE IN THE EURO AREA

Issuance of general government debt securities continued to be strong in 2005, as governments' financing needs to fund their budget deficits increased. By 1999, when Stage Three of EMU began, most euro area countries had only small budgetary imbalances, or even surpluses, and the borrowing needs of these countries were therefore low. However, from 2000 onwards budgetary positions started to deteriorate, partly as a result of worsening economic conditions, and consequently the gross borrowing requirements of euro area countries increased. This development is reflected in both the increase in the debt-to-GDP ratio and the annual growth

Table A Annual growth rates of debt securities issued by euro area governments

(percentages; end of period)

	1998	1999	2000	2001	2002	2003	2004	2005
Total general government	4.3	3.6	2.5	2.7	4.1	4.7	5.0	4.1
Long-term	*6.3*	*5.7*	*3.3*	*2.2*	*2.9*	*3.9*	*5.7*	*4.8*
Fixed rate			5.1	5.2	3.9	5.0	6.1	4.7
Floating rate			-4.0	-16.2	-9.4	-5.5	5.1	9.3
Short-term	*-10.5*	*-16.0*	*-7.1*	*8.8*	*19.1*	*13.4*	*-1.3*	*-3.3*

Source: ECB.

rate of debt securities issued by the general government sector in the euro area. The latter rate stood at around 4.5%, on average, in the last four years (see Table A).

An analysis of the structure of outstanding general government debt securities reveals that government debt issuance is predominantly undertaken by central government, which accounted for 93.8% of outstanding debt securities in December 2005, with other general government responsible for the remaining 6.2%. Nevertheless, the other general government sector has been becoming more active. Between 1998 and 2005 the share of debt securities issued by central government steadily declined, while the share of debt securities issued by other general government doubled (see Table B).

Countries continued to have a long-term orientation in their debt management. An important factor making the issuance of long-term debt securities by governments more attractive was the low level of interest rates. In fact, long-term debt accounted for 92.3% of outstanding debt securities at the end of 2005, while the share of short-term debt securities was only 7.7%. This is also consistent with the negative growth rate of short-term debt securities observed in 2005. The annual growth rate of long-term debt securities declined somewhat in 2005, to 4.8%, from 5.7% in 2004.

Table B indicates that the vast majority of long-term general government debt securities were issued at a fixed rate. Over time, the share of long-term floating rate debt securities has decreased substantially, from 11.9% in 1998 to 7.9% in December 2005. Underlying this development was the gradual decline witnessed towards the end of the 1990s in the term premium paid by some governments on long-term fixed rate securities in an environment of price stability. Nevertheless, the share of floating rate debt securities increased slightly in 2005, to 7.9%, from 7.7% in 2004. The only country where the share of floating rate debt securities is significantly above the euro area average is Italy (21%), although this share has declined significantly since 1998. In the euro area, the rate of growth of long-term floating rate securities increased to 9.3% in 2005, mirroring developments in the issuance of debt securities in other segments of the market, such as MFIs (see Section 2.2 of this chapter). This increase may be related to the fact that floating rate securities were positively affected by the very low levels of short-term interest rates (see Table A).

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

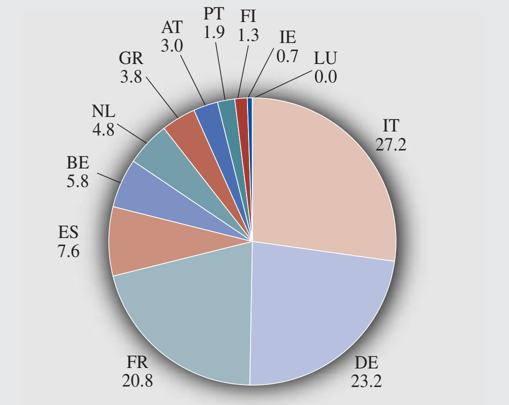
(percentages of total debt securities issued by general government; end of period)

	1998	1999	2000	2001	2002	2003	2004	2005
Central government	96.9	96.9	96.7	96.3	95.4	94.7	94.3	93.8
Long-term securities	*87.5*	*89.3*	*89.8*	*89.0*	*87.2*	*85.8*	*86.0*	*86.2*
Short-term securities	*9.4*	*7.6*	*6.9*	*7.2*	*8.2*	*8.9*	*8.3*	*7.6*
Other general government	3.1	3.1	3.3	3.7	4.6	5.3	5.7	6.2
Long-term securities	*3.0*	*3.0*	*3.2*	*3.6*	*4.5*	*5.2*	*5.6*	*6.1*
Short-term securities	*0.1*	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Total general government								
Long-term	*90.5*	*92.3*	*93.0*	*92.6*	*91.7*	*91.1*	*91.6*	*92.3*
Fixed rate	75.9	79.2	81.1	82.5	82.0	82.2	82.8	83.4
Floating rate	11.9	10.6	10.0	8.8	8.1	7.6	7.7	7.9
Short-term	*9.5*	*7.7*	*7.0*	*7.4*	*8.3*	*8.9*	*8.4*	*7.7*
Total general government in EUR billions	3,314.6	3,450.7	3,547.6	3,765.7	3,940.2	4,142.0	4,370.5	4,588.3

Source: ECB.

Chart A Euro area outstanding government debt securities in 2005 by issuing country

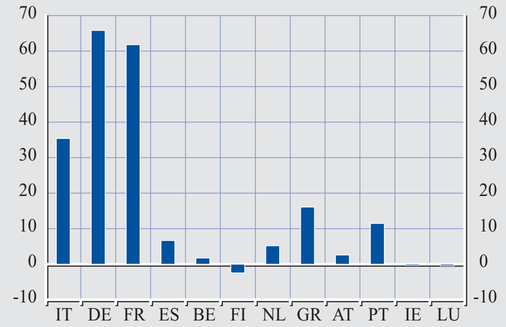
(percentages; end of period)



Source: ECB.

Chart B Net issuance of government debt securities in 2005 by issuing country

(EUR billions; period averages)



Source: ECB.

Overall, recent trends in the structure of government financing reflect the fact that national debt management strategies have taken advantage of the favourable developments in financial market conditions that have resulted from more stability-oriented economic policies over the last decade. The most visible benefit for the public is the significantly lower proportion of governments' budgets being spent on interest payments.

Looking at the total amounts of general government debt outstanding in December 2005 (see Chart A), Italy is by far the largest issuer, with 27.2% of the total amount in the euro area. Germany and France follow with 23.2% and 20.8% respectively. The governments of these three countries alone account for more than two-thirds of all euro area sovereign debt. When comparing levels of net issuance in 2005, Germany has the largest amount, with €65.8 billion. France and Italy follow with €61.8 billion and €35.4 billion respectively (see Chart B).

PROSPECTS FOR PUBLIC FINANCES IN 2006

The latest updates of the stability programmes suggest that targets represent consolidation progress that is in most cases broadly consistent with the revised Stability and Growth Pact. However, as in previous years, many governments do not have sufficiently concrete or credible plans to comprehensively address their fiscal imbalances. Some degree of intended spending restraint can be seen, but this is expected to be offset by tax reductions, resulting in government expenditure and revenue declining in tandem. As a consequence, it is to be feared that most countries will once again accomplish too little to contain budget deficits and will also fall short of comprehensive structural reforms. For 2006 the stability programmes indicate a moderate decline of 0.2 percentage point in the average euro area deficit, to 2.3% of GDP, while economic growth is set to be close to potential. In these circumstances, the business cycle would exert a neutral effect on fiscal developments in 2006, and interest payments would decrease slightly at the euro area level. The average debt ratio would remain broadly stable at close to 71% of GDP.

Of the countries with an excessive deficit, Greece aims to bring its deficit below the 3% threshold in 2006, while Germany and Italy plan to do so only in 2007, and Portugal expects to correct its excessive deficit in 2008. While these countries, together with France, plan to achieve fiscal positions in line with their medium-term objectives only beyond their programme horizons, all others will do so by 2008 at the latest.

FISCAL POLICY IN NEED OF A STRATEGIC TURNAROUND

Past and prospective fiscal developments, as recorded by the European Commission and outlined in the updated stability programmes, give rise to a number of serious challenges.

First, fiscal consolidation should be prioritised. The number of countries with severe fiscal imbalances is particularly worrying. The improving growth outlook provides a good opportunity for countries to progress towards the correction of excessive deficits and the achievement of sound public finances. However, it appears that, without additional measures, a number of countries may not live up to their consolidation commitments. This must be avoided, not least in order to rebuild the credibility of the revised Stability and Growth Pact. The European fiscal framework is an essential pillar of EMU which anchors expectations of fiscal discipline and thereby contributes to growth, stability and cohesion in the euro area.

Second, in line with economic reasoning, the revised Pact places great emphasis on the sustained consolidation of budgetary balances rather than one-off and temporary measures to improve the fiscal situation. It would thus be very welcome if reliance on such measures were to be reduced, as foreseen by some governments. It is evident that temporary measures may delay the consolidation efforts required in order to address the structural budgetary challenges faced by many euro area countries. Furthermore, short-term gains on account of such measures may cause a further deterioration in the future. This could lead to a larger fiscal burden on later generations.

Third, most euro area countries are in need of a comprehensive reform strategy in order to support employment and growth. These reforms must include the pursuit of fiscal consolidation. Given that many countries want to reduce effective rates of tax on labour and capital income as part of such a strategy, control of public expenditure is crucial. Structural expenditure reforms are essential for healthy and growth-promoting public finances. In order to promote investment, innovation and employment, expenditure needs to be directed towards productive goals. At the same time, expenditure control mechanisms may need strengthening to avoid spending overruns, which often lead to an upward adjustment of budget deficit targets. In many cases, it will also be essential to review government commitments, with a view to improving the quality of public expenditure. This will allow countries to attain sound finances while adequately financing the core tasks of the public sector.

2.6 EXCHANGE RATES AND BALANCE OF PAYMENTS DEVELOPMENTS

EURO DEPRECIATED IN 2005

Following its strong appreciation during the last three months of 2004, the euro declined in the first half of 2005. This depreciation was rather broad-based but most pronounced against the US dollar and several Asian currencies which were formally or de facto pegged to the US dollar. Thereafter, while the euro recovered its earlier losses against the Japanese yen, fluctuations in most other bilateral euro currency pairs were relatively modest. As a result, by the end of 2005 the euro had stabilised, in nominal effective terms, at about 6% below its level at the beginning of the year (see Chart 32).

After reaching its highest level since its launch in 1999 at the end of 2004, both in nominal effective terms and against the US dollar, the euro started to lose ground amid shifting market perceptions about the forces affecting exchange rates. At that time, there were increasing signs of an improvement in economic activity in both the United States and Japan, while the prevailing perception concerning the euro area outlook continued to be more subdued. In the United States, in particular, news suggesting robust economic activity, coupled with signs of rising inflationary pressures, apparently switched the market's attention from the large and persistent current account deficit towards expectations of higher interest rates in the United States, thereby supporting the US currency. This process paused only briefly between mid-February and early March 2005, when the US currency came under temporary pressure amid speculation about possible foreign exchange reserve diversification by some central banks. From mid-March onwards, however, market sentiment towards the US dollar improved, whereas it turned more negative vis-à-vis the euro – a development which was further exacerbated in early June following the rejection in France and the Netherlands of the Treaty establishing a Constitution for Europe. The broad-based decline in the euro's external value between mid-March and end-July was only partly offset by its appreciation against the currencies of the four largest new EU Member States. A temporary reduction in global risk appetite seems to have influenced investment decisions in central and eastern Europe, particularly between mid-March and early June, resulting in the rather broad-based weakness of the currencies in this region.

In the second half of 2005, foreign exchange markets continued to be dominated by cyclical factors, whereas structural factors appear to have remained in the background. In particular, the widening interest rate differential of the United States relative to other major economies appears to have continued to support the dollar. This was further helped by US corporate flows related to the Homeland Investment Act [12] and news that foreign demand for US assets remained buoyant, thereby possibly dampening market concerns about the financing of the US current account deficit. However, signs of an improvement in the euro area's business climate counterbalanced the dollar's strength and, consequently, the euro declined only marginally against the US dollar between July and end-December 2005. The improvement in the Japanese economic outlook was not apparently sufficient to counteract the downward impact on the Japanese yen emanating from higher oil prices and a widening yield differential between Japan and other major economies. As a result, the Japanese yen experienced a broad-based weakness in the second half of 2005. On 21 July China abandoned the US dollar peg and moved to a managed floating exchange rate regime with reference to a basket of currencies. This change was felt mostly in Asia and did not appear to have a lasting direct impact on the euro exchange rate.

On 30 December 2005 the euro stood at USD 1.20. This was roughly 11% lower than at the beginning of the year. In 2005 the euro also weakened against the pound sterling (by 3.9%), the Norwegian krone (by 2.5%) and the Australian and Canadian dollars (by 7.0% and 14.4% respectively). It also depreciated against some of the currencies of the new EU Member States, namely the Polish zloty (by 5.4%) and the Czech koruna (by 4.7%). Over the same period, the euro was almost unchanged vis-à-vis the Japanese yen and the Swiss franc.

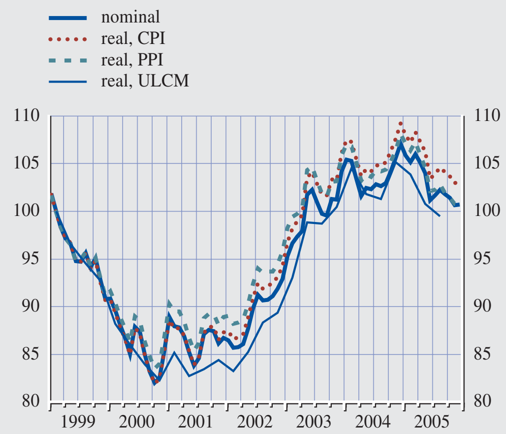
The euro's depreciation against the above-mentioned currencies was only partly counterbalanced by its moderate appreciation against the Hungarian forint and, more significantly, against the Swedish krona (by 5.1%).

In January 2006 the euro rebounded against most major currencies but retreated in February. During the first two months of 2006, euro exchange rate developments appear to have been mainly influenced by market expectations about the future course of monetary policy, particularly in the euro area, the United States and Japan. On 24 February 2006 the euro stood, in nominal effective terms, about 0.3% below its level at the beginning of the year.

12 The Homeland Investment Act allows US companies to repatriate profits held offshore at a beneficial tax rate during their respective fiscal years.

Chart 32 Euro nominal and real effective exchange rates[1)]

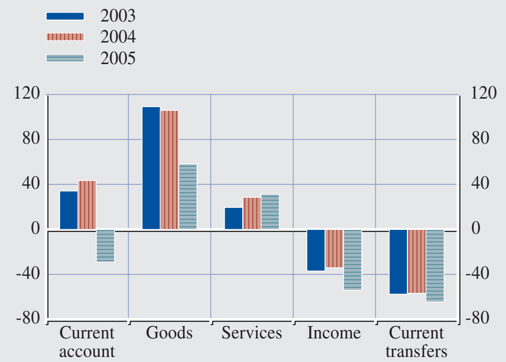
(monthly/quarterly data; index: Q1 1999 = 100)



Source: ECB.
1) An upward movement of the EER-23 indices represents an appreciation of the euro. The latest observations for monthly data are for December 2005. In the case of the ULCM-based real EER-23, the latest observation is for Q3 2005 and is partly based on estimates.

Chart 33 Current account balance and its components

(EUR billions; seasonally adjusted data)



Source: ECB.

The real effective exchange rate of the euro – based on different cost and price indices – also declined in 2005 in line with the decrease in the nominal effective exchange rate (see Chart 32). In the fourth quarter of 2005, the real effective exchange rate indices of the euro were slightly above the level observed in the first quarter of 1999 and close to their average level over the past ten years.

CURRENT ACCOUNT DECLINED IN 2005, MOSTLY AS A RESULT OF HIGHER COST OF OIL IMPORTS

In 2005 the current account of the euro area recorded a deficit of €29.0 billion (or 0.4% of GDP), down from a surplus of €43.5 billion in 2004 (0.6% of GDP). This decline was largely the result of a deterioration in the goods surplus and, to a lesser extent, in the income deficit, while the balances for services and current transfers remained broadly unchanged (see Chart 33).

The geographical breakdown of the euro area current account, which is available up to the third quarter of 2005, reveals that the sharp decrease in the cumulated current account surplus in the 12-month period up to September 2005 was mostly due to increases in oil trade deficits with oil-exporting countries. Over the same period the surplus with the United States remained roughly unchanged (at around €41 billion), while the surplus with other countries in the EU rose by €14 billion, mostly due to an increase in the surplus with the United Kingdom.

In 2005 the goods surplus declined by €47.6 billion, as import values grew more rapidly than export values. Export values of goods increased at roughly the same pace as in 2004, while the growth of import values of goods accelerated somewhat. The income deficit rose sharply, particularly towards the end of the year, reflecting a larger increase in income payments.

Developments in trade in goods can be better understood by using Eurostat's external trade statistics, which break down the value of extra-euro area exports and imports of goods into their price and volume components (the statistics available cover the period up to November 2005). On the imports side, the strong rise in import values of goods in 2005 was mostly accounted for by the robust growth in import values of energy products, largely reflecting the rise in the price of oil. In addition, particularly in the second half of 2005, import volumes rose. After being flat during the first part of 2005, import volumes accelerated due to the pick-up in euro area total final demand, especially in the import-intensive categories of expenditure, such as investment and exports.

On the exports side, both export prices and export volumes contributed to the growth in export values of goods in 2005. The rise in export prices was partly accounted for by the increase in costs associated with higher oil prices. In the course of the year export volumes of goods accelerated mostly due to developments in euro area foreign demand. Having been weak in the first quarter, growth in euro area foreign demand increased robustly during the rest of the year, albeit less rapidly than in the previous year. In particular, exports to Asia (especially China) and the new EU Member States grew fast, reflecting the strength of economic activity in these regions in 2005. Euro area exports also benefited from the recycling of oil export revenues by oil-exporting countries (see Box 8). In terms of products, exports of capital goods registered the strongest growth, while exports of consumer goods were more subdued. With regard to price competitiveness, export volumes were negatively affected at the start of the year by the lagged effects of the euro appreciation. However, its subsequent depreciation may have helped export volumes to exceed the growth rate of foreign demand in the second and third quarters of 2005.

Box 8

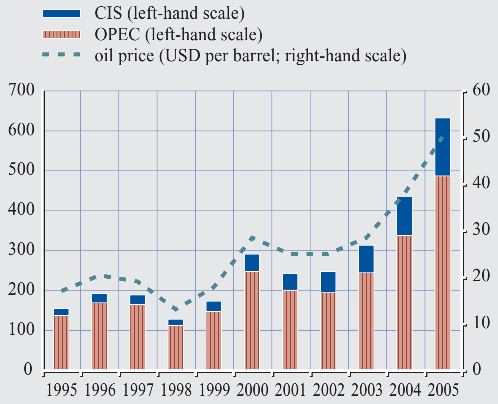
OIL-BILL RECYCLING AND ITS IMPACT

Oil price increases and rising production volumes have generated substantially higher oil export revenues for oil-exporting countries since 2002. This box focuses on export revenues accruing to the Organization of the Petroleum Exporting Countries (OPEC) and the Commonwealth of Independent States (CIS), which together produce approximately 70% of internationally traded oil. Combined OPEC and CIS revenues are estimated to have increased from USD 250 billion in 2002 to around USD 630 billion in 2005 (see Chart A). The box reviews the feedback effects stemming from rising oil revenues ("oil-bill recycling") and, in particular, the two main channels – financial markets and international trade – through which the oil export revenues are transmitted to the oil-importing countries.

One possible scenario associated with the reallocation of wealth following a period of sustained high oil prices is that oil-exporting countries increase their deposits with international banks and/or purchase foreign equity and debt instruments. Traditionally, and particularly in the aftermath of the second oil price shock in the early 1980s, OPEC countries have mainly invested in US assets and markets and have made their banking deposits almost exclusively in US dollars. Similarly, the rise in oil prices from mid-1998 to end-2000 was accompanied, with a slight lag, by a near doubling of the stock of OPEC's net assets held in international banks – a measure of the net channelling of OPEC funds into deposits with international banks. However, this was not the case in the most recent period of surging oil prices, as the stock of OPEC's net

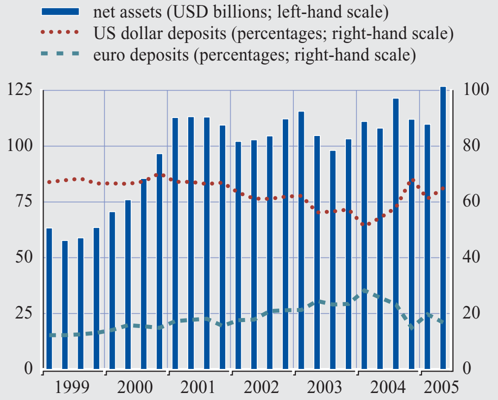
Chart A Oil export revenues

(USD billions, unless otherwise stated)



Sources: International Energy Agency and ECB estimates.

Chart B OPEC's net assets and currency composition



Sources: BIS and ECB calculations.
Note: The last observation refers to Q2 2005.

assets vis-à-vis BIS reporting banks has remained broadly flat since the first quarter of 2001 (see Chart B).[1] The investment pattern that can be observed by monitoring banks' balance sheet positions may, however, not give the full picture. Indeed, looking at cross-border capital flows, the US Department of the Treasury reports an increase of 92% in OPEC holdings of US Treasury securities between January 2001 and September 2005 (from USD 28.5 billion to USD 54.6 billion). In addition, oil export revenues may also have been channelled into US Treasury securities through offshore markets.

There are some visible changes in the currency composition of oil-exporting countries' assets. OPEC economies gradually increased the share of euro-denominated deposits from 12% at the beginning of 1999 to over 28% at the end of the first quarter of 2004. This was accompanied by a steady fall in the share of US dollar-denominated deposits. Since 2004, however, OPEC economies have gradually shifted their deposits back into US dollars, despite the relatively strong appreciation of the euro during that year. This increased the share of deposits denominated in US dollars, from a low of 51% at the end of the first quarter of 2004 to 65% in the second quarter of 2005. This development coincided with a similar decline, in terms of magnitude, in the share of deposits denominated in euro, which was 17% in the second quarter of 2005.

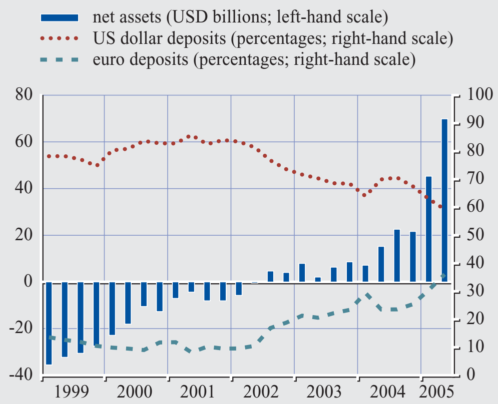
Net assets held by Russia, the largest oil producer in the CIS and the world's largest non-OPEC oil exporter, rose considerably during the most recent oil price increases and also changed in terms of their currency composition (see Chart C). Russia has been a net creditor to BIS reporting banks since 2002. The share of euro-denominated deposits more than tripled between mid-2002 and the second quarter of 2005, rising from 11% to 36%. This fairly sharp increase over the past three years also reflects, to a certain extent, the strong appreciation of the euro against the US dollar during the period and the growing use of the euro as a reserve currency

1 See the BIS Quarterly Review, December 2005, pp. 25-27. Net assets refers to the difference between OPEC's assets and liabilities vis-à-vis BIS reporting banks and is a measure of the net channelling of funds into the international banking system.

by Russia's monetary authorities. As explained below, this move towards a more balanced deposit portfolio, in terms of currencies, may signal a desire by oil producers to safeguard their purchasing power when their imports are shifting away from the United States towards Europe and other countries.

International trade represents the second potential recycling channel for increased oil revenues. During the first and second oil price shocks in the 1970s, OPEC's oil export revenues persistently exceeded, to a relatively large extent, its total imports, giving rise to "oil-dependent trade surpluses". These surpluses turned into small deficits in the mid-1980s when the price of oil plunged back to around USD 15 per barrel. The large surplus appeared again in 2000 when oil prices started to pick up sharply. However, since 2001, OPEC's oil-dependent trade surpluses have remained relatively moderate compared with previous periods of high oil prices, despite the strong rise in both oil prices and oil export volumes. This implies that the rising oil export revenues that have accrued to OPEC have coincided with rising OPEC imports. A similar trend can be observed in the case of the CIS. The oil-dependent trade deficits recorded by the CIS declined sharply after the surge in oil prices in 1999 and 2000. The strong increase in oil prices, however, coincided with a deterioration in the CIS' oil-dependent trade balance between 2001 and 2004. This implies that the rising oil export revenues that have accrued to the CIS in those years also coincided with rising imports. In the first half of 2005, however, the oil-dependent trade deficit recorded by the CIS again declined significantly.

Chart C Russia's net assets and currency composition



Sources: BIS and ECB calculations.
Note: The last observation refers to Q2 2005.

Total OPEC and CIS imports registered average annual increases of 18% and 21% respectively between 2001 and 2004 in nominal US dollar terms. The euro area seems to have benefited from the strong demand originating from oil-exporting countries. The average annual growth rates of OPEC and CIS imports from the euro area were 21% and 26% respectively between 2001 and 2004, resulting in an increase in the euro area's market share in both oil-exporting regions (see table). Non-Japan Asia also succeeded in increasing its relative share in total

Market shares of selected economies in OPEC and CIS imports

(as a percentage of total imports)

	OPEC			CIS		
	1998	2001	2004	1998	2001	2004
Euro area	26.0	24.8	26.7	32.0	31.6	33.2
United States	15.4	12.5	8.9	7.0	6.5	3.7
United Kingdom	5.9	5.0	4.4	2.5	2.3	2.5
Asia excl. Japan and China	9.8	10.7	12.3	2.8	2.5	3.1
Japan	9.2	8.3	7.0	1.4	1.8	3.3
China	3.7	4.8	7.4	1.9	2.9	5.9

Sources: IMF and ECB calculations.

OPEC and CIS imports. These figures contrast sharply with those of the United States, which saw its market share fall significantly over the same period. In 2005 the euro area continued benefiting from rising imports in oil-exporting countries. OPEC and CIS imports in the first half of 2005 (the latest available data) stood, respectively, 22% and 25% higher than in the same period one year earlier.

Overall, since 1999, different patterns have emerged in the allocation of additional oil export revenues by oil-exporting economies, particularly the OPEC economies. In the aftermath of the substantial rise in oil prices in 1999, the OPEC countries deposited large percentages of their oil revenues in international banks while import spending remained low. However, since 2001 both the OPEC economies and the CIS economies have substantially increased their imports. The euro area seems to have benefited from this recent increase in import activity. Thus, while the elevated price of oil should have dampened economic activity in the euro area, it appears that the feedback effects associated with oil-bill recycling have, to a certain extent, mitigated the negative first-round effects of surging oil prices recently.

NET OUTFLOWS IN COMBINED DIRECT AND PORTFOLIO INVESTMENT IN 2005

In the financial account, the euro area experienced net outflows of €13 billion in combined direct and portfolio investment in 2005, compared with net inflows of €24 billion in 2004. This was mainly the result of increased net inflows in equity portfolio investment, which were offset by net outflows in direct investment and lower net inflows in debt instruments (see Chart 34).

The larger deficit in direct investment in 2005 is due to an increase in foreign direct investment (FDI) by the euro area, largely in the form of equity capital investment. This pick-up may partly reflect the renewed interest by euro area corporations in enhancing competitiveness through foreign affiliates, as well as the exceptional restructuring operation of Royal Dutch Shell. At the same time, FDI inflows into the euro area stabilised at low levels in 2004. Expectations that the rest of the world would experience stronger economic growth than the euro area might have accounted for the developments observed.

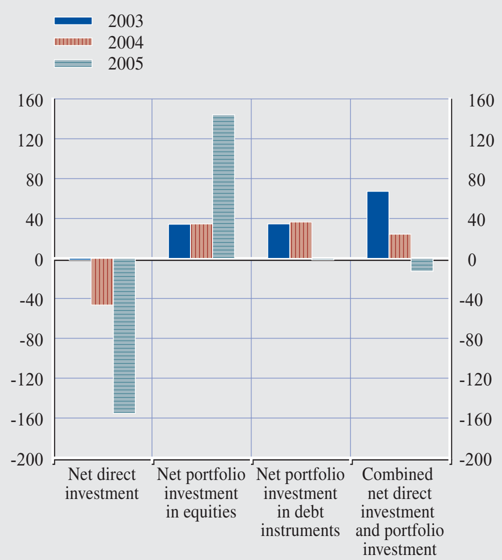
The rise in net inflows in portfolio investment emanated from an increase in net purchases of euro area equity securities by non-residents. These purchases were driven in part by the equities acquired in the context of the restructuring of Royal Dutch Shell, but also by expectations of relatively higher returns in the euro area stock markets. Market survey data also indicated that foreign investors were interested in euro area equities, which they find to be more attractively priced than equities in other markets.

Turning to debt instruments, cross-border flows rose sharply in 2005, with most transactions in bonds and notes. There were two distinct trend movements in the course of 2005: in the early part of the year, there was a steady rise in net inflows in euro area debt instruments, which reached a peak in early summer. Subsequently, this trend reversed into net outflows in the second half of the year. This may have reflected the fact that the yield differentials between US and euro area government bonds and notes became fairly sizeable, particularly over the summer.

Based on cumulated flows over the first three quarters of 2005, the United Kingdom and the new EU Member States were the main recipients of euro area direct investment. The new EU Member States were also the main investors in the euro area over this period. The geographical

Chart 34 Euro area financial account

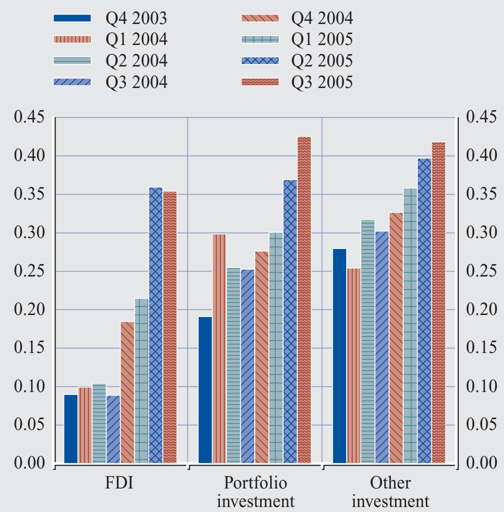
(EUR billions)



Source: ECB.

Chart 35 Euro area financial outflows to the new EU Member States

(as a percentage of the new EU Member States' GDP; quarterly cumulated data)



Source: ECB.

breakdown of portfolio investment shows that euro area portfolio investment abroad in the first three quarters of 2005 was directed primarily towards the United Kingdom and offshore centres. Euro area investors were also large net purchasers of US bonds and notes, but were net sellers of US equities and money market instruments.

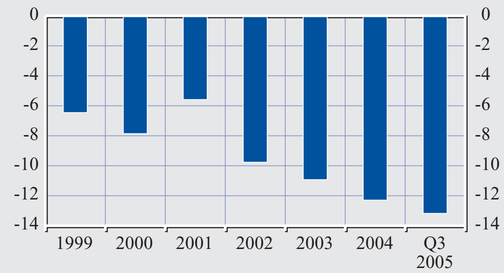
The new EU Member States as a whole received considerable euro area foreign investment. A positive trend is clearly evident, implying that euro area investors may have found this region to be relatively profitable and that financial integration between the euro area and the new EU Member States has possibly strengthened during this period (see Chart 35).

INTERNATIONAL INVESTMENT POSITION DETERIORATED FURTHER IN 2005

Data on the international investment position (i.i.p.) of the euro area vis-à-vis the rest of the world, available up to the end of the third quarter of 2005, indicate that the euro area recorded net liabilities of €1,049 billion (representing 13.2% of euro area GDP), compared with net liabilities of €946 billion (12.4% of GDP) at the end of 2004 and €809 billion (11.0% of GDP) at the end of 2003 (see Chart 36). The higher net liabilities in 2005 largely resulted from an increase in the net liability positions in portfolio investment (from €1,071 billion to €1,350 billion), which was partly offset by an increase in the net asset position in direct investment (from €89 billion

Chart 36 Net international investment position

(as a percentage of GDP)



Source: ECB.

to €224 billion) and a decrease in the net liability position in other investment (from €241 billion to €212 billion).

As for the geographical breakdown of the stock of euro area FDI at the end of 2004, 24% was invested in the United Kingdom and 21% in the United States. For the stock of euro area portfolio investment abroad, the corresponding shares of these two countries were 23% and 35% respectively. These two countries were also the most important direct investors in the euro area.

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

ECONOMIC ACTIVITY

In 2005 real GDP growth in the non-euro area EU Member States moderated compared with 2004, but remained stronger than in the euro area (see Table 6). As in previous years, output growth was highest in the Baltic States, where growth was higher than 7%, and in Slovakia and the Czech Republic, which both had growth rates of 6%.

The robustness of domestic demand was sustained in most countries by strong growth in private consumption, which remained at high levels in 2005, particularly in the majority of the new Member States. Household spending was supported by significant growth in real disposable income, as well as expansionary fiscal policies and rising house prices in some countries. In addition, increasing credit growth to the private sector in a number of non-euro area EU countries, especially the Baltic States, backed a continuing increase in real estate investment and household spending. Consumption growth was subdued in 2005 in Malta (reflecting low growth in disposable income), Poland (owing to wage restraint and higher savings) and the United Kingdom (on the back of higher interest rates and a cooling of the housing market). Domestic demand was further supported by continued strength in investment growth in many of the non-euro area Member States, in particular the Baltic States, Hungary, Malta, Slovakia and Sweden. Low interest rates, recovering industrial confidence, a high degree of capital utilisation and a positive outlook for sustained demand contributed to the strong growth in investment, while financial resources stemming from EU funds also supported investment growth in the new Member States.

As regards external demand, exports were a main driver of real GDP growth in most new Member States, notably the Baltic States, the Czech Republic, Hungary and Poland. However, the contribution of net exports to real GDP growth varied significantly across the non-euro area EU countries and was broadly neutral for the group as a whole. Both export and import growth remained rather high in 2005 in the new Member States, suggesting that the long-standing process of trade integration had gained

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

(annual percentage changes)

	2001	2002	2003	2004	2005	2005 Q1	2005 Q2	2005 Q3	2005 Q4
Czech Republic	2.6	1.5	3.2	4.4	6.0	5.3	5.8	6.0	6.7
Denmark	0.7	0.5	0.7	1.9	3.4	0.3	4.7	4.8	3.7
Estonia	6.5	7.2	6.7	7.8	.	7.2	9.9	10.6	.
Cyprus	4.1	2.1	1.9	3.9	3.8	3.9	3.6	4.0	3.6
Latvia	8.0	6.5	7.2	8.5	10.2	7.3	11.4	11.4	10.5
Lithuania	7.2	6.8	10.5	7.0	7.5	4.4	8.4	7.6	8.8
Hungary	4.3	3.8	3.4	4.6	4.1	3.2	4.5	4.5	4.3
Malta	0.3	1.5	-2.5	-1.5	2.5	0.1	2.8	4.1	2.8
Poland	1.1	1.4	3.8	5.3	3.2	3.6	1.2	3.4	.
Slovenia	2.7	3.5	2.7	4.2	3.9	2.8	5.4	3.6	3.7
Slovakia	3.8	4.6	4.5	5.5	6.0	5.1	5.1	6.2	7.6
Sweden	1.1	2.0	1.7	3.7	2.7	1.1	3.3	3.5	2.9
United Kingdom	2.2	2.0	2.5	3.2	1.8	2.0	1.6	1.8	1.8
EU10 1)	2.8	2.6	3.9	5.1	4.5	4.1	3.8	4.8	.
EU13 2)	2.1	2.0	2.5	3.5	2.5	2.2	2.4	2.7	2.5
Euro area	1.9	0.9	0.7	2.1	1.3	0.6	1.9	1.4	1.3

Sources: Eurostat and the national statistical offices in Lithuania and Slovenia for the annual growth rates in 2005 in these two countries.
Notes: Quarterly figures are not seasonally adjusted, with the exception of the Czech Republic (seasonally adjusted) and the United Kingdom (seasonally and working day-adjusted). The annual growth rate for the Czech Republic in 2005 is an average of quarterly figures.
1) The EU10 aggregate comprises the data for the ten countries that joined the EU on 1 May 2004.
2) The EU13 aggregate comprises the data for the 13 non-euro area EU Member States.

further momentum with the removal of trade barriers, primarily on food products, following EU accession.

The labour market situation continued to improve in most non-euro area Member States in 2005, particularly in the Baltic States, Poland and Slovakia. While unemployment rates fell only gradually, employment growth strengthened markedly in the new Member States, notably in the countries with the highest unemployment rates. In Poland and Slovakia, the unemployment rate remained particularly high, around twice as high as in the euro area. In Cyprus, Denmark and the United Kingdom, the labour markets were relatively tight, with unemployment rates of below 6%.

PRICE DEVELOPMENTS

In 2005 HICP inflation was lowest – below the euro area average – in Sweden, the Czech Republic, Denmark and the United Kingdom. In most other non-euro area EU countries, HICP inflation was just above the euro area average, although in Latvia, Estonia and Hungary it was above 3% (see Table 7). Compared with 2004, most of the new Member States, with the exception of the Baltic States, recorded lower HICP inflation rates in 2005, while Denmark and the United Kingdom, starting from low levels, recorded higher inflation rates.

Inflation developments in the non-euro area Member States were partly driven by common factors. In several of the new Member States, a deceleration of inflation in the first half of 2005 reflected the base effect of price increases in 2004 related to EU accession. In addition,

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

(annual percentage changes)

	2001	2002	2003	2004	2005	2005 Q1	2005 Q2	2005 Q3	2005 Q4
Czech Republic	4.5	1.4	-0.1	2.6	1.6	1.4	1.2	1.6	2.2
Denmark	2.3	2.4	2.0	0.9	1.7	1.1	1.6	2.2	2.0
Estonia	5.6	3.6	1.4	3.0	4.1	4.5	3.6	4.3	4.0
Cyprus	2.0	2.8	4.0	1.9	2.0	2.5	2.1	1.7	1.9
Latvia	2.5	2.0	2.9	6.2	6.9	6.7	6.7	6.7	7.5
Lithuania	1.6	0.3	-1.1	1.2	2.7	3.1	2.4	2.2	3.0
Hungary	9.1	5.2	4.7	6.8	3.5	3.5	3.6	3.5	3.2
Malta	2.5	2.6	1.9	2.7	2.5	2.3	2.2	2.1	3.5
Poland	5.3	1.9	0.7	3.6	2.2	3.6	2.2	1.8	1.2
Slovenia	8.6	7.5	5.7	3.7	2.5	2.8	2.2	2.3	2.6
Slovakia	7.2	3.5	8.4	7.5	2.8	2.8	2.6	2.2	3.7
Sweden	2.7	1.9	2.3	1.0	0.8	0.7	0.5	0.9	1.1
United Kingdom	1.2	1.3	1.4	1.3	2.0	1.7	1.9	2.4	2.1
EU10 1)	5.7	2.6	1.9	4.1	2.5	3.2	2.4	2.2	2.2
EU13 2)	2.7	1.8	1.6	2.1	2.1	2.1	2.0	2.2	2.1
Euro area	2.4	2.3	2.1	2.1	2.2	2.0	2.0	2.3	2.3

Source: Eurostat.
1) The EU10 aggregate comprises the data for the ten countries that joined the EU on 1 May 2004.
2) The EU13 aggregate comprises the data for the 13 non-euro area EU Member States.

strong competition appears to have exerted downward pressure on price developments in most non-euro area Member States, particularly in industrial goods and food. By contrast, the rising price of oil exerted upward pressure on inflation. Its precise impact, however, varied across countries, largely reflecting differences in consumption patterns, market structures and the energy intensity of production. Moreover, as energy prices are largely administered in many non-euro area EU countries, the pass-through of higher oil prices to inflation may not have fully materialised in 2005. Inflationary pressures also emerged as a result of continued strong domestic demand in some of the new Member States.

Exchange rate developments and their lagged pass-through to overall inflation also affected inflation developments in 2005. In a number of countries, particularly the Czech Republic, Hungary, Poland and Slovakia, currency appreciation had a dampening impact on inflation.

FISCAL POLICIES

On the basis of the latest updates of convergence programmes submitted in late 2005 and early 2006, the general picture of fiscal policies in the non-euro area EU Member States was heterogeneous in 2005. Three non-euro area Member States (Denmark, Estonia and Sweden) recorded a fiscal surplus, whereas the other ten countries registered fiscal deficits. The estimated budgetary outcomes for 2005 were either broadly in line with, or better than, the targets of the convergence programmes, with the exceptions of the Czech Republic, Hungary, Malta and Slovakia. General government balances deteriorated in six of the thirteen non-euro area EU Member States over the year (see Table 8), although the convergence programmes in some cases contain relatively conservative estimates. The deteriorations occurred despite the fact that fiscal balances were supported by a favourable economic environment, which resulted in higher than expected revenues in a number of countries.

The cyclical contribution to the budget was mostly positive or neutral. Nevertheless, the only countries with a tightening fiscal stance were Denmark, Cyprus, Malta, Poland and the United Kingdom. In Cyprus and Hungary, temporary measures had a decreasing impact of more than 0.5% of GDP on the deficit in 2005. By contrast, the deficit of Slovakia increased in 2005 on account of one-off expenditures.

Expenditure execution was mostly kept close to planned spending paths. However, as in 2004, some governments, including those of the Czech Republic, Estonia, Latvia, Lithuania and Slovakia, used some of the excess revenue to finance additional expenditure rather than to improve their fiscal balances.

Based on the decisions of the ECOFIN Council of 5 July 2004, six non-euro area Member States (the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) were found to be in a situation of excessive deficit. Of these countries, Cyprus reduced its deficit to below 3% of GDP in 2005, as required by the corresponding Council decision. By contrast, according to the latest updates of convergence programmes, the deficits increased in the Czech Republic, Hungary and Slovakia (albeit, in the case of Slovakia, on account of a one-off debt remission of a magnitude of 0.8% of GDP). Cyprus, Malta and Poland complied with the consolidation benchmark of a positive change in the cyclically adjusted budget balance of at least 0.5% of GDP, net of one-off and other temporary measures. Hungary again showed significant slippage relative to its budget target for 2005, which was revised upwards from 3.6% to 6.1% of GDP. The Council decided twice, in accordance with Article 104(8) of the Treaty, that no effective action had been taken by Hungary to correct the excessive deficit (see also Section 1.1 of Chapter 4). The United Kingdom recorded a deficit ratio above the 3% of GDP reference value for the third consecutive year. The ECOFIN Council decided on 24 January 2006 that an excessive deficit existed in the United Kingdom and issued a

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 (-)	2002	2003	2004	Convergence programme data for 2005
Czech Republic	-6.8	-12.5	-3.0	-4.8
Denmark	1.4	1.2	2.9	3.6
Estonia	1.5	2.5	1.7	0.3
Cyprus	-4.5	-6.3	-4.1	-2.5
Latvia	-2.3	-1.2	-0.9	-1.5
Lithuania	-1.4	-1.2	-1.4	-1.5
Hungary	-8.5	-6.5	-5.4	-6.1
Malta	-5.8	-10.4	-5.1	-3.9
Poland	-3.3	-4.8	-3.9	-2.9
Slovenia	-2.7	-2.7	-2.1	-1.7
Slovakia	-7.8	-3.8	-3.1	-4.1
Sweden	-0.3	0.2	1.6	1.6
United Kingdom	-1.7	-3.3	-3.2	-3.0
EU10 1)	-4.8	-6.1	-3.6	-3.6
EU13 2)	-1.9	-3.1	-2.3	-2.2
Euro area	-2.5	-3.0	-2.7	-2.5

General government gross debt	2002	2003	2004	Convergence programme data for 2005
Czech Republic	29.8	36.8	36.8	37.4
Denmark	47.6	45.0	43.2	35.6
Estonia	5.8	6.0	5.5	4.6
Cyprus	65.2	69.8	72.0	70.5
Latvia	14.2	14.6	14.7	13.1
Lithuania	22.4	21.4	19.6	19.2
Hungary	55.5	57.4	57.4	57.7
Malta	63.2	72.8	75.9	76.7
Poland	41.2	45.3	43.6	42.5
Slovenia	29.8	29.4	29.8	29.0
Slovakia	43.7	43.1	42.5	33.7
Sweden	52.4	52.0	51.1	50.9
United Kingdom	38.2	39.7	41.5	43.3
EU10 1)	39.9	43.3	42.6	41.5
EU13 2)	40.6	42.0	42.8	43.2
Euro area	69.2	70.4	70.8	71.0

Sources: European Commission (for 2002-04), 2005-06 updated convergence programmes and Commission assessments (for 2005) and ECB calculations.
Notes: Data are based on the excessive deficit procedure definition. Budget balances (Commission data) exclude proceeds from the sale of UMTS licences. Data include second pillar pension funds within general government. Their estimated improving effect (where available) as a percentage of GDP is as follows: Denmark (0.9% on the budget balance), Hungary (1.3% on the budget balance, 3.8% on the debt), Poland (1.8% on the budget balance, 5.4% on the debt), Slovakia (0.8% on the budget balance) and Sweden (1.0% on the budget balance, 0.6% on the debt).
1) The EU10 aggregate comprises the data for the ten countries that joined the EU on 1 May 2004.
2) The EU13 aggregate comprises the data for the 13 non-euro area EU Member States.

recommendation in accordance with Article 104(7) of the Treaty, calling for the excessive deficit to be corrected as soon as possible and by the financial year 2006/07 at the latest.

In 2005 the debt ratio of most non-euro area EU Member States remained well below the euro area average. Only Cyprus and Malta continued to record ratios above the 60% of GDP reference value. With some exceptions, the debt ratio declined in the non-euro area Member States, reflecting, in part, favourable growth-interest differentials and debt-decreasing deficit-debt adjustments.[13]

13 The debt figures for 2005 from the latest updates of convergence programmes are not strictly comparable with European Commission data for previous years.

BALANCE OF PAYMENTS DEVELOPMENTS

The combined current and capital account of the non-euro area EU Member States continued to vary considerably across countries in 2005 (see Table 9). While Sweden and Denmark reported sizeable surpluses, the United Kingdom and the new EU Member States recorded deficits. The deficits in Estonia, Latvia and Malta remained very high – at around or above 10% of GDP – albeit declining in the former two countries, while Cyprus, Lithuania, Hungary and Slovakia recorded current and capital account deficits of more than 5% of GDP. The Czech Republic, Poland, Slovenia and the United Kingdom reported more moderate deficits in their current and capital accounts.

Although large current account deficits in some countries could signal risks to the sustainability of external positions, such deficits are, to some extent, also a normal feature of catching-up economies, such as the new Member States, where capital inflows allow financing of high-return investments that it would not have been possible to undertake solely on the basis of domestic savings. Although external imbalances in most countries originated mainly from deficits in goods, income deficits – often linked to the repatriation of profits from foreign-owned firms and thus to past FDI inflows – were another important source in a number of cases. The recent developments in the current account should be interpreted with some caution, as they are influenced to some extent by methodological changes in the compilation of trade data following EU accession.

In most new EU Member States, FDI – partly associated with privatisation programmes – continued to be an important source of external financing. Net FDI inflows increased slightly in 2005, compared with 2004, for this group of countries as a whole (see Table 9). Net FDI inflows (in terms of GDP) were particularly sizeable in Estonia, where they were strongly affected by one large transaction. They also continued to be rather strong in the Czech Republic and Malta. Net FDI inflows were positive in all the new Member States apart from Slovenia, which recorded rather balanced net FDI flows in 2005. As regards the other non-euro area EU Member States, Sweden and Denmark witnessed net outflows of FDI, which

Table 9 Balance of payments, selected items

(as a percentage of GDP)

	Combined current and capital account balance				Net FDI flows				Net portfolio investment flows			
	2002	2003	2004	2005 [1]	2002	2003	2004	2005 [1]	2002	2003	2004	2005 [1]
Czech Republic	-5.7	-6.3	-5.7	-3.3	11.2	2.1	3.6	7.6	-1.9	-1.4	2.2	-1.9
Denmark	2.3	3.3	2.4	2.9	0.8	0.1	0.4	-1.1	0.1	-7.0	-6.0	-7.1
Estonia	-9.9	-11.6	-12.0	-10.8	2.2	8.4	6.9	21.8	2.1	1.9	6.5	-14.3
Cyprus	-4.5	-2.4	-4.9	-6.5	5.7	3.0	3.0	4.3	-4.9	1.9	7.6	7.1
Latvia	-6.4	-7.4	-11.9	-9.9	2.7	2.3	4.3	4.0	-2.2	-2.0	1.7	-0.8
Lithuania	-4.7	-6.4	-6.4	-5.2	5.0	0.8	2.3	1.3	0.1	1.5	0.9	-0.3
Hungary	-6.8	-8.7	-8.5	-7.2	4.1	0.6	3.5	2.8	2.6	3.6	6.8	6.7
Malta	0.5	-5.5	-8.7	-9.0	-10.4	8.6	8.1	9.9	-9.1	-33.5	-31.3	-25.7
Poland	-2.5	-2.1	-3.8	-1.2	2.0	2.0	4.6	3.3	1.0	1.1	3.8	5.1
Slovenia	0.8	-1.0	-2.5	-1.1	6.5	-0.5	0.8	-0.3	-0.3	-0.9	-2.2	-2.9
Slovakia	-7.6	-0.5	-3.1	-5.6	17.0	2.3	3.4	3.8	2.3	-1.7	2.2	-1.2
Sweden	5.0	7.4	8.2	7.3	0.5	-6.6	-3.8	-7.2	-4.5	-3.0	-6.9	0.8
United Kingdom	-1.5	-1.3	-1.8	-1.7	-1.7	-1.9	-0.9	4.9	4.8	5.4	-4.7	-5.6
EU10 [2]	-4.2	-4.3	-5.3	-3.5	5.0	1.8	3.9	4.2	0.4	0.5	3.2	2.5
EU13 [3]	-1.0	-0.6	-1.1	-0.8	-0.1	-1.6	-0.2	0.0	2.7	2.6	-3.5	-1.7
Euro area	0.9	0.6	0.8	0.2	0.3	0.0	-0.6	-1.9	1.9	0.9	0.9	2.9

Source: ECB.
1) The figures for 2005 refer to the four-quarter average up to Q3 2005.
2) The EU10 aggregate comprises the data for the ten countries that joined the EU on 1 May 2004.
3) The EU13 aggregate comprises the data for the 13 non-euro area EU Member States.

were rather sizeable in the case of Sweden, whereas net FDI inflows to the United Kingdom were strongly positive. Overall, although net FDI flows constituted an important source of financing for a number of the non-euro area Member States in 2005, in most cases these inflows were not sufficient to cover the deficit in the combined current and capital account.

Net portfolio investment flows also contributed significantly to the financing of current account deficits in 2004 and 2005 in Cyprus, Hungary and Poland, compared with rather moderate inflows in previous years. This development reflected mainly higher net debt inflows – which, in some cases, could have been partly related to yield differentials – but net equity inflows also gained in importance. Partly as a result of the additional financing provided by net inflows in portfolio investment and also other investment, the external indebtedness of some countries relative to GDP also rose.

ERM II AND EXCHANGE RATE-RELATED ISSUES

In 2005 four new EU Member States joined Estonia, Lithuania, Slovenia and Denmark in ERM II: Cyprus, Malta and Latvia entered the mechanism on 2 May 2005 and Slovakia on 28 November 2005, all with a standard fluctuation band of ±15% around their central rates against the euro. Prior to ERM II entry, both the Cyprus pound and the Latvian lats had already been unilaterally pegged to the euro. While the Cyprus pound had been pegged to the euro since the launch of the single currency in 1999, Latvia re-pegged its currency from the special drawing right – a unit of account, mainly of the IMF, whose value is based on a basket of currencies – to the euro at the beginning of 2005 and retained a ±1% fluctuation band. Following ERM II entry, the Latvian authorities announced that they would unilaterally maintain the exchange rate of the lats at the central rate against the euro with a fluctuation band of ±1%. Upon joining the mechanism, the Maltese lira was re-pegged to the euro from a basket arrangement which included the euro, the pound sterling and the US dollar. Moreover, the Maltese authorities declared that they would unilaterally maintain the exchange rate of the Maltese lira at the central rate against the euro. In the case of the Slovak koruna and the Cyprus pound, the authorities did not undertake any formal unilateral commitment to a narrower band. Unilateral commitments place no additional obligations on the ECB. To ensure a smooth participation in ERM II, the participating countries have committed themselves to take the necessary measures to preserve macroeconomic and exchange rate stability.

Participation in ERM II has not been associated with notable tensions in the foreign exchange markets in any of the participating countries. The Estonian kroon, the Lithuanian litas, the Maltese lira and the Slovenian tolar have traded continuously at or very close to their central

Table 10 Developments in ERM II

	Entry date	Upper rate	Central rate	Lower rate	Max. deviation in %	
					Upward	Downward
DKK	1.1.1999	7.62824	7.46038	7.29252	0.1	0.4
EEK	28.6.2004	17.9936	15.6466	13.2996	0.0	0.0
CYP	2.5.2005	0.673065	0.585274	0.497483	0.0	2.1
LVL	2.5.2005	0.808225	0.702804	0.597383	0.0	1.0
LTL	28.6.2004	3.97072	3.45280	2.93488	0.0	0.0
MTL	2.5.2005	0.493695	0.429300	0.364905	0.0	0.0
SIT	28.6.2004	275.586	239.640	203.694	0.2	0.1
SKK	28.11.2005	44.2233	38.4550	32.6868	0.0	3.2

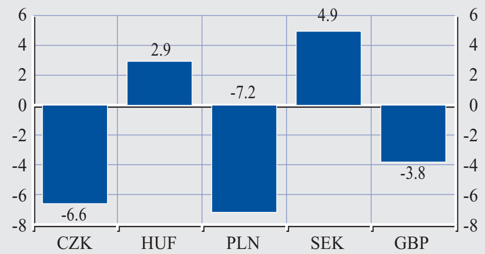
Source: ECB.
Note: A downward (upward) deviation corresponds to a movement towards the lower (upper) rate and constitutes a strengthening (weakening) of the currency against the euro. For the reported maximum deviations, the reference periods are from the respective ERM II entry dates to 24 February 2006. In the case of Denmark the reference period is from 1 January 2004 to 24 February 2006.

rates since joining the mechanism. The Danish krone also continued to trade close to its central rate in 2005. Following ERM II entry, the Cyprus pound strengthened somewhat against the euro in the first two months, before stabilising about 2% stronger than the central rate in the second half of 2005. The Latvian lats remained unchanged on the strong side of the standard fluctuation band and close to the upper limit of its unilaterally announced band. Since joining ERM II, the Slovak koruna has exhibited greater volatility than the other ERM II currencies and has traded up to 3.2% stronger than its central rate (see Table 10).

Most of the currencies of the non-euro area Member States outside ERM II strengthened against the euro in 2005, but less so on a trade-weighted (effective) basis, as this was partially counterbalanced by their depreciation against the US dollar and the currencies linked to the US dollar. In the first half of 2005 the Polish zloty and the Czech koruna experienced a partial reversal of their strong appreciation in 2004, but resumed their appreciation in the second half of the year. On 24 February 2006 these currencies had strengthened significantly against the euro compared with their levels at the beginning of 2005, implying a depreciation of the euro of 7.2% and 6.6% respectively (see Chart 37). The Hungarian forint, by contrast, depreciated amid significant exchange rate fluctuations, which were mainly related to a deteriorating fiscal outlook, over the year as a whole. On 24 February 2006 the forint was trading at almost 3% lower than its level at the beginning of 2005. Movements in interest rate differentials seem to have affected the Swedish krona and the pound sterling. Whereas the Swedish krona depreciated rather strongly against the euro throughout most of 2005 on account of a widening negative interest rate differential vis-à-vis the euro area, the pound sterling strengthened against the euro in 2005 and early 2006 – by almost 4% – amid notable fluctuations.

Chart 37 Exchange rate changes of the euro against EU currencies outside ERM II

(percentages)



Source: ECB.
Notes: A positive (negative) value represents an appreciation (depreciation) of the euro. Changes refer to the period from 3 January 2005 to 24 February 2006.

MONETARY POLICY

The primary objective for monetary policy in all non-euro area EU Member States is price stability. Monetary policy strategies differ considerably from country to country, reflecting the heterogeneity among them in nominal, real and structural terms (see Table 11). In 2005, with the exception of the entry of Cyprus, Latvia, Malta and Slovakia into ERM II, the monetary policy and exchange rate regimes of the non-euro area EU countries remained largely unchanged, although some refinements were made to the monetary policy frameworks in a few countries with a view to future monetary integration.

Regarding monetary policy decisions in 2005 in countries with an exchange rate objective, Danmarks Nationalbank increased its key policy rate by 25 basis points to 2.4% as a consequence of the ECB's interest rate increase on 1 December 2005. It raised its rate further – by 10 basis points to 2.5% – on 17 February 2006 owing to an outflow of foreign exchange in February, among other things as a result of Danish institutional investors' purchases of foreign shares and other securities. The Central Bank of Cyprus decreased its minimum bid rate by a total of 125 basis points to 3.25% by the end of 2005, in order to help curb appreciation pressures arising from improved investor confidence in the economic outlook, which resulted from the improvement in public finances and the Cyprus pound's entry into ERM II.

Latvijas Banka increased its minimum reserve ratio in two steps, from 4% to 8%, to curb very high credit growth in Latvia. In Malta, the official interest rate was raised by 25 basis points to 3.25% in response to strong credit growth. In February 2006 Banka Slovenije cut its key policy rate by 25 basis points to 3.75%.

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

	Monetary policy strategy	Currency	Features
Czech Republic	Inflation target	Czech koruna	Target: 2-4% by end-2005, thereafter 3%, ensuring that inflation outcomes do not differ by more than one percentage point (p.p.) in either direction from this target. Managed floating exchange rate.
Denmark	Exchange rate target	Danish krone	Participates in ERM II with a ±2.25% fluctuation band around a central rate of DKK 7.46038 per euro.
Estonia	Exchange rate target	Estonian kroon	Participates in ERM II with a ±15% fluctuation band around a 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	Participates in ERM II with a ±15% fluctuation band around a central rate of CYP 0.585274 per euro.
Latvia	Exchange rate target	Latvian lats	Participates in ERM II with a ±15% fluctuation band around a central rate of LVL 0.702804 per euro. Latvia continues with a fluctuation band of ±1% as a unilateral commitment.
Lithuania	Exchange rate target	Lithuanian litas	Participates in ERM II with a ±15% fluctuation band around a central rate of LTL 3.45280 per euro. Lithuania continues with its currency board arrangement as a unilateral commitment.
Hungary	Combined exchange rate and inflation target	Hungarian forint	Exchange rate target: peg to the euro at HUF 282.36 per euro, with a ±15% fluctuation band. Inflation target: 4% (± 1 p.p.) by end-2005, 3.5% (±1 p.p.) by end-2006 and 3% (±1 p.p.) medium-term target from 2007.
Malta	Exchange rate target	Maltese lira	Participates in ERM II with a ±15% fluctuation band around a central rate of MTL 0.42930 per euro. Malta maintains the exchange rate against the euro unchanged from the central rate as a unilateral commitment.
Poland	Inflation target	Polish zloty	Inflation target: 2.5% ±1 p.p. (annual rate of change in the 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 a central rate of SIT 239.640 per euro.
Slovakia	Inflation targeting in the conditions of ERM II	Slovak koruna	Participates in ERM II with a ±15% fluctuation band around a central rate of SKK 38.4550 per euro. Inflation objective: short-term inflation target set at 3.5% ±0.5 p.p. at end-2005. The inflation target for the period 2006-08 is set below 2.5% for end-2006 and below 2% at end-2007 and at end-2008.
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 [1]. In case of a deviation of more than 1 p.p., the MPC is expected to write an open letter to the Chancellor of the Exchequer. Free floating exchange rate.

Source: ESCB.
1) The CPI is identical to the HICP.

Turning to the non-euro area EU countries with an inflation-targeting framework in place, most countries reduced their key policy rates in 2005. In light of the improved inflation outlook Hungary, Poland and Slovakia reduced their policy rates by a total of 350, 200 and 100 basis points to 6%, 4.5% and 3% respectively. In Slovakia, the interest rate decisions were also motivated by the currency appreciation. In Poland, the key policy rate was further decreased by 25 basis points to 4.25% in January 2006. In Sweden and the United Kingdom, key policy rates were lowered in 2005 by 50 and 25 basis points to 1.5% and 4.5% respectively, reflecting weakening output growth and lower prospective inflation. However, in Sweden, policy rates were raised by 25 basis points to 1.75% in January 2006 and by a further 25 basis points to 2.0% in February 2006. The decisions were based on the December 2005 and February 2006 Inflation Reports' forecasts (given a rising path for short-term interest rates). In the Czech Republic, policy rates were reduced by a total of 75 basis points in the first half of 2005 in light of a favourable inflation outlook and the appreciating koruna, although they were raised again by 25 basis points, to 2%, towards the end of October in line with the latest inflation forecast and the related risks.

FINANCIAL DEVELOPMENTS

In 2005 movements of long-term bond yields in the majority of the non-euro area EU Member States followed those of similar rates in the euro area and showed a general decline until September, after which they increased somewhat, particularly in Hungary and Poland. In Lithuania and Slovenia, long-term interest rates declined gradually to the euro area level, whereas in Malta and the United Kingdom they were somewhat more stable. Overall, for most of the countries, long-term interest rates were between 20 and 55 basis points lower at the end of 2005 than at the beginning of the year, with stronger declines recorded for Latvia, Poland, Slovakia and, in particular, Cyprus (of more than 200 basis points). With euro area long-term interest rates declining by around 30 basis points during 2005, bond yield spreads vis-à-vis the euro area remained stable or narrowed. However, spreads vis-à-vis the euro area increased rather markedly in Hungary and Poland in the final quarter of the year. Market reaction reflected unfavourable fiscal trends in Hungary and uncertainty concerning fiscal developments and economic policy after parliamentary elections in Poland.

Stock markets in the non-euro area EU countries continued to perform favourably in 2005 and, with the exceptions of Slovenia and the United Kingdom, outperformed the average stock price developments in the euro area, as measured by the Dow Jones EURO STOXX index. At the end of 2005, stock prices in the new EU Member States, with the exception of Slovenia, were between 25% and 65% higher than at the beginning of the year.

Artist
Ilse Haider
Title
Kopf eines Athleten, 1994
Material
Willow rods, photo emulsion
Format
180 x 120 x 40 cm

CHAPTER 2

CENTRAL BANK OPERATIONS AND ACTIVITIES

1 MONETARY POLICY OPERATIONS, FOREIGN EXCHANGE OPERATIONS AND INVESTMENT ACTIVITIES

1.1 MONETARY POLICY OPERATIONS

The operational framework for the implementation of the single monetary policy[1] continued to work effectively in 2005. Very short-term money market interest rates were stable throughout the year. The EONIA registered very low levels of volatility in 2005. The standard deviation of the spread between the EONIA and the minimum bid rate stood at 5 basis points, as compared with 9 basis points in 2004 and 16 basis points in 2003.

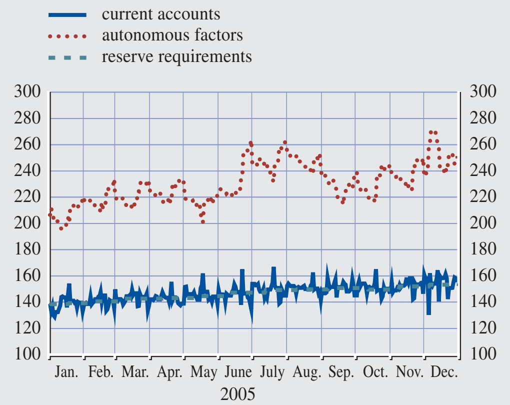
Developments in late 2005 provided the first opportunity to test, to some extent, the capability of the operational framework – as amended in March 2004[2] – to neutralise within a maintenance period the impact of a change in expectations regarding the key ECB interest rates. After more than two years of anticipating no change in interest rates, the money market was affected in November 2005 by expectations of an interest rate increase. Following a statement by the President of the ECB on 18 November prior to the Governing Council meeting of 1 December, the overnight rate rose by up to 12 basis points. However, it started to fall a few days later and, following a liquidity allotment above the benchmark[3] in the last main refinancing operation (MRO) of the maintenance period, which was accompanied by an explanatory statement, it moved closer to its former levels. It therefore seems that, despite the initial reaction, the alignment of the start of the maintenance period with the implementation of interest rate change decisions effectively helped to avoid significant and lasting interference from expectations of interest rate changes during the preceding maintenance period.

ASSESSMENT AND MANAGEMENT OF LIQUIDITY CONDITIONS

The Eurosystem's liquidity management relies on the daily assessment of the liquidity conditions in the euro area banking system in order to determine the liquidity needs of the system and thus the volume of liquidity to be allotted in the weekly MROs, in the monthly longer-term refinancing operations (LTROs) and potentially through other open market operations such as fine-tuning operations. The liquidity needs of the banking system are defined by the sum of reserve requirements imposed on banks, by funds held in excess of these requirements on credit institutions' current accounts with their NCBs (excess reserves) and by autonomous factors (see Chart 38). The latter are a set of items on the Eurosystem's balance sheet which have an impact on banks' liquidity needs but are not normally under the direct control of the Eurosystem's liquidity management (e.g. banknotes in circulation, government deposits and net foreign assets).

Chart 38 Liquidity factors in the euro area in 2005

(EUR billions)



Source: ECB.

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.

2 Two changes were introduced in March 2004: i) the timing of the reserve maintenance periods was adjusted so that these periods always start on the settlement date of the main refinancing operation (MRO) following the Governing Council meeting at which the monthly decision on the monetary policy stance is scheduled, and ii) the maturity of the MROs was shortened from two weeks to one week. See the ECB's Annual Report 2004, pp. 82-83.

3 The benchmark amount is the allotment amount normally required to establish balanced conditions in the short-term money market, given the Eurosystem's complete liquidity forecast. The published benchmark allotment is rounded to the nearest €500 million.

In 2005 the daily liquidity needs of the euro area banking system amounted to €377.4 billion on average, representing an increase of 21% compared with 2004. On average, reserve requirements stood at €146.5 billion, excess reserves at €0.8 billion and autonomous factors at €230.1 billion. Among the autonomous factors, banknotes continued to show the strongest annual rate of growth. The average amount of banknotes recorded an annual growth rate of around 15%, which was similar to that in 2004. Banknotes reached an all-time high of €568 billion on 24 December 2005.

MAIN REFINANCING OPERATIONS

The MROs are weekly liquidity-providing operations with a maturity of one week, conducted as variable rate tenders with a minimum bid rate following the multiple rate auction procedure. The MROs are the most important open market operations conducted by the Eurosystem as they play a pivotal role in steering interest rates, managing the liquidity situation in the market and signalling the stance of monetary policy through the level of the minimum bid rate.

To help credit institutions to prepare their bids in the MROs, the ECB continued in 2005 to publish a forecast each week of the daily average autonomous factors and the benchmark amount. The purpose of this communication policy is to avoid misperceptions in the market as to whether or not the allotment decisions in MROs aim to balance liquidity conditions.

In 2005 the amounts allotted in MROs ranged from €259.0 billion to €333.5 billion. The average number of bidders in an MRO was 351, thus remaining at similar levels to those observed in 2004 after the changes to the framework had been implemented. The liquidity provided through MROs represented 77% of the overall net liquidity supplied by the Eurosystem through monetary policy operations. The average spread between the marginal rate and the minimum bid rate amounted to 5.3 basis points, compared with 1.6 basis points in 2004 and 4.7 basis points in 2003. The spread remained generally stable at 5 basis points for the first three quarters of 2005, but started to drift upwards in September, reaching 7 basis points in mid-October. At that point the ECB communicated its uneasiness with regard to the rise and initiated a policy of allotting slightly more than the benchmark amount, while still aiming for balanced conditions at the end of the reserve maintenance period. This "loose allotment policy" effectively led to the stabilisation of the spread between the marginal rate and the minimum bid rate at 5 basis points.

FINE-TUNING OPERATIONS

As a consequence of the changes to the operational framework implemented in March 2004, the scope increased for liquidity forecast errors to accumulate during the eight-day period between the last MRO of a maintenance period and the end of that maintenance period. The absolute difference between the forecast and the actual outcome over eight days reached, on average, €7.16 billion in 2005. In order to prevent these errors from triggering significant recourse to standing facilities, and to avoid large spreads between the overnight rate and the minimum bid rate, the ECB carried out fine-tuning operations on the last day of the reserve maintenance period whenever it expected a notable liquidity imbalance. In total, nine fine-tuning operations were carried out, three of them liquidity-providing (18 January, 7 February and 6 September) and six liquidity-absorbing (8 March, 7 June, 12 July, 9 August, 11 October and 5 December). They all aimed at restoring balanced liquidity conditions and contributed to stabilising the overnight rate at the end of the reserve maintenance periods.

LONGER-TERM REFINANCING OPERATIONS

The LTROs are liquidity-providing operations conducted on a monthly basis. They are usually allotted on the last Wednesday of the month and have a three-month maturity, thereby giving banks the opportunity to cover their liquidity needs for a longer period of time. In contrast to the MROs, the LTROs are not used to signal the Eurosystem's monetary policy stance. They are conducted as pure variable rate tenders with a pre-announced allotment volume, and the Eurosystem therefore acts as a rate-taker.

LTROs accounted for around 23% of the total net liquidity provided through open market operations in 2005. The allotment volume for each operation increased from €25 to €30 billion in January 2005 and to €40 billion in January 2006.

STANDING FACILITIES

The two standing facilities offered by the Eurosystem, i.e. the marginal lending facility and the deposit facility, provide and absorb overnight liquidity at interest rates which form a corridor for the interbank overnight rate. In 2005 the width of the corridor remained unchanged at 200 basis points, centred around the minimum bid rate of the MROs.

In 2005 the average daily recourse to the marginal lending facility amounted to €106 million, while the average daily recourse to the deposit facility totalled €122 million. The low recourse to the standing facilities in 2005 was in line with previous years and reflects the high efficiency of the interbank market, as well as the lower liquidity imbalances observed on the last day of each reserve maintenance period. This reduction in liquidity imbalances is consistent with the more frequent recourse in 2005 to fine-tuning operations in the event of notable liquidity forecast errors.

MINIMUM RESERVE SYSTEM

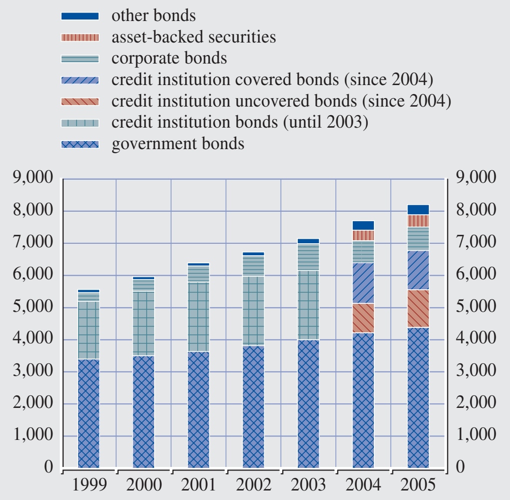
Credit institutions in the euro area must hold minimum reserves on accounts with the NCBs. The minimum reserves amount to 2% of a credit institution's reserve base, which is determined in relation to elements of the institution's balance sheet. The minimum reserve obligation must be fulfilled on average over a reserve maintenance period. The system has two functions: first, to stabilise short-term money market rates through the averaging provision, and second, to enlarge the liquidity deficit, i.e. banks' overall need for refinancing from the Eurosystem. The amount of reserve requirements gradually increased in 2005, reaching €153 billion during the last maintenance period of the year.

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. Owing to the special nature of European financial markets and the Eurosystem's operational framework for monetary policy, a broad range of assets are accepted as collateral. The average amount of eligible marketable collateral was €8.3 trillion in 2005, which was 7% higher than in 2004 (see Chart 39). General government debt comprised 53% of the total, with the remainder taking the form of covered (i.e. Pfandbrief-style) or uncovered credit institution bonds (29%), corporate bonds (9%), asset-backed securities (5%), and other bonds, such as those issued by supranational organisations, (4%). The average value of marketable assets deposited by counterparties as collateral against Eurosystem credit operations stood at €866

Chart 39 Eligible marketable assets

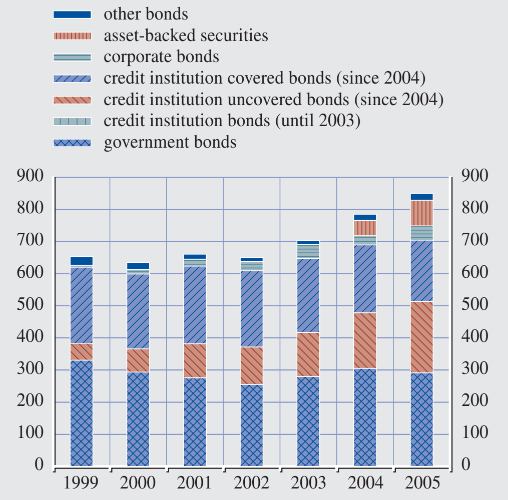
(EUR billions)



Source: ECB.

Chart 40 Eligible marketable assets put forward as collateral

(EUR billions)



Source: ECB.

billion in 2005, compared with €787 billion in 2004 (see Chart 40).

Chart 41 illustrates the difference between the assets eligible to be used as collateral and those actually put forward as collateral in Eurosystem credit operations, broken down by asset type. Government debt accounted for 53% of the available marketable collateral, but only 34% of collateral put forward. However, credit institution uncovered bonds accounted for 14% of available marketable collateral, but for 27% of the amount of collateral put forward. Asset-backed securities accounted for 5% of available collateral, but for 10% of the collateral used.

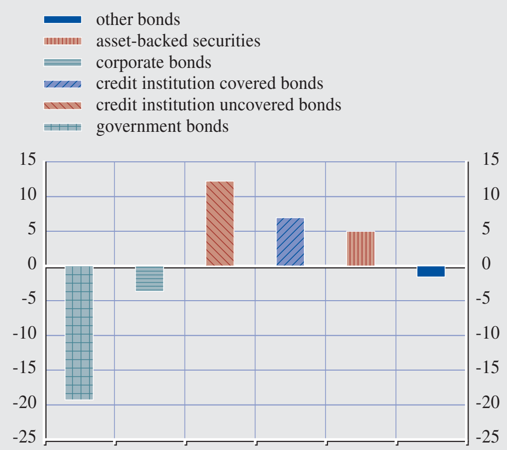
There were a number of important developments with regard to the Eurosystem's collateral policy during 2005. First, the Eurosystem finalised its reformulation of the eligibility criteria for asset-backed securities. This was necessary as asset-backed securities are becoming an increasingly important source of collateral in Eurosystem operations, and counterparties were calling for greater transparency regarding the types of asset-backed securities which are accepted. The amended criteria were announced in January 2006 and will be applicable from May 2006. The asset-backed securities which are currently on the list of eligible assets but do not comply with the criteria will be phased out by October 2006.

The Eurosystem also made explicit the minimum credit standard that has consistently been applied when accepting assets as collateral since the single currency was introduced – namely, at least a "single A" credit rating from one of the three major international rating agencies. The "single A" credit rating is equivalent to a long-term rating of at least A- from Standard & Poor's or Fitch Ratings, or at least A3 from Moody's. It was also clarified that this requirement applies in the same way to private and public sector issuers.

Progress was also made in the move towards establishing a single list of collateral which will gradually replace the present two-tier collateral system. It is expected that the single list will increase the availability of collateral, enhancing the level playing-field in the euro area, further promoting equal treatment for counterparties and issuers, and increasing the overall transparency of the collateral framework.

Chart 41 Difference between the share of collateral put forward and the share of eligible marketable assets in 2005

(percentages)



Source: ECB.

The first two main measures towards implementing the single list entered into force in 2005:

– First, the list of non-regulated markets acceptable to the Eurosystem from a collateral management point of view was published on 30 May. The list is available on the ECB's website and will be updated at least once a year. Assets listed, quoted or traded only on non-regulated markets that are not included in this list will remain acceptable until May 2007, after which date they will become ineligible.

– Second, a new category of previously ineligible collateral, namely euro-denominated debt instruments issued by entities established in those G10 countries that are not part of the EEA, was introduced into the tier one list on 1 July. The total amount of new eligible collateral amounted to €137 billion at the end of 2005. The use of these new instruments gradually increased throughout the second half of 2005, reaching €5.3 billion by the end of December.

In February 2005 the Governing Council announced that the next step towards the single list – the inclusion of bank loans – would take place according to the following time frame:

– Bank loans will be eligible as collateral for Eurosystem credit operations in all euro area countries from 1 January 2007, when common eligibility criteria and the Eurosystem credit assessment framework (ECAF) will be implemented. The ECAF is a set of procedures and rules establishing the Eurosystem's requirement that all eligible collateral in the future single list meet high credit standards (see below).

– Between 1 January 2007 and 31 December 2011 an intermediate regime will be in place, allowing each euro area NCB to determine the size threshold above which loans will be eligible for collateral purposes and to decide whether a handling fee should be applied.

– As from 1 January 2012 a unified regime will be in place for the use of bank loans as collateral with a common minimum threshold of €500,000.

In July 2005 the Governing Council approved the general eligibility criteria that bank loans will have to fulfil and, in November 2005, also approved the core elements of the ECAF, which will ensure that debtors meet the Eurosystem's high standards of financial soundness. Implementation work for the bank loans framework is under way. The final technical and operational details regarding the inclusion of bank loans will be announced during the first half of 2006.

RISK MANAGEMENT ISSUES

When conducting credit operations for monetary policy or payment system purposes, the Eurosystem incurs both credit and market risks associated with potential counterparty default. These risks are mitigated by the requirement to provide adequate collateral, as laid down by Article 18.1 of the Statute of the ESCB, in conjunction with an appropriate valuation of collateral and risk control measures.

The ECAF will be effective as of 1 January 2007. It relies on four sources of credit quality assessment: external credit assessment institutions, NCBs' in-house credit assessment systems, counterparties' internal ratings-based systems and third-party providers' rating tools. Consistency, accuracy and comparability will be the core principles underpinning the ECAF.

In order to ensure that these core principles are applied, all credit quality assessment sources will have to fulfil certain eligibility criteria. In addition, a set of technical specifications and tools – including a credit quality threshold and a credit assessment performance monitoring and reporting procedure – will be used to guarantee that eligible collateral meets the minimum creditworthiness standards.

As regards the benchmark for credit risk, the Eurosystem will in principle only accept the debt instruments of borrowers:

- with at least a "single A" rating from one of the three major international rating agencies; or

- with a probability of default of no more than 0.10%, which includes borrowers belonging to a risk bucket with an expected one-year probability of default of no more than 0.10%.

This definition applies equally to private and public issuers as required by Article 102 of the Treaty, which prohibits the ECB from granting more favourable terms to public sector debt instruments.

1.2 FOREIGN EXCHANGE OPERATIONS

In 2005 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 five occasions in 2005.

1.3 INVESTMENT ACTIVITIES

The ECB's investment activities are organised in such a way as to ensure that no insider information about central bank policy actions may be used when making investment decisions. A set of rules and procedures, known as the Chinese wall, separates the ECB business units involved in investment activities from other ECB business units.

FOREIGN RESERVE MANAGEMENT

The ECB's foreign reserve portfolio reflects transfers of foreign reserves from the euro area NCBs to the ECB, as well as past foreign exchange and gold operations of the ECB. The main purpose of the ECB's foreign reserves is to facilitate intervention by the ECB in the foreign exchange market. The objectives for the management of the ECB's foreign reserves are, in order of importance, liquidity, security and return. In 2005 the ECB's foreign reserves were managed in a decentralised way, with each NCB holding and actively managing a fraction of the ECB's portfolio.

The ECB's foreign reserve portfolio mainly consists of US dollars, but also includes Japanese yen, gold and SDRs. Gold and SDR holdings were not actively invested in 2005. The ECB carried out gold sales amounting to 47 tonnes of gold in total. These sales were in full conformity with the Central Bank Gold Agreement of 27 September 2004, of which the ECB is a signatory. The value of the ECB's official foreign reserve assets at current exchange rates and market prices increased from €35.1 billion at end-2004 to €41.0 billion at end-2005. The change in the value of the portfolio during 2005 mainly reflected the appreciation of the US dollar and gold vis-à-vis the euro as well as the positive returns (comprising capital gains and interest income) generated by portfolio management activities.

In January 2006 a new operational framework was implemented for the ECB's foreign reserve management. The changes to the framework were introduced in order to increase the efficiency of the decentralised execution of investment operations within the Eurosystem. In the area of the operational management of the ECB's foreign reserves (i.e. the carrying-out of operations to invest those funds), each euro area NCB may now as a rule manage only one portfolio (i.e. either a US dollar or a Japanese yen portfolio). However, two NCBs each manage two portfolios. Furthermore, a euro area NCB may choose to opt out of the operational management of the ECB's foreign reserves while still being involved in strategic portfolio management activities, such as strategic benchmark reviews and reviews of the risk control framework. Euro area NCBs that choose to take part in the operational management may also pool these activities.

In 2005 work continued on extending the list of eligible instruments in which foreign reserves can be invested. In early 2006 foreign exchange swaps and US STRIPS[4] were added to this list. Preparatory work for the introduction of interest rate swaps was also carried out.

OWN FUNDS MANAGEMENT

The ECB's own funds portfolio consists of the paid-up share of the subscribed capital and the general reserve fund of the ECB. 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 2005 the list of issuers of instruments eligible for investment was further expanded in the very high-grade agency and covered bond segment. In early 2006 senior unsecured bonds issued by financial sector firms with high credit ratings were added to the list of investment options.

The ECB's own funds portfolio at current market prices grew from €6.1 billion at end-2004 to €6.4 billion at end-2005, reflecting positive portfolio management returns in the form of capital gains and interest income.

RISK MANAGEMENT ISSUES

The framework used by the ECB to mitigate the financial risks it incurs (such as market, credit and liquidity risk) is implemented, inter alia, via stringent policy requirements (such as restrictions in terms of duration, currency distribution and minimum portfolio liquidity) and a detailed limits system, whereby compliance is monitored and verified on a daily basis. In 2005 preparations were made for the implementation of Value-at-Risk (VaR)[5] as the main tool for defining thresholds for the risks associated with portfolio managers' trading positions relative to the ECB's reference benchmark portfolios. VaR offers several conceptual advantages and, as a comprehensive risk measure, has gained wide popularity in the financial industry. This is also evidenced by the importance it has been accorded by the New Basel Capital Framework in relation to the calculation of capital requirements.

4 STRIPS stands for Separate Trading of Registered Interest and Principal of Securities, which are securities created by separating the bond principal from the interest payments in a US government bond.

5 VaR is defined as the loss amount that may be exceeded with a certain probability over a predefined time horizon. For instance, the one-year 99% VaR is the loss that will be exceeded within one year with only a 1% probability.

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. TARGET has been subject to enhancements over the past few years, and work is under way to develop a second-generation system, TARGET2.

In August 2005 the ECB released a policy statement on "Central banks' provision of retail payment services in euro to credit institutions". While recalling the Eurosystem's statutory backing for the provision of processing facilities for retail payments in euro for credit institutions, it noted, inter alia, that NCBs which offer retail payment services to credit institutions take due account of the requirements and competitive environment of the market concerned, including cost recovery.

With regard to securities settlement, 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 real-time gross settlement (RTGS) systems of 16 EU Member States, the ECB payment mechanism (EPM) and an interlinking mechanism that enables the processing of payments between the linked systems.

In 2005 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 2005 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 2005 89% of the total turnover of large-value payments in euro was executed via TARGET. TARGET is available for all credit transfers in euro between connected banks, without any upper or lower value limit. 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).

A survey conducted in 2005 revealed that as at 31 December 2004 there were 10,564 participants in TARGET. Overall, around 53,000 institutions, in particular branches of participants, can be addressed through TARGET using a Bank Identifier Code.

TARGET OPERATIONS

In 2005 the daily average of payments processed by TARGET increased by 10% both in volume and in value. Table 12 provides an overview of the payment traffic in TARGET in 2005, comparing it with the traffic in the previous year.

In 2005 the overall availability of TARGET, i.e. the extent to which participants were able to use TARGET during its business hours without incident, reached 99.83% (see Table 13). On average, 95.59% of inter-Member State payments were processed within five minutes.

Table 12 Payment traffic in TARGET [1]

Volume (number of transactions)	2004	2005	Change (%)
Overall			
Total	69,213,486	76,150,602	9
Daily average	267,234	296,306	10
Intra-Member State [2]			
Total	52,368,115	58,467,492	10
Daily average	202,193	227,500	11
Inter-Member State			
Total	16,845,371	17,683,110	5
Daily average	65,040	68,806	5

Value (EUR billions)	2004	2005	Change (%)
Overall			
Total	443,992	488,900	9
Daily average	1,714	1,902	10
Intra-Member State [2]			
Total	297,856	324,089	8
Daily average	1,150	1,261	9
Inter-Member State			
Total	146,137	164,812	11
Daily average	564	641	12

Source: ECB.
1) 259 operating days in 2004 and 257 operating days in 2005.
2) Includes the traffic of remote participants.

Table 13 Overall availability of TARGET

(percentages)

RTGS system	2005
EPM (ECB)	99.52
ELLIPS (BE)	99.66
KRONOS (DK)	99.84
RTGSplus (DE)	99.24
HERMES euro (GR)	99.80
SLBE (ES)	99.93
TBF (FR)	99.62
IRIS (IE)	99.93
BI-REL (IT)	99.89
LIPS-Gross (LU)	99.93
TOP (NL)	100.00
ARTIS (AT)	99.86
SORBNET-EURO (PL)	100.00
SPGT (PT)	99.97
BOF-RTGS (FI)	99.98
E-RIX (SE)	99.89
CHAPS Euro (UK)	99.97
Overall system availability	99.83

Source: ECB.

CONTINGENCY MEASURES 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 2005 a number of further 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 NCBs of the new Member States would be allowed – but not obliged – to connect to the current TARGET system. 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 NCBs of the new Member States to connect their systems to the current TARGET system.

Poland was the first new Member State to join TARGET. On 7 March 2005 Narodowy Bank Polski's euro RTGS system (SORBNET-EURO) was connected to TARGET via the Banca d'Italia's RTGS system (BI-REL).

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 2005, as in previous years, regular meetings were held between the 16 NCBs linked to TARGET and the national TARGET user groups. In addition, joint meetings of the ESCB's Working Group on TARGET2 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

On 8 February 2005 the ECB published the first progress report on TARGET2. The report contained information about the decisions taken by the Governing Council in December 2004 on the TARGET2 service, the general pricing framework for the core service and the migration to TARGET2. It also provided an overview of the overall project planning.

The second progress report was published on 21 October 2005. It presented the decisions made by the Governing Council mainly in respect of the planned start date of TARGET2, the dates for the different migration windows, and the pricing of the liquidity pooling service and ancillary system settlement. It also outlined a pricing scheme for the TARGET2 core service which will be discussed with the banking community before a final decision is taken. Finally, the report provided details on the timetable of the TARGET2 operational day and the ongoing work related to contingency arrangements.

The main preparatory work undertaken in 2005 related to the finalisation of the functional specifications. An interim version of the User Detailed Functional Specifications (UDFS) was completed at the end of August 2005, in close collaboration with the TARGET user community. The final UDFS (version 2.0) were made available to users on 30 November. The finalisation allowed progress to be made on the development and technical implementation of the single shared platform for TARGET2, as well as on the adaptation of the internal systems of the individual participants for connection to the new system.

With regard to the planned start date, the Governing Council communicated to the market on 17 June 2005 that the period of extensive user consultation had been concluded and that the go-live date for the first migration window would be during the second half of 2007. After a comprehensive assessment of the planning arrangements, 19 November 2007 was set as the go-live date for the first group of countries to migrate. All central banks participating in TARGET2, together with their national banking communities, are expected to be using the new system by May 2008. Sveriges Riksbank and the Bank of England have decided not to connect to TARGET2.

Another major area of work in 2005 focused on the preparations for the forthcoming testing and migration activities. The Eurosystem agreed to split the migration into four waves, with the last wave being reserved for contingency purposes only. Each wave will consist of a group of NCBs and their respective banking communities. The planned dates of each migration wave are as follows: 19 November 2007, 18 February 2008, 19 May 2008 and 15 September 2008 (in the event that the contingency window has to be used). In May 2005 the Eurosystem published national migration profiles describing the usage of the different modules from the date the central banks will migrate to TARGET2. Testing will be carried out with users according to migration waves. For each wave, tests will be split into different streams, for example at the institutional level, at the level of national banking communities and at the European level. Testing activities with central banks are planned to start in early 2007. At the end of October 2005 a general description of the planning and organisational aspects of the user testing activities was published on the websites of the NCBs.

The envisaged pricing scheme for the core service aims to meet two main objectives. First, it should ensure broad access to the system, which means that it should not discourage smaller institutions from direct participation. Second, the pricing should be attractive to the major market participants, which account for a very large share of the current TARGET transactions. The scheme presented in the second progress report allows participants to choose between i) a small monthly fee of €100 plus a flat rate of €0.80 per transaction and ii) a monthly fee of €1,250 plus a volume-based degressive fee ranging from €0.60 to €0.20 per transaction. The monthly fee is a fixed amount payable by each participant per settlement account. The average fees under the envisaged pricing scheme are, in almost all countries concerned, considerably lower than those of the existing TARGET system. All central banks, irrespective of their individual migration dates, will apply TARGET2 prices only when the countries in the third migration group have joined the shared platform, i.e. as from May 2008.

Work was also conducted on the contractual and other legal issues relating to TARGET2, as well as on the business framework (e.g. contingency arrangements and interaction with ancillary systems). The Eurosystem will continue its fruitful dialogue and close cooperation with the TARGET community for the remainder 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 mainly by means of the correspondent central banking model (CCBM) or through eligible links between euro area 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 €370 billion in December 2004 to €444 billion in December 2005. Overall, at the end of 2005 cross-border collateral represented 49.1% 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 located in another euro area country.

THE CORRESPONDENT CENTRAL BANKING MODEL

The CCBM has remained the main channel for transferring cross-border collateral in Eurosystem monetary policy and intraday credit operations. It accounted for 36.7% of the total collateral provided to the Eurosystem in 2005. Assets held in custody through the CCBM increased from €298 billion at the end of 2004 to €353 billion at the end of 2005.

Work on the review of the CCBM's technical and operational set-up started in 2005 in view of the forthcoming implementation of the new Eurosystem collateral framework approved by the Governing Council in July 2005. This framework foresees a single list of eligible assets and allows bank loans to be used as collateral in any euro area country. Furthermore, initial steps have been taken to integrate some of the new EU Member States into the CCBM framework in view of the future enlargement of the euro area.

As there is no comprehensive market alternative to the CCBM service, which was designed as an interim arrangement in the absence of a market solution throughout the euro area, the ECB started an analysis of possible ways to develop the operational framework for collateral management in the Eurosystem.

ELIGIBLE LINKS BETWEEN NATIONAL SECURITIES SETTLEMENT SYSTEMS

National 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. 59 links are currently available to counterparties, of which only a limited number are actively used. 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.[6] The Eurosystem assesses any new links or updates of eligible links against these standards. In 2005 three existing eligible links were updated and positively assessed.

Collateral held through links increased from €72 billion in December 2004 to €91 billion in December 2005. This represented 8.6% of the total collateral, cross-border and domestic, held by the Eurosystem in 2005.

In 2005 the Eurosystem decided that relayed links between SSSs could be used for the cross-border transfer of collateral to the Eurosystem. A relayed link is a contractual and technical arrangement that allows two SSSs which are not directly connected to settle a transaction through a third SSS. To prevent the Eurosystem from being exposed to any unacceptable risks, a relayed link used by market participants will be considered eligible only if the link itself and the SSSs it links comply with the Eurosystem user standards. In this context, a methodology for the assessment of relayed links by the Eurosystem has been developed. A first wave of assessments of relayed links started in 2005.

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

3 BANKNOTES AND COINS

3.1 THE CIRCULATION OF EURO BANKNOTES AND COINS AND THE HANDLING OF CURRENCY

DEMAND FOR EURO BANKNOTES AND COINS

In 2005 the value of euro banknotes in circulation increased by €63.9 billion to €565.2 billion (see Chart 42). The annual growth rate declined to about 12.8%, from 15.0% in 2004. The number of banknotes in circulation increased to 10.4 billion at the end of 2005, at an annual growth rate of 7.4%, compared with 6.8% in 2004 (see Chart 43). Statistical analyses indicate that the continuing increase in demand for euro banknotes originates to some extent from markets outside the euro area. It is estimated that, in value terms, between 10% and 20% of the euro banknotes in circulation are held by non-euro area residents, mainly as a store of value or as a parallel currency.

The value of the euro banknotes in circulation continued to grow more strongly than the number in 2005, as it has done every year since the cash changeover. This indicates a lasting strong demand for high-denomination euro banknotes. The growth patterns of the individual denominations were similar to those in 2004: the circulation of €5, €10, €20 and €200 banknotes rose moderately at rates between 3.1% and 3.9%, while the circulation of €50, €100 and €500 banknotes increased strongly, at 11.4%, 10.8% and 20.9% respectively (see Chart 44).

The euro coins in circulation have continued to increase in terms of both volume and value since January 2003. In 2005 the value of euro coins in circulation (i.e. the net circulation excluding stocks held by NCBs) increased by 8.5%, from €15.3 billion to €16.6 billion. The number of euro coins in circulation grew by 12.1%, from 56.2 billion to 63.0 billion. The strong increase in the number of coins was mainly driven by a growing demand for low-value coins.

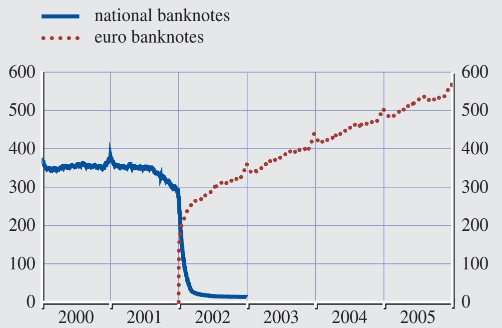
BANKNOTE HANDLING BY THE EUROSYSTEM

2005 saw a continuation of the slight upward trend in euro banknote issuance and deposits seen in previous years. The total number of euro banknotes issued amounted to 31.3 billion, while 30.6 billion were returned to the NCBs.

All euro banknotes returned from circulation to the euro area NCBs are authenticated and checked for circulation fitness using fully automated banknote-processing machines. Approximately 1 billion more banknotes than in the previous year were checked in this way in 2005. Some 4.3 billion banknotes were destroyed because they were soiled or worn and thus no longer fit for circulation.

Chart 42 Total value of banknotes in circulation between 2000 and 2005

(EUR billions)



Source: ECB.

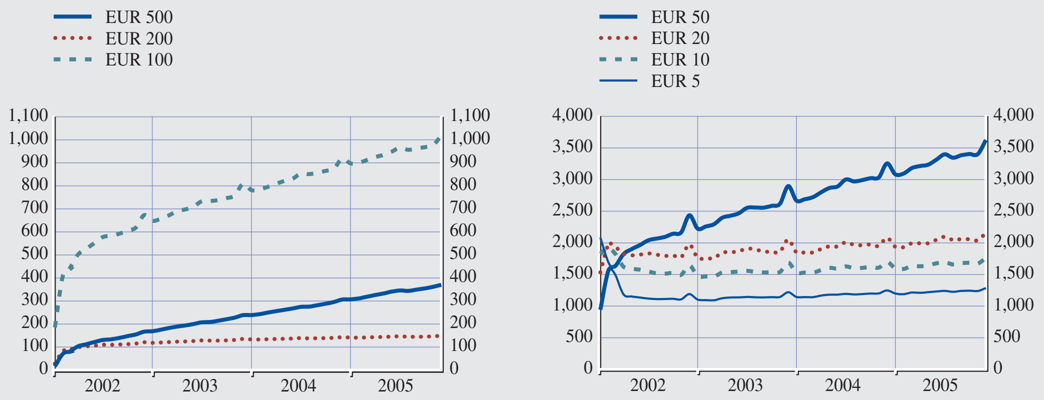
Chart 43 Total number of euro banknotes in circulation between 2002 and 2005

(billions)

Source: ECB.

Chart 44 Number of euro banknotes in circulation between 2002 and 2005

(millions)



Source: ECB.

3.2 BANKNOTE COUNTERFEITING AND COUNTERFEIT DETERRENCE

COUNTERFEIT EURO BANKNOTES

The number of reported counterfeit euro banknotes remained stable in 2005. From the beginning of 2004 until the end of 2005, around 49,000 counterfeits per month were removed on average from circulation. The total number of counterfeits received by National Analysis Centres[7] in 2005 was around 582,000. This is very similar to the figure for 2004 (594,000). The public can be confident in the security of the euro: it is 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 ECB's advice to the public is to be alert and to remember the "feel-look-tilt" test.[8] Chart 45 shows the trend in counterfeits recovered from circulation, with figures taken at half-yearly intervals since the euro banknotes were launched. Table 14 shows that the €50 banknote has been the most frequently counterfeited; since 2004 the proportion of €50 counterfeits has risen, whereas the proportion of €100 counterfeits has shown a corresponding fall.

Table 14 Distribution of counterfeits by denomination

	€5	€10	€20	€50
Percentage	1	7	21	59
	€100	**€200**	**€500**	**Total**
Percentage	7	4	1	100

Source: Eurosystem.

COUNTERFEIT DETERRENCE

The ECB continues to work closely with the euro area NCBs, Europol and the European Commission (in particular the European Anti-Fraud Office, OLAF) in the fight against counterfeiting of the euro. The Eurosystem is active, both in the EU and beyond, in training cash-handling professionals in the recognition and handling of counterfeit banknotes.

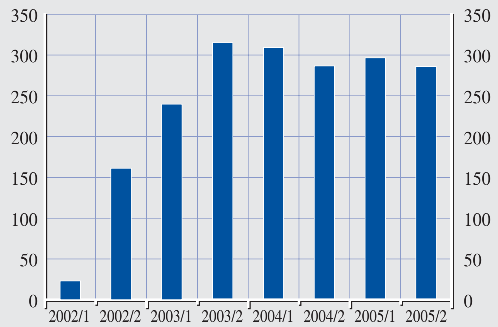
The International Counterfeit Deterrence Centre (ICDC) evaluates new reproduction equipment and counterfeit deterrence systems and supports the Central Bank Counterfeit Deterrence Group (a group of 27 central banks collaborating under the auspices of the governors of the G10 central banks). The growth in the deployment of counterfeit deterrence systems has resulted in a significant increase in

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

8 For details, see http://www.ecb.int/bc/banknotes/security/html/index.en.html

Chart 45 Number of counterfeit euro banknotes recovered from circulation between 2002 and 2005

(thousands)



Source: Eurosystem.

activity for the ICDC. The infrastructure supporting the fight against counterfeiting continues to be developed and, in particular, the upgraded website www.rulesforuse.org has improved communication between issuing authorities and the public regarding counterfeit deterrence systems.

3.3 BANKNOTE ISSUANCE AND PRODUCTION

FRAMEWORK FOR THE DETECTION OF COUNTERFEITS AND FITNESS SORTING

In order to ensure that the banknotes in circulation are genuine and in good condition, the ECB in January 2005 published a framework for the detection of counterfeits and fitness sorting by credit institutions and other professional cash handlers. The framework sets out a common policy for the recycling of banknotes received by credit institutions and other professional cash handlers from their customers. In addition, it provides these institutions with assistance in fulfilling their obligations as laid down in Article 6 of Council Regulation (EC) No 1338/2001 regarding the detection and withdrawal of counterfeit euro banknotes. In order to safeguard consistency in the implementation of the framework across the Eurosystem, the Governing Council adopted a manual of procedures in December 2005. The NCBs will be responsible for implementing the framework, taking into account the national situation (e.g. the economic environment, the banking structure, the existing NCB branch network and the role of the NCB in the cash cycle), at the latest by the end of 2006. In addition, there will be a transition period of two years – finishing no later than the end of 2007 – for the adaptation of procedures and machines currently in operation by credit institutions and other professional cash handlers.

A key element of the framework is the obligation of credit institutions and other professional cash handlers to check for authenticity and, according to minimum sorting standards, for fitness all euro banknotes received from customers and reissued to other customers. Where credit institutions and other professional cash handlers decide against the recycling of banknotes, they will continue to have the option of having their euro banknote requirements met by the NCBs.

Banknotes dispensed by credit institutions through automated teller machines (ATMs) will be checked using banknote-handling machines which have been tested for their compliance with the framework by euro area NCBs. Other organisations which operate ATMs, particularly retailers, are also expected to check banknotes in accordance with these standards. The Eurosystem will follow developments in this area.

The framework also stipulates that credit institutions and other professional cash handlers are to provide NCBs with information regarding their cash-handling activities to enable the Eurosystem to monitor compliance with the framework. The Governing Council decided in December 2004 that the details of this data collection would be developed by the Eurosystem in consultation with the banking sector. To this end, the Eurosystem set up a joint task force in 2005 with representatives from the European Payments Council's Cash Working Group and the European Security Transport Association. In a cost-effective approach, a limited amount of key information concerning the cash-handling infrastructure and operational data on banknote processing will be collected from institutions that recycle euro banknotes through ATMs.

THE ESTABLISHMENT OF AN EXTENDED CUSTODIAL INVENTORY PILOT PROGRAMME

The ECB is considering the establishment of an extended custodial inventory (ECI) pilot programme for euro banknotes to facilitate their international distribution and to improve the monitoring of their circulation outside the euro area, given that between 10% and 20% of the total value of euro banknotes in circulation is estimated to be held outside the euro area. An ECI is a cash depot maintained by a private bank (ECI bank) that holds currency on a custodial basis. Under such a programme, ECI banks would report on the destination and origin of banknotes traded, collect information on counterfeits seized and identify any banknotes unfit for circulation, thereby providing the Eurosystem with data on the use of the euro outside the euro area and on counterfeiting. ECI banks could also channel information concerning the introduction of a new series of euro banknotes and facilitate replacement of an old series. Before taking a final decision on the establishment and functioning of such a programme, the ECB will consider launching a one-year ECI pilot programme with two banks located in Asia.

PRODUCTION ARRANGEMENTS

A total of 3.63 billion euro banknotes were produced in 2005, compared with 1.6 billion in 2004. The production growth in 2005 reflected the following factors: i) the depletion of NCBs' stock levels in 2004, ii) an increase in circulation in 2005, iii) a rise in the number of banknotes in circulation requiring replacement and iv) the decision to produce in 2005 a share of future banknote requirements. This decision should reduce expected future production peaks and allow a more efficient use of the production capacity over the coming years.

The allocation of euro banknote production continued in 2005 to be based on the decentralised production scenario with pooling adopted in 2002. 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 2005 production allocation.

THE SECOND SERIES OF EURO BANKNOTES

Following the Governing Council's approval of the master plan for the development, printing and issuance of a second series of euro banknotes, work on this project has started and is progressing well. The main phases of the

Table 15 Allocation of euro banknote production in 2005

Denomination	Quantity (millions of banknotes)	NCB commissioning production
€5	530	FR
€10	1,020	DE, GR, IE, AT
€20	700	ES, FR, NL, PT, FI
€50	1,100	BE, DE, ES, IT, NL
€100	90	IT
€200	-	-
€500	190	DE, LU
Total	3,630	

Source: ECB.

project are the determination of the functional and technical requirements of different groups of banknote users, industrial validation to identify potential problems in large-scale printing, design and origination, pilot production, large-scale printing and phased issuance.

Basic functional requirements for the new banknotes, including a shortlist of security features, are being established on the basis of market research and consultations with European consumer associations and the European Blind Union. The consultation process has also involved the European banking, security transport, retail and vending machine sectors, as well as the association of banknote equipment manufacturers.

The first banknote in the new series is expected to be issued towards the end of this decade. The exact timing and sequence of issuance will depend on the progress made in the security feature innovation process and on the counterfeiting situation. The current denominational range of the euro banknotes will be maintained in the second series and the design will be based on the "ages and styles" theme of the present series.

4 STATISTICS

The ECB, assisted by the NCBs, collects, compiles and publishes a wide range of statistics which support the monetary policy of the euro area as well as various tasks of the ESCB. In 2005, as in previous years, the provision of statistics proceeded smoothly. In addition, new statistics became available in accordance with the ECB's medium-term strategy for statistics, and the ECB continued to contribute to the harmonisation of statistical concepts and the promotion of their observance in cooperation with Community institutions and other international organisations.

4.1 GENERAL STATISTICAL DEVELOPMENTS IN THE EURO AREA

Over the last few years significant results have been achieved in developing statistics for the euro area. The statistical framework for the euro area aims to accommodate in a forward-looking manner ongoing changes in financial markets and the economy in general, while addressing remaining statistical gaps identified by users inside and outside the ECB. In fulfilling these objectives, the ECB is firmly committed to being cost-effective and to keeping the reporting burden to a minimum. Proposals for new or substantially changed statistics are thus subject to a cost-benefit assessment involving reporting agents and compilers as well as users.

Highest priority is being given to the design and compilation of a system of quarterly financial and non-financial accounts by institutional sector for the euro area, which the Eurosystem is preparing together with the European Commission (Eurostat) and the national statistical institutes (NSIs). This integrated system of accounts is expected to be ready in 2007. It will show the interaction among various sectors of the economy, namely non-financial corporations, financial corporations, government and households, as well as the interaction between these sectors and the rest of the world. It will provide a framework for analysing the links between the financial and non-financial developments in the economy, in particular with respect to balancing items such as household and corporate savings and investment, government deficit and GDP. Over time, it should thus be possible to gain further insights into the various transmission channels of monetary policy and to better analyse the impact of economic shocks on the euro area. Ultimately, the quarterly euro area accounts will allow the monitoring of a wide range of statistics and key indicators within a single and coherent macroeconomic accounting framework.

The ECB is also developing a framework for the collection of harmonised statistics on non-monetary financial intermediaries (excluding insurance corporations and pension funds), with a particular focus on investment funds, thereby addressing the increasingly important role of these institutions in euro area financial markets.

Preparing for the future enlargement of the euro area constitutes another core element of the ECB's medium-term strategy for statistics. The ECB has been working closely with the NCBs of the non-euro area Member States to ensure that the wide range of data for which the ECB is primarily responsible are reported from the date those countries join the euro area. A general policy has been adopted for the transmission of relevant back data by all EU Member States in order to ensure that sufficiently long time series will be available for any enlarged euro area.

The ECB cooperates closely with Eurostat and other international organisations and is actively involved in the ongoing update of global statistical standards such as the System of National Accounts (SNA 93) and the IMF Balance of Payments Manual. The further development and application of internationally agreed statistical standards, as well as governance rules in the field of statistics, enables the compilation of meaningful euro area aggregates, allows cross-country comparisons and contributes to the reliability and independence of official statistics.

4.2 NEW OR ENHANCED STATISTICS

The amended ECB Regulation concerning the consolidated balance sheet of MFIs entered into force on 1 January 2005. This Regulation obliges credit institutions and money market funds to continue to report data on deposits and loans at nominal value, regardless of the application of International Financial Reporting Standards on financial instruments, thus ensuring that the conceptual basis of monetary statistics is preserved.

Since January 2005 the ECB has published a geographical breakdown of the euro area balance of payments and international investment position. Since April 2005 the international investment position has been released on a quarterly basis. These new statistics provide greater insight into the effects of cross-border transactions and positions on the euro area economy.

In September 2005 the ECB started publishing statistical indicators measuring the degree of integration in the main financial markets of the euro area, namely the money, bond, equity and banking markets. These indicators range from retail lending to wholesale equity trading (see Section 3 of Chapter 3).

Some further changes were made to the ECB's legal framework to enable the publication of new statistics in the future. As part of the above-mentioned strategy to compile an integrated set of quarterly euro area financial and non-financial accounts by institutional sector, the Governing Council amended the ECB Guideline on quarterly financial accounts. This will ensure a more comprehensive and timely provision of quarterly financial accounts from 2006, with a complete breakdown by sector and instrument, as well as counterpart sector information for deposits and loans (from 2008). Moreover, the adoption of the ECB Guideline on government finance statistics facilitated the integration of government sector statistics into the quarterly euro area accounts by institutional sector. Quarterly figures for both the euro area public debt and the deficit-debt adjustment have been published since November 2005.

In line with the ECB's commitment to improve the availability and quality of statistics for the euro area, the Governing Council adopted measures in 2005 to permit, for statistical purposes only, the exchange of confidential statistical information between statistical authorities. Sharing information – under terms of strict confidentiality – avoids multiple requests for the same information from reporting entities.

In order to facilitate the achievement of the Single Euro Payments Area (see Chapter 3), the Governing Council also endorsed the European Commission's intention to increase the threshold for balance of payments reporting of euro-denominated payments within the EU. The proposal would imply that, from January 2008, banks will no longer have to report cross-border customer payments in euro below €50,000.

Further improvements were made in 2005 regarding the dissemination and accessibility of statistics. For some statistics, tables containing both euro area aggregates and all national contributions to these aggregates became available on the ECB's website and on the websites of most euro area NCBs. Work also continued on providing policy-makers, the media, analysts, academics and other users of statistics with easier access to the statistical information on the ECB's website. This work is scheduled to be completed in the second half of 2006.

4.3 STATISTICS FOR THE ASSESSMENT OF CONVERGENCE

The Treaty states that convergence reports have to be prepared by the ECB and the European

Commission at least once every two years, or at the request of a Member State not participating in the euro area. The next convergence reports will be released in 2006.

The statistical data needed to examine the extent to which Member States have fulfilled the convergence criteria on prices, fiscal positions, exchange rates and long-term interest rates are provided by Eurostat. The ECB, together with the NCBs of the Member States concerned, assists Eurostat with the provision of long-term interest rate statistics and collects and compiles additional statistical data which supplement the four primary indicators.

As the assessment of the convergence process crucially hinges on the quality and integrity of the underlying statistics, recent developments in the compilation and reporting of statistics, particularly government finance statistics, have been closely monitored by the ECB. In this context, the ECB welcomes the initiatives carried out by the European Commission in 2005 regarding the implementation of a Code of Practice for Eurostat and the NSIs. Adherence to this code is expected to reinforce the independence, integrity and accountability of the national and Community statistical authorities, which is crucial for the production of high quality and reliable statistics in the EU.

5 ECONOMIC RESEARCH

The objective of economic research at the ECB, as well as in the Eurosystem as a whole, 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 euro area's monetary policy and the fulfilment of other tasks of the Eurosystem.

5.1 RESEARCH AGENDA

The research agenda in 2005 can be broken down into six main areas: macroeconomics and monetary economics; international economics and finance; financial stability; financial integration; macroeconometric modelling and forecasting tools; and general economic and structural issues.

In the area of macroeconomics and monetary economics, projects finalised in 2005 focused on explaining risk premia in bond yields with economic fundamentals, thus allowing more precise market-based inflation expectations to be extracted, as well as on analysing non-Ricardian households and financial market imperfections, such as credit constraints and their role in the monetary transmission mechanism. Further topics examined were the relevance of asset price movements for monetary policy, the identification of appropriate policy rules, the role of money, the importance of central bank communication and differences in economic developments across the euro area.

In the area of international economics and finance, the focus was on the exchange rate pass-through, the international transmission of shocks, risk-sharing in a monetary union, the determinants of global imbalances and the information obtained from the yield curve.

Research on financial stability issues concentrated on developing new techniques to measure the risk of bank instability. In the area of financial integration, major research was carried out on the design and calculation of indicators of financial integration in both the euro area and the new EU Member States (see Box 10). Research was also completed on the public good factor of TARGET2.

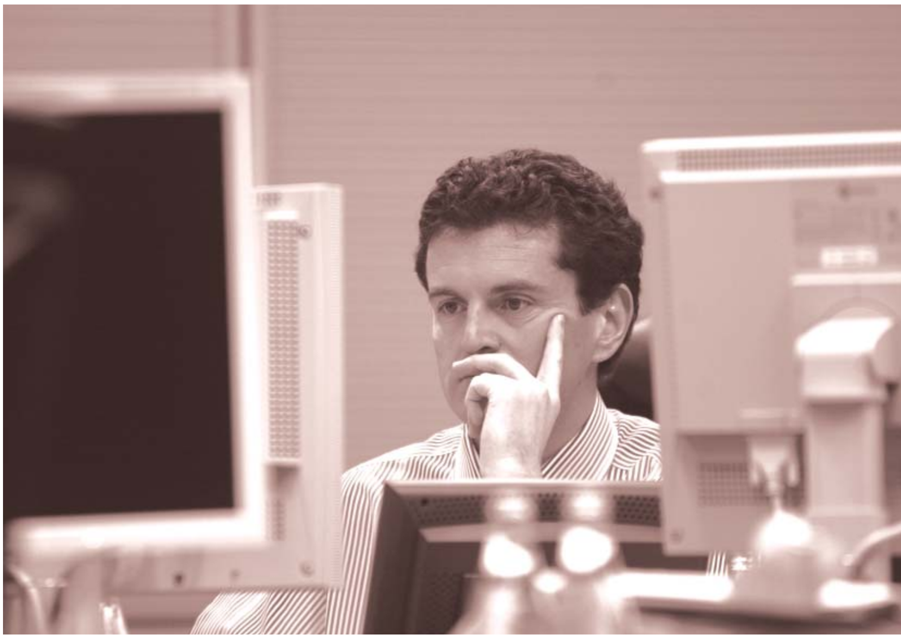
Significant progress was made in the field of macroeconometric modelling in 2005 with respect to the ECB's new area-wide model. The model has been built in line with recent developments in macroeconomic theory. By comparison with earlier models, the new generation of macroeconometric models, known as dynamic stochastic general equilibrium (DSGE) models, are based to a much larger extent on microeconomic foundations and allow a more detailed analysis of economic disturbances. The results of the technical work on the new area-wide model, together with the first empirical results of another DSGE model incorporating monetary and financial variables, were presented at a joint conference with the Board of Governors of the Federal Reserve System and the IMF in December 2005.

Further work has been undertaken to improve the short-term projections of euro area inflation and GDP growth. This has involved analysing the transmission of shocks across countries, sectors and industries, examining the predictive power of "global" inflation trends and investigating the appropriate model selection procedures. Additional research explored the comparative advantages of forecasting aggregate and disaggregate series and examined the informational content of high frequency data.

In the area of general economic and structural issues, research in 2005 shed light on the impact of labour market institutions, the factors underlying labour supply and the national differences in job-flow dynamics and real wages. Further research was conducted on the effects of fiscal reform, especially with regard to the new EU Member States.

Most of the results of the research activities carried out within or in cooperation with the

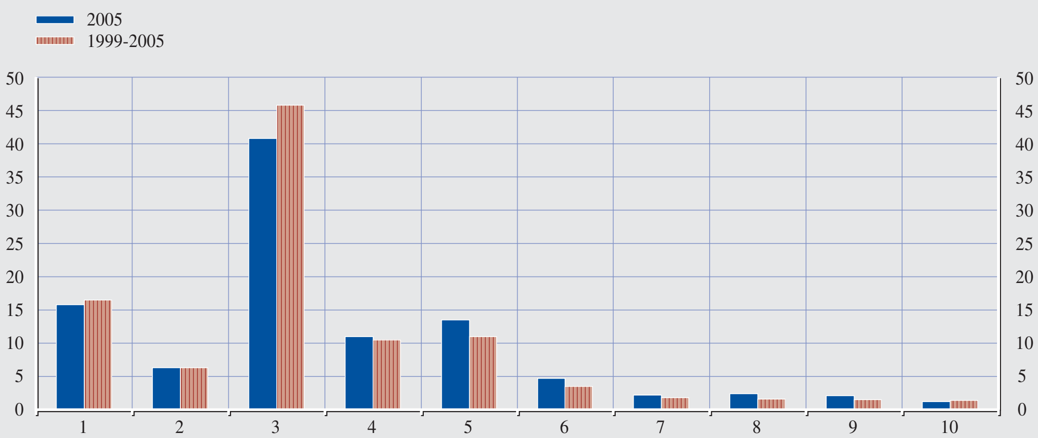
ECB were presented in the ECB's Working Paper series and – to a lesser extent – the ECB's Occasional Paper series, as well as at various conferences and workshops. 145 ECB Working Papers were published in 2005 (as compared with 126 in 2004). Of these, 68 (72 in 2004) were compiled with the involvement of ECB staff, while 77 (54 in 2004) were written by non-ECB staff in the context of research visitor programmes or conferences organised by the ECB. A considerable number of the Working Papers produced by ECB staff since the series was launched in 1999 have been published or are forthcoming in academic journals (123) or books (22). Given the long lags in publication resulting from the peer review process, this already significant proportion will increase in 2006. Chart 46 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 the year the ECB hosted a number of conferences and workshops, such as the workshop on "Monetary policy implementation in the euro area: lessons from the past and challenges ahead"; the third conference of the International Research Forum on Monetary Policy; a conference entitled "What effects is

Chart 46 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.

EMU having on the euro area and its member countries?"; a joint workshop with the Centre for Economic Policy Research (CEPR) on "Labour markets in an enlarged European Union: what would raise employment?"; an ECB-BIS workshop on "Macro-finance modelling of the term structure of interest rates"; the ninth CEPR-European Summer Institute annual conference on "Structural reforms and economic growth"; the fourth joint central bank research conference on "Risk measurement and systemic risk" in cooperation with the Bank of Japan and the Board of Governors of the Federal Reserve System under the auspices of the Committee on the Global Financial System; and the fourth workshop on forecasting techniques, entitled "Forecast evaluation and conditional forecasts".

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 brought 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. The network finalised its work in 2005. A wide range of data was used to study the phenomena of inflation persistence and price-setting, including individual and sectoral data on consumer and producer prices, macroeconomic inflation rates and survey results. 23 research papers related to the network's activities appeared in the ECB's Working Paper series in 2005. Feedback from the academic community was collected in presentations at the Annual Meeting of the American Economic Association and the Annual Congress of the European Economic Association (see Box 4 for further details).

The Euro Area Business-Cycle Network, organised in collaboration with 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 2005 the network organised a third training school, hosted by the Banca d'Italia, which addressed topics in the areas of applied time series and forecasting. Two workshops were also organised, one on the need for a real-time database for the euro area, hosted by the Nationale Bank van België/Banque Nationale de Belgique, and the second on productivity and the business cycle in the euro area and the United States, hosted by Suomen Pankki – Finlands Bank. The research output of the network is available in an online research paper database (251 papers) and in a discussion paper series jointly published with 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 ECB and the CFS 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. In 2005 the Oesterreichische Nationalbank hosted and co-organised an ECB-CFS research network conference in Vienna on financial development, integration and stability in central, eastern and south-eastern Europe (see Box 10 for further details).

6 OTHER TASKS AND ACTIVITIES

6.1 COMPLIANCE WITH THE PROHIBITION OF MONETARY FINANCING AND PRIVILEGED ACCESS

Pursuant to Article 237(d) of the Treaty, the ECB is entrusted with the task of monitoring the compliance of the 25 EU NCBs and the ECB with the prohibitions implied by 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.

In 2005 the Governing Council identified two cases of non-compliance with the above Treaty requirements and the associated Council Regulations. The Banca d'Italia and the Oesterreichische Nationalbank reported primary market purchases of debt instruments issued by the European Investment Bank (EIB). On 13 October 2005 the Banca d'Italia bought USD-denominated EIB securities amounting to USD 10 million for the purpose of foreign exchange reserve management. On 14 September 2005 the Oesterreichische Nationalbank bought EUR-denominated EIB securities amounting to €200 million. Since the EIB is a Community body, such purchases constitute a breach of the monetary financing prohibition according to Article 101 of the Treaty and Council Regulation (EC) No 3603/93. In the case of the Banca d'Italia, the EIB debt instruments purchased in the primary market were sold on 8 March 2006. The Oesterreichische Nationalbank sold the EIB debt instruments purchased in the primary market at the end of October 2005. Moreover, both NCBs took immediate measures to avoid the occurrence of such events in the future.

In 2004[9] the Governing Council found one case of non-compliance by an NCB with the above Treaty requirements and the associated Council Regulations. In the context of the strong reflows of national coins to the NCBs as a result of the introduction of the euro banknotes and coins on 1 January 2002, Suomen Pankki – Finlands Bank from October 2001 to February 2004 exceeded the limit of 10% of coins in circulation laid down in Article 6 of Council Regulation (EC) No 3603/93. The situation was fully corrected in March 2004, however, and the Treaty provisions have been respected since that date.

6.2 ADVISORY FUNCTIONS

Article 105(4) of the Treaty requires that the ECB be consulted on any proposed Community or national legislation which falls within the ECB's fields of competence.[10] All ECB opinions are published on the ECB's website. Since January 2005 opinions on draft national legislation have, as a rule, been published immediately after their adoption and subsequent transmission to the consulting authority, following the procedure already in place for opinions on proposed EU legislation. In June

9 The reference to the events concerning 2004 in this Annual Report is explained by the fact that the corresponding monitoring exercise by the ECB ended after the cut-off date for the Annual Report 2004.

10 In accordance with the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, as annexed to the Treaty, the obligation to consult the ECB does not extend to the United Kingdom.

2005 the ECB published a "Guide to consultation of the European Central Bank by national authorities regarding draft legislative provisions", which is designed to provide practical assistance and information to national authorities.

The ECB adopted 61 opinions in 2005, 13 in response to consultations by the EU Council and 48 in response to consultations by national authorities. This compares with 39 opinions in 2004, with the increase being due to a higher number of consultations from the new Member States in their first full year of EU membership. A list of the opinions adopted in 2005 is annexed to this Annual Report.

In its opinions on the new EU Council regulations on surveillance and on the excessive deficit procedure reforming the Stability and Growth Pact,[11] the ECB emphasised that sound fiscal policies were fundamental to the success of EMU and a prerequisite for macroeconomic stability, growth and cohesion in the euro area. In addition, the ECB considered it necessary to maintain a credible excessive deficit procedure including a strict time frame (see also Section 1.1 of Chapter 4). The ECB was also consulted on the Council regulation regarding the future adoption of the euro by new Member States.[12] The ECB considered that the maximum length for the transitional period between the introduction of the euro as the currency of new Member States and the introduction of euro banknotes and coins should be no more than three years, and that even shorter transitional periods should be encouraged. The ECB also emphasised the importance of the requirement that the name of the single currency be the same in all official EU languages, taking into account the existence of different alphabets.[13]

The ECB continued to be consulted by national authorities on issues pertaining to the independence of NCBs – including those of Italy, Lithuania, Slovakia and Spain – as members of the ESCB,[14] as well as on amendments to the Estonian, Latvian, Lithuanian, Slovak and Swedish central bank statutes, which arose in the context of the ECB's Convergence Report 2004.[15] The ECB was also consulted by national authorities on matters relating to compliance with the prohibition of monetary financing under Article 101 of the Treaty, including a draft law authorising the Oesterreichische Nationalbank to make a deposit on a special account with the IMF for the benefit of Poverty Reduction and Growth Facility countries affected by natural disasters[16], and a draft law authorising the Banca d'Italia to extend a credit line to the Republic of Lebanon[17]. The ECB concluded that the Austrian draft law complied with the prohibition on monetary financing, as it fell within the scope of the Community law exemption for the financing by NCBs of public sector obligations vis-à-vis the IMF.[18] In the case of the Italian draft law, however, the ECB concluded that the proposed financing would constitute a form of monetary financing prohibited by the Treaty. The draft law was subsequently withdrawn by the Italian authorities.

The ECB was consulted by national authorities on legislative proposals relating to the financial supervisory framework.[19] In its opinion on a draft law establishing Česká národní banka as the sole financial supervisory authority in the Czech Republic, the ECB expressed the view

11 CON/2005/18 and CON/2005/17 of 3 June 2005.
12 CON/2005/51. The ECB was also consulted by national authorities in some new Member States, including Lithuania and Slovenia, on national legislation facilitating the future introduction of the euro in those Member States (see CON/2005/38 and CON/2005/57).
13 The ECB was also consulted on other significant draft EU acts which are discussed elsewhere in this Annual Report. These include the proposal for a capital adequacy directive (CON/2005/4) and the proposal for a Council decision concerning the signing of the Hague Convention on securities held with an intermediary (CON/2005/7). For more details, see Section 2 of Chapter 3.
14 CON/2005/25; CON/2005/30; CON/2005/34; CON/2005/38; CON/2005/58.
15 CON/2005/20; CON/2005/26; CON/2005/38; CON/2005/54; CON/2005/59; CON/2005/60.
16 CON/2005/29.
17 CON/2005/1.
18 Under Article 7 of Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibition referred to in Article 101 of the Treaty.
19 CON/2005/9; CON/2005/24; CON/2005/26; CON/2005/39.

that, faced with the increasing blurring of traditional borders between the banking, securities and insurance sectors and the resulting challenges to prudential supervision and the stability of the financial system, an NCB with overall responsibility for the financial markets was likely to cope better than several supervisors with individual limited competence for a particular financial sector. In a separate consultation on a Czech draft insolvency law,[20] the ECB welcomed the fact that the draft law acknowledged Česká národní banka's responsibility for supervising banks in financial difficulties and for deciding when insolvency proceedings should be started against such banks.

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 2005 the ECB did not perform any administration tasks. There was no outstanding balance at the end of 2004 and no new operations were initiated during 2005.

20 CON/2005/36.

Box 9

EUROSYSTEM RESERVE MANAGEMENT SERVICES

In January 2005 a new framework was introduced for the management of Eurosystem customers' euro-denominated reserve assets. The new framework – which is available to central banks, monetary authorities and government agencies located outside the euro area, as well as to international organisations – provides a comprehensive range of services enabling eligible customers to manage their euro-denominated reserve assets in an efficient manner. The services range from the provision of custody accounts and related custodian (safekeeping) and settlement services to cash and investment services. They are offered under harmonised terms and conditions in line with general market standards by individual Eurosystem central banks (the Eurosystem service providers) acting as dedicated service providers. Eligible customers can access the complete set of services covered by the new framework through any one of these service providers.

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.

The new framework has been well received by eligible customers. On the basis of information collected by the ECB, the number of customers who have established a business relationship with one of the Eurosystem central banks appears to be representative of the population of eligible customers to which the new framework is addressed. With respect to the services themselves, customers' total cash balances and/or securities holdings with Eurosystem central banks have increased by comparison with the situation prior to the introduction of the new framework. This is particularly the case with respect to customers' holdings of non-domestic government securities (i.e. securities issued by governments of countries other than that of the central bank with which the securities are deposited). Customers are also appreciative of the automatic overnight investment facility available under the new framework, which allows the investment of funds directly with the respective service provider and/or in the market at attractive remuneration rates.

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.

Artist
Pep Agut
Title
Read your voice, 2000
Material
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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 of the monitoring 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. The monitoring thus also covers developments in these other components.

CYCLICAL DEVELOPMENTS

In 2005 the resilience of the euro area financial system strengthened. Financial institutions benefited from the expansion of global economic activity, which continued at a fairly robust pace despite further oil price rises, and from a continued improvement in the balance sheets of large euro area firms. In this environment, the profitability of euro area banks improved further and the balance sheets of insurance companies strengthened. However, looking ahead, financial institutions face some risks stemming from, for instance, the possibility of an abrupt unwinding of global imbalances, the vulnerability to a correction of prices – which have been stretched by the ongoing search for yield – in some fixed income and credit markets, and the possibility of additional increases in oil prices. In addition, household balance sheets remain vulnerable to the possibility of corrections in house prices in some countries.

In the euro area banking sector, the recovery of large banks' profitability that had begun in 2003 continued also in 2005, although for those banks that shifted to International Financial Reporting Standards (IFRS) in 2005, it is more difficult to draw comparisons with past indicators of profitability. Importantly, the recovery in profitability was broad based, extending also to those national banking sectors which had experienced below average performances in 2003. The main sources of increased profitability in 2005 were reduced provisions, sustained growth in lending to the household sector (mostly for house purchases) and an incipient recovery in lending to the corporate sector. Cost-cutting, which had contributed to banks' profitability in 2004, lessened in 2005.

Provisions for loan losses continued to fall in 2005. This was due to the low number of insolvencies in the household and corporate sectors and an only marginal deterioration in the quality of banks' assets, while significant write-offs or write-downs of credit overdue from previous years, at least in some euro area countries, reduced the impact of credit risk on banks' balance sheets. In addition, there is some evidence that the coverage ratio, i.e. the ratio of provisions to non-performing assets, fell in 2005. However, it cannot be ruled out that the reduced flows, and in some countries stocks, of provisions could result in inadequate provisions in the event of an unexpected deterioration in the credit cycle.

The pick-up in the growth of corporations' borrowing seen in 2004-05, if it continues, could provide banks with a desirable diversification of

1 Since the end of 2004 the ECB has published a biannual report on the stability of the euro area financial system entitled "Financial Stability Review". In 2005 it also published the fourth 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.

their sources of income away from the household sector. However, notwithstanding the increase in lending volumes, net interest income – the core component of banks' profitability – continued to decline in 2005 due to interest rate margin erosion. This decline was driven by the flattening of yield curves, persistently low interest rates and the strength of competition among banks for loans and deposits. With regard to net non-interest income, banks generally reported increased income both from fees and commissions and from trading activity. In some cases, these revenues were sufficiently large to more than offset reduced income from maturity transformation, which is banks' core business.

Despite further improvements in some countries, the key regulatory solvency ratios for the euro area banking sector remained broadly unchanged in 2004, the latest year for which consolidated data are available. Non-consolidated data available for a set of large euro area banks show some improvement in solvency indicators in 2005.

The euro area insurance industry further improved its profitability and capital base in 2005, although investment income remained subdued in an environment of low interest rates. The strengthening of non-life insurers' balance sheets was driven by an improvement in the profitability of the underwriting business, which was the result of strict pricing discipline. In the life insurance sector, lower guaranteed rates of return on savings products contributed to the improvement in profitability, as did cost savings. Furthermore, ongoing reforms of public pension schemes in the euro area favoured the placement of private savings in life insurance products. In the reinsurance sector, a decline in the value of policies sold contributed to a decrease in profitability.

The global hedge fund and private equity industry continued to grow in 2005. Inflows into hedge funds proceeded throughout 2005, with some moderation in the second and third quarters linked to weaker returns in the sector. In particular, certain credit strategies suffered in spring 2005 after the downgrading of the credit ratings of two large US car manufacturers to sub-investment grade. Moreover, given the increasing presence of hedge funds in the markets for relative value instruments and complex structured credit products, it cannot be ruled out that, should credit markets endure further volatility, banks could be exposed to future losses from their activities with hedge funds. However, a recent survey on EU banks' exposures to hedge funds[2] found that, in most countries, the existing direct exposures were generally moderate in relation to the size of banks' balance sheets and by comparison with the exposures of similar US banks. This reflects the fact that the global prime brokerage market remains largely dominated by US financial institutions. Nevertheless, it remains important that adequate management by banks of risks associated with hedge funds be put in place.

STRUCTURAL DEVELOPMENTS

Structural changes in the banking industry can affect financial stability in the longer term, for instance through changes in competitive conditions or through increased internationalisation. Important structural developments are ongoing in the euro area banking sector with regard to consolidation, internationalisation, financial intermediation

2 "Large EU banks' exposures to hedge funds", ECB, November 2005.

and funding structures. Although banking market structures across the euro area continue to differ in terms of concentration, ownership structure, foreign presence, and size and importance of delivery channels, this may change as a result of increased merger and acquisition (M&A) activity in the sector and other structural developments.[3]

The pace of consolidation at both the national and cross-border levels has declined over recent years, as illustrated by the low number of M&As and the slowdown in the decrease of the number of credit institutions.[4] In the course of 2005, however, a number of large cross-border M&A deals took place, confirming the indications of renewed interest in cross-border consolidation that had emerged in 2004. In some Member States, domestic consolidation among large banks may gradually be coming to an end, since the respective banking markets are already very concentrated. Therefore, apart from organic growth, cross-border consolidation has become the main expansion strategy in these Member States, despite the remaining barriers.

There have also been signs of a gradual change in bank balance sheet structures, with the pace of lending growth exceeding that of deposit-taking growth. This trend may reflect the reduced attractiveness of deposits for households in an environment characterised by persistently low interest rates and changing risk/return trade-offs, as well as structural factors, such as the changing demographic environment, which raises the importance of private pension and insurance products. It also implies that banks increasingly resort to funding through interbank markets and capital market-based instruments.

Euro area banks also appear to be transferring more risks to other sectors of the economy, rather than solely mediating between lenders and borrowers, and some seem to be moving away from the integrated provision of financial services. Nevertheless, bank financing remains the predominant form of financial intermediation in the euro area.[5]

Finally, banks are increasingly adopting more flexible types of organisation, outsourcing non-core parts of their value chain and specialising in a specific stage of the service cycle, be it the origination, production, distribution or settlement stage.

All in all, the role of banks in the euro area is gradually evolving. Direct capital market financing is gaining in importance and non-traditional financial service providers may gain further ground in specific fields of banking, thus increasing the efficiency of the euro area financial system and transforming the risk landscape.

1.2 COOPERATION IN FINANCIAL CRISIS SITUATIONS

The EU framework for cooperation between the competent authorities in the area of financial crisis management was further enhanced in 2005.

First, in May the banking supervisors, central banks and finance ministries of the EU agreed on a Memorandum of Understanding (MoU) on cooperation in financial crisis situations, which entered into force on 1 July. The MoU – which was adopted under the aegis of the Economic and Financial Committee – applies to crisis situations with a potential for both cross-border and systemic consequences affecting credit institutions, banking groups or banking

3 A more detailed analysis of structural developments in the EU and euro area banking sectors can be found in the BSC report entitled “EU banking structures”, October 2005, and in the article entitled “Consolidation and diversification in the euro area banking sector” in the May 2005 issue of the ECB’s Monthly Bulletin.
4 The number of credit institutions decreased by 2.8% in 2004 and by 2.3% in 2005 (annualised figure from information up to the third quarter), falling to slightly below 6,300.
5 The ratio of domestic credit to GDP stood at 115% in 2005, while the ratio of stock market capitalisation to GDP reached 68%.

components of financial groups, as well as to other systemic disturbances with cross-border implications in the financial markets, including those affecting payment systems or other market infrastructures. The principles and procedures contained in the MoU deal with the sharing of information, views and assessments among authorities and with cooperation at the national and cross-border level. In order to further support the enhanced cooperation between authorities, the MoU also includes arrangements for the development of contingency plans for the management of crisis situations, along with stress-testing and simulation exercises. The MoU itself will be tested in a crisis simulation exercise planned for 2006.

Second, further enhancements of the crisis management framework, in terms of central banking and supervisory practices for handling financial crises at the cross-border level, were jointly considered by the BSC and the Committee of European Banking Supervisors (CEBS).

2 FINANCIAL REGULATION AND SUPERVISION

2.1 GENERAL ISSUES

In July 2005 the European Commission released for public consultation a Green Paper on Financial Services Policy (2005-2010). In its contribution to this consultation, the Eurosystem underlined that an improvement to the EU framework for financial supervision should seek to exploit the potential of the Lamfalussy framework to the greatest extent possible.[6] The Eurosystem also expressed its preference for a further rationalisation of financial rules through use of the main elements of the Lamfalussy framework. A clearer distinction could be made between core principles (Level 1 legislation) and technical details (Level 2 legislation). This should be supported by further convergence in supervisory practices, which also plays an important role in ensuring a consistent enforcement across Member States. It also noted that robust and consistent cooperation arrangements between home and host authorities were particularly important for financial groups that are active across borders. As regards financial stability arrangements, the Eurosystem identified the monitoring of financial stability across borders and financial sectors, the management of financial stress and deposit insurance as areas for potential enhancement.

2.2 BANKING

Following the release in June 2004 of the revised framework for the "International Convergence of Capital Measurement and Capital Standards", commonly known as Basel II, the focus of the Basel Committee on Banking Supervision (BCBS) shifted to key implementation issues. The BCBS has also pursued work in a number of technical areas.

At the European level, Basel II has been introduced into EU legislation by amending the Codified Banking Directive and the Capital Adequacy Directive. The European Parliament and the EU Council adopted the final legislative texts in September and October 2005 respectively. Member States will have to amend national law to incorporate the new rules, which will become applicable from 2007 onwards. In addition, at the end of 2005 the BCBS undertook a fifth quantitative impact study (known as the "QIS5") of the new capital rules. The results will become available in spring 2006 and may lead to further quantitative adjustments of the framework. The CEBS was also involved in the study.

The ECB continues to support the work of the BCBS and contributes to it through its participation as an observer in the committee and its main sub-structures. In addition, the ECB issued an opinion on the new EU capital framework in which it supported the general thrust of the new rules.

The ECB also analysed the possible policy implications of increased cross-border banking in the EU in the context of safeguarding financial stability. This analysis, which was mainly pursued through the BSC, covers the areas of financial supervision, crisis management, financial stability monitoring and deposit guarantee arrangements. The results obtained in the latter area have proved to be useful for the European Commission's review of the Deposit Guarantee Schemes Directive that is currently under way.[7]

2.3 SECURITIES

In 2005 activities in the securities sector mainly focused on completing the EU regulatory framework by adopting the outstanding Level 2 implementing measures concerning the Market in Financial Instruments Directive and the Transparency Directive. Given the importance of these measures for the integration of European financial markets and the enhancement of financial stability, the ECB has closely

6 "Final Report of the Committee of Wise Men on the Regulation of European Securities Markets", 15 February 2001. This report is available on the European Commission's website. See also the ECB's Annual Report 2003, p. 111.

7 "Review of the Deposit Guarantee Schemes Directive (94/19/EC)", European Commission, 14 July 2005. The consultation document is available on the Commission's website.

followed, and contributed to, the work in this area through its participation in the European Securities Committee.

The Eurosystem contributed to the debate on the review of the Lamfalussy process by replying to the preliminary assessment published by the European Commission for public consultation. The Eurosystem confirmed its positive stance with regard to the Lamfalussy framework. In particular, it emphasised that the Lamfalussy process should be used in such a way as to streamline existing regulatory requirements and develop a common set of harmonised technical rules that would satisfy the needs of both regulators and market participants. This common set of harmonised rules should provide market participants offering cross-border services with a single source of rights and obligations in the areas concerned.

Finally, the Eurosystem contributed to the debate on the enhancement of the EU framework for investment funds, launched by the European Commission's Green Paper published on 12 July 2005 for public consultation. The Eurosystem highlighted the fact that further efforts to remove remaining regulatory and legal barriers might lead to further consolidation in the European investment fund industry and a rationalisation of the products offered, with consequent benefits for investors and for the EU financial market. With regard to hedge funds, the Eurosystem supported the approach taken so far at the international level to address the financial stability concerns created by hedge funds primarily through their interaction with regulated firms, in particular banks.

2.4 ACCOUNTING

On 1 January 2005 Council Regulation (EC) No 1606/2002 came into force, requiring all listed companies, including banks, to prepare their consolidated financial statements in accordance with IFRS. Given the importance of sound accounting standards from a financial stability perspective, the ECB continued to contribute to the work related to the implementation of the new accounting framework in the EU.

During the first half of the year the focus was on the introduction in International Accounting Standard 39 (IAS 39) of a new option allowing the use of fair values[8] for all types of financial instrument, generally known as the fair value option. Progress was made in a constructive dialogue between the ECB, the BCBS and the International Accounting Standards Board (IASB), culminating with a letter from the President of the ECB to the IASB in April 2005 supporting the proposed amendments to IAS 39. These amendments were subsequently incorporated by the IASB in June 2005.

In this context, the ECB, via its participation as an observer in the Accounting Task Force of the BCBS, also contributed to the supervisory guidance developed by this task force. In July 2005 the BCBS released for consultation a document entitled "Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards", which mainly links – from a supervisory perspective – the use of the fair value option to sound risk management practices.[9]

The trustees of the International Accounting Standards Committee Foundation (IASCF) concluded a review of their constitution in April 2005. In response to comments received during the consultation period, including from the ECB, the IASCF decided to set up a new restructured Standards Advisory Council for the provision of broad strategic advice, as well as a Trustee Appointments Advisory Group which is to be consulted before new trustees are appointed. The ECB is represented in both bodies.

8 The fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. In practice, the fair value is often equal to the quoted market price or is estimated using a valuation technique discounting future cash flows.
9 The supervisory guidance is not intended to set additional accounting requirements.

In the second quarter of 2005 the BSC launched work on an analysis of the links between accounting and financial stability. The work focuses on the financial stability implications of the introduction of IFRS and on whether these standards effectively contribute to a further strengthening of financial stability.

3 FINANCIAL INTEGRATION

Against the background of its core tasks, the Eurosystem has a keen interest in financial integration in Europe, in particular in the euro area. First, a well-integrated financial system enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. Second, financial integration has implications for the Eurosystem's task of safeguarding financial stability. It is also important for the effective operation of payment systems and the smooth functioning of settlement systems. Furthermore, in accordance with Article 105 of the Treaty, the Eurosystem supports, without prejudice to the objective of price stability, the general economic policies in the Community. Financial integration, as a priority Community objective, can help to promote the development of the financial system, raising the potential for economic growth.

The Eurosystem generally distinguishes between four types of activity through which it contributes to enhancing financial integration: (i) raising awareness of and monitoring the progress of European financial integration, (ii) acting as a catalyst for private sector activities by facilitating collective action, (iii) giving advice on the legislative and regulatory framework for the financial system and (iv) providing central banking services that also foster European financial integration. Throughout 2005 the ECB continued to pursue initiatives in all four areas, as described below. More generally, the ECB also continued its research activities on financial integration (see Box 10).

Box 10

RESEARCH NETWORK ON CAPITAL MARKETS AND FINANCIAL INTEGRATION IN EUROPE

The ECB and the Center for Financial Studies (CFS) in Frankfurt have continued the activities of their research network on capital markets and financial integration in Europe.[1] The current second phase of research activity has been extended to include 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 first conference of the second phase of the network's activities was hosted by the Nationale Bank van België/Banque Nationale de Belgique in Brussels in May 2005 and co-organised with the Centre for Economic Policy Research (CEPR). The conference was entitled "Competition, stability and integration in European banking" and addressed in particular the network's priorities with regard to bank competition and the geographical scope of banking, as well as financial integration and financial stability.

One of the main topics discussed at the conference was cross-border banking in Europe. Analyses on foreign bank entry in emerging markets, which considered central and eastern European countries, Russia and Ukraine, suggested that lending by foreign-owned banks in these countries stimulates growth of firms in terms of sales and assets.[2] This applies even to smaller firms, although they still lose market share in relative terms. Moreover, foreign bank presence has beneficial effects on credit availability, as domestic firms face lower interest

1 For more details on past activities, see Box 10 of the ECB's Annual Report 2003 and Box 12 of the ECB's Annual Report 2004, as well as the network's website at www.eu-financial-system.org.
2 ECB Working Paper No 498, June 2005.

rates, increase their debt-to-asset ratios and lengthen their maturity structures on the liabilities side. Finally, foreign bank entry appears to foster industry dynamics or "creative destruction", as firm entries and exits increase.

The second conference of the second phase was co-organised with the Oesterreichische Nationalbank, which also hosted the conference in Vienna in November 2005. The conference focused on "Financial development, integration and stability in central, eastern and south-eastern Europe" and addressed, in particular, the network priority on EU accession, financial development and financial integration. A body of results suggest that the (still small) stock markets of larger central and eastern European countries (CEECs), namely the Czech Republic, Hungary and Poland, are increasingly integrated with euro area stock markets. This is not the case for the stock markets of smaller CEECs. There is relatively little evidence to suggest that CEEC government bond markets have integrated with those of the euro area.

The network will continue its activities in 2006 with a conference hosted by the Deutsche Bundesbank addressing the priority area of financial system modernisation and economic growth in Europe, and another hosted by the Banco de España addressing financial integration and financial stability.

MONITORING FINANCIAL INTEGRATION

In September 2005 the ECB published its first report and first set of indicators on financial integration. These provide an overall assessment of the degree of financial integration in the main segments of the euro area financial market. When assessing financial integration, a market for a given set of financial instruments or services is considered fully integrated if all economic agents with the same relevant characteristics acting in that market face a single set of rules, have equal access and are treated equally. Two broad categories of indicators were considered, price-based and quantity-based indicators. The indicators were either computed (in the case of standard deviations and ratios) or model-based (derived from econometric models). The range of indicators will be further developed, in particular by adding indicators related to financial institutions and market infrastructures.

The available evidence suggests that the degree of integration varies greatly between market segments. The unsecured money market has been fully integrated since shortly after the introduction of the euro. The integration of the repo market is also making clear progress. Government bond markets became considerably integrated even before the start of Monetary Union, although some yield differentials still remain, reflecting, among other things, differences in issuers' credit ratings and the liquidity of bonds. The corporate bond market also shows a high degree of integration, and progress has been made in the integration of equity markets. Banking markets, in particular the retail segment, are generally much less integrated. Overall, some cross-country differences in bank lending and deposit rates are still observed in the euro area (see Box 11).

Box 11

INTER-REGIONAL COMPARISON OF MORTGAGE RATES IN THE EURO AREA AND IN THE UNITED STATES

This box analyses the degree of heterogeneity across euro area countries in the rates on loans to households for house purchase. The finding that euro area mortgage rates are overall more dispersed across countries than US rates are across regions may suggest that the euro area mortgage market is less integrated. In this context, it should be noted that the US data used in the analysis do not include dispersion within regions (i.e. across states).

Differences in the structure of the funding of mortgage loans, which are likely to have an impact on the type of product provided, may explain some of the differences in the rates on loans for house purchase within the euro area. The euro area mortgage market is still fragmented

Chart A Dispersion of floating and short-term rates on loans to households for house purchase and corresponding market rates across US regions and euro area countries, respectively

(new business rates; coefficient of variation)

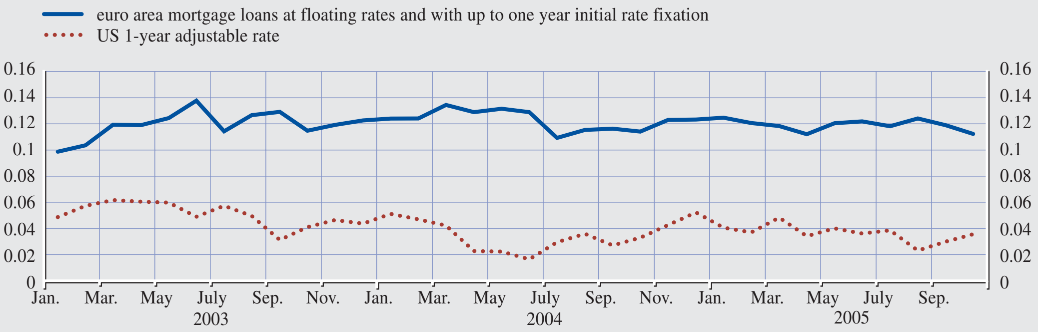
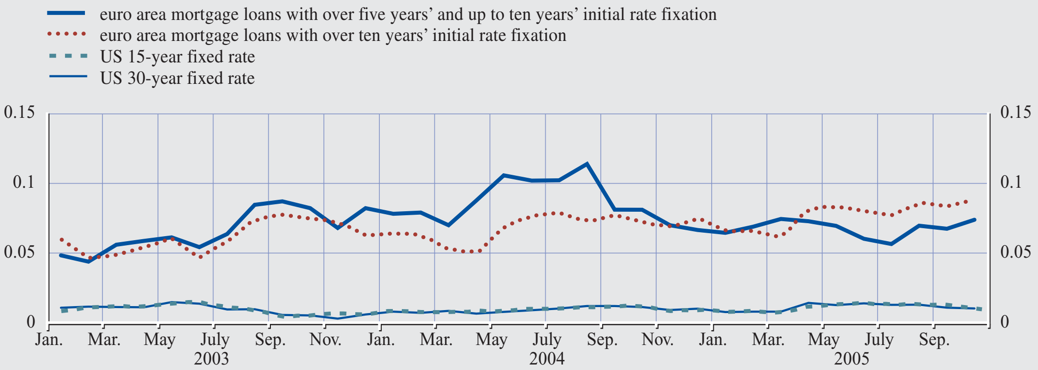


Chart B Dispersion of long-term rates on loans to households for house purchase and corresponding market rates across US regions and euro area countries, respectively

(new business rates; coefficient of variation)



Sources: Freddie Mac (Primary Mortgage Market Survey) and ECB.
Notes: In order to avoid any spurious behaviour in the rates owing to low/volatile volumes, the euro area dispersion has been calculated including only those countries where volumes are substantial. The US data measure the dispersion across the five US regions (Northeast; Southeast; North Central; Southwest; West). It cannot be ruled out that some of the dispersion within the regions (i.e. across the states) is not captured and hence that the US dispersion measures would be somewhat higher if the intra-regional dispersion were included. Furthermore, the size of the respective samples may influence the degree of dispersion.

in terms of funding practices, varying from deposit funding to mortgage (covered) bonds and mortgage-backed securities. Mortgage rates may also differ owing to variations in product characteristics, interest rate fixation periods and customer preferences (exemplified by different loan maturities and loan-to-value ratios), as well as in the role of government and market regulation.

Against this background, the cross-country dispersion of rates on loans to households for house purchase in the euro area was significantly higher than the cross-regional dispersion of mortgage rates in the United States over the period from January 2003 to October 2005 (see Charts A and B).

ACTING AS A CATALYST FOR PRIVATE SECTOR ACTIVITIES

The Short-Term European Paper (STEP) initiative, set up and led by ACI – the Financial Markets Association, promotes convergence of standards in the fragmented European short-term securities markets through market players' compliance with the STEP Market Convention, covering disclosure, documentation, settlement and the provision of data. Since May 2005 the European Banking Federation (FBE) has been supporting ACI in this initiative and it will directly contribute to the functioning of the STEP market. The first STEP-labelled programme is expected in early 2006.

The ECB supports this initiative by acting as a catalyst, for example by providing a discussion forum and hosting ACI's public consultation on its website. The Eurosystem will also provide operational support. In July 2004 the Governing Council decided to support, in principle, the activities pertaining to the introduction of a STEP label for the first two years after its launch. The STEP Secretariat, managed by the FBE, will perform the STEP labelling with the support of several euro area NCBs. The Governing Council also decided, following an efficiency check regarding the collection process, to accept the request to produce and publish STEP statistics on yields and volumes on an ongoing basis.

In 2005 the ECB provided continued support to the Single Euro Payments Area (SEPA) project, primarily promoting the timely achievement of the first SEPA milestone, which would mean that euro area citizens, by 1 January 2008, will be able to use SEPA payment instruments for credit transfers, direct debits and card transactions in parallel with existing national payment instruments. In addition, the ECB followed the work of the banking industry to reach a second milestone, which involves the establishment of a fully fledged SEPA infrastructure for credit transfers, direct debits and card transactions by the end of 2010. The ECB actively supported the European Payments Council (EPC), and high-level coordination between the Eurosystem and the EPC took place at meetings of the Contact Group on Euro Payments Strategy. To ensure the involvement of all stakeholders, the Eurosystem arranged a number of meetings with SEPA end-users, including consumer organisations, small and medium-sized enterprises, retailers and corporate treasurers. It subsequently entered into a dialogue with banks on how best to integrate the expectations and requirements of these groups into the SEPA project. The ECB recognised as a major achievement the EPC's work on defining standards and business rules for SEPA cards, credit transfers and direct debits, while noting the large amount of work still ahead in order to overcome national barriers and to meet different end-users' requirements. In view of the migration of national payments to SEPA instruments from 2008, the ECB initiated a high-level dialogue between Eurosystem central banks and major credit institutions in the euro area to ensure a commitment to SEPA investments and project delivery.

The ECB carried out a legal and an economic analysis of interchange fees applied by card payment schemes within the euro area. Moreover, in close cooperation with NCBs, the ECB also conducted a survey covering more than 100 different e-payment schemes in the EU, gathering information on innovative e-payments, the results of which will be made available in 2006.

In the field of securities clearing and settlement, there is competition between the market participants offering different integration solutions. While the Eurosystem maintains a neutral stance towards solutions, it strongly supports further integration. In this context, biannual meetings were held with the Contact Group on Euro Securities Infrastructures, bringing together representatives from the banking and securities settlement industries of the euro area to discuss the integration of the euro securities settlement industry. Meetings were also held with industry organisations. In addition, the ECB participated in the Clearing and Settlement Advisory and Monitoring Experts Group as well as the Legal Certainty Group, set up by the Commission in 2004 and 2005, respectively, with a view to supporting the removal of the 15 barriers to integration identified by the Giovannini Group relating to technical or market practices, tax procedures and legal issues.

The European Master Agreement (EMA) is an initiative to permit cross-border trading on the basis of a legal master agreement. This is a multi-lingual, multi-jurisdictional, multi-product agreement covering, in particular, trading in repurchase agreements, foreign exchange, derivatives and securities loans. The ECB, which participated in the drafting of the EMA, has used it since 2001 with all its European foreign reserve management and own funds repo counterparties, as well as since June 2005 for its derivatives operations in 15 European jurisdictions.

ADVICE ON THE REGULATORY AND LEGISLATIVE FRAMEWORK OF THE FINANCIAL SYSTEM

The Eurosystem contributed to the European Commission's public consultations on the Green Paper on the priorities for financial services policy over the next five years (see Section 2.1 of this chapter), the enhancement of the EU framework for investment funds (see Section 2.3 of this chapter), mortgage credit in the EU and securities clearing and settlement systems. The ECB also took part in the Commission's work on a New Legal Framework for Payments, which aims to increase the efficiency and security of payments by removing technical and legal barriers and to improve consumer protection.

In March 2005 the ECB adopted an opinion regarding a proposal for a Council decision concerning the signing of the Hague Convention on securities held with an intermediary. The ECB noted that the Hague Convention offered one possible approach to identifying the location of a securities account for conflict-of-law purposes and said that it would welcome a comprehensive prior assessment of the impact of the Convention in the EU. Such an assessment should not prejudice the Community's initiatives in the area of clearing and settlement or the need for substantive reform and harmonisation of book-entry securities law. Furthermore, the ECB participated in the activities of UNIDROIT, the International Institute for the Unification of Private Law, regarding a draft international convention on harmonised rules for intermediated securities.

PROVIDING CENTRAL BANKING SERVICES CONDUCIVE TO FINANCIAL INTEGRATION

In 2005 work continued on TARGET2, the next generation of the TARGET system (see Section 2.2 of Chapter 2). The Eurosystem also took the first steps for the gradual introduction of a single list in the collateral framework of the Eurosystem (see Section 1 of Chapter 2). At the global level, the ECB took part in work related to the analysis of cross-border collateral arrangements. This work was carried out by a working group commissioned by the G10 Committee on Payment and Settlement Systems (CPSS).

4 OVERSIGHT OF MARKET INFRASTRUCTURES

One of the statutory roles of the Eurosystem is to exercise oversight over payment and clearing systems. This 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 securities clearing and settlement systems because failures during the settlement and custody of collateral could jeopardise the implementation of monetary policy and the smooth functioning of payment systems. The ECB contributed to the international debate on oversight in two reports published by the CPSS in May 2005.[10]

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.

TARGET

The oversight framework for the existing TARGET system has been fully implemented. As regards the oversight of the future TARGET2 system, the general organisational framework is in place. The ECB will lead and coordinate the TARGET2 oversight activities of the central banks in TARGET2. The NCBs will have primary responsibility to perform oversight activities on the local features of the system – whenever such features are only relevant for the domestic environment – and will participate in the central oversight activities. The development of the TARGET2 system is being monitored by the TARGET overseers and, in the same way as any other large-value euro payment system in the euro area, TARGET2 will have to comply with the Eurosystem's oversight standards. A comprehensive preliminary oversight assessment of TARGET2 in its design phase is currently being performed.

In early 2005 the TARGET overseers carried out an oversight assessment of SORBNET-EURO, Narodowy Bank Polski's euro real-time gross settlement (RTGS) system, in anticipation of its connection to TARGET via the Banca d'Italia and its BI-REL system. A further extension of the current TARGET system is expected to take place in the context of EMU enlargement. The RTGS systems intending to connect to the current TARGET system, together with all other systemically important euro infrastructures in the Member States concerned, will be subject to oversight assessments in accordance with the Eurosystem's common oversight policy.

EURO1

EURO1 is a large-value net settlement system for euro payments, owned and operated by a private entity, the EBA Clearing Company. In 2005 the oversight of EURO1 focused on the legal soundness of the system. In order to prepare EURO1 for the joining of banks from the new EU Member States, the system operator commissioned legal opinions under the relevant jurisdictions in order to verify that EURO1 would continue to comply with Core Principle I ("legal soundness"). These legal opinions were reviewed by the ECB in its capacity as overseer of EURO1. The review highlighted some general shortcomings in the national legislation of the countries concerned, which could thus also have an impact on the soundness of other payment systems in those countries. These issues have been followed up by the ECB in close cooperation with the relevant NCBs.

CONTINUOUS LINKED SETTLEMENT SYSTEM

The Continuous Linked Settlement (CLS) system settles foreign exchange transactions in 15 currencies on a payment versus payment basis, thus eliminating foreign exchange settlement risk to a very large extent.

10 See the BIS reports entitled "Central bank oversight of payment and settlement systems" and "New developments in large-value payment systems".

In December 2005 CLS settled an average of 194,000 transactions per day with an average daily value equivalent to USD 2.6 trillion.[11] After the US dollar, the euro is the most important currency for settlement. In December 2005 euro settlements in CLS averaged €429 billion per day and accounted for 20% of total settlements in terms of value (US dollar settlements represented 47%). The share of the euro decreased slightly by comparison with December 2004 as a result of the higher number of currencies settled in CLS.

In 2006 the BIS will launch a study among major foreign exchange market participants in order to identify the risk mitigation methods they use to reduce foreign exchange settlement risk. The results of this study will form the basis of a central bank assessment of the G10 strategy to reduce foreign exchange settlement risk, as defined in the 1996 BIS report entitled "Settlement risk in foreign exchange transactions". The measures implemented since 1996 will be assessed to establish whether they can be considered successful or whether regulatory measures may be needed to achieve acceptable levels of foreign exchange settlement risk.

SWIFT

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a limited liability cooperative company which provides secure messaging services to more than 7,500 financial institutions.

In 2005 the central banks cooperating in the oversight of SWIFT further strengthened the practical oversight arrangements. The two core concepts in the initial set-up of the oversight of SWIFT remain valid, i.e. the concept of cooperative oversight with the Nationale Bank van België/Banque Nationale de Belgique as lead overseer, and that of moral suasion to bring about changes. As part of these arrangements, in February 2005 the ECB and the Nationale Bank van België/Banque Nationale de Belgique formally agreed on their cooperation in the oversight of SWIFT.

BUSINESS CONTINUITY

On 10 May 2005 the ECB published for public consultation an issues paper entitled "Payment systems business continuity". The paper contains implementation guidelines with regard to business continuity for systemically important payment systems based on Core Principle VII. It focuses on key elements of business continuity, such as strategy, planning, crisis management and testing. The comments received will be considered in the finalisation of the paper scheduled for 2006. Once finalised, the paper is expected to be applied to the design and operation of business continuity arrangements for systemically important payment systems and to oversight assessments conducted by the Eurosystem.

4.2 RETAIL PAYMENT SERVICES

OVERSIGHT OF RETAIL PAYMENT SYSTEMS

The 15 euro retail payment systems identified as being of systemic or prominent importance (on the basis of the "Oversight standards for euro retail payment systems" adopted by the Governing Council in 2003) were assessed against the applicable Core Principles by the Eurosystem in 2004 and 2005. Two systemically important systems and one prominently important system observed all applicable Core Principles. The other systems were found to have shortcomings with respect to one or more Core Principles. However, the assessments reflect the status as at end-June 2004, and the shortcomings – which vary in severity – are in the process of being rectified.[12]

4.3 SECURITIES CLEARING AND SETTLEMENT

The Eurosystem has a particular interest in the smooth functioning of securities clearing and

11 Each foreign exchange trade consists of two transactions, one in each currency involved. Thus, in December 2005 CLS settled trades with an average daily value equivalent to USD 1.3 trillion (around €1.1 trillion).

12 See the ECB report entitled "Assessment of euro area retail payment systems against the applicable Core Principles", August 2005.

settlement systems and their oversight. First, it assesses the compliance of securities settlement systems (SSSs) in the euro area with the "Standards for the use of EU securities settlement systems in ESCB credit operations" (known as the "Eurosystem user standards")[13], as well as links between those SSSs. Second, it cooperates with the authorities responsible for the regulation and oversight of securities clearing and settlement systems at the EU level.

ASSESSMENT OF SECURITIES SETTLEMENT SYSTEMS AGAINST USER STANDARDS

In the context of its regular assessments of SSSs, the Eurosystem in 2004 recommended that a new arrangement be implemented for the issuance, safe-keeping and settlement of international debt securities. Such securities, issued jointly in the two international central securities depositories (ICSDs), Euroclear Bank (Belgium) and Clearstream Banking Luxembourg, account for a significant proportion of securities eligible for Eurosystem credit operations. In 2005 the ICSDs, together with other market participants, started work in preparation for the implementation of the "New Global Note" (NGN) arrangement. In this new structure, a new form of global bearer certificate – the NGN – will represent the securities issue. Under the terms of the NGN, the legally relevant record of the issuer's indebtedness will be maintained by the ICSDs. Further information about the NGN arrangement can be obtained, for example, from the websites of the ICSDs. The implementation of the new arrangement is scheduled for 30 June 2006.

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. Using as a basis the recommendations for SSSs made by the International Organization of Securities Commissions (IOSCO) and the CPSS (known as the "CPSS-IOSCO Recommendations"), this working group drew up a consultative report on "Standards for securities clearing and settlement in the European Union"[14], which was approved for release for public consultation by both the Governing Council and CESR in October 2004. The consultative report contains 19 standards[15] that aim to increase the safety, soundness and efficiency of securities clearing and settlement in the EU. 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 safety and efficiency of market infrastructures, thus fostering the integration and competitiveness of EU capital markets. The European Commission's work in this area has been taken into account.

13 In the absence of harmonised EU oversight standards, the Eurosystem 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.
14 Available on the ECB's website.
15 Available on the ECB's website.

Since October 2004 the working 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 custodian banks and (iv) analysing the topics of interest with regard to cooperation among regulatory, supervisory and oversight authorities.

The working group has conducted its work in an open and transparent manner. In 2005 it had a large number of meetings with representatives of the banking and securities clearing and settlement industries to discuss specific issues and to foster better mutual understanding of industry practices and the risk concerns of authorities. Furthermore, there has been increased cooperation between central banks and securities regulators on the one hand and banking supervisory authorities on the other.

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CHAPTER 4

EUROPEAN AND INTERNATIONAL RELATIONS

1 EUROPEAN ISSUES

In 2005 the ECB maintained its regular contacts with EU institutions and bodies. The President of the ECB attended meetings of the ECOFIN Council when matters relating to the tasks and objectives of the ESCB were discussed. The President of the Eurogroup and a member of the European Commission participated in meetings of the Governing Council when they deemed it appropriate. The President and the Vice-President of the ECB also participated in meetings of the Eurogroup, which has continued to serve as a particularly important forum for an open and informal policy dialogue between the ECB, the finance ministers of the euro area countries and the Commission.

1.1 POLICY ISSUES

THE STABILITY AND GROWTH PACT

In 2005 an excessive deficit existed in 12 EU Member States (see also Section 2.5 of Chapter 1). In the euro area, excessive deficit procedures were initiated or ongoing for Germany, Greece, France, Italy and Portugal, while the procedure for the Netherlands was abrogated. In January 2005 the ECOFIN Council agreed that, in the light of an analysis carried out by the European Commission, additional initiatives vis-à-vis Germany and France under the excessive deficit procedure were not necessary at that stage. The ECOFIN Council gave notice to Greece in February 2005, requesting that it put an end to its excessive deficit situation as rapidly as possible, and at the latest by 2006. In July 2005 the ECOFIN Council requested that Italy correct its excessive deficit by 2007 at the latest, granting an extended deadline in view of special circumstances. For Portugal, the ECOFIN Council in September 2005 set an extended deadline of 2008 at the latest, also in the light of special circumstances. In January 2006 the ECOFIN Council decided on the existence of an excessive deficit in the United Kingdom and requested that it put an end to the excessive deficit situation as soon as possible and by the financial year 2006/07 at the latest. Among the new Member States, the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia were also subject to excessive deficit procedures. The budgetary situation in Hungary deteriorated rapidly throughout the year, and on 8 November the ECOFIN Council stated that the action taken by Hungary was inadequate. Further steps regarding Member States' excessive deficit procedures will depend on the budgetary outcomes for 2005 as well as on the countries' consolidation plans and actions compared with their commitments for 2006 and beyond.

The procedural rules laid down in the Stability and Growth Pact were reformed in the course of 2005. Following technical discussions which had been ongoing since mid-2004, the ECOFIN Council reached political agreement on 20 March 2005 and issued a report to the European Council entitled "Improving the implementation of the Stability and Growth Pact". After political endorsement by the European Council, the ECOFIN Council concluded the formal review of the Pact and amended the Council Regulations related to the Stability and Growth Pact.[1] In October 2005 the ECOFIN Council also endorsed a revised Code of Conduct, which contains procedural specifications and guidelines for the implementation of the Pact. The European Commission and relevant EU fora continued to work on procedural and methodological issues related to the reformed Pact throughout the year.

The changes to the Pact include the introduction of country-specific medium-term budgetary objectives with adjustment paths that place the emphasis on consolidation efforts during economically good times. This is part of the preventive arm of the Pact. Changes have also been introduced in the framework for excessive deficit procedures, i.e. the corrective arm. A severe economic downturn, which exempts a

1 Two new Council Regulations were adopted on 27 June 2005: Council Regulation (EC) No 1055/2005 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, and Council Regulation (EC) No 1056/2005 amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

country from an excessive deficit procedure, is now defined as a negative annual real GDP growth rate or an accumulated loss of output during a protracted period of very low annual real GDP growth relative to potential growth. Furthermore, if a deficit remains close to the 3% of GDP reference value and the excess is temporary, other relevant factors can be taken into account when assessing whether the deficit is excessive and when setting the initial deadline for correcting it. The adjustment path required for the correction of an excessive deficit is to be set in accordance with a benchmark of a minimum annual improvement in the country's cyclically adjusted balance of 0.5% of GDP, net of one-off and temporary measures. The deadline can be revised if a Council recommendation or a notice is reissued in the light of unexpected adverse economic events with major unfavourable budgetary effects, provided that effective action has been taken by the Member State concerned. In addition, a number of procedural deadlines have been extended. With respect to governance, the reformed Pact invites closer cooperation as well as improved peer support and peer pressure among Member States, the European Commission and the EU Council. It also calls for the development of national budgetary rules, the continuity of budgetary targets when a new government takes office, and greater involvement of national parliaments in the overall European fiscal framework. Finally, it stresses that the implementation of the fiscal framework and its credibility rely crucially on realistic macroeconomic forecasts and reliable budgetary statistics (see also Section 4.3 of Chapter 2).

The ECB is not a signatory to the Stability and Growth Pact and it does not have a formal role in the definition and implementation of the Pact's procedures. Nevertheless, the ECB participated in the reform debate and consistently voiced the need for a sound fiscal policy framework in EMU, geared towards fiscal discipline. The ECB argued that the Pact had been appropriate in its original form and that it was unwise to change the legal texts with regard to the corrective arm of the Pact. The ECB also pointed out that the preventive arm of the Pact could be improved. The Governing Council of the ECB released a statement on the reform agreement in March 2005 and issued opinions on the European Commission's legislative proposals in June 2005 (see Box 12).

Box 12

ECB PUBLIC STATEMENTS ON THE REFORM OF THE STABILITY AND GROWTH PACT

Statement of the Governing Council of 21 March 2005

"The Governing Council of the ECB is seriously concerned about the proposed changes to the Stability and Growth Pact. It must be avoided that changes in the corrective arm undermine confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States. As regards the preventive arm of the Pact, the Governing Council also takes note of some proposed changes which are in line with its possible strengthening. Sound fiscal policies and a monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union. They are prerequisites for macroeconomic stability, growth and cohesion in the euro area. It is imperative that Member States, the European Commission and the Council of the European Union implement the revised framework in a rigorous and consistent manner conducive to prudent fiscal policies. More than ever, in the present circumstances, it is essential that all parties concerned fulfil their respective responsibilities. The public and the markets can trust that the Governing Council remains firmly committed to deliver on its mandate of maintaining price stability."

Excerpt from the ECB opinions of 3 June 2005 on the amended Council Regulations

"Sound fiscal policies are fundamental to the success of Economic and Monetary Union. They are prerequisites for macroeconomic stability, growth and cohesion in the euro area. The fiscal framework enshrined in the Treaty and in the Stability and Growth Pact is a cornerstone of EMU and thus key to anchoring expectations of fiscal discipline. This rules-based framework, which aims to secure sustainable public finances while allowing the smoothing of output fluctuations through the operation of automatic stabilisers, needs to remain clear, simple and enforceable. Compliance with these principles will also facilitate transparency and equal treatment in the implementation of the framework."

The reform of the Stability and Growth Pact creates an opportunity for renewed commitment to the conduct and enforcement of sound fiscal policies that meet both shorter and longer-term budgetary challenges. However, it is essential that Member States, the European Commission and the EU Council implement the revised framework in a rigorous and consistent manner that is conducive to sound fiscal policies.

THE LISBON STRATEGY

In March 2005 the European Council concluded its mid-term review of the Lisbon strategy, the EU's wide-ranging programme of economic, social and environmental reform. The review came at the mid-point between 2000, when the strategy was adopted, and 2010, which was set as the target date for transforming the EU into "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". Against the backdrop of such an ambitious goal, coupled with a relatively poor implementation record up to that point, the spring 2005 European Council decided to relaunch the strategy and refocus its priorities on growth and employment. It also endorsed a new governance framework with the aim of improving the delivery of reforms.

The content of the strategy was largely kept intact. Nevertheless, while maintaining the economic, social and environmental dimensions of the strategy, the Heads of State or Government and the President of the European Commission identified four overall policy priorities for pushing forward with reforms: promoting knowledge and innovation, making the EU an attractive area to invest and work in, fostering growth and employment on the basis of social cohesion and promoting sustainable development.

Given that the main shortcoming of the Lisbon strategy has been the insufficient delivery of structural reforms, the European Council placed greater emphasis on improving the governance framework of the strategy. Thus, changes were made to the rules and procedures governing the formulation and implementation of the strategy, aiming to streamline policy coordination processes over time, across policy areas and between the EU and the national level. This new governance framework also aims to improve the consistency of national programmes, reporting and assessment.

In practical terms, these changes mean that the Broad Economic Policy Guidelines and the Employment Guidelines will be incorporated into a single package known as the "Integrated Guidelines for Growth and Jobs". The first package was adopted in June 2005 and will remain broadly valid for a three-year period (2005-2008). In autumn 2005 the Member States adopted national reform programmes based on the Integrated Guidelines and appointed national Lisbon coordinators, high-level government figures whose task is to enhance the internal coordination of actions related to the strategy. The programmes provide a detailed plan of Member States' reform

policies up to 2008, taking into account their particular needs and situation. They also cover the implementation of reforms, bringing together into a single document the former national reports on employment and on structural reforms in product and capital markets (the "Cardiff reports"), among others. In addition, the European Commission adopted a Community Lisbon Programme in July 2005, which covers all Lisbon-related action to be undertaken at the Community level over the following three years. Progress is to be assessed in a more integrated manner, in the form of an annual progress report by the Commission. The first such progress report was adopted by the Commission in January 2006. The report welcomed the national reform programmes and called for their rigorous implementation.

The most notable feature of the new governance framework is its emphasis on increasing national responsibility for delivering reforms. This is seen as essential to the implementation of the strategy, since the design of structural reforms and, to an even greater extent, their implementation are for the most part the prerogative of the Member States. Member States thus need to be fully committed to the policies they endorse at the national and EU levels. They must consult, as they did with their national reform programmes, the stakeholders involved, such as national parliaments and social partners, in drawing up and implementing these policies at the national level. This national "ownership" of the reforms to be undertaken should, in turn, improve the implementation records of the Member States.

The ECB attaches great importance to the implementation of the Lisbon strategy and contributes to its success by pursuing a stability-oriented monetary policy. The ECB has always stressed the benefits of structural reform and welcomes the efforts undertaken by governments and social partners in this regard. By acting on the Lisbon agenda with a high degree of commitment, the Member States can set in motion a virtuous cycle of reforms. Well-designed structural reforms in goods, services, labour and capital markets, as envisaged by the strategy, will increase the flexibility of the euro area economy, making it more resilient to economic shocks and ultimately resulting in a higher sustainable long-term growth rate and a higher level of employment. The mid-term review was an important step in revitalising the strategy. With a mixed overall implementation record so far, greater efforts are needed to achieve the goals that have been set in order to face the challenges of globalisation, technological change and an ageing population.

1.2 INSTITUTIONAL ISSUES

THE EUROPEAN CONSTITUTION

Following the signing of the Treaty establishing a Constitution for Europe (European Constitution) by the Heads of State or Government on 29 October 2004 in Rome, Member States started the ratification procedure in accordance with their respective constitutional requirements. So far, 15 Member States, representing more than 50% of the EU's population, have ratified the European Constitution or are very close to formal completion: Belgium, Germany, Estonia, Greece, Spain, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, Austria, Slovenia and Slovakia.

In France and the Netherlands, where the European Constitution was put to a referendum (a binding one in the case of France and a non-binding one in the case of the Netherlands), it failed to achieve majority support by about 5 percentage points in France and about 12 percentage points in the Netherlands. Since then, a number of Member States have suspended the ratification process.

Against this background, the European Council considered the ratification of the Constitution at its meeting on 16-17 June 2005, during which the Heads of State or Government adopted a declaration recalling that the Constitution was "designed to provide the appropriate response to ensure that an enlarged European Union functions more democratically, more transparently and more effectively". Noting the outcome of the referendums in France and the Netherlands, the European Council did not think that the results called into question citizens' attachment to the construction of Europe. At the same time, it was felt that they revealed the concerns of citizens and that a period of reflection was warranted during which broad debates should take place in all Member States. The European institutions were invited to contribute to the debate. Although the European Council agreed that the timetable for ratification in the individual Member States could be altered if necessary, the developments were not considered to undermine the validity of continuing with the ratification process. The European Council intends to come back to this issue during the first half of 2006 to establish a clearer perspective for the future and agree on how to proceed.

In the view of the ECB, the European Constitution clarifies the legal and institutional framework of the EU and enhances the Union's ability to act at both the European and the international level, while confirming the existing monetary framework. The ECB therefore supports the Constitution. However, it should be stressed that the Constitution's ratification process will have no bearing on the functioning of Monetary Union and will not affect the stability of the euro. The ECB, whether operating under the current Treaty or the European Constitution, will continue to secure the value of the euro and contribute to a non-inflationary macroeconomic environment conducive to growth and employment.

1.3 DEVELOPMENTS IN AND RELATIONS WITH EU ACCEDING AND ACCESSION COUNTRIES

A key objective of the ECB in its relations with the central banks of EU acceding and accession countries is to contribute to a smooth monetary integration process that complies with Treaty procedures. Consequently, relations between the ECB and the central banks of these countries naturally intensify in parallel with the overall progress of the countries towards EU membership.

Since Bulgaria and Romania signed the Accession Treaty in Luxembourg on 25 April 2005, the governors of the central banks of these two countries have been attending the meetings of the General Council of the ECB as observers, while experts from the two central banks have been participating as observers in the meetings of ESCB committees (see Section 1.4 of Chapter 7).

The ECB further strengthened its bilateral relations with the central banks of Bulgaria and Romania in order to contribute to their smooth integration into the ESCB upon EU accession. The Eurosystem as a whole continued to support their preparations with technical assistance projects in the form of EU-financed twinning schemes. These activities focused primarily on statistics, legal issues, payment systems, monetary policy and operational issues, but also covered other areas, such as financial stability and supervision, banknotes, internal audit and information technology.

The date for Bulgaria and Romania to enter the EU is set for 1 January 2007; however, the Accession Treaty includes a "safeguard clause" which allows for the postponement of accession by one year if there is clear evidence that the progress of preparations is insufficient to meet the requirements of EU membership. The European Commission published a monitoring report in October 2005 which indicated that, despite the progress made, there remained a certain number of areas of serious concern. These include the fight against corruption and issues linked to the functioning of the internal market and to the security of the EU (e.g. food safety and the control of external borders). The European Commission continued its intensive monitoring of Bulgaria and Romania and is expected to make its final recommendation in the spring of 2006. On the basis of this recommendation, the European Council will then make a decision on the date of EU entry.

In accordance with the European Council decision of December 2004, accession negotiations with Turkey were opened on 3 October 2005 after the framework for negotiations had been adopted by the EU Council. The ECB continued its long-standing high-level policy dialogue with the Central Bank of the Republic of Turkey, including annual meetings at the Executive Board level. In this context, the Vice-President led an ECB delegation to Turkey in July 2005. The discussions focused on Turkey's macroeconomic stabilisation and structural reform process, the Central Bank of the Republic of Turkey's monetary and exchange rate policy, the economic situation in the euro area and central banks' role in financial stability.

On 13 December 2004 the EU Council decided that accession talks with Croatia would start on 17 March 2005, on condition of the country's full cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). As cooperation was judged insufficient, the EU postponed the start of accession talks. On 3 October 2005 the EU judged that the Croatian authorities were now fully cooperating with the ICTY and decided to open negotiation talks. The ECB further strengthened its bilateral relations with the Croatian National Bank, with the first official visit by the ECB at the Executive Board level taking place in March 2005. Bilateral meetings will be held annually in Frankfurt until Croatia signs the Accession Treaty.

2 INTERNATIONAL ISSUES

2.1 KEY DEVELOPMENTS IN THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

SURVEILLANCE OF MACROECONOMIC POLICIES IN THE GLOBAL ECONOMY

Given the euro area's economic and financial integration in the global economy, the Eurosystem closely monitors and analyses macroeconomic policies and underlying developments in countries outside the euro area. It also participates in the multilateral surveillance conducted by international organisations and fora, which takes place mainly at meetings of the IMF, the Organisation for Economic Co-operation and Development (OECD), and the G7, G10 and G20 finance ministers and central bank governors, as well as at the BIS's bi-monthly meetings of central bank governors. In some of the institutions and fora, the ECB has been granted either member status (for example, at the G20) or observer status (for example, at the IMF). The ECB assesses international economic policy developments with a view to contributing to a stable macroeconomic environment and sound macroeconomic policies.

The international policy environment in 2005 was dominated by the widening of global current account imbalances. The large current account deficit of the United States continued to increase in the course of the year. At the same time, current account surpluses in Asia remained substantial, reaching around 0.8% of world GDP, with a significant increase in the surplus of China offsetting a decline in the rest of emerging Asia and Japan. Oil-exporting countries also played an increasingly important role with regard to global imbalances owing to the spike in oil prices. In 2005 the current account surplus of these countries, which stood at around 1% of world GDP, surpassed that of Asia. Asian and oil-exporting economies also continued to accumulate considerable amounts of reserve assets. The accumulation of reserves was particularly large in the case of China, at around USD 200 billion (around €165 billion).

The Eurosystem continued to stress the risks and uncertainties related to the continuation of such imbalances on various occasions and maintained its full support for a cooperative approach on this issue, whereby all economies would contribute to an orderly adjustment of existing imbalances. This international policy agenda includes policies to increase savings in deficit countries, to implement structural reforms in countries with relatively low potential growth and to foster exchange rate flexibility in major countries and regions that lack such flexibility. In this respect, the ECB welcomed the decision of the Chinese authorities in July 2005 to shift to a new managed floating exchange rate. It considered the move towards greater flexibility desirable for a better functioning of the global economy, and expected the new managed floating exchange rate regime to contribute to global financial stability.

Capital flows to emerging market economies, which the ECB continuously monitors on account of their relevance for international financial stability, remained robust in 2005, as did the economic performance of these countries in general. Crucial external factors in these developments were favourable international financing conditions, high international prices of export commodities and strong real GDP growth in the United States and China. Strengthened domestic policies, accommodative financing conditions and increasing interest from international investors allowed some emerging market borrowers to tap the international bond markets by issuing securities in domestic currency for the first time. Having temporarily widened in April owing to, inter alia, fears of rising inflation in the United States and an increase in investor risk aversion resulting from the rating downgrade of certain US corporations, emerging market bond spreads returned to low levels by historical standards later in the year.

Finally, the euro area itself is subject to international policy surveillance exercises. Both the IMF and the OECD conducted their

regular reviews of the euro area, as a complement to their reviews of the individual euro area countries. The reviews examined the monetary, financial and economic policies of the euro area. The Article IV consultations of the IMF and the review by the OECD's Economic and Development Review Committee provided an opportunity for useful discussions between these international organisations and the ECB, the Eurogroup presidency and the European Commission. Following these discussions, both the IMF and the OECD produced a report assessing the euro area policies.[2]

INTERNATIONAL FINANCIAL ARCHITECTURE

The IMF is currently undertaking a strategic review which has been discussed not only within the IMF itself, but also in various international fora, such as the G7 and the G20. The ESCB is monitoring and contributing to these discussions. The aim of the strategic review is to set medium-term priorities for the work of the IMF. Important areas covered in the review include IMF surveillance, the IMF's role in emerging market economies, and voice and representation.

The Managing Director of the IMF highlighted, in particular, the need for the IMF to help members to tackle the challenges of globalisation. In the subsequent international policy discussions, members stressed the need for the IMF to place greater emphasis in its bilateral surveillance on exchange rate issues and international spillovers from national policy measures. The issue of adequate voice and representation in international fora, and in particular in the IMF, has been widely debated over the past year. Some IMF member countries, especially in Asia, feel that their quotas do not adequately reflect their growing weight in the world economy. The issue of quotas and voice will need to be discussed in parallel with the other aspects of the strategic review in the run-up to the next IMF Annual Meetings, which will be held in Singapore in September 2006. The IMF is also conducting its 13th general review of quotas, which provides an opportunity to assess the extent to which the current distribution of quotas among IMF members is in line with agreed measures of member countries' relative economic and financial importance. The review is to be concluded by January 2008.

The promotion of orderly crisis management has been high on the agenda of the international community for several years. The ESCB has continued to discuss issues related to crisis management and, in particular, the role that the private sector is expected to play in the resolution of financial crises. Although a number of steps have been taken to improve the framework for private sector involvement, critical challenges still remain, not least in terms of timely diagnosis of the actions needed by all stakeholders. To assess these challenges,

2 IMF: "Euro Area Policies: Staff Report", August 2005; OECD: "Economic Survey of the Euro Area", July 2005.

ESCB central banks prepared a report on private sector involvement which takes stock of past experience and identifies areas of possible improvement in the framework for crisis resolution. The report[3] suggests that improving the predictability of crisis resolution processes – by guiding the behaviour of debtors, creditors and the official sector – could lower the overall cost of financial crises and bring about a distribution of costs that would be likely to be seen as more appropriate from a general welfare perspective than is currently the case.

INTERNATIONAL ROLE OF THE EURO

In 2005 the role of the euro as an international currency continued to gradually expand in certain segments. In particular, the use of the euro in international debt securities, as an anchor and intervention currency and as a deposit currency in third countries continued to rise gradually. The increase in the use of the euro as an anchor and intervention currency took place largely in the new EU Member States, EU acceding and accession countries and other EU neighbouring regions. The share of the euro in the special drawing right (SDR) was increased from 29% to 34% on 1 January 2006, following a decision announced by the IMF in December 2005. For the euro component of the SDR interest rate, the three-month EURIBOR was replaced by the three-month EUREPO rate.

In other markets, such as those in international loans and deposits, foreign exchange and official reserves, as well as in international trade, the use of the euro remained largely stable.

The ECB continued to develop the statistical coverage required for its monitoring and analysis of the euro's international role. In particular, newly collected data on the currency breakdown of debt securities in the euro area balance of payments and international investment position contributed to the monitoring of the international use of the euro in capital markets (see Section 4.2 of Chapter 2). The ECB also began research on the factors behind the use of the euro in international trade.

2.2 COOPERATION WITH COUNTRIES OUTSIDE THE EU

The Eurosystem continued to build up its contacts within the central banking community outside the EU, largely through the organisation of seminars and workshops, but also through technical assistance, which has become an important tool in supporting institution-building and enhancing effective compliance with European and international standards. The objective of such contacts is to gather information and exchange views on economic and monetary developments in different regions of the world with a potential bearing on the global economic environment and the euro area. The Eurosystem has maintained its offer of cooperation with central banks in its neighbouring regions, and the ECB has established a small, permanent technical assistance unit.

The Eurosystem held its second bilateral high-level seminar with the Central Bank of the Russian Federation (Bank of Russia) in October 2005 in St Petersburg. The seminar focused on monetary and exchange rate policies in Russia and on the challenges for banking sector stability arising, among other things, from the rapid growth of bank lending and the expansion of cross-border borrowing. The issues of deposit insurance and banking sector development were also discussed. Similar events will continue to be organised on a regular basis, with the next Eurosystem seminar to be held in Dresden in 2006, with the support of the Deutsche Bundesbank.

Central Banking Training III, the Eurosystem's technical assistance project with the Bank of Russia in the area of banking supervision, was

3 "Managing financial crises in emerging market economies – experience with the involvement of private sector creditors", ECB Occasional Paper No 32, July 2005.

completed on 31 October 2005. The project, which was funded by the EU, started in November 2003 within the EU's framework for Technical Assistance to the Commonwealth of Independent States (TACIS). The Eurosystem project was implemented by the ECB in partnership with nine euro area NCBs and three EU non-central bank supervisors.[4] The two-year training project aimed to help the Bank of Russia to enhance its role in banking supervision by transferring knowledge relating to the sound practices employed by EU banking supervisors. The wider objective was to foster the stability of the Russian banking system. The project was executed mainly through courses and seminars in Russia, which were attended by 800 of the Bank of Russia's banking supervisors. The publication entitled "Banking supervision: European experience and Russian practice"[5], which is available in English and Russian, was an important part of the project, as it allows the dissemination of know-how.

The second and third high-level Eurosystem seminars with governors of central banks of the EU's Euro-Mediterranean partners took place in, respectively, Cannes on 9 February 2005 and Nafplion on 25 January 2006. Discussions focused on, among other things, central bank independence and remittances (Cannes), and the capital account liberalisation process and progress in the modernisation of monetary policy operational frameworks (Nafplion).

The Eurosystem also took on the responsibility of assisting the Central Bank of Egypt in the reform of its banking supervisory setting, against the background of an overall reform of the country's financial sector. The ECB and four euro area NCBs (the Deutsche Bundesbank, the Bank of Greece, the Banque de France and the Banca d'Italia) have committed themselves to a two-year technical assistance programme, funded by the EU Delegation to Egypt under the Mediterranean aid programme (MEDA). The technical assistance programme started on 1 December 2005. Since October 2005 the ECB has also extended – under the aegis of the IMF – technical assistance to the Central Bank of Egypt in the reform of its monetary policy operational framework.

The ECB continued to deepen its relations with countries in the western Balkans, given that they are potential EU candidate countries (the Former Yugoslav Republic of Macedonia was granted candidate status in December 2005). Representatives from the ECB visited the National Bank of the Republic of Macedonia and the Bank of Albania in 2005. Following the adoption of a twin-track approach by the EU regarding accession negotiations with Serbia and Montenegro, a staff visit to the Central Bank of Montenegro also took place.

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 their plan to introduce a single currency in the GCC member states[6] by 2010.

On 28 February 2005 the ECB held a regional meeting with the Committee of Central Bank Governors of the Southern African Development Community (SADC)[7] to discuss experiences in regional integration and monetary integration processes.

The ECB strengthened its direct relations with Asian central banks by organising, together with Bank Indonesia, a high-level seminar bringing together the 11 governors from the

4 The Deutsche Bundesbank, the Banco de España, the Banque de France, the Central Bank and Financial Services Authority of Ireland, the Banca d'Italia, De Nederlandsche Bank, the Oesterreichische Nationalbank, the Banco de Portugal, Suomen Pankki – Finlands Bank, Rahoitustarkastus – Finansinspektionen (the Finnish financial supervision authority), Finansinspektionen (the Swedish financial supervision authority) and the Financial Services Authority (the UK financial supervision authority).

5 This publication can be accessed via the ECB's website following a link from the 13 October 2005 press release entitled "Completion of central banking training project in Russia".

6 The six member states of the GCC are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

7 SADC is a regional grouping encompassing the following countries in the southern part of Africa: Angola, Botswana, the Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

Executive Meeting of East Asia-Pacific Central Banks (EMEAP) and members of the Governing Council of the ECB. The participants in the seminar, which took place at the ECB in November 2005, discussed ways of moving towards more balanced global growth patterns and reviewed recent developments and related policy issues in both the euro area and the Asia-Pacific region. The experience of the two regions with multilateral macroeconomic and financial surveillance was also assessed, together with cross-border financial integration at the global level and within both the Asia-Pacific region and the euro area.

As regards institutional relations with Latin American countries, the ECB attended, with observer status, the Annual Meeting of the Inter-American Development Bank, which took place in Okinawa in early April. As a collaborative member of the Centre for Latin American Monetary Studies, the ECB continued to be involved in several activities hosted or co-organised by this institution. These included the biannual meetings for central bank governors which took place in Cartagena and Washington, D.C. in April and September respectively, as well as a seminar on workers' remittances in Latin America which took place in Mexico City in October. The ECB continued its efforts to further strengthen bilateral relations with monetary and other official authorities in the Latin American region, including visits to Mexico, Brazil and Argentina. The ECB also welcomed to Frankfurt official delegations from a number of Latin American economies during 2005.

Artist
David Farrell
Title
Ballynultagh, 2000 (from the series “Innocent Landscapes”)
Material
Photograph
Format
100 x 100 cm

CHAPTER 5

ACCOUNTABILITY

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

Over the past decades, central bank independence has emerged as an indispensable element of a monetary regime which gives priority to price stability. At the same time, it is a fundamental principle of modern democracies that any independent institution bestowed with a public function be accountable for its actions to citizens and their democratically elected representatives. For an independent central bank, accountability can be understood as the obligation to explain its decisions to citizens and their elected representatives, thus enabling them to hold the central bank responsible for achieving its objectives.

Since its establishment, the ECB has recognised the fundamental importance of being accountable for its policy decisions and to this end has maintained a regular dialogue with EU citizens and the European Parliament. The ECB's commitment in this respect is illustrated inter alia by the numerous publications it released in 2005 and the large number of speeches delivered by the members of the Governing Council during the year (see Section 2 of Chapter 6).

The Treaty lays down precise reporting requirements for the ECB, which include the publication of quarterly reports, a weekly financial statement and an annual report. The ECB in fact exceeds these statutory obligations, for instance by publishing a Monthly Bulletin rather than a quarterly report, by holding monthly press conferences and by communicating on a monthly basis Governing Council decisions taken in addition to interest rate decisions.

At the institutional level, the Treaty assigns a prominent role to the European Parliament with regard to the accountability of the ECB. In line with the provisions of Article 113 of the Treaty, the President presented the ECB's Annual Report 2004 to the plenary session of the European Parliament in 2005. In addition, the President continued to report regularly on the ECB's monetary policy and its other tasks during his quarterly appearances before the Parliamentary Committee on Economic and Monetary Affairs (ECON).

Other members of the Executive Board were also invited to appear before the European Parliament on a number of occasions. In April 2005 the Vice-President presented the ECB's Annual Report 2004 to ECON. In October the Committee invited Lorenzo Bini Smaghi to an exchange of views on the strategic review of the IMF (see Section 2.1 of Chapter 4).

In line with established practice, a delegation of members of ECON visited the ECB to exchange views with the members of the Executive Board on a variety of issues. In addition, informal discussions took place with members of the European Parliament on issues related to securities clearing and settlement in the EU, as well as on euro communication issues with a specific focus on the new EU Member States planning to introduce the euro. The ECB also continued its voluntary practice of replying to questions submitted in writing by members of the European Parliament on issues falling within the ECB's field of competence.

Finally, Article 112 of the Treaty stipulates that the European Parliament give its opinion on candidates for the Executive Board prior to their appointment. In order to prepare its position, the Parliament invited Lorenzo Bini Smaghi to appear before ECON to present his views and answer questions from Committee members. Following this hearing, the Parliament endorsed his appointment.

2 SELECTED TOPICS RAISED AT MEETINGS WITH THE EUROPEAN PARLIAMENT

In the course of the various exchanges between the ECB and the European Parliament, a wide range of issues were addressed, with monetary policy being the main focus during the President's appearances before the European Parliament. Some of the other issues discussed are outlined below.

THE REFORM OF THE STABILITY AND GROWTH PACT

A significant part of the exchange of views between the European Parliament and the ECB was dedicated to developments in public finances and the reform of the Stability and Growth Pact. In its resolution on public finances in EMU adopted in February 2005, the European Parliament warned that "excessive government expenditure puts at risk price stability, low interest rates and government investment levels, and in addition reduces the capacity to face the challenge of demographic changes". As regards the reform of the Stability and Growth Pact, the Parliament welcomed the strengthening of the Pact's preventive arm and the increased attention given to debt levels and the Lisbon objectives. At the same time, it expressed its concern about the lack of clarity in the rules of the corrective arm of the Pact and regretted that an opportunity had been missed to strengthen the role of the European Commission.

The President of the ECB welcomed the high degree of convergence between the views of the two institutions on this issue. During his appearances before the Committee on Economic and Monetary Affairs, he stressed that sound fiscal policies were fundamental to the success of EMU. Against this backdrop, he indicated that the reform of the Pact created an opportunity for a renewed commitment to sound fiscal policies, provided that the revised framework was implemented rigorously and consistently (see Section 1.1 of Chapter 4).

THE MID-TERM REVIEW OF THE LISBON STRATEGY

Another issue discussed regularly by the ECB and the European Parliament was the mid-term review of the Lisbon strategy. In its resolutions on this issue, the Parliament welcomed the commitment made by the EU Council and the European Commission to inject new dynamism into the Lisbon strategy and expressed its support for the new governance framework. The Parliament also underlined that "growth-oriented, sustainable macroeconomic conditions must be guaranteed if (...) economic, social and environmental objectives are to be achieved". The Parliament regretted that the European Council had not endorsed the suggestion of the high-level group chaired by Wim Kok that the Commission should produce annual league tables of Member States' progress towards achieving the Lisbon goals.

The President of the ECB said that the revised Lisbon strategy constituted a good blueprint for unlocking Europe's growth and employment potential. In addition, he concurred with the Parliament's view that a stable macroeconomic environment was a precondition for increasing growth and employment. He also emphasised the need for "benchmarking" and peer support at the European level to improve the implementation of structural reforms (see Section 1.1 of Chapter 4).

COMMUNICATION ON THE EURO AND EMU

In 2005 the European Parliament also considered in close detail the communication policy on the euro and EMU vis-à-vis the citizens of current and prospective euro area countries. In March the European Parliament's rapporteur on this issue visited the ECB to exchange views with Executive Board Member José Manuel González-Páramo and a number of ECB experts. In its resolution on the implementation of an information and communication strategy on the euro and EMU, the Parliament welcomed the benefits of EMU and called the euro "possibly the most successful European project ever launched". In order to support the single currency and prepare the prospective members of the euro area for a smooth currency changeover, the Parliament called for a coherent, ambitious and long-lasting communication strategy on the euro and EMU. One of the measures suggested by the Parliament was that the ECB undertake a yearly quantitative analysis of the benefits of the single currency for citizens.

During his appearance before the plenary of the European Parliament, the President emphasised that the ECB was considering all appropriate means to enhance communication on the benefits of the single currency. He explained that a wide-ranging quantitative analysis of the benefits of the euro may be subject to methodological problems and data constraints. In a letter to the Parliament, it was also pointed out that such an analysis may need to include issues which go beyond the realm of central banking.

FINANCIAL INTEGRATION AND REGULATION

Issues related to financial integration and regulation again figured prominently in the exchanges between the ECB and the European Parliament. The Parliament paid particular attention to the activities of the ESCB and the Committee of European Securities Regulators (CESR) in the area of securities clearing and settlement. In the resolution it adopted on this topic in July 2005, the Parliament stated that the ESCB-CESR standards (see Section 4.3 of Chapter 3) must not predetermine EU legislation and stressed the need for a wide and open consultation of the affected parties on this issue.

The President emphasised that the standards were an important contribution to a safe and integrated infrastructure in the field of securities clearing and settlement, and that the ESCB and CESR had taken their decisions in an open and transparent manner, following a broad consultation of market participants. He also said that the ESCB-CESR standards neither pre-empted nor precluded future legislative acts in this area.

EURO COINS AND BANKNOTES

The possible issuance of very low-denomination euro banknotes was also discussed in 2005. In addition to submitting written questions to the President on this issue, the European Parliament adopted a declaration calling on the European Commission, the EU Council and the ECB to recognise the need to issue €1 and €2 banknotes.

The Governing Council had decided in 2004 not to introduce very low-denomination euro banknotes in view of the fact that the arguments against the introduction of such banknotes outweighed the arguments in favour. The Governing Council's decision was motivated by the insufficient popular demand for very low-denomination banknotes, the practical problems posed for third parties by the introduction of such banknotes and the high costs of printing and processing. The President explained that no new evidence had emerged to change the Governing Council's assessment.

Artist
Natividad Bermejo
Title
Duérmete niño, 2000
Material
Graphite on paper
Format
145 x 212 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.

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. Monetary policy decisions are explained at a press conference immediately after the Governing Council has taken them. A detailed introductory statement is made by the President and, together with the Vice-President, he is at the media's disposal to answer questions. Since December 2004 decisions taken by the Governing Council other than those setting interest rates have also been published every month on the websites of the Eurosystem central banks.

The ECB's legal acts are made available in all 20 official languages of the EU, as are the consolidated financial statements of the Eurosystem. The ECB's other statutory publications – the Annual Report, the quarterly version of the Monthly Bulletin and the Convergence Report – are made available in 19 of the 20 official EU languages.[1] For the purposes of accountability and transparency vis-à-vis European citizens and their elected representatives, the ECB also publishes other documentation in all official languages, in particular press releases on monetary policy decisions, 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 close collaboration with the NCBs.

1 A temporary exception applies to Maltese.

2 COMMUNICATION ACTIVITIES

The ECB needs to address a variety of audiences, such as financial experts, the media, governments, parliaments and the general public, with varying levels of knowledge of finance and economics. Its mandate and policy decisions are therefore explained through a range of communication tools and activities which are constantly being refined in order to make them more effective.

The ECB publishes a number of studies and reports. The Annual Report presents a 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 regular updates of the ECB's assessment of economic and monetary developments and the detailed information underlying its decisions. The ECB contributes to the dissemination of research findings by publishing working papers and occasional papers and by organising academic conferences, seminars and workshops.

In 2005 the ECB, in cooperation with the euro area NCBs, produced an educational tool to be used by young teenagers and their schoolteachers. This new tool aims to provide a broad and clear overview of the reasons why price stability is important in ensuring long-term prosperity and of how the ECB's monetary policy is geared towards achieving this objective. The information kit, which has been produced in the languages of the euro area and distributed to around 50,000 secondary schools in the euro area, contains an eight-minute film, leaflets for pupils and a teachers' booklet. It can also be downloaded from the ECB's website, where it is available in all official languages of the EU.

The ECB has also refined its method of communicating monetary policy decisions to financial markets and of making its announcements available to the public. Since February 2005 the monthly press conference has been webcast live via the ECB's website. In addition, the related video and audio files are made available to the public shortly after the conference.

Together with the BIS and the G10 central banks, the ECB launched a new publication entitled the "International Journal of Central Banking", the first quarterly issue of which was published on 19 May 2005. 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.

All members of the Governing Council directly contribute to enhancing public knowledge and understanding of the Eurosystem's tasks and policies by giving testimonies before the European Parliament and national parliaments, making public speeches and providing information to the media. In 2005 the Executive Board members gave around 220 speeches and numerous interviews, as well as having articles published in journals, magazines and newspapers.

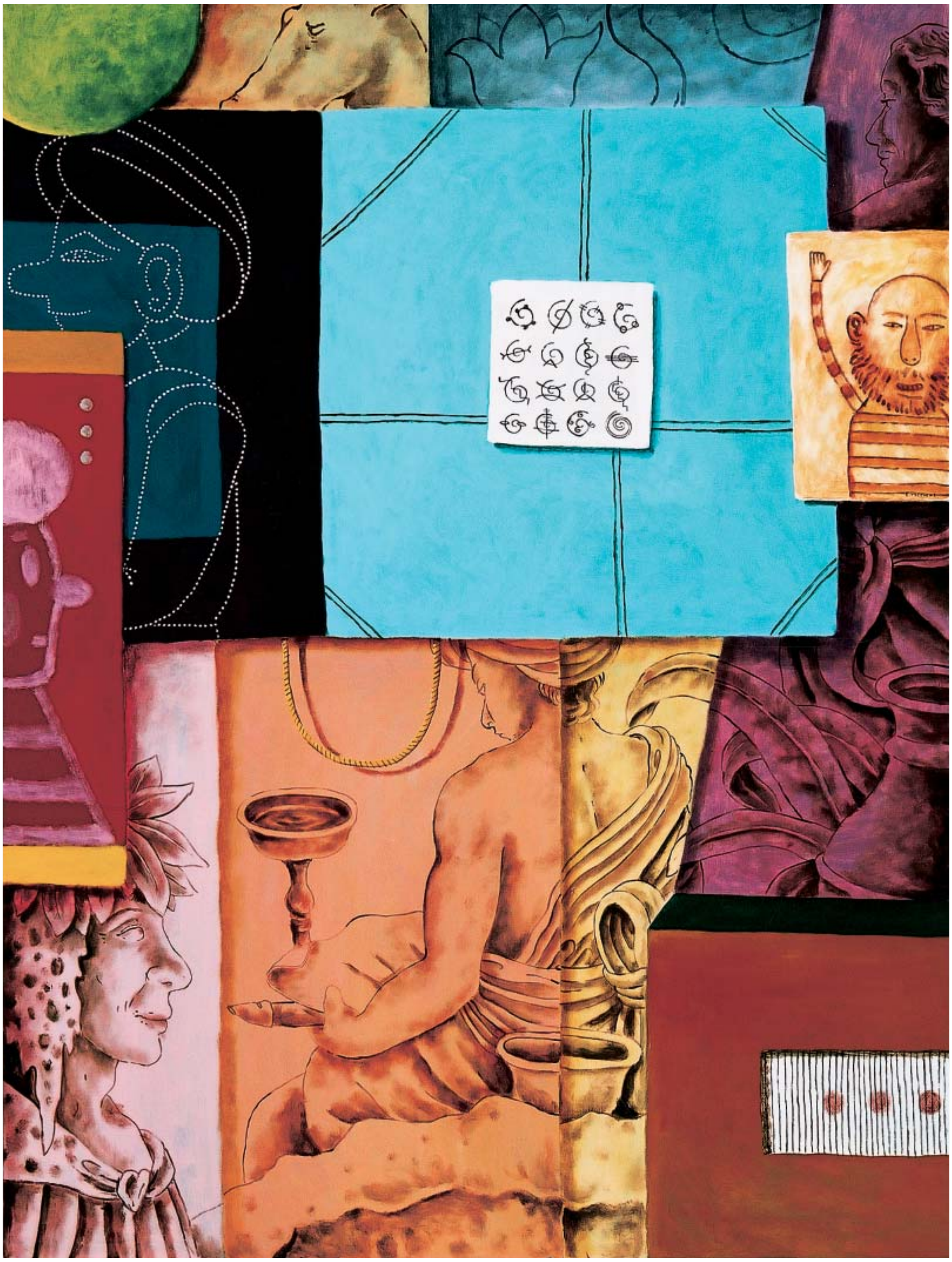
The euro area NCBs also play an important role in ensuring the dissemination at the national level of information on the euro and the activities of the Eurosystem to the general public and interested parties. They address a variety of national and regional audiences in their own languages and environments.

The ECB also welcomes visitor groups to its premises in Frankfurt. In 2005 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.

All documents published by the ECB and its various activities are presented on the ECB's website. Around 65,000 requests for information were received through various channels and handled in 2005.

The ECB holds an annual Cultural Days programme which aims to bring the cultural diversity and liveliness of the EU Member States closer to the public as well as to the ECB's own employees. Each year this initiative highlights the richness of the culture of one country, thus fostering a better understanding of the nations in the EU. In 2005 the Cultural Days programme focused on Hungary, following on from Portugal in 2003 and Poland in 2004. The programme of events was organised in close cooperation with Magyar Nemzeti Bank and took place between 2 and 28 November.

Artist
Pedro Proença
Title
Alla turca (algumas anotações musicais), 2001
Material
Acrylic on canvas
Format
200 x 150 cm



CHAPTER 7

INSTITUTIONAL FRAMEWORK, ORGANISATION AND ANNUAL ACCOUNTS

1 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 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. In January 2005 the ECB and the euro area NCBs published on their websites a mission statement for the Eurosystem together with strategic intents and organisational principles for the fulfilment of the functions of the Eurosystem by all of its members.

The ESCB is composed of the ECB and the NCBs of all EU Member States (currently 25), 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 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. The General Council is constituted as a third decision-making body of the ECB, for as long as there are EU 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]. 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.

1.2 THE GOVERNING COUNCIL

The Governing Council comprises all the members of the Executive Board of the ECB and the governors of the NCBs of the Member States which have adopted the euro. Its main responsibilities, as laid down in the Treaty, 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 2005 two meetings were held outside Frankfurt: one was hosted by the Deutsche Bundesbank in Berlin and the other by the Bank of Greece in Athens.

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.

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.

THE GOVERNING COUNCIL

Back row (left to right):
Lorenzo Bini Smaghi,
Klaus Liebscher, Axel A. Weber,
José Manuel González-Páramo,
Otmar Issing

Middle row (left to right):
Jaime Caruana, Vítor Constâncio,
Erkki Liikanen, Antonio Fazio,
John Hurley, Guy Quaden

Front row (left to right):
Nicholas C. Garganas, Yves Mersch,
Gertrude Tumpel-Gugerell,
Lucas D. Papademos,
Jean-Claude Trichet, Nout Wellink,
Christian Noyer

Jean-Claude Trichet
President of the ECB
Lucas D. Papademos
Vice-President of the ECB
Lorenzo Bini Smaghi (from 1 June 2005)
Member of the Executive Board of the ECB
Jaime Caruana
Governor of the Banco de España
Vítor Constâncio
Governor of the Banco de Portugal
Vincenzo Desario
(from 20 December 2005 to 15 January 2006)
Acting Governor of the Banca d'Italia
Mario Draghi (from 16 January 2006)
Governor of the Banca d'Italia
Antonio Fazio (until 19 December 2005)
Governor of the Banca d'Italia
Nicholas C. Garganas
Governor of the Bank of Greece
José Manuel González-Páramo
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
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 (until 31 May 2005)
Member of the Executive Board of the ECB
Guy Quaden
Governor of the Nationale Bank van België/ Banque Nationale de Belgique
Gertrude Tumpel-Gugerell
Member of the Executive Board of the ECB
Axel A. Weber
President of the Deutsche Bundesbank
Nout Wellink
President of De Nederlandsche Bank

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):
Lorenzo Bini Smaghi,
José Manuel González-Páramo,
Otmar Issing

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

Jean-Claude Trichet
President of the ECB
Lucas D. Papademos
Vice-President of the ECB
Lorenzo Bini Smaghi (from 1 June 2005)
Member of the Executive Board of the ECB
José Manuel González-Páramo
Member of the Executive Board of the ECB
Otmar Issing
Member of the Executive Board of the ECB
Tommaso Padoa-Schioppa
(until 31 May 2005)
Member of the Executive Board of the ECB
Gertrude Tumpel-Gugerell
Member of the Executive Board of the ECB

Executive Board

Directorate General Statistics
Steven Keuning
Deputy: Werner Bier
Divisions: • Euro Area Accounts and Economic Statistics
• External Statistics
• Monetary, Financial Institutions and Markets Statistics
• Statistical Information Management and User Services
• Statistics Development and Coordination

Directorate General Administration
Gerald Grisse
Divisions: • Office Services
• Premises
• Security
Directorate Internal Finance: Ian Ingram
Divisions: • Accounting
• Financial Reporting and Policy

Directorate Banknotes
Antti Heinonen
Divisions: • Banknote Issue
• Banknote Printing

Directorate Communications
Elisabeth Ardaillon-Poirier
Divisions: • Official Publications and Library
• Press and Information
• Protocol and Conferences

Counsel to the Executive Board
Gilles Noblet

ECB Permanent Representation in Washington, D.C.
Johannes Onno de Beaufort Wijnholds

Directorate General Economics
Wolfgang Schill
Deputy: Philippe Moutot
Division: • Fiscal Policies
Directorate Economic Developments
Hans-Joachim Klöckers
Divisions: • EU Countries
• Euro Area Macroeconomic Developments
• External Developments
Directorate Monetary Policy
Philippe Moutot
Divisions: • Capital Markets and Financial Structure
• Monetary Policy Stance
• Monetary Policy Strategy

Directorate Financial Stability and Supervision
Mauro Grande
Divisions: • Financial Stability
• Financial Supervision

Directorate General Human Resources, Budget and Organisation
Koenraad De Geest
Deputy: Berend van Baak
Divisions: • Budget and Projects
• Compensation and Staff Relations
• Organisational Planning
• Recruitment and Staff Development
• Risk Management [2]

Directorate General Information Systems
Hans-Gert Penzel
Deputy: François Laurent
Divisions: • IT Management Functions
• IT Operations and Support
Directorate IT Projects: Magí Clavé

Directorate Internal Audit
Klaus Gressenbauer
Divisions: • Audit Missions
• Audit Services

Directorate General International and European Relations
Pierre van der Haegen
Deputy: Georges Pineau
Divisions: • EU Institutions and Fora
• EU Neighbouring Regions
• International Policy Analysis and Emerging Economies

Directorate General Legal Services
Antonio Sáinz de Vicuña
Deputy: n. n.
Divisions: • Lawyer-Linguists
• Legal Advice [1]

Directorate General Market Operations
Francesco Papadia
Deputies: Paul Mercier, Werner Studener
Divisions: • Back Office
• Front Office
• Investment
• Market Operations Analysis
• Market Operations Systems

Directorate General Payment Systems and Market Infrastructure
Jean-Michel Godeffroy
Deputy: Daniela Russo
Divisions: • Market Infrastructure
• Oversight
• TARGET

Directorate General Research
Lucrezia Reichlin
Deputy: Frank Smets
Divisions: • Econometric Modelling
• Financial Research
• Monetary Policy Research

Directorate General Secretariat and Language Services
Frank Moss
Deputy: Julio Durán
Divisions: • Linguistic Services
• Secretariat
• Translation

Executive Board

Back row (left to right): Lorenzo Bini Smaghi, José Manuel González-Páramo, 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.

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 mainly 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 2005 the General Council met four times. The General Council decided in March 2005 to invite the governors of the central banks of Bulgaria and Romania to attend, as from the date their countries signed the Accession Treaty, the meetings of the General Council in an observer capacity. This decision was taken in line with the approach applied to the then ten acceding country central banks (ACCBs) in 2003 with a view to enhancing cooperation with the ACCBs in preparation for their entry into the ESCB. On 16 June 2005 the governors of the Bulgarian and Romanian central banks participated for the first time as observers in a meeting of the General Council.

Back row (left to right):
Andres Lipstok, Erkki Liikanen, Ilmārs Rimšēvičs, Lars Heikensten, Zdeněk Tůma, Axel A. Weber, Reinoldijus Šarkinas, Mitja Gaspari

Middle row (left to right):
Nicholas C. Garganas, Jaime Caruana, Leszek Balcerowicz, Vítor Constâncio, Klaus Liebscher, Antonio Fazio, John Hurley, Zsigmond Járai

Front row (left to right):
Yves Mersch, Bodil Nyboe Andersen, Christodoulos Christodoulou, Lucas D. Papademos, Jean-Claude Trichet, Michael C. Bonello, Nout Wellink, Christian Noyer, Guy Quaden

Note: Mervyn King and Ivan Šramko were unable to attend the meeting at which the photograph was taken.

Jean-Claude Trichet President of the ECB
Lucas D. Papademos Vice-President of the ECB
Bodil Nyboe Andersen (until 31 October 2005)
Governor of Danmarks Nationalbank
Leszek Balcerowicz
President of Narodowy Bank Polski
Nils Bernstein (from 1 November 2005)
Governor of Danmarks Nationalbank
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
Vincenzo Desario
(from 20 December 2005 to 15 January 2006)
Acting Governor of the Banca d'Italia
Mario Draghi (from 16 January 2006)
Governor of the Banca d'Italia
Antonio Fazio (until 19 December 2005)
Governor of the Banca d'Italia
Nicholas C. Garganas
Governor of the Bank of Greece
Mitja Gaspari Governor of Banka Slovenije
Lars Heikensten (until 31 December 2005)
Governor of Sveriges Riksbank
John Hurley Governor of the Central Bank and Financial Services Authority of Ireland
Stefan Ingves (from 1 January 2006)
Governor of Sveriges Riksbank
Zsigmond Járai Governor of Magyar Nemzeti Bank
Mervyn King Governor of the Bank of England
Vahur Kraft (until 6 June 2005)
Governor of Eesti Pank
Klaus Liebscher
Governor of the Oesterreichische Nationalbank
Erkki Liikanen
Governor of Suomen Pankki – Finlands Bank
Andres Lipstok (from 7 June 2005)
Governor of Eesti Pank
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 Governor of Národná banka Slovenska
Zdeněk Tůma Governor of Česká národní banka
Axel A. Weber President of the Deutsche Bundesbank
Nout Wellink President of De Nederlandsche Bank

1.5 EUROSYSTEM/ESCB COMMITTEES, THE BUDGET COMMITTEE AND THE HUMAN RESOURCES CONFERENCE

EUROSYSTEM/ESCB COMMITTEES, BUDGET COMMITTEE, HUMAN RESOURCES CONFERENCE AND THEIR CHAIRPERSONS

Accounting and Monetary Income Committee (AMICO) Ian Ingram	**International Relations Committee (IRC)** Henk Brouwer
Banking Supervision Committee (BSC) Edgar Meister	**Legal Committee (LEGCO)** Antonio Sáinz de Vicuña
Banknote Committee (BANCO) Antti Heinonen	**Market Operations Committee (MOC)** Francesco Papadia
Eurosystem/ESCB Communications Committee (ECCO) Elisabeth Ardaillon-Poirier	**Monetary Policy Committee (MPC)** Wolfgang Schill
Information Technology Committee (ITC) Hans-Gert Penzel	**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	**Human Resources Conference (HRC)** Koenraad De Geest

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. Since the signing of the Accession Treaty in April 2005, and in line with the decision to invite ACCB governors to attend the meetings of the General Council, experts from the central banks of Bulgaria and Romania have been invited to the meetings of ESCB committees in an observer capacity whenever they deal with matters that fall within the field of competence of the General Council. 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, assists the Governing Council in matters related to the ECB's budget.

In November 2005 the Governing Council established a Human Resources Conference under Article 9a of the Rules of Procedure (see Section 2 of this chapter).

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 external control layers, namely the external auditor [2], which is appointed to audit the annual accounts of the 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 on the ECB's website and in the Official Journal of the European Union.

In August 2002 the Governing Council decided that, in order to reinforce 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

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 and determine the acceptable level of risk. For example, a set of rules and procedures – known as a Chinese wall – is in place to prevent inside information 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, different divisions within the Directorate General Human Resources, Budget and Organisation monitor the control process and make proposals to improve the effectiveness of risk identification, assessment and mitigation in the ECB as a whole.

Independently from the control structure and risk monitoring of the ECB, audit missions are performed by the Directorate Internal Audit under the responsibility of the Executive Board. In accordance with the mandate defined in the ECB Audit Charter [3], the ECB's internal auditors evaluate, on an ad hoc basis, the adequacy and effectiveness of the ECB's system of internal control as well as the ECB's performance in carrying out assigned responsibilities. The ECB's internal auditors 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.

There are two Codes of Conduct in place at the ECB. The first is for the members of the Governing Council and reflects their responsibility to safeguard the integrity and reputation of the Eurosystem and to maintain the effectiveness of its operations.[4] It gives guidance to, and sets ethical standards for, the members of the Governing Council and their alternates when exercising their functions as members of the Governing Council. An adviser has also been appointed by the Governing Council to provide guidance to its members on some aspects of professional conduct. 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.

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.

second Code is the Code of Conduct of the ECB, which 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 Code of Conduct's 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.

ANTI-FRAUD MEASURES

In 1999 the European Parliament and the EU Council adopted a regulation[7] to step up the fight against fraud, corruption and any other illegal activity detrimental to the Communities' financial interests. The regulation provides inter alia for the internal investigation of suspected fraud by the European Anti-Fraud Office (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.

PUBLIC ACCESS TO ECB DOCUMENTS

The ECB's Decision on public access to ECB documents[9] adopted in March 2004 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.

In 2005 the number of public access requests remained limited.

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.
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 Case-11/00 Commission v European Central Bank, ECR I-7147.
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 2005 was 1,369.5 full-time equivalent (FTE) positions. This compares with 1,362.5 FTE positions for 2004. At the end of 2005 the number of staff employed by the ECB on permanent or fixed-term contracts of at least 12 months was 1,360, which corresponds to 1,351 FTE positions.[10] After 15 May 2005 the ECB started accepting applications from nationals of the two acceding countries, Bulgaria and Romania. All external recruitment to fill permanent positions was carried out on the basis of five-year fixed-term contracts for managerial and advisory positions and three-year fixed-term contracts for all other staff.

In 2005 the ECB offered 106 short-term contracts of less than one year in order to fill temporary staffing needs (replacement for staff on maternity, parental or unpaid leave, etc.), compared with 123 in 2004.

Additionally, in accordance with one of the Eurosystem organisational principles which states that "the exchange of personnel, know-how and experience shall be promoted by and among all members of the Eurosystem", 80 experts from the NCBs of the ESCB, as well as from the Bulgarian National Bank and the Banca Naţională a României, were recruited by the ECB for short periods of 3 to 11 months. These short-term assignments provided a very useful opportunity for ECB and NCB staff to gain from each other's experience, thus fostering an ESCB-wide team spirit. They also contributed to the preparations for further EU enlargement and the future integration of the Bulgarian National Bank and the Banca Naţională a României into the ESCB.

In 2005 the ECB provided internships for 158 students and graduates with backgrounds in economics, statistics, business administration, law and translation. Of the 158 internships, 10 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 Visitor Programme, which focuses on specific high-level research projects in the field of monetary policy, 19 research visitors were welcomed in 2005, compared with 18 in 2004.

The ECB's Graduate Programme, which is aimed at recent graduates with a broad educational background, was launched in 2005 with a call for interest. The first intake is expected in 2006.

INTERNAL MOBILITY

Internal mobility represents an opportunity for staff to broaden their expertise and a means to increase synergies across business areas. In this respect, the internal recruitment policy, which places greater emphasis than in the past on broader competencies, aims to further facilitate internal staff mobility. Other initiatives, such as exchanges between staff and temporary internal transfers to new functions to cover for the absence of colleagues, also support internal mobility. In 2005 more than 100 members of staff moved internally to other positions.

EXTERNAL MOBILITY

ECB staff continued to be seconded to NCBs and to other relevant international and European institutions (e.g. the European Commission and the IMF) for periods of 2 to 12 months. 15 members of staff participated in the external work experience scheme in 2005. In addition, the ECB continued to grant unpaid leave for up to three years for staff who wanted to take up employment at an NCB or other eligible financial organisation. 14 members of staff took advantage of this option in 2005.

10 This compares with 1,314 staff employed on permanent or fixed-term contracts at the end of 2004, which corresponded to 1,309 FTE positions.

STRENGTHENING HUMAN RESOURCES

The implementation of the new human resources (HR) strategy initiated in 2004 continued throughout 2005. In addition to promoting mobility, including managerial rotation, the HR strategy focuses on the development of ECB management. Managerial and leadership skills continued to be strengthened through training, individual coaching and a multi-source feedback exercise. This yearly exercise, which is mandatory for all managers, provides an assessment by relevant staff and feeds into the ECB managers' annual performance assessment. In addition, the Advanced Management Training Programme was extended to cover the management of staff performance and organisational change.

Furthermore, the six ECB common values (competence, effectiveness and efficiency, integrity, team spirit, transparency and accountability, and working for Europe) identified in 2004 were gradually embedded in the human resources policies. The first steps in translating the values into the day-to-day behaviour and performance of staff involved encouraging initiatives to develop the values into concrete behavioural standards and actions and incorporating the values into the assessment of staff performance.

The continuous acquisition and development of skills and competencies is one of the most important aspects of the ECB's HR strategy. As a basic principle, learning and development are a shared responsibility. The ECB provides the budgetary means and training framework, managers define the training needs to ensure that staff maintain the high level of professional knowledge and skills required for their current position, and staff have the primary responsibility for learning and development. In addition to several in-house training opportunities, staff and managers can make use of external training opportunities to address individual specific training needs of a more "technical" nature. They can also benefit from training opportunities organised as common ESCB programmes or offered by the NCBs.

Additionally, under the Secondary Training Policy, the ECB offered support to 19 members of staff to acquire a qualification that would increase their professional competence beyond the requirements of their current position.

THE HUMAN RESOURCES CONFERENCE AND THE FOLLOW-UP TO THE EUROSYSTEM MISSION STATEMENT

With the aim of further promoting the cooperation and team spirit among Eurosystem/ESCB central banks in the field of human resources management, the Governing Council established a Human Resources Conference (HRC), thus formalising the long-standing cooperation between the heads of personnel of the central banks of the EU. Without prejudice to the exclusive competence of the NCBs and the ECB in the area of human resources, the Governing Council gave the HRC a mandate for the exchange of experience, expertise and information on relevant human resources policies and practices. The HRC will contribute, inter alia, towards identifying opportunities for common training activities and developing measures to foster staff exchange. It will also coordinate activities of common interest in the human resources area.

On 1 September 2005 the Governing Council decided on a number of concrete measures to promote the Eurosystem mission statement published in January 2005. The HRC and the Eurosystem/ESCB Communications Committee were subsequently mandated to implement the approved measures. Giving a concrete meaning to the mission statement for Eurosystem employees in their day-to-day work will be an ongoing process.

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 an institution that employs staff from the 25 EU Member States as well as the two acceding countries. The ECB has thus integrated diversity management into its day-to-day business so that the individual competencies of staff are recognised and fully utilised to enable the ECB to perform at the high level necessary to fulfil its tasks. A general diversity policy, a framework policy concerning dignity at work and a proposal for the monitoring of diversity issues were further developed in 2005.

2.2 REVIEWING THE ECB'S EFFECTIVENESS AND EFFICIENCY

As a public institution, the ECB is committed to delivering the best services at the lowest cost. As a complement to the existing internal and external control mechanisms that permanently monitor the ECB's fulfilment of this commitment, the ECB decided to review its effectiveness and efficiency by conducting a zero-based budgeting assessment (ZBB) in which its staff and management were actively involved. The ZBB was a "green field" review of the effectiveness and efficiency of the activities of all ECB business areas, conducted through a survey of the activities and output of all ECB staff and management.

Based on the ZBB findings, the Executive Board decided that a substantial number of positions were to be saved, but without laying off staff. A temporary recruitment freeze was implemented for a few months of 2005 while the possible reassignment of some members of staff within the institution was assessed. The Executive Board adopted a number of other measures covering a wider range of organisational issues within and across the various business areas of the ECB. Such measures included: creating a Central Procurement Office within the Directorate General Administration; merging the Directorate Planning and Controlling with the Directorate Human Resources to form a new Directorate General Human Resources, Budget and Organisation; clarifying the allocation of responsibilities between the Directorate General Information Systems and other business areas of the ECB with regard to IT application; concentrating statistical work in the Directorate General Statistics; and enhancing the operational risk management function.

2.3 NEW ECB PREMISES

On 13 January 2005 the Governing Council reached a decision on the design for the ECB's future premises. After careful consideration and extensive discussions based on the selection criteria for the competition, the Governing Council decided in favour of the revised design concept of COOP HIMMELB(L)AU, the architects who had won the international urban planning and architectural design competition. At the same time, the Governing Council launched an optimisation phase to review the functional, spatial and technical requirements with the aim of minimising costs and ensuring an optimal use of resources.

On 15 December 2005 the Governing Council approved COOP HIMMELB(L)AU's optimised design concept for the ECB's new premises. The new concept fully met the requirements of the ECB. The building cost estimates were well within the envisaged cost frame of €500 million. The building costs for the new premises cover the construction, technical infrastructure and landscaping, as well as certain necessary features and user-specific requirements which will ensure the proper functioning of the ECB as a modern central bank. The overall investment cost frame comprises not only the building costs but also all other cost elements which are necessary to complete the project. These other cost elements cover in particular the cost of purchasing the Grossmarkthalle site, the subsequent preparation and development of the site, all planning fees and other expenses covering items such as building permits,

furnishings and IT. These costs are estimated to amount to a total of €350 million, of which around €80 million has already been invested in the purchase, preparation and development of the site as well as in the design competition. The overall investment cost, comprising building costs and all other costs, is therefore estimated to be €850 million. The cost estimates follow the methodology used for this type of project and are based on a constant 2005 price level.

The optimisation phase led to several changes in the design proposal. First, a new building element was introduced, which will intersect the Grossmarkthalle, connecting the hall to the towers and providing a distinctive entrance to the new ECB premises from the north. Second, the use of the Grossmarkthalle was intensified, while the view of the Grossmarkthalle from the south was improved. Within the optimised design proposal, the architectural aspects of the towers and their function of essentially providing office space remained unchanged.

On 15 December 2005 the Governing Council also decided on the launch of the planning phase, which will commence in March 2006. It is envisaged that construction will begin towards the end of 2007, with an estimated completion date of the end of 2011.

On 16 February 2006 the Governing Council approved the framework concept for the management, organisation, controlling and auditing of the planning phase of the new ECB premises project, including procurement and operational risk management.

A memorial and information space to commemorate the Grossmarkthalle's role in the deportation of Jewish citizens will also be constructed. A task force consisting of representatives of the City of Frankfurt, the Frankfurt Jewish Community and the ECB was set up to prepare an international competition for the design of the memorial and information space. The competition is expected to be launched in the first half of 2006.

3 ESCB SOCIAL DIALOGUE

The ESCB Social Dialogue is a consultative forum involving the ECB and employee representatives from all central banks of the ESCB and from European trade union federations. Its purpose is to provide information and an exchange of views on issues that may have a major impact on the employment situation at the central banks of the ESCB.

Three meetings of the ESCB Social Dialogue were held in 2005. In addition to issues relating to banknote production and circulation, payment systems (TARGET2) and financial supervision, which are topics regularly addressed by the Social Dialogue, the discussions dealt with the Eurosystem mission statement, strategic intents and organisational principles and with their implications for the day-to-day work of Eurosystem staff.

The Governing Council acknowledged the staff representatives' wish to be involved in discussions regarding further consequences of the Eurosystem mission statement for employees and consulted them before deciding on a number of initial implementation measures related to the mission statement. First, a decentralised consultation to be conducted locally with employee representatives was proposed to the euro area NCBs in May 2005. Second, following on from that initiative, a consultation of the employee representatives was carried out in the context of the Social Dialogue meeting of July 2005. At that meeting, the European trade union federations made a joint declaration presenting their own vision of the Eurosystem mission statement, strategic intents and organisational principles.

The ECB continued to issue, between meetings, a newsletter to keep employee representatives informed of the latest developments with regard to the above topics. Other ways of further enhancing the ESCB Social Dialogue and of increasing the involvement of staff representatives and trade unions of the NCBs of the ten new Member States were also agreed on at the 2005 meetings.

4 ANNUAL ACCOUNTS OF THE ECB

MANAGEMENT REPORT FOR THE YEAR ENDING 31 DECEMBER 2005

1 PRINCIPAL ACTIVITIES

The ECB's activities in 2005 are described in detail in the relevant chapters of the Annual Report.

2 FINANCIAL ACCOUNTS

Under Article 26.2 of the Statute of the ESCB, 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 then published.

3 PROVISION FOR FOREIGN EXCHANGE RATE, INTEREST RATE AND GOLD PRICE RISKS

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 strongly affected by exchange rate exposures and, to a lesser extent, interest rate exposures. These exposures stem mainly from its holdings of foreign reserve assets held in US dollars, Japanese yen and gold, which are predominantly invested in interest-bearing instruments.

Taking into account the ECB's large exposure to these risks and the current size of its revaluation accounts, the Governing Council decided to establish a provision against foreign exchange rate, interest rate and gold price risks. As at 31 December 2005, an amount of €992 million was recorded in this provision, which had the effect of reducing net profit for the year to exactly zero.

This provision will be used to cover realised and unrealised losses, in particular valuation losses not covered by the revaluation accounts. Its size will be reviewed annually.

4 FINANCIAL RESULT

Had the provision against foreign exchange rate, interest rate and gold price risks not been established, the ECB's net profit for 2005 would have been €992 million. In 2004, the ECB reported a net loss of €1,636 million.

The loss in 2004 was mainly due to the appreciation of the euro. This resulted in write-downs in the euro value of the ECB's holdings of US dollar-denominated assets, which were expensed in the Profit and Loss Account. The average cost of assets and liabilities denominated in US dollars in the books of the ECB was also adjusted to the year-end exchange rate.

In 2005, the depreciation of the euro vis-à-vis the US dollar and gold resulted in a substantial increase in the related revaluation accounts, but with no concomitant effect on the Profit and Loss Account. The harmonised accounting policies for the ECB and the Eurosystem, which are described in the notes to the Annual Accounts, 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.

In 2005 net interest income increased mainly due to a rise in US dollar interest rates, after historically low levels of domestic and foreign interest rates in 2004. Net interest income includes €868 million earned on the ECB's share of euro banknotes in circulation.

Total administrative expenses of the ECB, including depreciation, declined by 7% from €374 million in 2004 to €348 million in 2005. Staff costs decreased primarily due to a change in the accounting treatment applied to the recognition of net actuarial gains/losses in respect of the ECB's retirement plan and other post-employment benefits. The pension charge in 2004 was considerably higher due to the recognition of €23.7 million in net actuarial losses in their entirety in the year in which they arose. From 2005 onwards, net actuarial gains and losses exceeding a prescribed limit are to be amortised over the expected average remaining working lives of the participating employees.

This decrease in staff costs was, however, partially offset by the effect of an increase in staff numbers on total salaries.

Other administrative expenses also declined, primarily due to a reduction in consultancy and professional fees.

In 2005 the emoluments of the Executive Board amounted in total to €2.1 million (2004: €2.1 million).

5 INVESTMENT ACTIVITIES AND RISK MANAGEMENT

The ECB's foreign reserves portfolio consists of foreign reserve assets transferred to it by the Eurosystem NCBs in accordance with the provisions of Article 30 of the Statute of the ESCB, and the 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.

6 GOVERNANCE OF THE ECB

Information relating to the governance of the ECB is given in Chapter 7.

7 EMPLOYEES

The average number of staff employed by the ECB rose from 1,261 in 2004 to 1,331 in 2005. For further details, see the notes on the Profit and Loss Account and Chapter 7, Section 2, which also describes the ECB's human resources strategy.

BALANCE SHEET AS AT 31 DECEMBER 2005

ASSETS	NOTE NUMBER	2005 €	2004 €
Gold and gold receivables	**1**	**10,064,527,857**	**7,928,308,842**
Claims on non-euro area residents denominated in foreign currency	**2**		
Receivables from the IMF		170,162,349	163,794,845
Balances with banks and security investments, external loans and other external assets		31,062,557,242	26,938,993,980
		31,232,719,591	**27,102,788,825**
Claims on euro area residents denominated in foreign currency	**2**	**2,908,815,389**	**2,552,016,565**
Claims on non-euro area residents denominated in euro	**3**		
Balances with banks, security investments and loans		**13,416,711**	**87,660,507**
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		45,216,783,810	40,100,852,165
Other claims within the Eurosystem (net)		5,147,038,409	3,410,918,324
		50,363,822,219	**43,511,770,489**
Other assets	**6**		
Tangible fixed assets		175,237,902	187,318,304
Other financial assets		6,888,490,580	6,308,075,905
Accruals and prepaid expenses		1,091,945,157	770,894,480
Sundry		4,397,807	6,933,022
		8,160,071,446	**7,273,221,711**
Loss for the year		**0**	**1,636,028,702**
Total assets		**102,743,398,213**	**90,091,820,641**

LIABILITIES	NOTE NUMBER	2005 €	2004 €
Banknotes in circulation	7	**45,216,783,810**	**40,100,852,165**
Liabilities to other euro area residents denominated in euro	8	**1,050,000,000**	**1,050,000,000**
Liabilities to non-euro area residents denominated in euro	9	**649,304,896**	**137,462,706**
Liabilities to euro area residents denominated in foreign currency	10	**0**	**4,967,080**
Liabilities to non-euro area residents denominated in foreign currency	10		
Deposits, balances and other liabilities		**855,933,000**	**1,254,905,957**
Intra-Eurosystem liabilities	11		
Liabilities equivalent to the transfer of foreign reserves		**39,782,265,622**	**39,782,265,622**
Other liabilities	12		
Accruals and income collected in advance		1,331,685,870	1,136,708,542
Sundry		632,012,224	265,799,279
		1,963,698,094	**1,402,507,821**
Provisions	13	**1,027,507,143**	**52,396,126**
Revaluation accounts	14	**8,108,628,098**	**1,921,117,190**
Capital and reserves	15		
Capital		4,089,277,550	4,089,277,550
Reserves		0	296,068,424
		4,089,277,550	**4,385,345,974**
Total liabilities		**102,743,398,213**	**90,091,820,641**

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDING 31 DECEMBER 2005

	NOTE NUMBER	2005 €	2004 €
Interest income on foreign reserve assets		889,408,789	422,418,698
Interest income arising from the allocation of euro banknotes within the Eurosystem		868,451,848	733,134,472
Other interest income		1,794,267,421	1,456,650,188
Interest income		*3,552,128,058*	*2,612,203,358*
Remuneration of NCBs' claims in respect of foreign reserves transferred		(710,160,404)	(693,060,433)
Other interest expense		(1,572,338,709)	(1,229,369,015)
Interest expense		*(2,282,499,113)*	*(1,922,429,448)*
Net interest income	**18**	**1,269,628,945**	**689,773,910**
Realised gains/losses arising from financial operations	**19**	149,369,135	136,045,810
Write-downs on financial assets and positions	**20**	(97,494,081)	(2,093,285,109)
Transfer to/from provisions for foreign exchange rate and price risks		(992,043,443)	0
Net result of financial operations, write-downs and risk provisions		**(940,168,389)**	**(1,957,239,299)**
Net expense from fees and commissions	**21**	**(182,373)**	**(261,517)**
Other income	**22**	**18,281,961**	**5,956,577**
Total net income		**347,560,144**	**(1,261,770,329)**
Staff costs	**23**	(153,048,314)	(161,192,939)
Administrative expenses	**24**	(158,457,219)	(176,287,651)
Depreciation of tangible fixed assets		(31,888,637)	(33,655,824)
Banknote production services	**25**	(4,165,974)	(3,121,959)
Profit/(loss) for the year		**0**	**(1,636,028,702)**

Frankfurt am Main, 7 March 2006

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 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, including on-balance-sheet and off-balance-sheet instruments, is performed on a currency-by-currency basis.

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, for the year ending 31 December 2005, was derived from the exchange rate of the euro against the US dollar on 30 December 2005.

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 2005, mid-market prices on 30 December 2005 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, as amended.

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

Reverse transactions are operations whereby the ECB buys or sells assets under a repurchase agreement or conducts credit operations against collateral.

Under a repurchase agreement, securities are sold for cash with a simultaneous agreement to repurchase them from the counterparty at an agreed price on a set future date. Repurchase agreements are recorded as collateralised inward deposits 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. Reverse repurchase agreements are recorded as collateralised loans on the asset side of the Balance Sheet but are not included in the ECB's security holdings. They 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 2005 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 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 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, as follows:

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 new premises.

THE ECB'S RETIREMENT PLAN AND OTHER POST-EMPLOYMENT BENEFITS

The ECB operates a defined benefit scheme for its staff. This is funded by assets held in a long-term employee-benefit fund. The ECB has modified its accounting policy with effect from 1 January 2005. The effects on the financial statements are outlined below.

Balance Sheet

The liability now recognised in the Balance Sheet in respect of the defined benefit plans is the present value of the defined benefit obligation at the Balance Sheet date, *less* the fair value of plan assets used to fund the obligation, adjusted for unrecognised actuarial gains or losses.

The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash flows, using interest rates of high-quality corporate bonds that are denominated in euro and have similar terms of maturity to the term of the related pension liability.

Actuarial gains and losses can arise from experience adjustments (where actual outcomes are different from the actuarial assumptions previously made) and changes in actuarial assumptions.

Until 2005 the ECB disclosed this defined benefit obligation and the fair value of plan assets separately (gross presentation). Moreover, all actuarial gains and losses were recognised in the Profit and Loss Account in the year in which they occurred. Consequently, the comparative figures for 2004 have been reclassified to bring them into line with the revised accounting policy. Since all actuarial gains and losses were previously recognised in their entirety in the year in which they arose, no prior year adjustment to the Profit and Loss Account was required in this respect.

Profit and Loss Account

The net amount now charged to the Profit and Loss Account comprises:

(a) the current service cost of the benefits accruing for the year;

(b) interest at the discount rate on the defined benefit obligation;

(c) the expected return on the plan assets; and

(d) any actuarial gains and losses recognised in the Profit and Loss Account, using a "10% corridor" approach.

"10% corridor" approach

Net cumulative unrecognised actuarial gains and losses which exceed the greater of (a) 10% of the present value of the defined benefit obligation and (b) 10% of the fair value of plan assets, are to be amortised over the expected average remaining working lives of the participating employees.

Pensions of Executive Board members and other post-retirement obligations

Unfunded arrangements are in place for the pensions of members of the Executive Board and disability benefit provisions for the staff. The expected costs of these benefits are accrued over the Executive Board/staff members' terms of office/employment using an accounting approach similar to that of defined benefit pension plans. Actuarial gains and losses are recognised in the same manner as outlined above.

These obligations are valued annually by independent actuaries to establish the appropriate liability in the financial statements.

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 decided in 2002 that this income would be distributed separately to the NCBs in the form of an interim distribution after the end of each quarter.[6] It is distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation, and also after any decision by the Governing Council to make transfers to a provision for foreign exchange rate, interest rate and gold price risks, and subject to any decision by the Governing Council to charge against this income 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 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, the EU Council 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.

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.

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.

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. This Decision was repealed by Decision ECB/2005/11, OJ L 311, 26.11.2005, p. 41, which became effective on 18 November 2005. From 2006, this distribution will occur at the end of the year only.

NOTES ON THE BALANCE SHEET

1 GOLD AND GOLD RECEIVABLES

As at 31 December 2005 the ECB held 23.1 million ounces of fine gold (2004: 24.7 million ounces). The reduction was due to gold sales in accordance with the Central Bank Gold Agreement of 27 September 2004, of which the ECB is a signatory. The overall value of the holding increased compared with end-2004 due to a significant rise in the price of gold during 2005 (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 2005. 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 the exchange rates of 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 and loans denominated in foreign currency, and investments in securities denominated in US dollars and Japanese yen, as follows:

Claims on non-euro area residents	2005 €	2004 €	Change €
Current accounts	5,149,756,962	2,682,171,017	2,467,585,945
Money market deposits	1,182,580,317	848,227,002	334,353,315
Reverse repurchase agreements	1,306,216,228	2,408,046,989	(1,101,830,761)
Security investments	23,424,003,735	21,000,548,972	2,423,454,763
Total	31,062,557,242	26,938,993,980	4,123,563,262

Claims on euro area residents	2005 €	2004 €	Change €
Current accounts	25,019	26,506	(1,487)
Money market deposits	2,908,790,370	2,547,022,979	361,767,391
Reverse repurchase agreements	0	4,967,080	(4,967,080)
Total	2,908,815,389	2,552,016,565	356,798,824

The increase in these positions in 2005 is primarily due to the year-end revaluation of the ECB's US dollar-denominated assets (see "Gold and foreign currency assets and liabilities" in the notes on accounting policies).

3 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO

As at 31 December 2005 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 2005 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 2005 an amount of €634 million (2004: €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, "Net interest income").

	2005 €	2004 €
Due from euro area NCBs in respect of TARGET	75,906,443,905	64,024,554,579
Due to euro area NCBs in respect of TARGET	(71,393,877,603)	(61,149,859,140)
Net TARGET position	4,512,566,302	2,874,695,439
Due from/(to) euro area NCBs in respect of the interim distribution of the ECB's income derived from banknotes	634,472,107	536,222,885
Other claims within the Eurosystem (net)	5,147,038,409	3,410,918,324

6 OTHER ASSETS

Tangible fixed assets

These assets comprised the following main items on 31 December 2005:

	Net book value as at 31 Dec. 2005 €	Net book value as at 31 Dec. 2004 €	Change €
Land and buildings	128,986,932	135,997,016	(7,010,084)
Computer hardware and software	30,751,165	43,089,388	(12,338,223)
Equipment, furniture, plant in building and motor vehicles	2,929,688	3,809,292	(879,604)
Assets under construction	11,576,491	3,215,050	8,361,441
Other fixed assets	993,626	1,207,558	(213,932)
Total	175,237,902	187,318,304	(12,080,402)

The decrease in this item is principally due to the absence of major additions in land and buildings or computer hardware and software in 2005, in contrast to 2004.

The increase in the category "Assets under construction" relates mainly to the new ECB premises. Transfers from this category to the relevant fixed asset captions are effected once the assets are in use.

Other financial assets

The main components of this item are as follows:

	2005 €	2004 €	Change €
Securities denominated in euro	5,710,256,343	5,399,222,333	311,034,010
Reverse repurchase agreements in euro	1,136,043,600	869,977,933	266,065,667
Other financial assets	42,190,637	38,875,639	3,314,998
Total	6,888,490,580	6,308,075,905	580,414,675

(a) Securities denominated in euro and reverse repurchase agreements in euro constitute the investment of the ECB's own funds (see also note 12, "Other liabilities").

(b) At end-2004, the investment portfolios relating to the ECB's retirement plan, amounting to €120.2 million, were classified under this item. These have now been reclassified as part of the pension scheme net liability under "Other liabilities" (see "The ECB's retirement plan and other post-employment benefits" in the notes on accounting policies).

(c) In 2005 the ECB acquired 211 additional shares in the Bank for International Settlements (BIS). This brought the ECB's total holding to 3,211 shares, which are included at the acquisition cost of €41.8 million.

Accruals and prepaid expenses

In 2005 this position included accrued interest receivable 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).

Also included under this item is accrued interest on securities and other financial assets.

Sundry

Included in this item is a claim against the German Federal Ministry of Finance in respect of recoverable value added tax and other indirect taxes paid. Such taxes are refundable under the terms of Article 3 of the Protocol on 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	2005 €	2004 €	Change €
Repurchase agreements	0	4,967,080	(4,967,080)

Liabilities to non-euro area residents	2005 €	2004 €	Change €
Repurchase agreements	855,933,000	1,254,905,957	(398,972,957)

11 INTRA-EUROSYSTEM LIABILITIES

These represent the liabilities to the euro area NCBs that arose from the transfer of foreign reserve assets to the ECB when they joined the Eurosystem. In 2004, two adjustments were made to these balances to reflect (a) the five-yearly adjustment of the weighting in the ECB's capital key on 1 January 2004 and (b) the accession of ten new Member States on 1 May 2004, which also altered the ECB's capital key weighting. The combined effect of the two adjustments was to reduce these balances from €40.5 to €39.8 billion. No further adjustments took place in 2005.

These balances 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, "Net interest income").

	Capital key %	€
Nationale Bank van België/ Banque Nationale de Belgique	2.5502	1,419,101,951
Deutsche Bundesbank	21.1364	11,761,707,508
Bank of Greece	1.8974	1,055,840,343
Banco de España	7.7758	4,326,975,513
Banque de France	14.8712	8,275,330,931
Central Bank and Financial Services Authority of Ireland	0.9219	513,006,858
Banca d'Italia	13.0516	7,262,783,715
Banque centrale du Luxembourg	0.1568	87,254,014
De Nederlandsche Bank	3.9955	2,223,363,598
Oesterreichische Nationalbank	2.0800	1,157,451,203
Banco de Portugal	1.7653	982,331,062
Suomen Pankki – Finlands Bank	1.2887	717,118,926
Total	**71.4908**	**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, "Intra-Eurosystem liabilities"). Also included within this balance are (a) other accruals and outstanding repurchase transactions of €556 million conducted in connection with the management of the ECB's own funds (see note 6, "Other assets") and (b) the net liability in respect of the ECB's pension obligations.

The ECB's retirement plan and other post-employment benefits

The amounts recognised in the Balance Sheet in respect of the ECB's pension obligations (see "The ECB's retirement plan and other post-employment benefits" in the notes on accounting policies) are as follows:

	2005 € millions	2004 € millions
Present value of obligations	223.5	178.5
Fair value of plan assets	(161.2)	(120.2)
Unrecognised actuarial gains/(losses)	6.5	0
Liability recognised in the Balance Sheet	68.8	58.3

Included in the present value of the obligations are unfunded obligations relating to the pensions of Executive Board members and staff disability provisions of €30.4 million (2004: €23.0 million).

The amounts recognised in the Profit and Loss Account in 2005 and the amounts that would have been recognised in 2004 in respect of "Current service cost", "Interest on obligation" and "Expected return on plan assets" are as follows:

	2005 € millions	2004 € millions
Current service cost	24.6	17.6
Interest on obligation	6.2	4.8
Expected return on plan assets	(5.2)	(4.2)
Net actuarial (gains)/losses recognised in year	0	23.7
Total included in "Staff costs"	25.6	41.9

Changes in the present value of the defined benefit obligation are as follows:

	2005 € millions	2004 € millions
Opening defined benefit obligation	178.5	123.4
Service cost	24.6	17.6
Interest cost	6.2	4.8
Contributions paid by plan participants	9.3	8.4
Other net changes in liabilities representing plan participants' contributions	6.1	1.8
Benefits paid	(2.2)	(1.0)
Actuarial (gains)/losses	1.0	23.5
Closing defined benefit obligation	223.5	178.5

Changes in the fair value of plan assets are as follows:

	2005 € millions	2004 € millions
Opening fair value of plan assets	120.2	91.8
Expected return	5.2	4.2
Actuarial gains/(losses)	7.5	(0.2)
Contributions paid by employer	14.7	14.6
Contributions paid by plan participants	9.3	8.4
Benefits paid	(1.8)	(0.4)
Other net changes in assets representing plan participants' contributions	6.1	1.8
Closing fair value of plan assets	161.2	120.2

In preparing the valuations referred to in this note, the actuaries have used assumptions which the Executive Board has accepted for the purposes of accounting and disclosure.

The principal assumptions used for the purposes of calculating the staff scheme liability are as follows. The expected rate of return on plan assets is used by the actuaries for the purpose of calculating the annual charge to the Profit and Loss Account.

	2005 %	2004 %
Discount rate	4.10	4.50
Expected return on plan assets	6.00	6.00
Future salary increases	2.00	3.75
Future pension increases	2.00	2.25

13 PROVISIONS

Taking into account the ECB's large exposure to foreign exchange rate, interest rate and gold price risks, and the current size of its revaluation accounts, the Governing Council deemed it appropriate to establish a provision against these risks. As at 31 December 2005, an amount of €992 million was recorded in this provision, which had the effect of reducing net profit to exactly zero.

The provision will be used to fund future realised and unrealised losses, in particular valuation losses not covered by the revaluation accounts. The size and continuing requirement of this provision will be reviewed annually, based on the ECB's assessment of its future exposure to foreign exchange rate, interest rate and gold price risks. This assessment is based on generally accepted methods for estimating financial risks.

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 and other provisions are included in this item.

14 REVALUATION ACCOUNTS

These accounts represent revaluation reserves arising from unrealised gains on assets and liabilities.

	2005 €	2004 €	Change €
Gold	4,362,459,301	1,853,957,106	2,508,502,195
Foreign currency	3,737,934,137	0	3,737,934,137
Securities	8,234,660	67,160,084	(58,925,424)
Total	8,108,628,098	1,921,117,190	6,187,510,908

The foreign exchange rates used for the year-end revaluation were as follows:

Exchange rates	2005	2004
US dollars per euro	1.1797	1.3621
Japanese yen per euro	138.90	139.65
Euro per SDR	1.2099	1.1396
Euro per fine ounce of gold	434.856	321.562

15 CAPITAL AND RESERVES

Capital

The subscribed capital of the ECB is €5.565 billion. Paid-up capital amounts to €4.089 billion. The euro area NCBs have fully paid up their share of the capital, amounting to €3.978 billion (no changes having occurred in 2005), as follows:[7]

	Capital key %	€
Nationale Bank van België/ Banque Nationale de Belgique	2.5502	141,910,195
Deutsche Bundesbank	21.1364	1,176,170,751
Bank of Greece	1.8974	105,584,034
Banco de España	7.7758	432,697,551
Banque de France	14.8712	827,533,093
Central Bank and Financial Services Authority of Ireland	0.9219	51,300,686
Banca d'Italia	13.0516	726,278,371
Banque centrale du Luxembourg	0.1568	8,725,401
De Nederlandsche Bank	3.9955	222,336,360
Oesterreichische Nationalbank	2.0800	115,745,120
Banco de Portugal	1.7653	98,233,106
Suomen Pankki – Finlands Bank	1.2887	71,711,893
Total	**71.4908**	**3,978,226,562**

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. In 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 end-2004. There were no changes during 2005. 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.

Non-euro area NCBs have paid up the following amounts:

	Capital key %	€
Česká národní banka	1.4584	5,680,860
Danmarks Nationalbank	1.5663	6,101,159
Eesti Pank	0.1784	694,916
Central Bank of Cyprus	0.1300	506,385
Latvijas Banka	0.2978	1,160,011
Lietuvos bankas	0.4425	1,723,656
Magyar Nemzeti Bank	1.3884	5,408,191
Central Bank of Malta	0.0647	252,024
Narodowy Bank Polski	5.1380	20,013,889
Banka Slovenije	0.3345	1,302,967
Národná banka Slovenska	0.7147	2,783,948
Sveriges Riksbank	2.4133	9,400,451
Bank of England	14.3822	56,022,530
Total	**28.5092**	**111,050,988**

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 €0.9 billion (2004: €1 billion) were outstanding as at 31 December 2005 (see "Reverse transactions" in the notes on accounting policies).

17 INTEREST RATE FUTURES

In 2005 foreign currency interest rate futures were used as part of the management of the ECB's foreign reserves. As at 31 December 2005, the following transactions were outstanding:

Foreign currency interest rate futures	Contract value €
Purchases	5,021,586,677
Sales	100,873,103

7 Individual amounts are shown rounded to the nearest euro. Totals in the tables of this section may not add up due to rounding.

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:

	2005 €	2004 €	Change €
Interest on current accounts	7,519,063	3,744,188	3,774,875
Money market deposit income	124,214,410	49,854,512	74,359,898
Reverse repurchase agreements	153,568,329	63,759,141	89,809,188
Net income on securities	641,956,243	317,073,827	324,882,416
Total interest income on foreign reserve assets	927,258,045	434,431,668	492,826,377
Interest expense on current accounts	(221,697)	(32,020)	(189,677)
Repurchase agreements	(37,562,595)	(11,947,990)	(25,614,605)
Other interest expense (net)	(64,964)	(32,960)	(32,004)
Interest income on foreign reserve assets (net)	889,408,789	422,418,698	466,990,091

Interest income increased significantly during 2005 due to rising interest rates on US dollar-denominated assets.

Interest income arising from the allocation of euro banknotes within the Eurosystem

This item consists of the interest income relating to the ECB's 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 under "Banknotes in circulation" in the notes on accounting policies.

Based on the ECB's estimated financial result for 2005, the Governing Council decided in December 2005:

(a) to recall the three quarterly interim distributions already paid to the NCBs during the year, amounting to €634 million in total;

(b) to withhold the final quarterly interim distribution of €234 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 items include interest income of €1.6 billion (2004: €1.2 billion) and expenses of €1.5 billion (2004: €1.1 billion) on balances arising from TARGET. Interest income and expenses in respect of other assets and liabilities denominated in euro are also shown here.

19 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

Net realised gains arising from financial operations in 2005 were as follows:

	2005 €	2004 €	Change €
Net realised price gains on securities	14,854,774	94,643,135	(79,788,361)
Net realised gold price and exchange rate gains/(losses)	134,514,361	41,402,675	93,111,686
Realised gains arising from financial operations	149,369,135	136,045,810	13,323,325

20 WRITE-DOWNS ON FINANCIAL ASSETS AND POSITIONS

	2005 €	2004 €	Change €
Unrealised price losses on securities	(97,487,772)	(28,485,006)	(69,002,766)
Unrealised exchange rate losses	(6,309)	(2,064,800,103)	2,064,793,794
Total	(97,494,081)	(2,093,285,109)	1,995,791,028

This expense is primarily due to the write-down of the average acquisition cost of the ECB's US dollar security holdings to their end-of-year prices.

21 NET EXPENSE FROM FEES AND COMMISSIONS

	2005 €	2004 €	Change €
Income from fees and commissions	473,432	297,964	175,468
Expenses relating to fees and commissions	(655,805)	(559,481)	(96,324)
Net expense from fees and commissions	(182,373)	(261,517)	79,144

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, "Interest rate futures").

22 OTHER INCOME

Other miscellaneous income during the year arose principally from the transfer of unused administrative provisions to the Profit and Loss Account. In particular, following changes in the ECB's tenancy agreements, the reassessment and consequent reduction of the provision against its contractual obligation to restore its current premises to their original condition when they are vacated, led to an increase in this item.

23 STAFF COSTS

Salaries, allowances and staff insurance costs of €126.9 million (2004: €120.0 million) are included under this heading. The emoluments of the Executive Board amounted to a total of €2.1 million (2004: €2.1 million). In 2005, transitional payments made to departing members of the Executive Board and pensions paid to former members or their dependants amounted to €0.4 million in total (2004: €0.5 million).

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.

Also included under this item is an amount of €25.6 million (2004: €41.9 million) recognised in connection with the ECB's retirement plan and other post-employment benefits (see note 12, "Other liabilities").

The reduction in the item "Staff costs" is primarily due to a change in the accounting treatment applied to the recognition of net actuarial gains/losses in respect of the ECB's retirement plan and other post-employment benefits. The pension charge in 2004 was considerably higher due to the recognition of €23.7 million in net actuarial losses in their entirety in the year in which they arose. In 2005, since the 10% corridor approach now applies, no actuarial gains/losses were recognised in the Profit and Loss Account (see note 12, "Other liabilities").

At the end of 2005 the ECB employed 1,351 staff, of whom 131 held managerial positions. The change in the number of staff during 2005 was as follows:

	2005	2004
As at 1 January	1,309	1,213
New staff	82	137
Resignations	40	41
As at 31 December	1,351	1,309
Average number of staff employed	1,331	1,261

24 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.

25 BANKNOTE PRODUCTION SERVICES

This expense relates to costs arising from cross-border transportation of euro banknotes between NCBs to meet unexpected fluctuations in demand for banknotes. These costs are borne centrally by the ECB.

NOTE ON PROFIT DISTRIBUTION/ ALLOCATION OF LOSSES

This note is not part of the financial statements of the ECB for the year 2005.

INCOME RELATED TO THE ECB'S SHARE OF TOTAL BANKNOTES IN CIRCULATION

In 2004, following a decision by the Governing Council, income of €733 million earned on the ECB's share of total banknotes in circulation was retained to ensure that the ECB's total profit distribution for the year did not exceed its net profit for the year. Similarly, in 2005 an amount of €868 million was retained. Both amounts represented the full income earned on the ECB's share of total euro banknotes in circulation in the years in question.

PROFIT DISTRIBUTION/COVERAGE OF LOSSES

Pursuant to Article 33 of the Statute of the ESCB, the net profit of the ECB shall be transferred in the following order:

(a) an amount to be determined by the Governing Council, which may not exceed 20% of the net profit, shall be transferred to the general reserve fund subject to a limit equal to 100% of the capital; and

(b) the remaining net profit shall be distributed to the shareholders of the ECB in proportion to their paid-up shares.

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 NCBs in accordance with Article 32.5 of the Statute.[1]

In 2005 the establishment of a provision against foreign exchange rate, interest rate and gold price risks for the amount of €992 million had the effect of reducing net profit to exactly zero. Consequently, no transfers to the general reserve fund or profit distribution to the shareholders of the ECB took place. There was also no requirement to offset a loss.

The treatment of the ECB's net profit/loss arising in 2004 and 2005 can therefore be summarised as follows:

	2005 €	2004 €
Net profit/(loss) for the year	0	(1,636,028,702)
Withdrawals from the general reserve fund	0	296,068,424
Transfer from NCBs' pooled monetary income	0	1,339,960,278
Total	0	0

1 Under Article 32.5 of the Statute of the ESCB, the sum of the NCBs' monetary income shall be allocated to the NCBs in proportion to their paid-up shares in the capital of the ECB.

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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 2005 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 2005 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, 7 March 2006

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Wohlmannstetter
Wirtschaftsprüfer

Dr. Lemnitzer
Wirtschaftsprüfer

5 CONSOLIDATED BALANCE SHEET OF THE EUROSYSTEM AS AT 31 DECEMBER 2005

(EUR MILLIONS)

ASSETS	31 DECEMBER 2005	31 DECEMBER 2004
1 Gold and gold receivables	**163,881**	**125,730**
2 Claims on non-euro area residents denominated in foreign currency	**154,140**	**153,856**
2.1 Receivables from the IMF	16,391	23,948
2.2 Balances with banks and security investments, external loans and other external assets	137,749	129,908
3 Claims on euro area residents denominated in foreign currency	**23,693**	**16,974**
4 Claims on non-euro area residents denominated in euro	**9,185**	**6,849**
4.1 Balances with banks, security investments and loans	9,185	6,849
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	**405,966**	**345,112**
5.1 Main refinancing operations	315,000	270,000
5.2 Longer-term refinancing operations	90,017	75,000
5.3 Fine-tuning reverse operations	0	0
5.4 Structural reverse operations	0	0
5.5 Marginal lending facility	949	109
5.6 Credits related to margin calls	0	3
6 Other claims on euro area credit institutions denominated in euro	**3,636**	**3,763**
7 Securities of euro area residents denominated in euro	**92,367**	**70,244**
8 General government debt denominated in euro	**40,113**	**41,317**
9 Other assets	**145,635**	**120,479**
Total assets	**1,038,616**	**884,324**

Totals/subtotals may not add up due to rounding.

LIABILITIES	31 DECEMBER 2005	31 DECEMBER 2004
1 Banknotes in circulation	**565,216**	**501,256**
2 Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**155,535**	**138,735**
2.1 Current accounts (covering the minimum reserve system)	155,283	138,624
2.2 Deposit facility	252	106
2.3 Fixed-term deposits	0	0
2.4 Fine-tuning reverse operations	0	0
2.5 Deposits related to margin calls	0	5
3 Other liabilities to euro area credit institutions denominated in euro	**207**	**126**
4 Debt certificates issued	**0**	**0**
5 Liabilities to other euro area residents denominated in euro	**41,762**	**42,187**
5.1 General government	34,189	35,968
5.2 Other liabilities	7,573	6,219
6 Liabilities to non-euro area residents denominated in euro	**13,224**	**10,912**
7 Liabilities to euro area residents denominated in foreign currency	**366**	**247**
8 Liabilities to non-euro area residents denominated in foreign currency	**8,405**	**10,679**
8.1 Deposits, balances and other liabilities	8,405	10,679
8.2 Liabilities arising from the credit facility under ERM II	0	0
9 Counterpart of special drawing rights allocated by the IMF	**5,920**	**5,573**
10 Other liabilities	**67,325**	**51,791**
11 Revaluation accounts	**119,094**	**64,581**
12 Capital and reserves	**61,562**	**58,237**
Total liabilities	**1,038,616**	**884,324**

ANNEXES

LEGAL INSTRUMENTS ADOPTED BY THE ECB

The following table lists the legal instruments that were adopted by the ECB in 2005 and early 2006 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 "Legal framework" section of the ECB's website.

Number	Title	OJ reference
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	OJ L 111, 2.5.2005, p. 1
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	OJ L 109, 29.4.2005, p. 6
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	OJ L 109, 29.4.2005, p. 81
ECB/2005/6	Guideline of the European Central Bank of 11 March 2005 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving the foreign reserve assets of the European Central Bank	OJ L 109, 29.4.2005, p. 107
ECB/2005/7	Recommendation of the European Central Bank of 7 April 2005 to the Council of the European Union on the external auditors of the Bank of Greece	OJ C 91, 15.4.2005, p. 4
ECB/2005/8	Recommendation of the European Central Bank of 7 April 2005 to the Council of the European Union on the external auditors of the Nationale Bank van België/Banque Nationale de Belgique	OJ C 91, 15.4.2005, p. 5

Number	Title	OJ reference
ECB/2005/9	Recommendation of the European Central Bank of 20 May 2005 to the Council of the European Union on the external auditor of De Nederlandsche Bank	OJ C 151, 22.6.2005, p. 29
ECB/2005/10	Recommendation of the European Central Bank of 26 October 2005 to the Council of the European Union on the external auditors of the Central Bank and Financial Services Authority of Ireland	OJ C 277, 10.11.2005, p. 30
ECB/2005/11	Decision of the European Central Bank of 17 November 2005 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	OJ L 311, 26.11.2005, p. 41
ECB/2005/12	Decision of the European Central Bank of 17 November 2005 amending Decision ECB/2002/11 on the annual accounts of the European Central Bank	OJ L 311, 26.11.2005, p. 43
ECB/2005/13	Guideline of the European Central Bank of 17 November 2005 amending Guideline ECB/2002/7 on the statistical reporting requirements of the European Central Bank in the field of quarterly financial accounts	OJ L 30, 2.2.2006, p. 1
ECB/2005/14	Decision of the European Central Bank of 9 December 2005 on the approval of the volume of coin issuance in 2006	OJ L 333, 20.12.2005, p. 55
ECB/2005/15	Guideline of the European Central Bank of 15 December 2005 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving the foreign reserve assets of the European Central Bank	OJ L 345, 28.12.2005, p. 33
ECB/2005/16	Guideline of the European Central Bank of 30 December 2005 on a Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET)	OJ L 18, 23.1.2006, p. 1
ECB/2005/17	Guideline of the European Central Bank of 30 December 2005 amending Guideline ECB/2000/7 on monetary policy instruments and procedures of the Eurosystem	OJ L 30, 2.2.2006, p. 26

OPINIONS ADOPTED BY THE ECB

The following table lists the opinions adopted by the ECB in 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/2005/1	Italy	Extension of credit lines by the Banca d'Italia to Lebanon
CON/2005/3	Hungary	Cash processing and distribution
CON/2005/5	Malta	The Central Bank of Malta's statistical reporting requirements for credit institutions
CON/2005/8	Lithuania	Minimum reserve requirements for credit unions (kredito unija)
CON/2005/9	Belgium	Rules relating to the prudential supervision of securities settlement institutions and assimilated institutions
CON/2005/10	Hungary	Magyar Nemzeti Bank's statistical reporting requirements regarding the transaction codes for payments
CON/2005/12	Luxembourg	Financial collateral arrangements
CON/2005/13	Cyprus	Reporting by monetary financial institutions of their monthly balance sheets
CON/2005/14	Hungary	Minimum reserve requirements
CON/2005/15	Denmark	Apportionment of the costs of operating a debit card system between banks, consumers and retailers
CON/2005/19	Hungary	Technical tasks and other duties related to the protection of legal tender against counterfeiting
CON/2005/20	Latvia	Amendments to the statutes of Latvijas Banka
CON/2005/21	Lithuania	Legal framework for adoption of the euro
CON/2005/23	Austria	Reporting of cross-border services for balance of payments and international investment position statistics
CON/2005/24	Czech Republic	Reorganisation of financial market supervision and the oversight of payment and securities settlement systems
CON/2005/25	Slovakia	Regulation of lobbying, including lobbying activities in relation to Národná banka Slovenska

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/2005/26	Slovakia	Národná banka Slovenska's task in relation to integrated supervision of the whole financial market and amendments to its statutes
CON/2005/27	Netherlands	Cooperation between De Nederlandsche Bank and the Centraal Bureau voor de Statistiek on the statistical reporting requirements of the ECB
CON/2005/28	Cyprus	Amendments to the Law implementing Directive 98/26/EC on settlement finality in payment and securities settlement systems ("Settlement Finality Directive")
CON/2005/29	Austria	Financing by the Oesterreichische Nationalbank of a contribution by Austria to the IMF trust fund for low income countries affected by natural disasters
CON/2005/30	Spain	Rules for payment of the Banco de España's profits to the Treasury
CON/2005/31	Belgium	Introduction of a direct reporting system for balance of payments and international investment position statistics
CON/2005/32	Lithuania	Lietuvos bankas' statistical reporting requirements regarding payment instruments
CON/2005/34	Italy	Changes to the Banca d'Italia's structure and internal governance resulting from a law on the protection of savings
CON/2005/35	Cyprus	Amendments to the Central Bank of Cyprus's minimum reserve regime
CON/2005/36	Czech Republic	Modernisation of the insolvency framework introducing new means of resolving insolvency and strengthening creditors' rights
CON/2005/37	Germany	Amendments to the reporting obligations for cross-border payments
CON/2005/38	Lithuania	Lietuvos bankas' right to issue banknotes and coins upon adoption of the euro and its Governor's personal independence
CON/2005/39	Czech Republic	Revised proposal for comprehensive integration of financial market supervision with Česká národní banka as the sole supervisory authority
CON/2005/40	France	Implementation of rules concerning the transfer of ownership of financial instruments
CON/2005/41	Italy	Oversight of low-value payment systems
CON/2005/42	Hungary	Material, technical, security and business continuity requirements for clearing transactions

Number[2]	Originator	Subject
CON/2005/43	Belgium	Abolition of bearer securities and modernisation of the legal framework regarding corporate securities
CON/2005/44	Poland	Amendments to the foreign exchange legal framework
CON/2005/45	Czech Republic	Statistical reporting requirements for certain financial institutions including insurance corporations and pension funds
CON/2005/46	Czech Republic	Exchange of individual statistical data between Česká národní banka and Český statistický úřad (Statistical Office) for statistical purposes
CON/2005/47	Slovakia	Exclusion of Národná banka Slovenska from criminal liability of legal persons
CON/2005/48	Sweden	Interest cost remuneration paid by Sveriges Riksbank to undertakings that separate and store cash
CON/2005/49	Czech Republic	Statistical reporting requirements for banks and foreign bank branches
CON/2005/50	Slovakia	Decrease in commercial banks' annual contributions to the Deposit Protection Fund and prohibition of monetary financing
CON/2005/52	Hungary	The scope of information to be supplied to the central bank's information system and the method and time limits for data supply
CON/2005/54	Sweden	Amendments to Sveriges Riksbank's statutes
CON/2005/55	Slovakia	Changes to the state treasury system
CON/2005/57	Slovenia	Redenomination of the capital of public limited companies and limited liability companies and the introduction of no-par value shares resulting from the introduction of the euro
CON/2005/58	Italy	Revised proposal on changes to the Banca d'Italia's structure and internal governance resulting from a law on the protection of savings
CON/2005/59	Estonia	Amendments to Eesti Pank's statutes in preparation for the adoption of the euro
CON/2005/60	Lithuania	Amendments to Lietuvos bankas' statutes in preparation for the adoption of the euro
CON/2005/61	Slovakia	Accounting and financial reporting standards to be used by Národná banka Slovenska

(b) ECB opinions following a consultation by a European Institution[3]

Number[4]	Originator	Subject	OJ reference
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
CON/2005/6	Council	Appointment of a member of the ECB's Executive Board	OJ C 75, 24.3.2005, p. 14
CON/2005/7	Council	Hague Convention on securities held with an intermediary	OJ C 81, 2.4.2005, p. 10
CON/2005/11	Council	Quality of statistical data in the context of the excessive deficit procedure	OJ C 116, 18.5.2005, p. 11
CON/2005/16	Council	Community statistics on the structure and activity of foreign affiliates	OJ C 144, 14.6.2005, p. 14
CON/2005/17	Council	Speeding up and clarifying the implementation of the excessive deficit procedure to reflect changes in the implementation of the Stability and Growth Pact	OJ C 144, 14.6.2005, p. 16
CON/2005/18	Council	Strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies to reflect changes in the implementation of the Stability and Growth Pact	OJ C 144, 14.6.2005, p. 17
CON/2005/22	Council	Extension of the exchange, assistance and training programme for the protection of the euro against counterfeiting (the "Pericles" programme)	OJ C 161, 1.7.2005, p. 11
CON/2005/33	Commission	Common index reference periods for the harmonised index of consumer prices (HICP)	OJ C 254, 14.10.2005, p. 4
CON/2005/51	Council	Regime for introduction of the euro in the Member States that have not yet adopted the euro	OJ C 316, 13.12.2005, p. 25

3 Also published on the ECB's website.
4 Consultations are numbered in the order in which the Governing Council adopted them.

Number[4]	Originator	Subject	OJ reference
CON/2005/53	Council	Extension of the deadlines for transposition and application of Directive 2004/39/EC on markets in financial instruments	OJ C 323, 9.12.2005, p. 31
CON/2005/56	Council	Information on the payer accompanying transfers of funds	OJ C 336, 31.12.2005, p. 109

CHRONOLOGY OF MONETARY POLICY MEASURES OF THE EUROSYSTEM[1]

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 the year 2005 from €25 billion to €30 billion. This increased amount takes into consideration the higher liquidity needs of the euro area banking system anticipated in 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, 7 APRIL, 4 MAY, 2 JUNE, 7 JULY, 4 AUGUST, 1 SEPTEMBER, 6 OCTOBER AND 3 NOVEMBER 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 DECEMBER 2005

The Governing Council of the ECB decides to increase the minimum bid rate on the main refinancing operations by 0.25 percentage point to 2.25%, starting from the operation to be settled on 6 December 2005. In addition, it decides to increase the interest rates on both the marginal lending facility and the deposit facility by 0.25 percentage point, to 3.25% and 1.25% respectively, both with effect from 6 December 2005.

16 DECEMBER 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 the year 2006 from €30 billion to €40 billion. This increased amount takes two aspects into consideration. First, the liquidity needs of the euro area banking system are expected to increase further in the year 2006. Second, the Eurosystem has decided to increase slightly the share of the liquidity needs satisfied by the longer-term refinancing operations. 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 2007.

12 JANUARY AND 2 FEBRUARY 2006

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 2.25%, 3.25% and 1.25% respectively.

1 The chronology of monetary policy measures of the Eurosystem taken between 1999 and 2004 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, on pages 217 and 218 of the ECB's Annual Report 2003 and on page 217 of the ECB's Annual Report 2004 respectively.

DOCUMENTS PUBLISHED BY THE EUROPEAN CENTRAL BANK SINCE 2005

This list is designed to inform readers about selected documents published by the European Central Bank since January 2005. For Working Papers, the list only refers to publications released between December 2005 and February 2006. 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).

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"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.
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22 "Assessing potential output growth in the euro area – a growth accounting perspective" by A. Musso and T. Westermann, January 2005.

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26 "Analysing banking sector conditions: how to use macro-prudential indicators" by L. Mörttinen, P. Poloni, P. Sandars and J. Vesala, April 2005.

27 "The EU budget: how much scope for institutional reform?" by H. Enderlein, J. Lindner, O. Calvo-Gonzalez and R. Ritter, April 2005.

28 "Regulatory reforms in selected EU network industries" by R. Martin, M. Roma and I. Vansteenkiste, April 2005.

29 "Wealth and asset price effects on economic activity" by F. Altissimo, E. Georgiou, T. Sastre, M. T. Valderrama, G. Sterne, M. Stocker, M. Weth, K. Whelan and A. Willman, June 2005.

30 "Competitiveness and the export performance of the euro area" by a task force of the Monetary Policy Committee of the European System of Central Banks, June 2005.

31 "Regional monetary integration in the member states of the Gulf Cooperation Council" by M. Sturm and N. Siegfried, June 2005.

32 "Managing financial crises in emerging market economies – experience with the involvement of private sector creditors" by an International Relations Committee Task Force, June 2005.

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37 "Financing conditions in the euro area" by L. Bê Duc, G. de Bondt, A. Calza, D. Marqués Ibáñez, A. van Rixtel and S. Scopel, October 2005.

38 "Economic reactions to public finance consolidation: a survey of the literature" by M. G. Briotti, October 2005.

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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: countries which have signed the Accession Treaty. Bulgaria and Romania did so on 25 April 2005.

Accession countries: countries with which negotiations for accession to the EU have begun. Negotiations were started with Croatia and Turkey on 3 October 2005.

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 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 or otherwise transferred (e.g. by **credit institutions** to central banks) as a guarantee for the repayment of loans, as well as assets sold (e.g. by credit institutions to central banks) 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: rules, 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.

Corporate profitability: a measure of the earnings performance of corporations, mainly in relation to their sales, assets or equity. There are a number of different corporate profitability ratios based on company financial statements, such as the ratio of operating income (sales minus operating expenses) to sales, the ratio of net income (operating and non-operating income, after tax, depreciation and extraordinary items) to sales, the return on assets (relating net income to total assets) and the return on equity (relating net income to shareholders' funds). At the macroeconomic level, the **gross operating surplus** is often used as a measure of profitability, based on national accounts, for instance in relation to GDP or value added.

Cost of the external financing of non-financial corporations (real): the cost incurred by non-financial corporations when taking up new external funds. For **euro area** non-financial corporations, it is calculated as a weighted average of the cost of bank lending, the cost of **debt securities** and the cost of equity, based on the amounts outstanding (corrected for valuation effects) and deflated by inflation expectations.

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 payments 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. Debt securities issued with an original maturity of more than one year are classified as long-term.

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. 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 **ECOFIN 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 process that led to the single currency, the euro, and the single monetary policy in the **euro area**, as well as to the coordination of the economic policies of the EU Member States. This process, as laid down in the Treaty, took place in three stages. Stage Three, the final 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 of 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, as reported by a panel of contributing banks, computed daily for interbank deposits with different maturities of up to 12 months.

Euro area: the area encompassing those Member States which have adopted the euro 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 its own legal personality in accordance with the Treaty (Article 107(2)). 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 comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the EU 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. Article 104 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 (as amended by Council Regulation (EC) No 1056/2005 of 27 June 2005), 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 Member States that have adopted the euro.

Fine-tuning operation: an **open market operation** executed by the **Eurosystem** in order to deal with unexpected liquidity fluctuations in the market. The frequency and maturity of fine-tuning operations are not standardised.

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 the NCBs of the **European System of Central Banks**.

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 Member States that have adopted the euro.

Gross operating surplus: the surplus (or deficit) on the value of output of production activities after the costs of intermediate consumption, compensation of employees and taxes less subsidies on production have been deducted, but before payments and receipts of income related to the borrowing/renting or owning of financial and non-produced assets have been taken into account.

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: the expected volatility (i.e. standard deviation) in the rates of change of the price of an asset (e.g. a share or a bond). It can be derived from the asset's price, maturity date and exercise price of its options, as well as from a riskless rate of return, using an option pricing model such as the Black-Scholes model.

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.

Lisbon strategy: a comprehensive agenda of structural reforms aimed at transforming the EU into "the most dynamic and competitive knowledge-based economy in the world", launched in 2000 by the Lisbon European Council.

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**. 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. 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 **Eurosystem**, resident **credit institutions** (as defined in Community law) and all other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credit and/or invest in securities. The latter group consists predominantly of **money market** funds.

MFI credit to euro area residents: MFI loans granted to non-MFI **euro area** residents (including **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 **credit institutions** and other **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).

Other financial intermediary (OFI): a corporation or quasi-corporation other than an insurance corporation or pension fund that is engaged mainly in financial intermediation by incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional entities other than MFIs, in particular those engaged primarily in long-term financing, such as corporations engaged in financial leasing, financial vehicle corporations created to be holders of securitised assets, financial holding corporations, dealers in securities and derivatives (when dealing for their own account), venture capital corporations and development capital companies.

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 **European Central Bank (ECB)** staff projections are published in March and September. They form part of the **economic analysis** pillar of the monetary policy strategy of the ECB 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 whereby an asset is sold while the seller simultaneously obtains the right and obligation to repurchase it at a specified price on a future date or on demand. Such an agreement is similar to collateralised borrowing, with the difference that ownership of the securities is not retained by the seller.

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**.

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. Such a 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: the Stability and Growth Pact 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. To this end, the Pact prescribes that Member States specify medium-term budgetary objectives. It also contains concrete specifications on the **excessive deficit procedure**. The Pact consists of the Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and 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 as amended by Regulation (EC) 1055/2005 of 27 June 2005, and (ii) Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure as amended by Regulation (EC) 1056/2005 of 27 June 2005. The Stability and Growth Pact is complemented by the ECOFIN Council's report entitled "Improving the implementation of the Stability and Growth Pact", which was endorsed by the Brussels European Council of 22 and 23 March 2005. It is also complemented by the new Code of Conduct entitled "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes", which was endorsed by the ECOFIN Council on 11 October 2005.

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 16 national RTGS systems, the ECB payment mechanism (EPM) and the interlinking mechanism.

TARGET2: a new generation of the **TARGET** system in which the current decentralised technical structure will be replaced by a single shared platform offering a harmonised service with a uniform pricing scheme.

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**.

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